AGENDA

FINANCIAL SERVICES COMMISSION
OFFICE OF FINANCIAL REGULATION

https://www.flofr.com/sitePages/OFRNews.htm

September 22, 2020

MEMBERS

Governor Ron DeSantis
Attorney General Ashley Moody
Chief Financial Officer Jimmy Patronis
Commissioner Nicole "Nikki" Fried

Contact: **Alexander "Alex" Anderson**
Director of Legislative Affairs (OFR)
(850) 410-9601

9:00 A.M.
LL-03, The Capitol
Tallahassee, Florida

ITEM	SUBJECT	RECOMMENDATION

1. The OFR respectfully requests approval to publish a Notice of Proposed Rule to create new rules 69V-559.1000, 69V-559.1012, 69V-559.1013, 69V-559.102, 69V-559.1021, 69V-559.103, 69V-559.104, 69V-559.105, 69V-559.200, 69V-559.201, 69V-559.300, and 69V-559.800, to amend rules 69V-40.0312, 69V-40.0321, 69V-40.036, 69V-40.0611, 69V-40.066, 69V-45.005, 69V-85.002, 69V-85.003, 69V-160.030, 69V-180.020, and 69V-180.030, Florida Administrative Code, and to repeal Rule 69V-50.080, Florida Administrative Code.

   (ATTACHMENT 1) **FOR APPROVAL**

2. The OFR respectfully requests approval to publish a Notice of Proposed Rule to adopt Rule 69W-600.0141, Florida Administrative Code.

   (ATTACHMENT 2) **FOR APPROVAL**

3. The OFR respectfully requests approval to publish a Notice of Proposed Rule to amend Rules 69W-200.001, 69W-200.002, 69W-500.010, 69W-600.001, 69W-600.0012, 69W-600.0013, 69W-600.0015, 69W-600.0016, 69W-600.0017, 69W-600.0019, 69W-600.002, 69W-600.0022, 69W-600.0023, 69W-600.0024, 69W-600.013, 69W-600.0131, 69W-600.0132, 69W-600.014, 69W-700.001, and 69W-1000.001, Florida Administrative Code.

   (ATTACHMENT 3) **FOR APPROVAL**

4. The OFR respectfully requests approval to publish a Notice of Proposed Rule to amend Rules 69U-100.003, 69U-100.004, 69U-100.03852, 69U-100.045,69U-100.0451, 69U-100.057, 69U-100.600, 69U-100.948, 69U-100.956, 69U-100.963, and 69U-100.964, Florida Administrative Code and to repeal Rule 69U-100.002 Florida Administrative Code.

   (ATTACHMENT 4) **FOR APPROVAL**

5. The OFR respectfully requests approval to publish a Notice of Proposed Rule to amend Rules 69U-120.001, 69U-120.004, 69U-120.005, 69U-120.045, 69U-120.330, and 69U-120.670, Florida Administrative Code and to create Rule 69U-120.003, Florida Administrative Code.

(ATTACHMENT 5) **FOR APPROVAL**

ATTACHMENT 1

FINANCIAL SERVICES COMMISSION
OFFICE OF FINANCIAL REGULATION
AGENDA ITEM # 1: REQUEST APPROVAL TO PUBLISH NOTICE OF PROPOSED RULE

Action Requested

The Office of Financial Regulation ("Office") respectfully requests approval to publish a Notice of Proposed Rule to create new rules 69V-559.1000, 69V-559.1012, 69V-559.1013, 69V-559.102, 69V-559.1021, 69V-559.103, 69V-559.104, 69V-559.105, 69V-559.200, 69V-559.201, 69V-559.300, and 69V-559.800, to amend rules 69V-40.0312, 69V-40.0321, 69V-40.036, 69V-40.0611, 69V-40.066, 69V-45.005, 69V-85.002, 69V-85.003, 69V-160.030, 69V-180.020, and 69V-180.030, Florida Administrative Code ("F.A.C."), and to repeal Rule 69V-50.080, F.A.C.

Summary and Justification of Rules

Rule 69V-559.1000, F.A.C.: The Office proposes to create new rule 69V-559.1000, F.A.C., to implement the provisions of section 559.952(10), F.S. Section 559.952(10), F.S., grants the Office the authority to suspend or revoke a licensee's approval to participate in the Financial Technology Sandbox when a licensee violates certain provisions and/or conditions. This new rule will set forth the disciplinary action(s) that may be imposed against a person for a violation of section 559.952, F.S.

Rule 69V-559.1012, F.A.C.: The Office proposes to create new rule 69V-559.1012, F.A.C., which will allow for the adoption of certain forms to implement the provisions of section 559.952, F.S.

Rule 69V-559.1013, F.A.C.: The Office proposes to create new rule 69V-559.1013, F.A.C., which will require an applicant or licensee to file all required forms electronically and to pay all required fees electronically.

Rule 69V-559.102, F.A.C.: The Office proposes to create new rule 69V-559.102, F.A.C., which will set forth the application procedure and requirements for filed applications.

Rule 69V-559.1021, F.A.C.: The Office proposes to create new rule 69V-559.1021, F.A.C., which will set forth the evaluation process for completed applications.

Rule 69V-559.103, F.A.C.: The Office proposes to create new rule 69V-559.103, F.A.C, which will specify the information that certain licensee must provide in connection with the commencement of operations at branch offices or through authorized vendors.

Rule 69V-559.104, F.A.C.: The Office proposes to create new rule 69V-559.104, F.A.C., to implement section 559.952(5)(g), F.S., which places a continuing obligation upon a licensee to promptly inform the Office of any material change to information provided during the application process.

Rule 69V-559.105, F.A.C.: The Office proposes to create new rule 69V-559.105, F.A.C, to implement the provisions of sections 559.952(7)(a) and (b), F.S., which allow a licensee to apply for one 12-month extension of the initial 24-month sandbox period.

Rule 69V-559.200, F.A.C.: The Office proposes to create new rule 69V-559.200, F.A.C., to implement the provisions of section 559.952(6)(c), F.S., which provides that the Office may enter into an agreement with a state, federal, or foreign regulatory agency to allow licensees under the Financial Technology Sandbox to make their products or services available in other jurisdictions.

Rule 69V-559.201, F.A.C.: The Office proposes to create new rule 69V-559.201, F.A.C, to implement the provisions of section 559.952(8), F.S., which requires a licensee to submit a Bi-Annual Report to the Office including transactional and financial data.

Rule 69V-559.300, F.A.C.: The Office proposes to create new rule 69V-559.300, F.A.C., to detail net worth and surety bond requirements.

Rule 69V-559.800, F.A.C.: The Office proposes to create new rule 69V-559.800, F.A.C., to implement the provisions of section 559.952(7)(c), F.S. Section 559.952(7)(c), F.S., requires a licensee to provide written notification to consumers regarding the conclusion of the initial or extended sandbox period. This rule specifies the way the notice must be provided and the information that must be included in the written notice.

Rule 69V-40.0312, F.A.C.: The Office proposes to amend Rule 69V-40.0312, F.A.C., to grant a loan originator license applicant an additional 45 days to submit requested information and to allow the Office to abandon an application if the loan originator license applicant fails to provide additional information timely.

Rule 69V-40.0321, F.A.C.: The Office proposes to amend Rule 69V-40.0321, F.A.C., to grant a Mortgage Broker license applicant an additional 45 days to submit requested information and to allow the Office to abandon an application if the Mortgage Broker license applicant fails to provide additional information timely.

Rule 69V-40.036, F.A.C.: The Office proposes to amend Rule 69V-40.036, F.A.C., to grant a Mortgage Broker Branch Office license applicant an additional 45 days to submit requested information and to allow the Office to abandon an application if the Mortgage Broker Branch Office license applicant fails to provide additional information timely.

69V-40.0611, F.A.C.: The Office proposes to amend Rule 69V-40.0611, F.A.C., to grant a Mortgage Lender license applicant an additional 45 days to submit requested information and to allow the Office to abandon an application if the Mortgage Lender license applicant fails to provide additional information timely.

69V-40.066, F.A.C.: The Office proposes to amend Rule 69V-40.066, F.A.C., to grant a Mortgage Lender Branch Office license applicant an additional 45 days to submit requested information and to allow the Office to abandon an application if the Mortgage Lender Branch Office license applicant fails to provide additional information timely.

Rule 69V-45.005, F.A.C.: The Office proposes to amend Rule 69V-45.005, F.A.C., to grant a Title Loan Lender license applicant an additional 45 days to submit requested information and to allow the Office to abandon an application if the Title Loan Lender license applicant fails to provide additional information timely.

Rule 69V-85.002, F.A.C.: The Office proposes to amend Rule 69V-85.002, F.A.C., to grant a Motor Vehicle Retail Installment Seller, Retail Installment Seller, Sales Finance Company, and Home Improvement Finance Seller license applicant an additional 45 days to submit requested information and to allow the Office to abandon an application if an applicant fails to provide additional information timely.

Rule 69V-85.003, F.A.C.: The Office proposes to amend Rule 69V-85.003, F.A.C, to grant a Motor Vehicle Retail Installment Seller, Retail Installment Seller, Sales Finance Company, and Home Improvement Finance Seller Branch Office license applicant an additional 45 days to submit requested information and to allow the Office to abandon an application if an applicant fails to provide additional information timely.

69V-160.030, F.A.C.: The Office proposes to amend 69V-160.030, F.A.C., to grant a Consumer Finance license applicant an additional 45 days to submit requested information and to allow the Office to abandon an application if a Consumer Finance license applicant fails to provide additional information timely.

Rule 69V-180.020, F.A.C.: The Office proposes to amend Rule 69V-180.020, F.A.C., to grant a Commercial Collection Agency registration applicant an additional 45 days to submit requested information and to allow the Office to abandon an application if a Commercial Collection Agency registration applicant fails to provide additional information timely.

Rule 69V-180.030, F.A.C.: The Office proposes to amend Rule 69V-180.030, F.A.C., to grant a Consumer Collection Agency registration applicant an additional 45 days to submit requested information and to allow the Office to abandon an application if a Consumer Collection Agency registration applicant fails to provide additional information timely.

Rule 69V-50.080, F.A.C.: The Office proposes to repeal Rule 69V-50.080, F.A.C., as it is outdated and unnecessary.

Proposed Text of Rules

69V-559.1000 Disciplinary Guidelines (NEW)
69V-559.1012 Adoption of Forms (NEW)
69V-559.1013 Electronic Filing of Forms and Fees (NEW)
69V-559.102 Application or Appointment Procedures and Requirements (NEW)
69V-559.1021 Application Evaluation (NEW)
69V-559.103 Application for Branch Offices and Appointment of Authorized Vendors (NEW)
69V-559.104 Changes to License Information (NEW)
69V-559.105 Application for Extension (NEW)
69V-559.200 Operation of the Financial Technology Sandbox (NEW)

69V-559.201 Bi-Annual Reports (NEW)
69V-559.300 Net Worth and Bond (NEW)
69V-559.800 Conclusion of Sandbox Period and Business Operations (NEW)
69V-40.0312 Application Procedure for Loan Originator License (AMEND)
69V-40.0321 Application Procedure for a Mortgage Broker license (AMEND)
69V-40.036 Application Procedure for a Mortgage Broker Branch Office License (AMEND)
69V-40.0611 Application Procedure for a Mortgage Lender License (AMEND)
69V-40.066 Application Procedure for a Mortgage Lender Branch Office License (AMEND)
69V-45.005 Application Procedure for Title Loan Lender (AMEND)
69V-85.002 Application Forms, Fees, Procedures and Requirements (AMEND)
69V-85.003 Branch Application Forms, Fees, Procedures and Requirements (AMEND)
69V-160.030 Application Procedure for Consumer Finance License (AMEND)
69V-180.020 Commercial Collection Registration Form and Procedures (AMEND)
69V-180.030 Consumer Collection Registration Form and Procedures (AMEND)
69V-50.080 Calculation of Finance Charge for Contracts Providing for Unequal or Irregular Installment Payments (REPEAL)

69V-559.1000 Disciplinary Guidelines.

(1) Pursuant to section 559.952(10), F.S., disciplinary guidelines applicable to each ground for disciplinary action that may be imposed by the Office against a person for a violation of section 559.952, F.S., are hereby adopted. The disciplinary guidelines are contained in Office of Financial Regulation, Division of Consumer Finance, Form OFR-559-FTS-007, Disciplinary Guidelines for Financial Technology Sandbox, which is hereby incorporated by reference, effective XX/XX/XXXX. A copy of the disciplinary guidelines is available on the Office's website at www.flofr.com and http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXX.

(2) The Office shall consider the following circumstances in determining an appropriate penalty within the range of penalties prescribed in the disciplinary guidelines for each violation. The Office shall also consider the circumstances when determining whether a deviation from the range of penalties in the disciplinary guidelines is warranted:

(a) The following circumstances are considered mitigating factors which will be used to reduce the penalty:

1. The violation rate is less than 5% when compared to the overall sample size reviewed;

2. The disciplinary history of the licensee;

3. The licensee detected and voluntarily instituted corrective action or measures to avoid the recurrence of the violation prior to the detection and intervention by the Office;

4. The violation is attributable to a single person or employee, and the licensee or person removed or otherwise disciplined the individual prior to detection or intervention by the Office;

5. The person is responsive to the Office's requests or inquiries or made no attempt to impede or delay the Office in its examination or investigation of the underlying misconduct; or

6. Other relevant, case-specific circumstances.

(b) The following circumstances are considered aggravating factors which will be used to increase the penalty:

1. The violation rate is more than 95% when compared to the overall sample size reviewed (sample size must be equal to or greater than 50 transactions and cover a date range of at least 6 months);

2. There is a potential for harm to customers or the public;

3. The disciplinary history of the licensee within the past 3 years which contain the same violations;

4. The violation was the result of willful misconduct or recklessness;

5. The licensee or control person attempted to conceal the violation or mislead the Office; or

6. Other relevant, case-specific circumstances.

(3) The list of violations cited in the disciplinary guidelines is intended to be comprehensive, but the omission of a violation from the list does not preclude the Office from taking any action authorized by section 559.952, F.S.

(4) The ranges for suspension imposed by the disciplinary guidelines are 3 to 15 days for an "A" level suspension; 16 to 30 days for a "B" level suspension; and, 31 to 90 days for a "C" level suspension. A "C" level suspension may be terminated early if the licensee demonstrates to the Office that it has cured the violation.

(5) When the Office finds that a licensee has violated Chapter 516 or 560, F.S., and corresponding rules not excepted pursuant to section 559.952(4)(a), F.S., it may impose penalties as prescribed in Rules 69V-160.111 or 69V-560.1000, F.A.C., respectively.

Rulemaking Authority 559.952(11)(a) FS. Law Implemented 559.952(9), 559.952(10), 559.952(11)(a) FS. History–New.

69V-559.1012 Adoption of Forms.

(1) The following forms are incorporated by reference and adopted by this rule for the purposes of Rules 69V-559.1000-800, F.A.C.:

(a) Application for Licensure as a Financial Technology Sandbox Innovator, Form OFR-559-FTS-001, effective XX-XX-XXXX, and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXX.

(b) Financial Technology Sandbox Innovator Location Notification Form, Form OFR-559-FTS-002, effective XX-XX-XXXX, and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXX.

(c) Financial Technology Sandbox Innovator Extension Request Form, Form OFR-559-FTS-003, effective XX-XX-XXXX, and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXX.

(d) Financial Technology Sandbox Innovator Bi-Annual Report Form, Form OFR-559-FTS-004, effective XX-XX-XXXX, and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXX.

(e) Financial Technology Sandbox Innovator Pledge Agreement, Form OFR-559-FTS-005, effective XX-XX-XXXX, and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXX.

(f) Financial Technology Sandbox Innovator Surety Bond, Form OFR-559-FTS-006, effective XX-XX-XXX , and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXX.

(2) All forms adopted by this rule are available on the Office's website at www.flofr.com and by mail from the Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0376.

Rulemaking Authority 559.952(5), 559.952(8), 559.952(11)(a) FS. Law Implemented 559.952(4)(a), 559.952(5), 559.952(7)(a), 559.952(7)(b),559.952(8), 559.952(9), 559.952(11)(a) FS. History–New.

69V-559.1013 Electronic Filing of Forms and Fees.

(1) For purposes of this rule, "REAL System" means the Office of Financial Regulation's Regulatory Enforcement and Licensing System, which is accessible through the Office's website at www.flofr.com.

(2) All forms adopted under paragraphs 69V-559.1012(1)(a) through (1)(d), F.A.C., must be filed electronically with the Office through the REAL system.

(3) All fees required to be filed with the Office under Rule Chapter 69V-559, F.A.C., must be paid electronically through the REAL System.

Rulemaking Authority 559.952(5), 559.952(8), 559.952(11)(a) FS. Law Implemented 559.952(4)(a), 559.952(5), 559.952(7)(a), 559.952(7)(b), 559.952(8), 559.952(9), 559.952(11)(a) FS. History–New.

69V-559.102 Application or Appointment Procedures and Requirements.

(1) To apply for licensure as a Financial Technology Sandbox Innovator, an applicant must submit:

(a) An Application for Licensure as a Financial Technology Sandbox Innovator, Form OFR-559-FTS-001;

(b) The initial application fee ($375) required by section 560.143(1)(a), F.S., if the applicant indicates on the application that it intends to offer a product or service under Chapter 560, F.S.; or,

(c) The initial application fee ($625) and investigation fee ($200) required by section 516.03(1), F.S., if the applicant indicates on the application that it intends to offer a product or service under Chapter 516, F.S.; or,

(d) The initial application fee required by paragraphs (b) and (c) above, if the applicant indicates on the application that it intends to offer a product or service under both Chapters 560 and 516, F.S.;

(e) If the applicant indicates on the application that it intends to offer a product or service under Chapter 560, F.S., each person listed in question 5D of the Application for Licensure as a Financial Technology Sandbox Innovator, Form OFR-559-FTS-001, must submit fingerprints through a live-scan vendor approved by the Florida Department of Law Enforcement. A list of approved vendors is published on the Florida Department of Law Enforcement's website at http://www.fdle.state.fl.us/Criminal-History-Records/Documents/InternetDoc_ServiceProviders.aspx. Such fingerprints will be submitted to the Florida Department of Law Enforcement for a state criminal background check and the Federal Bureau of Investigation for a federal criminal background check. The cost of the fingerprinting process shall be borne by the applicant and paid directly to the live-scan vendor. Fingerprinting is not required if the applicant is publicly traded as prescribed in section 560.141(1)(c)6., F.S.

(f) Request for Additional Information. The Office shall review all application information submitted by the applicant for completeness and to determine whether sufficient information exists to evaluate the factors in section 559.952(5)(c), F.S. If the Office identifies additional information is needed, the Office will contact the applicant via email within thirty (30) days after receipt of the application with the requested information. The additional information must be received by the Office within forty-five (45) days from the date of the request.

1. The Office will grant a request for an additional forty-five (45) days to submit the additional information provided the request is received before the expiration of the initial forty-five (45) day period.

2. Failure to timely provide all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed.

(g) Withdrawal of Application. An application may be withdrawn if the applicant submits a request through the REAL system (https://real.flofr.com/) before the application is approved or denied.

(h) Amendments to Pending Applications. If the information contained in any application form for licensure as a Financial Technology Sandbox Innovator, or in any amendment thereto, becomes inaccurate for any reason, the applicant shall promptly file an amendment correcting such information on Form OFR-559-FTS-001.

(2) Form OFR-559-FTS-001 is incorporated by reference in Rule 69V-559.1012, F.A.C.

Rulemaking Authority 559.952(5), 559.952(11)(a) FS. Law Implemented 559.952(4)(a), 559.952(5), 559.952(9), 559.952(11)(a), 943.053 FS. History–New.

69V-559.1021 - Application Evaluation.

(1) Upon review of all application information, if the Office determines that the application is complete, the applicant will be notified by email of the application completion date and the date the Office must approve or deny the license application.

(2) Following a determination that the application is complete, the Office shall review all application information and evaluate the information by using the following factors:

(a) The nature of the innovative financial product or service proposed to be made available to consumers in the Financial Technology Sandbox, including all relevant technical details. At a minimum, this includes the following:

1. A full technical description of the innovative financial product or service;

2. How the product or service will be delivered to customers;

3. How customers will interact with the applicant;

4. How the product or service will benefit customers;

5. How the product or service is different from other products or services available in this state;

6. All technical specifications necessary to determine that the applicant has adequately developed the product or service and can handle the anticipated volume of customer transactions; and

7. A copy of the test plan and results demonstrating that the applicant has satisfactorily tested the information technology platform and approved it for production.

(b) The potential risk to consumers and the methods that will be used to protect consumers and resolve complaints during the sandbox period. At a minimum, this includes the following:

1. What risks will confront consumers that use or purchase the product or service;

2. A copy of the applicant's cybersecurity policy designed to detect, contain, and eliminate cyber security attacks;

3. A copy of any other policies designed to protect the customer's personal identifying information from a breach or attack;

4. How the applicant will wind down operations and protect customers and their funds in the event the applicant is not successful with its innovative financial product or service; and

5. A copy of the applicant's complaint procedures including how the customer contacts the applicant to file a complaint, procedures for handling complaints, complaint escalation hierarchy, and the name and contact information of the individual(s) who will serve as the liaison for resolving complaints filed with the Office.

(c) The business plan proposed by the applicant, including company information, market analysis, and financial projections or pro forma financial statements, and evidence of the financial viability of the applicant. At a minimum, this information includes:

1. A complete organizational chart of the applicant.

2. A market analysis which must include, but not be limited to, the following information:

a. Customer description depicting the consumers in the applicant's intended market and their income, buying habits, geographic location or age;

b. Customer perception indicating how the targeted demographic perceives the business and the product or service including how likely the intended customers are to buy the product or service;

c. Market trends which combines the information from the customer description, perception and market trends and forecasts the future of the target market, as wells as the applicant's place in the future of the market; and

d. Identification of the applicant's competition and how consumers will view the applicant's product in relation to its competitor's products or services and the likelihood that the applicant will be successful in the same marketplace as competitors.

3. Financial projections or pro forma financial statements including estimated revenues, total liabilities and costs, and estimated cash flow.

4. Evidence of financial viability of the applicant shall include at a minimum the amount and quality of liquid assets compared to the total of all assets and identification of access to additional capital to support growth of the applicant.

(d) Whether the applicant has the necessary personnel, adequate financial and technical expertise, and a sufficient plan to test, monitor, and assess the innovative financial product or service. At a minimum, this information includes:

1. A resume detailing the education and work experience of each person listed on the applicant's organization chart required in paragraph (c)1. above; and

2. A copy of the applicant's proposed plan for how it will test the innovative product or service during the sandbox period and any sandbox period extension to ensure compliance with section 559.952, F.S. and related rules, and to ensure compliance with Chapters 516 and 560, F.S., and related rules applicable to the innovative product or service. The plan should include how the applicant will monitor the product's or service's transactions and performance in order to assess whether there is an increased risk to consumers or viability of the applicant to continue offering its product or services to consumers. The plan must include a requirement to document the testing, monitoring, and assessment of the product or service and the applicant's personnel responsible for these tasks; and the plan must include organizational reporting and escalation procedures.

(e) Whether any control person of the applicant, regardless of adjudication, has pled no contest to, or has been convicted or found guilty of, or is currently under investigation for fraud, a state or federal securities violation, a property-based offense, or a crime involving moral turpitude or dishonest dealing. If an applicant answers affirmatively to disclosure questions in the application or if a criminal background check discloses an offense identified in this paragraph, the applicant must provide upon request, documents from a custodian of the records indicating the details necessary for the Office to identify the outcome of each offense. Documents shall include, but not be limited to, copies of certified court documents and final orders including settlement agreements from the issuing agency.

(f) A copy of the disclosures required under section 559.952(6)(b), F.S.

(g) The financial responsibility of the applicant and any control person, including whether the applicant or any control person has a history of unpaid liens, unpaid judgments, or other general history of nonpayment of legal debts, including, but not limited to, having been the subject of a petition for bankruptcy under the United States Bankruptcy Code within the past 7 calendar years. Applicants who answer in the affirmative to disclosure questions in the application disclosing an offense identified in this paragraph, must provide, upon request, documents from a custodian of records indicating the details necessary for the Office to identify the outcome of each offense.

Documents shall include, but not be limited to, copies of certified court documents demonstrating a lien or judgment has been satisfied, account statements or credit reports indicating the satisfactory payment of legal debts, and copies of documents from a bankruptcy court.

(3) Upon evaluation by the Office of all information and supporting documentation provided in the application, the Office will contact the applicant and schedule a consultation to discuss the Office's review and anticipated decision. In addition, during the consultation, the Office will advise the applicant of the number of consumers authorized to receive the innovative financial product or service if the application is approved. The consultation will be scheduled within 60-days of the date the application is deemed completed unless the applicant provides written authorization for an extension of time for the Office to make a decision on the application.

Rulemaking Authority 559.952(5), 559.952(11)(a) FS. Law Implemented 559.952(5), 559.952(6)(b), 559.952(11)(a) FS. History–New.

69V-559.103 Application for Branch Offices and Appointment of Authorized Vendors.

(1) A licensee that indicates in Question 1 of its initial application that it intends to offer a product or service under Part II of Chapter 560, F.S., and that commences operations at branch offices or through authorized vendors in this state, shall submit the following for each branch office or authorized vendor:

(a) Financial Technology Sandbox Innovator Location Notification Form, Form OFR-559-FTS-002; and,

(b) A $38 nonrefundable fee as required in sections 560.143(c) or (d), F.S.

(2) Form OFR-559-FTS-002 is incorporated by reference in Rule 69V-559.1012, F.A.C.

Rulemaking Authority 559.952(11)(a) FS. Law Implemented 559.952(4), 559.952(9), 559.952(11)(a) FS. History–New.

69V-559.104 Changes to license information.

In accordance with the section 559.952(5)(g), F.S., and as applicable to the business entity's activities:

(1) Each person licensed under section 559.952, F.S., that proposes to change the information contained in any initial application form, including any document submitted as a part of Rule 69V-559.102, F.A.C., or any amendment thereto, must file an amendment pursuant to section 559.952(5)(g), F.S., no later than thirty (30) days after the effective date of the change by submitting an Application for Licensure as Financial Technology Sandbox Innovator, Form OFR-559-FTS-001, which is incorporated by reference in Rule 69V-559.1012, F.A.C., through the Office's REAL System in accordance with Rule 69V-559.1013, F.A.C.

(2) If the amendment filed in paragraph (1) includes the addition of a natural person not currently listed on the application, the natural person must comply with the fingerprinting requirements in accordance with Rule 69V-559.102, F.A.C., within fifteen (15) days after filing the amendment.

(3) Form OFR-559-FTS-001 is incorporated by reference in Rule 69V-559.1012, F.A.C.

Rulemaking Authority 559.952(5), 559.952(11)(a) FS. Law Implemented 559.952(5), 559.952(11)(a), 943.053 FS. History–New.

69V-559.105 Application for Extension.

(1) In accordance with sections 559.952(7)(a) and (b), F.S., a licensee who wishes to apply for one extension for 12 additional months may apply by submitting the following:

(a) Financial Technology Sandbox Innovator Extension Request, Form OFR-559-FTS-003, no sooner than 180 days, but no later than ninety (90) days, prior to the conclusion of its initial sandbox period;

(b) One half ($375) of the renewal fee as required by section 560.143(2)(a), F.S., if the applicant indicated in Question 1 of its initial application that it intended to offer a product or service under Chapter 560, F.S.; or,

(c) One half ($312) of the renewal fee as required by section 516.03(1), F.S., if the applicant indicated in Question 1 of its initial application that it intended to offer a product or service under Chapter 516, F.S.; or,

(d) One half ($687) of both renewal fees as required by paragraphs (b) and (c) above, if the applicant indicated in Question 1 of its initial application that it intended to offer a product or service under both Chapters 560 and 516, F.S.;

(e) The current status of the factors previously considered in the initial application as required in Rule 69V-559.1021(a)-(g), F.A.C.

(2) An application for an extension of the initial 24-month sandbox period shall not be considered received for purposes of meeting the deadline in subparagraph (1)(a) above until all submissions as required in subparagraphs (1)(a)-(e) are received by the Office. Failure to provide all submission requirements by the deadline shall result in the incomplete application for extension of the initial sandbox period being deemed abandoned and the initial sandbox license expiring without consideration for an extension.

(3) Upon receipt of a completed application for an extension of the initial sandbox period filed by the 90-day deadline, the Office shall notify the licensee by email of the completion date along with the date the Office must make its decision whether to approve or deny the application for an extension (35 days before the conclusion of the initial sandbox period).

(4) Form OFR-559-FTS-003 is incorporated by reference in Rule 69V-559.1012, F.A.C.

Rulemaking Authority 559.952(11)(a) FS. Law Implemented 559.952(4), 559.952(7)(a), 559.952(7)(b), 559.952(9), 559.952(11)(a) FS. History–New.

69V-559.200 Operation of the Financial Technology Sandbox.

In accordance with section 559.952(6)(c), F.S., the Office may enter into an agreement with a state, federal, or foreign regulatory agency to allow licensees under the Financial Technology Sandbox to make their products or services available in other jurisdictions. The agreement shall be in the form of a mutually agreed Memorandum of Understanding which includes at a minimum:

(1) The terms by which a licensee may offer its products or services in such jurisdiction so long as it holds an active sandbox license in this state;

(2) Any restrictions imposed on the licensee by the state, federal, or foreign regulatory agency;

(3) The effective date and expiration date of the agreement;

(4) Identification of the licensee's information maintained by the Office that may be shared with the state, federal, or foreign regulatory authority;

(5) A statement that the state, federal, or foreign regulatory authority has sufficient public records exemptions to protect the licensee's information consistent with section 559.952(5)(h)1., F.S.; and

(6) The name, address, telephone number, and email address of contact person for both parties for questions related to the agreement.

Rulemaking Authority 559.952(6)(c), 559.952(11)(a) FS. Law Implemented 559.952(h), 559.952(6)(c), 559.952(11)(a) FS. History–New.

69V-559.201 Bi-Annual Reports.

(1) In accordance with section 559.952(8), F.S., after the first 180 days of licensure and every 180 days thereafter, so long as the license is active, each licensee shall submit a complete and accurate Bi-Annual Report to the Office by filing a Form OFR-559-FTS-004, Bi-Annual Report Form, electronically through the Office's REAL System at www.flofr.com. A completed Bi-Annual Report form must be received by the Office no later than forty-five (45) days after the conclusion of each 180-day period.

(2) Form OFR-559-FTS-004 is incorporated by reference in Rule 69V-559.1012, F.A.C.

Rulemaking Authority 559.952(8), 559.952(11)(a) FS. Law Implemented 559.952(8), 559.952(11)(a) FS. History–New.

69V-559.300 Net Worth and Bond.

(1) A licensee offering products or services under Chapter 560, F.S., must maintain a minimum net worth at all times. The minimum net worth amount is determined based on the maximum number of consumers as authorized by the Office to receive the innovative financial product or service. See table below to determine the minimum amount of net worth:

Total Number of Consumers	Required Amount of Net Worth
0 – 7,500	$25,000
7,501 – 15,000	$50,000
15,001 – 20,000	$75,000
20,001 – 25,000	$100,000

(2) A licensee offering products or services under Chapter 560, F.S., must maintain a surety bond or alternative security device at all times. Only alternative security devices allowed in section 560.209, F.S., may be substituted for a surety bond. See table below to determine the minimum amount of surety bond or alternative security device:

Total Number of Consumers	Required Minimum Amount
0 – 7,500	$75,000
7,501 – 15,000	$150,000
15,001 – 20,000	$200,000
20,001 – 25,000	$250,000

Rulemaking Authority 559.952(11)(a) FS. Law Implemented 559.952(4), 559.952(9), 559.952(11)(a) FS. History–New.

69V-559.800 Conclusion of Sandbox Period and Business Operations.

(1) In accordance with section 559.952(7)(c), F.S., written notification to consumers regarding the conclusion of the initial or extended sandbox period must be provided in the following manner:

a. Electronic notification via email or text messages, provided the email address or phone number used for the notification was provided by the customer as a part of the account creation or maintenance process, and the email address or phone number has been verified by the licensee as belonging to the customer; or

b. A letter sent First Class mail through the United States Postal Service.

(2) In addition to those items required in section 559.952(7)(c), F.S., the written notification to consumers shall at a minimum include the following:

(a) Date of the notice;

(b) The expiration date of the sandbox period;

(c) Outstanding balance owed to the licensee;

(d) Transaction date and amount of any outstanding money transmissions or payment instruments sold to the customer;

(e) The name and telephone number of a contact person(s) whom the customer may contact after the conclusion of the sandbox period or extended sandbox period;

(f) How the consumer can make payments after the conclusion of the sandbox period;

(g) Address where payments may be made for any outstanding balances owed to the sandbox innovator; and

(h) Any changes in the licensee's contact information including where to make payments.

Rulemaking Authority 559.952(11)(a) FS. Law Implemented 559.952(7)(c), 559.952(11)(a) FS. History–New.

69V-40.0312 Application Procedure for Loan Originator License.

(1) Each individual desiring to obtain licensure as a loan originator shall apply to the Office of Financial Regulation by submitting the following:

(a) A completed NMLS Individual Form (Form MU4), filed through the Registry;

(b) The statutory nonrefundable application fee of $195 filed through the Registry;

(c) The statutory nonrefundable mortgage guaranty fund assessment fee of $20, if required by section 494.00172, F.S., filed through the Registry;

(d) Evidence that the applicant has been awarded a high school diploma or the equivalent;

(e) Confirmation from the Registry that the applicant has satisfied the requirement to complete a 20-hour pre-license class approved by the Registry, of which a minimum of 2 hours shall cover the provisions of chapter 494, F.S., and rule chapter 69V-40, F.A.C.;

(f) Confirmation from the Registry that the applicant has satisfied the requirement to pass a test developed by the Registry and administered by a provider approved by the Registry;

(g) Submit fingerprints to the Registry for submission to the Federal Bureau of Investigation for a federal criminal background check;

(h) Submit fingerprints to a live scan vendor approved by the Florida Department of Law Enforcement and published on the Florida Department of Law Enforcement's website (http://www.fdle.state.fl.us/Content/Criminal-History/documents/ApplicantLivescanService-ProvidersVendors.aspx) for submission to the Florida Department of Law Enforcement for a state criminal background check. The cost of fingerprint processing shall be borne by the applicant and paid directly to the live scan vendor;

(i) Authorize the Registry to obtain and make available to the Office an independent credit report on the applicant.

(2) Request for Additional Information. Within 30 days of receipt, the Office shall review each loan originator application and inform the applicant of any request for additional information required to complete its review. The additional information must be received by the Office within 45 days from the date of the request. <u>The Office will grant a request for an additional forty-five (45) days to submit the additional information. The Office will not grant a request after the original forty-five (45) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed.</u> ~~Failure by the applicant to respond within 45 days from the date of the request shall be construed by the Office of Financial Regulation as grounds for denial for failure to provide the requested information.~~

(3) Amendments to Pending Applications. If the information contained in the NMLS Individual Form (Form MU4) or any amendment thereto becomes inaccurate for any reason the applicant shall file an amendment through the Registry correcting such information within 15 days of the change. An amendment changing answers to question 6 on the NMLS Individual Form (Form MU4) shall be considered a material change to the application and grounds for denial of the application.

(4) Withdrawal of Application. An applicant may request withdrawal of an application prior to a determination of the application being made by the Office by filing such request through the Registry.

(5) Upon approval of an application, a loan originator license will be issued with an expiration date of December 31 for the year in which the license was issued.

(6) NMLS Individual Form (Form MU4) is incorporated by reference in rule 69V-40.002, F.A.C.

(7) Persons wishing to obtain a waiver of licensure fees as set forth in section 494.00312(8), F.S., shall submit to the Office of Financial Regulation, via electronic filing through the Registry, a completed Office of Financial Regulation Active Military Member/Veteran/Spouse Fee Waiver and Military Service Verification, Form OFR-MIL-001, effective 09-2018, which is hereby incorporated by reference, and also incorporated by reference in rule 69V-40.002, F.A.C., and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-09912. Such form must be submitted within one hundred eighty (180) days after payment of licensure fees. For the complete processing of Form OFR-MIL-001, a loan originator application must be deemed received pursuant to the provisions of section 494.00312(3), F.S.

Rulemaking Authority 494.0011(2), 494.00312(2), 494.00312(8), 494.00313(4) FS. Law Implemented 494.0011(2), 494.00312, 494.00313 FS. History–New 10-1-10, Amended 11-9-15, 11-24-16, 9-25-18 Amended__________.

69V-40.0321 Application Procedure for a Mortgage Broker license.

(1) Each person desiring to obtain licensure as a mortgage broker shall apply to the Office of Financial Regulation by submitting the following:

(a) NMLS Company Form (Form MU1) filed through the Registry;

(b) The statutory nonrefundable application fee of $425 filed through the Registry;

(c) The statutory nonrefundable mortgage guaranty fund assessment fee of $100, if required by section 494.00172, F.S., filed through the Registry;

(d) Designate a qualified principal loan originator who meets the requirements of section 494.0035, F.S.;

(e) For each of the applicant's control persons, submit fingerprints to a live scan vendor approved by the Florida Department of Law Enforcement and published on the Florida Department of Law Enforcement's website (http://www.fdle.state.fl.us/Content/Criminal-History/documents/ApplicantLivescanService-ProvidersVendors.aspx) for submission to the Florida Department of Law Enforcement and the Federal Bureau of Investigation for a state criminal background check and a Federal criminal background check. The cost of fingerprint processing shall be borne by the applicant and paid directly to the live scan vendor;

(f) For each of the applicant's control persons, authorize the Registry to obtain and make available to the Office an independent credit report.

(2) For the purposes of this rule, the requirements in paragraphs (1)(e) and (f), above, are not required if the control person is currently licensed as a loan originator.

(3) Request for Additional Information. Within 30 days of receipt, the Office shall review each mortgage broker application and inform the applicant of any request for additional information required to complete its review. The additional information must be received by the Office within 45 days from the date of the request. The Office will grant a request for an additional forty-five (45) days to submit the additional information. The Office will not grant a request after the original forty-five (45) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed. ~~Failure by the applicant to respond within 45 days from the date of the request shall be construed by the Office of Financial Regulation as grounds for denial for failure to provide the requested information.~~

(4) Amendments to Pending Applications. If the information contained in the NMLS Company Form (Form MU1) or any amendment thereto becomes inaccurate for any reason, the applicant shall file an amendment through the Registry correcting such information within 15 days of the change. An amendment changing answers to question 14 on the NMLS Company Form (Form MU1) or question 8 on the NMLS Individual Form, NMLS Individual Form (Form MU2), shall be considered a material change to the application and grounds for denial of the application.

(5) Withdrawal of Application. An applicant may request withdrawal of an application prior to a determination of the application being made by the Office by filing such request through the Registry.

(6) Upon approval of an application, a mortgage broker license will be issued with an expiration date of December 31 for the year in which the license was issued.

(7) NMLS Company Form (Form MU1), and NMLS Individual Form (Form MU2), are incorporated by reference in rule 69V-40.002, F.A.C.

Rulemaking Authority 494.0011(2), 494.00321(1) FS. Law Implemented 494.0011(2), 494.00321 FS. History–New 10-1-10, Amended 11-9-15, Amended ____________.

69V-40.036 Application Procedure for a Mortgage Broker Branch Office License.

(1) Each mortgage broker desiring to obtain a mortgage broker branch office license shall apply to the Office of Financial Regulation by submitting the following:

(a) A completed NMLS Branch Form (Form MU3) is incorporated by reference in rule 69V-40.002, F.A.C., filed through the registry; and,

(b) The statutory nonrefundable application fee of $225 filed through the registry.

(2) Request for additional information. The Office shall review each mortgage broker branch office application and inform the licensee of any request for additional information required to complete its review. The additional

information must be received by the Office within 45 days from the date of the request. <u>The Office will grant a request for an additional forty-five (45) days to submit the additional information. The Office will not grant a request after the original forty-five (45) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed.</u> ~~Failure by the licensee to respond within 45 days from the date of the request shall be construed by the Office as grounds for denial of the renewal request.~~

Rulemaking Authority 494.0011(2), 494.0036(2) FS. Law Implemented 494.0011(2), 494.0036 FS. History–New 10-1-10, Amended 11-9-15, Amended _________.

69V-40.0611 Application Procedure for a Mortgage Lender License.

(1) Each person desiring to obtain licensure as a mortgage lender shall apply to the Office by submitting the following:

(a) A completed NMLS Company Form (Form MU1) filed through the Registry;

(b) The statutory nonrefundable application fee of $500 filed through the Registry;

(c) The statutory nonrefundable mortgage guaranty fund assessment fee of $100, if required by section 494.00172, F.S., filed through the Registry;

(d) Designate a qualified principal loan originator who meets the requirements of section 494.0035, F.S.;

(e) For each of the applicant's control persons, submit fingerprints to a live scan vendor approved by the Florida Department of Law Enforcement and published on the Florida Department of Law Enforcement's website (http://www.fdle.state.fl.us/Content/Criminal-History/documents/ApplicantLivescanService-ProvidersVendors.aspx) for submission to the Florida Department of Law Enforcement and the Federal Bureau of Investigation for a state criminal background check and a Federal criminal background check. The cost of fingerprint processing shall be borne by the applicant and paid directly to the live scan vendor;

(f) For each of the applicant's control persons, authorize the Registry to obtain and make available to the Office an independent credit report;

(g) Submit a copy of the applicant's financial audit report in compliance with section 494.00611(2)(f), F.S.

(2) Request for Additional Information. Within 30 days of receipt<u>,</u> the Office shall review each mortgage lender application and inform the <u>applicant</u> ~~application~~ of any request for additional information required to complete its review. The additional information must be received by the Office within 45 days from the date of the request. <u>The Office will grant a request for an additional forty-five (45) days to submit the additional information. The Office will not grant a request after the original forty-five (45) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed.</u> ~~Failure by the applicant to respond within 45 days from the date of the request shall be construed by the Office of Financial Regulation as grounds for denial for failure to provide the requested information.~~

(3) Amendments to Pending Applications. If the information contained in NMLS Company Form (Form MU1) or any amendment thereto becomes inaccurate for any reason the applicant shall file an amendment through the Registry correcting such information within 15 days of the change. An amendment changing answers to question 14 on the NMLS Company Form (Form MU1) or question 8 on the NMLS Individual Form (Form MU2), shall be considered a material change to the application and grounds for denial of the application.

(4) Withdrawal of Application. An applicant may request withdrawal of an application prior to a determination of the application being made by the Office by filing such request through the Registry.

(5) Upon approval of an application, a mortgage lender license will be issued with an expiration date of December 31 for the year in which the license was issued.

(6) NMLS Company Form (Form MU1) and NMLS Individual Form (Form MU2) are incorporated by reference in rule 69V-40.002, F.A.C.

Rulemaking Authority 494.0011, 494.00611(2) FS. Law Implemented 494.0011(2), 494.00611 FS. History–New 10-1-10, Amended 11-9-15, Amended _________.

69V-40.066 Application Procedure for a Mortgage Lender Branch Office License.

(1) Each mortgage lender desiring to obtain a mortgage lender branch office license shall apply to the Office of Financial Regulation by submitting the following:

(a) A completed NMLS Branch Form (Form MU3) is incorporated by reference in rule 69V-40.002, F.A.C. filed through the Registry; and,

(b) The statutory nonrefundable application fee of $225 filed through the Registry.

(2) Request for additional information. The Office shall review each mortgage lender branch office application and inform the licensee of any request for additional information required to complete its review. The additional information must be received by the Office within 45 days from the date of the request. <u>The Office will grant a request for an additional forty-five (45) days to submit the additional information. The Office will not grant a request after the original forty-five (45) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed.</u> ~~Failure by the licensee to respond within 45 days from the date of the request shall be construed by the Office as grounds for denial of the renewal request.~~

Rulemaking Authority 494.0011(2), 494.0066 FS. Law Implemented 494.0011(2), 494.0066 FS. History–New 10-1-10, Amended 11-9-15, Amended _________.

69V-45.005 Application Procedure for Title Loan Lender.

(1) Each person desiring to apply for licensure as a title loan lender shall submit the following to the Office of Financial Regulation:

(a) A completed Application for Title Loan Lender, Form OFR-TTL-101, effective 10/00, which is hereby incorporated by reference and available from the Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0375;

(b) The statutory, nonrefundable investigation fee required by section 537.004, F.S.;

(c) The statutory, nonrefundable application fee required by section 537.004, F.S.; and,

(d) The original bond, letter of credit, or certificate of deposit as required by section 537.005, F.S.

(2) Each ultimate equitable owner of 10% or greater interest and each director, general partner, and executive officer of an entity applying for licensure as a title loan lender, shall submit a completed fingerprint card and a Biographical Summary for Title Loan Lender, Form OFR-TLL-BIO-1, effective 10/00, to the Office of Financial Regulation. Form OFR-TLL-BIO-1 is hereby incorporated by reference and is available by mail from the Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0375.

(3) Request for Additional Information. Any request for additional information will be made by the Office of Financial Regulation within thirty (30) days after receipt of the application by the Office of Financial Regulation. The additional information must be received by the Office of Financial Regulation within forty-five (45) days from the date of the request. <u>The Office will grant a request for an additional forty-five (45) days to submit the additional information. The Office will not grant a request after the original forty-five (45) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed.</u> ~~Failure to respond to the request within forty-five (45) days from the date of request shall be construed by the Office of Financial Regulation as grounds for denial for failure to complete the application, and the application shall be denied pursuant to section 120.60(1), F.S.~~

(4) Withdrawal of Application. An applicant may request withdrawal of an application prior to a determination of the application being made by the Office of Financial Regulation by submitting a written request that the application be withdrawn.

(5) Refunds. If the application is withdrawn or denied, the investigation fee and the application fee are nonrefundable.

(6) If one's civil rights have been restored and the conviction did not directly relate to the title loan industry, the applicant shall provide evidence of restoration of civil rights. If one's civil rights have been restored and the conviction is directly related to the title loan industry, the applicant shall provide evidence of restoration of civil rights and

rehabilitation. Evidence of rehabilitation should include, but is not limited to, employment history and letters from probation officers and employers.

Rulemaking Authority 537.005, 537.016 FS. Law Implemented 537.004, 537.005 FS. History–New 10-1-00, Formerly 3D-45.005, Amended_________.

69V-85.002 Application Forms, Fees, Procedures and Requirements.

(1) Each person desiring to obtain licensure under chapter 520, F.S., shall apply to the Office of Financial Regulation by submitting the following:

(a) A completed Application for License under chapter 520, F.S., Form OFR-520-01, revised 12-20-07, which is hereby incorporated by reference and available on the Office's website at www.flofr.com and by mail from the Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0376; and,

(b) The statutory, non-refundable application fee required by sections 520.03, 520.32, 520.52, and 520.63, F.S., as applicable, which shall be the fee for the biennial period beginning January 1 of each odd-numbered year or any part thereof.

(2) Each ultimate equitable owner of 10% or greater interest, each chief executive officer, each chief financial officer, chief operations officer, chief legal officer, chief compliance officer, control person, member, partner, joint venturer, and each director of an entity applying for licensure, shall submit a completed Biographical Summary from Form OFR-520-01, to the Office of Financial Regulation. Form OFR-520-01 is incorporated by reference in subsection 69V-85.002(1), F.A.C.

(3) Request for Additional Information. Any request for additional information will be made by the Office of Financial Regulation within thirty (30) calendar days after receipt of the application by the Office of Financial Regulation. The additional information must be received by the Office of Financial Regulation within forty-five (45) calendar days after the date of the request. <u>The Office will grant a request for an additional forty-five (45) days to submit the additional information. The Office will not grant a request after the original forty-five (45) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed.</u> ~~Failure to respond to the request within forty-five (45) calendar days after the date of request shall be construed by the Office of Financial Regulation as grounds for denial for failure to complete the application, and the application shall be denied pursuant to section 120.60(1), F.S., unless the Office has received a written request prior to the original 45-day deadline from the applicant to extend the original 45-day period. However, no request for extension shall be granted for a period exceeding an additional forty-five (45) days.~~

(4) Amendments to Pending Applications. If the information contained in any application form for a licensure under chapter 520, F.S., or any amendment thereto, becomes inaccurate for any reason, the applicant shall file an amendment correcting such information within thirty (30) days after the change on Form OFR-520-01. An applicant may amend the application as to those factors generally within the control or selection of the applicant once, as a matter of course, at any time within thirty (30) days after receipt of the application by the Office. Otherwise, the application may be amended only with prior written permission from the Office of Financial Regulation. Requests to make changes that are material to the application shall be deemed by the Office of Financial Regulation to be grounds for denial, and a new application, accompanied by the appropriate filing fee, shall be required. Material changes include the substitution or addition of an ultimate equitable owner of 10% or greater interest, a chief executive officer, a chief financial officer, a chief operations officer, a chief legal officer, a chief compliance officer, a control person, a member, a partner, or a joint venturer. Form OFR-520-01 is incorporated by reference in subsection 69V-85.002(1), F.A.C.

(5) Withdrawal of Application. An applicant may request withdrawal of an application prior to a determination of the application being made by the Office of Financial Regulation by submitting a written request that the application be withdrawn. Withdrawals will be deemed effective upon receipt by the Office.

(6) Refunds. If the application is withdrawn or denied, all fees are non-refundable.

(7) Upon approval of an application, a license will be issued for the remainder of the biennial licensure period.

Rulemaking Authority 520.03(2), 520.32(2), 520.52(2), 520.63(2), 520.994(5) FS. Law Implemented 520.03(2), 520.32(2), 520.52(2), 520.63(2) FS. History–New 12-20-07, Amended __________.

69V-85.003 Branch Application Forms, Fees, Procedures and Requirements.

(1) Every licensee under chapter 520, F.S., that conducts business in a branch office shall apply for a license to operate a branch office using Form OFR-520-02, Application for Branch Office License, revised 12/20/2007, which is hereby incorporated by reference and available on the Office's website at www.flofr.com and by mail from the Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0376. Any office or location shall be deemed to be a branch office if the name or advertising of a licensee is displayed in such a manner as to reasonably lead the public to believe that such business may be conducted at such office, location, or advertised address. If a motor vehicle retail installment seller licensed under section 520.03, F.S., has more than one location in the same county, only one license is required for that county.

(2) The statutory, non-refundable application fee for an initial branch office license required by sections 520.03, 520.32, 520.52 and 520.63, F.S., as applicable, shall be the fee for the biennial period beginning January 1 of each odd-numbered year or any part thereof.

(3) Request for Additional Information. Any request for additional information will be made by the Office of Financial Regulation within thirty (30) calendar days after receipt of the application by the Office of Financial Regulation. The additional information must be received by the Office of Financial Regulation within forty-five (45) calendar days after the date of the request. The Office will grant a request for an additional forty-five (45) days to submit the additional information. The Office will not grant a request after the original forty-five (45) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to the request within forty-five (45) calendar days after the date of request shall be construed by the Office of Financial Regulation as grounds for denial for failure to complete the application and the application shall be denied pursuant to section 120.60(1), F.S., unless the applicant has made a good faith effort to comply with the statutory requirements of chapter 520, F.S., and the rules of this chapter.~~

(4) Amendments to Pending Applications. If the information contained in any application form for branch office license, or any amendment thereto, becomes inaccurate for any reason, the applicant shall file an amendment correcting such information within thirty (30) days after the change on Form OFR-520-02. An applicant may amend the application as to those factors generally within the control or selection of the applicant once, as a matter of course, at any time within thirty (30) days from receipt of the application by the Office. Otherwise, the application may be amended only with prior written permission from the Office of Financial Regulation. Requests to make changes that are material to the application shall be deemed by the Office of Financial Regulation to be grounds for denial, and a new application, accompanied by the appropriate filing fee, shall be required. Material changes include the substitution or addition of an ultimate equitable owner of 10% or greater interest, a chief executive officer, a chief financial officer, a chief operations officer, a chief legal officer, a chief compliance officer, a control person, a member, a partner, or a joint venturer. Form OFR-520-02 is incorporated by reference in subsection 69V-85.003(1), F.A.C.

(5) Withdrawal of Application. An applicant may request withdrawal of an application prior to a determination of the application being made by the Office of Financial Regulation by submitting a written request that the application be withdrawn. Withdrawals will be deemed effective upon receipt by the Office.

(6) Refunds. If the application is withdrawn or denied, all fees are non-refundable.

(7) Upon approval of an application, a license will be issued for the remainder of the biennial licensure period.

Rulemaking Authority 520.03(2), 520.32(2), 520.52(2), 520.63(2), 520.994(5) FS. Law Implemented 520.03(2), 520.32(2), 520.52(2), 520.63(2) FS. History–New 12-20-07, Amended ___________.

69V-160.030 Application Procedure for Consumer Finance License.

(1) Each person desiring to apply for licensure as a consumer finance company shall submit the following to the

Office of Financial Regulation:

(a) A completed Application for Consumer Finance License, Form OFR-516-01, revised 12/20/2007, which is hereby incorporated by reference and available on the Office's website at www.flofr.com and by mail from the Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0376;

(b) The statutory, non-refundable investigation fee required by section 516.03, F.S.;

(c) The statutory, non-refundable biennial license fee required by section 516.03, F.S.; and,

(d) Evidence that the applicant has liquid assets of at least $25,000.00 for the operation of the consumer finance company. For the purposes of this rule "Evidence" means documentation from an insured financial institution that the liquid assets are on deposit with the institution.

(2) Each ultimate equitable owner of 10% or greater interest, each chief executive officer, each chief financial officer, chief operations officer, chief legal officer, chief compliance officer, control person, member, partner, joint venturer, and each director of an entity applying for licensure as a consumer finance company, shall submit a completed Biographical Summary from Form OFR-516-01 to the Office of Financial Regulation.

(3) Request for Additional Information. Any request for additional information will be made by the Office of Financial Regulation within thirty (30) days after receipt of the application by the Office of Financial Regulation. The additional information must be received by the Office of Financial Regulation within forty-five (45) days from the date of the request. <u>The Office will grant a request for an additional forty-five (45) days to submit the additional information. The Office will not grant a request after the original forty-five (45) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed.</u> ~~Failure to respond to the request within forty-five (45) days from the date of request shall be construed by the Office of Financial Regulation as grounds for denial for failure to complete the application, and the application shall be denied pursuant to section 120.60(1), F.S., unless the Office has received a written request prior to the original 45-day deadline from the applicant to extend the original 45-day period. However, no request for extension shall be granted for a period exceeding an additional forty-five (45) days.~~

(4) Amendments to Pending Applications. If the information contained in any application form for licensure as a consumer finance company, or in any amendment thereto, becomes inaccurate for any reason, the applicant shall file an amendment correcting such information within thirty (30) days after the change on Form OFR-516-01, Application for Consumer Finance License. An applicant may amend the application as to those factors generally within the control or selection of the applicant once, as a matter of course, at any time within thirty (30) days after receipt of the application by the Office. Otherwise, the application may be amended only with prior written permission from the Office of Financial Regulation. Requests to make changes that are material to the application shall be deemed by the Office of Financial Regulation to be grounds for denial, and a new application, accompanied by the appropriate filing fees, shall be required. Material changes include:

(a) The substitution or addition of an ultimate equitable owner of 10% or greater interest, a chief executive officer, a chief financial officer, a chief operations officer, a chief legal officer, a chief compliance officer, a control person, a member, a partner, or a joint venturer; and,

(b) Amendments affecting the $25,000.00 liquid asset requirement.

(5) Withdrawal of Application. An applicant may request withdrawal of an application prior to a determination of the application being made by the Office of Financial Regulation by submitting a written request that the application be withdrawn. Withdrawals will be deemed effective upon receipt by the Office.

(6) Refunds. If the application is withdrawn or denied, all fees are non-refundable.

(7) Upon approval of an application, a license will be issued for the remainder of the biennial licensure period.

Rulemaking Authority 516.22(1), 516.23(3), 516.031 FS. Law Implemented 516.03(1), 516.05(1), 516.07 FS. History–New 12-18-88, Amended 5-9-90, 10-1-95, 1-5-00, Formerly 3D-160.030, Amended 12-20-07, Amended _________.

69V-180.020 Commercial Collection Registration Form and Procedures.

(1) Each person registering as a commercial collection agency shall submit the following to the Office of Financial

Regulation:

(a) A completed Registration of Commercial Collection Agency form, Form OFR-COM-101, effective 9/9/2015, which is hereby incorporated by reference and available by mail from the Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0376, and also incorporated by reference in rule 69V-180.002, F.A.C., and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-05778.

(b) If a partnership, sole proprietorship or corporation, a completed Exhibit A, as incorporated in subparagraph 69V-180.002(1)(a)2., F.A.C.

(c) A non-refundable registration fee of $500 for the annual registration period beginning January 1 of each calendar year or any part thereof.

(d) Evidence of a current surety bond in the amount of $50,000 as required in subsection 69V-180.010(1), F.A.C.

(2) Request for Additional Information. An incomplete registration form shall not be considered as validly received. A request for additional information will be made by the Office of Financial Regulation within thirty (30) days after initial receipt of the incomplete registration form by the Office of Financial Regulation. The additional information must be received by the Office of Financial Regulation within forty-five (45) days from the date of request. The Office will grant a request for an additional forty-five (45) days to submit the additional information. The Office will not grant a request after the original forty-five (45) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to the request within forty-five (45) days from the date of request shall be construed by the Office of Financial Regulation as grounds for rejection of the registration for failure to complete the registration and the registration shall be rejected pursuant to section 120.60(1), F.S.~~

(3) Amendment of Pending Registration.

(a) A prospective registrant shall notify the Office of Financial Regulation within ten (10) days of the occurrence of any change in the information reported on the registration.

(b) A prospective registrant may amend the registration form as to those factors generally within the control or selection of the prospective registrant once, as a matter of course, at any time within thirty (30) days from its initial receipt for filing. Otherwise the registration form may be amended only with prior written permission from the Office of Financial Regulation. Requests to make changes which are material to the registration or to the Office of Financial Regulation's evaluation of the registration filed at any time after initial receipt of the registration form shall be deemed by the Office of Financial Regulation to be grounds for rejection of the registration, and a new registration form, accompanied by the appropriate filing fee and evidence of a current surety bond in the amount of $50,000 shall be required.

(4) Withdrawal of Registration. A prospective registrant may request withdrawal of a registration prior to an initial determination of the registration being made by the Office of Financial Regulation by submitting a written request that the registration be withdrawn.

(5) Refunds. If the registration is withdrawn, voided, or rejected, the registration fee is non-refundable.

(6) Upon approval, a registration will be issued for the remainder of the annual registration period.

Rulemaking Authority 559.545 FS. Law Implemented 559.542, 559.544, 559.545 FS. History–New 2-15-94, Formerly 3D-180.020, Amended 9-10-15, Amended ____________.

69V-180.030 Consumer Collection Registration Form and Procedures.

(1) Each person registering as a consumer collection agency shall submit the following to the Office of Financial Regulation:

(a) A completed Application for Registration as Consumer Collection Agency form, Form OFR-559-101, effective 9/9/2015, which is hereby incorporated by reference and available by mail from the Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0376, and also incorporated by reference in rule 69V-180.002, F.A.C., and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-05814;

(b) A non-refundable registration fee of $200 for the annual registration period beginning January 1 of each calendar year or any part thereof.

(c) Each control person required to be listed on the Application for Registration as Consumer Collection Agency, Form OFR-559-101, must submit fingerprints through a live-scan vendor approved by the Florida Department of Law Enforcement. A list of approved vendors is published on the Florida Department of Law Enforcement's website (http://www.fdle.state.fl.us/Content/getdoc/941d4e90-131a-45ef-8af3-3c9d4efefd8e/Livescan-Service-Providers-and-Device-Vendors.aspx). Such fingerprints will be submitted to the Florida Department of Law Enforcement for a state criminal background check and the Federal Bureau of Investigation for a Federal criminal background check. The cost of the fingerprinting processing shall be borne by the applicant and paid directly to the live-scan vendor.

(2) Request for Additional Information. An incomplete registration form shall not be considered as validly received. A request for additional information will be made by the Office of Financial Regulation within thirty (30) days after initial receipt of the incomplete registration form by the Office of Financial Regulation. The additional information must be received by the Office of Financial Regulation within forty-five (45) days from the date of request. The Office will grant a request for an additional forty-five (45) days to submit the additional information. The Office will not grant a request after the original forty-five (45) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which will result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to the request within forty-five (45) days from the date of request shall be construed by the Office of Financial Regulation as grounds for rejection of the registration for failure to complete the registration and the registration shall be rejected pursuant to section 120.60(2), F.S.~~

(3) Amendment of Pending Registration.

(a) A prospective registrant shall notify the Office of Financial Regulation within ten (10) days of the occurrence of any change in the information reported on the registration.

(b) A prospective registrant may amend the registration form as to those factors generally within the control or selection of the prospective registrant once, as a matter of course, at any time within thirty (30) days from its initial receipt for filing. Otherwise the registration form may be amended only with prior written permission from the Office of Financial Regulation. Requests to make changes which are material to the registration or to the Office of Financial Regulation's evaluation of the registration filed at any time after initial receipt of the registration form shall be deemed by the Office of Financial Regulation to be grounds for rejection of the registration, and a new registration form, accompanied by the appropriate filing fee, shall be required.

(4) Withdrawal of Registration. A prospective registrant may request withdrawal of a registration prior to an initial determination of the registration being made by the Office of Financial Regulation by submitting a written request that the registration be withdrawn.

(5) Refunds. If the registration is withdrawn, voided, or rejected, the registration fee is non-refundable.

(6) Upon approval, a registration will be issued for the remainder of the annual registration period.

Rulemaking Authority 559.554, 559.555, 559.5551 FS. Law Implemented 559.5551, 559.553, 559.555 FS. History–New 2-15-94, Formerly 3D-180.030, Amended 9-10-15, Amended___________.

69V-50.080 Calculation of Finance Charge for Contracts Providing for Unequal or Irregular Installment Payments.

(1) For purposes of construing section 520.08, F.S., the following terms are defined:

(a) "Monthly payments" means installment payments substantially equal in amount and payable in successive monthly increments. Provided, however, that the first payment may exceed one month by as much as fifteen (15) days and the additional finance charge for such excess days may be added to the first payment.

(b) "Unequal installment payments" means installment payments which are not substantially equal in amount.

(c) "Irregular installment payments" means installment payments which are payable in other than successive monthly increments.

(2) As indicated in section 520.08(3), F.S., when a retail installment contract provides for unequal or irregular installment payments, the finance charge may not exceed a rate which will provide the same yield as is permitted on monthly payment contracts under section 520.08(1) and (2), F.S., having due regard for the schedule of payment.

Rulemaking Authority 520.994(5) FS. Law Implemented 520.08 FS. History–New 2-10-98, Formerly 3D-50.080, Repealed________.

Material Incorporated by Reference

[BEGINS ON NEXT PAGE]

STATE OF FLORIDA
OFFICE OF FINANCIAL REGULATION

Application for Licensure as a Financial Technology Sandbox Innovator
Chapter 559, Part XII, Florida Statutes

GENERAL INSTRUCTIONS

Pursuant to Rule 69V-559.1013, F.A.C. all forms and fees must be submitted through the Office's Regulatory Enforcement and Licensing (REAL) System at http://real.flofr.com.

Form OFR-559-FTS-001 is the application form used by Financial Technology Sandbox Innovators to either apply for an initial license or make an amendment to an existing license. This form can also be used to surrender an existing license or withdraw a pending application.

"Innovators" or "Innovative" means new or emerging technology, or new uses of existing technology, which provide a product, service, business model, or delivery mechanism to the public and which are not known to have a comparable offering in this state outside the Financial Technology Sandbox.

This form is divided into the following sections:

- Type of Filing
- Cryptocurrency/Virtual Currency Activity
- Applicant Information
- Contact Information
- Applicant Organization and History of Operations
- Preventive Law(s)
- Statement to Florida Consumers
- Financial Technology Documentation
- Disclosure Questions
- Chapter 516 Consumer Finance Product/Service Only Questions
- Chapter 560 Money Services Business Product/Service Only Questions

Upon completing the application form online, initial applicants must pay a non-refundable application fee of:

<u>Chapter 516 Financial Product/Service</u>

Application Fee	$625
Investigation Fee	$200
Total Fee	$825

**If applying to conduct activities under Chapter 516 only, fingerprinting of control person(s) is not required.

<u>Chapter 560 Financial Product/Service</u>

Application Fee	$375

**If applying to conduct activities that are related to Chapter 560, fingerprinting of control person(s) is required.

**If applying to conduct activities under both Chapter 516 and Chapter 560, both application fees, the investigation fee, and fingerprinting of control person(s) is required.

An applicant applying to be licensed under chapter 559, part XII, F.S., can only offer one product/service with this license. However, the one product/service may be related to a Chapter 516 product/service, a Chapter 560 product/service, or combination of both.

Type of Filing
Check the appropriate box for the type of filing. If filing for both services, check both boxes.

<u>Initial Application</u> – This designation applies to first-time filers.
<u>Amendment</u> – This designation applies to changes including, but not limited to, business name, fictitious name, physical address and phone numbers, mailing address, or records address. Additionally, if the information on a Disclosure Reporting Page has changed, it should be reported through this form. When filing amendments, complete the question(s) on the form that contain new information. **See section 559.952, F.S., and Rule 69V-559.104, F.A.C., for the requirements to file amendments.**
<u>Surrender License/Withdraw</u> – This designation applies to any request to surrender an active license or withdraw any pending application. If surrendering an existing license, update the address where records are stored in Question 3E and the contact information in Question 4.

1. Financial Product or Service
Specify the appropriate Chapter(s) (Chapter 516, Chapter 560, or both) that relate to the applicant's activities.

If the applicant-specified activities will be related to Chapter 560 in the question above, indicate the type. Refer to section 560.103, Florida Statutes, for more information.

2. Cryptocurrency/Virtual Currency Activity
Specify if the applicant will engage in Cryptocurrency/Virtual Currency Activity.

3. Applicant Information
A. Business Name – Provide the complete legal business name of the applicant.
B. Fictitious or D/B/A Name – Name under which the applicant operates if different from the business name. Provide evidence of fictitious name registration. If you do not use a fictitious name, leave the question blank.
C. IRS Employee Identification Number (FEID) – This is a nine-digit number assigned by the IRS.
D. Business Main Address – This is the main office physical address or the headquarters address.
E. Address where records stored – This is the physical location where any and all books and records will be maintained. Do not leave blank.
F. Mailing Address – Provide if different from business main address.
G. Business Telephone and Fax Numbers – Provide the telephone and fax number of the business location.

4. Contact Information
A. Contact Person Name & Title – Person to be contacted regarding the application.
B. Contact Person Mailing Address – Can be different from Business Mailing Address.
C. Contact Person Telephone – Can be different from Business.
D. Contact Person E-mail Address – Provide contact person's e-mail address.

5. Applicant Organization and History of Operations
If any question does not apply, answer "N/A" as the appropriate response.

Question 5A – Check type of organization.
Question 5B (1) - Check the appropriate box. The applicant must be a domestic corporation or other organized domestic entity with a physical presence, in this state. See section 559.952(3)(a), F.S.
Question 5B (2) – Attach a copy of the Certificate of Status or other appropriate documentation.
Question 5B (3) - Provide the date the business was incorporated/formed.
Question 5C - Attach a chart or description of the organizational structure of the applicant, including the identity of any parent or subsidiary of the applicant.
Question 5D - List all persons as requested in this section. A control person means an individual, a partnership, a corporation, a trust, or other organization that possesses the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or through other means. A person is presumed to control a company if, with respect to a particular company, that person:

1. Is a director, a general partner, or an officer exercising executive responsibility or having similar status or functions;
2. Directly or indirectly may vote 10 percent or more of a class of a voting security or sell or direct the sale of 10 percent or more of a class of voting securities; or
3. In the case of a partnership, may receive upon dissolution or has contributed 10 percent or more of the capital.

For each person listed, complete a Biographical Summary and attach a resume.

For applicants conducting activity under Chapter 560 (not required if applicant is publicly traded): For each natural person listed in this question submit fingerprints to a live scan vendor approved by the Florida Department of Law Enforcement (FDLE) and published on FDLE's website: (https://www.fdle.state.fl.us/Criminal-History-Records/Documents/InternetDoc_ServiceProviders.aspx) for submission to the FDLE and the Federal Bureau of Investigation for a state and federal criminal background check.

In addition, for applicants offering a Chapter 560 product/service, a BSA/AML Compliance Officer is required to be listed.

Question 5E – Provide the website of the business that will be provided to consumers to access the financial/product service.

6. Preventive Law(s)

Check the applicable boxes that currently prevent the innovative product or service from being made available. The applicant must check at least one box. Attach documentation explaining the reason why the law(s) selected prevent the innovative product or service from being made available.

7. Statement to Florida Consumers

Attach a copy of the statement that will be provided to Florida consumers pursuant to section 559.952(6)(b), F.S.

8. Financial Technology Documentation

A. Provide all documentation required by Rule 69V-559.1021(2)(a)-(d), F.A.C.
B. Specify the number of Florida consumers the applicant proposes to make the product/service available to. An applicant may propose a maximum of 15,000 Florida consumers.
C. List any other state the applicant currently holds or previously held a Financial Technology Sandbox Innovator license (or its equivalent).

9. Disclosure Information
For a “yes” answer to this question, complete a separate Disclosure Reporting Page (DRP), page 9 of this form, for each unrelated event. Attach documentation pertaining to each matter disclosed. Such documentation includes but is not limited to, copies of certified court documents demonstrating a lien or judgment has been satisfied, account statements or credit reports indicating the satisfactory payment of legal debts, and copies of documents from a bankruptcy court.

QUESTIONS 10 – 11 ARE ONLY REQUIRED OF APPLICANTS CONDUCTING A CHAPTER 516 – CONSUMER FINANCE PRODUCT/SERVICE

10. Liquid Assets

Applicant must provide documentation from an insured financial institution that liquid assets in the amount of $25,000 are on deposit with the institution and held solely for the purposes of licensure. The documentation should include the applicant/licensee name, street address, and account balance.

11. Pawnbroker Business

Indicate whether the applicant is engaged in the pawnbroker business. NOTE**:** Section 516.05(6), Florida Statutes, provides that “no license shall be granted to or renewed for any person or organization engaged in the pawnbroker business.”

QUESTIONS 12-15 ARE ONLY REQUIRED OF APPLICANTS CONDUCTING A CHAPTER 560 – MONEY SERVICES BUSINESS PRODUCT/SERVICE

Question 12 – Check the applicable box and provide the name of the exchange or regulator and stock symbol(s).
Question 13 – Check the applicable box. Registration as a Money Services Business with the Financial Crimes Enforcement Network (FinCEN), if applicable, is required.
Question 14 – Provide a copy of the applicant's written anti-money laundering program as required under 31 C.F.R. s. 1022.210 with this application.
Question 15 – If your response to this question is "Yes", complete and submit a Financial Technology Sandbox Innovator Location Notification Form, Form OFR-559-FTS-002, for each location within 60 days after the date the applicant/licensee opens a location within this state or authorizes a vendor location to operate on their behalf. Location/Vendor filings shall be accompanied by a non-refundable $38 fee for each branch or vendor location. Attach a copy of your sample vendor contract.
Question 16 – List all accounts through which licensed activities will be or are being conducted. An amendment filing is required for any changes to this information.
Question 17 – Provide the applicant’s/licensee’s fiscal year-end (Month/Day).
Question 18 – Provide a financial audit report as required in section 560.205(4), F.S.
Question 19 – Enter the number of consumers specified in response to question 8E.
Question 20 – A bond or alternative security device between $75,000 and $250,000 is required. Indicate the type of device you are submitting. If pledging a deposit, submit to the Office an originally executed Financial Technology Sandbox Innovator Pledge Agreement, Form OFR-559-FTS-005, with a copy of the security pledged.
If submitting a surety bond, submit to the Office an originally executed Financial Technology Sandbox Innovator Surety Bond form, Form OFR-559-FTS-006.
If submitting a letter of credit, submit to the Office an originally executed Letter of Credit.

An original fully executed Pledge Agreement, Surety Bond, or Letter of Credit must be mailed to:

Office of Financial Regulation
Division of Consumer Finance
Bureau of Registration
200 East Gaines Street
Tallahassee, Florida 32399-0376

21. Signature – This form must be electronically signed by a person legally authorized to bind the applicant and attest to the accuracy of the information contained in this form.

Filers may also find all forms, statutes and rules relating to Financial Technology Sandbox Innovator licenses on the Office’s website at www.flofr.com.

STATE OF FLORIDA
OFFICE OF FINANCIAL REGULATION

APPLICATION FOR LICENSURE AS FINANCIAL TECHNOLOGY SANDBOX INNOVATOR
Chapter 559, PART XII, Florida Statutes

Check the box that indicates what you would like to do:
☐ **File an Initial Application** (Filing fees required – See instructions)
☐ **File an Amendment** (circle the question(s) amended)
☐ ****Surrender License/Withdraw** (Effective date of surrender/withdrawal: ________________)
(MM/DD/YYYY)

1. **Check the type(s) of Financial Product or Service being offered**:

☐ Chapter 516 – Consumer Finance Product or Service

☐ Chapter 560 – Money Services Business Product or Service

**If the applicant's financial product or service is a combination of both Chapter 516 and Chapter 560, check both boxes.

If the product or service will be Money Services Business related, please indicate the type:

☐ Money Transmitter ☐ Payment Instrument Issuer

2. **Will the applicant/licensee also engage in cryptocurrency/virtual currency activity?** **Yes** ☐ **No** ☐

3. **Applicant Information**

A. Business Name of Applicant:

____

B. D/B/A or Fictitious Name:

____

C. IRS Employee Identification Number (FEID):

____

D. Business Main Address (Street address only - do not use a P.O. Box):

____
(Number and Street) (City) (State) (Zip Code)

E. Address where records stored (Street address only - do not use a P.O. Box):

____
(Number and Street) (City) (State) (Zip Code)

F. Mailing Address, if different from Business (P.O. Box acceptable):

____
(Number and Street) (City) (State) (Zip Code)

G. Business Telephone Numbers:

(_______) _____--___________ (_______) _____--___________
(Business Phone) (Business Fax)

4. **Contact Information:**

A. Contact Person Name and Title:

____
(Last Name) (First Name) (Middle) (Title)

B. Contact Person Mailing Address:

____
(Number and Street) (City) (State) (Zip Code)

C. Contact Person Telephone Number:

(_______) _____--___________ (Contact Person Phone)

(_______) _____--___________ (Contact Person Fax)

D. Contact Person E-mail address: ____

5. Applicant Organization and History of Operations:

A. Applicant is a: ☐ Corporation, ☐ Partnership, ☐ Association, ☐ LLC, ☐ Other (Explain): ___________________

B. If applicant is a corporation, partnership, association, LLC, or other legally formed entity:

(1) Is the applicant a domestic corporation or other organized domestic entity with a physical presence, in this state? Yes ☐ No ☐

(2) Attach a copy of the Certificate of Status or other appropriate documentation.

(3) Provide the date the business was incorporated / formed: ________________________________

C. Attach a chart or description of the organizational structure of the applicant, including the identity of any parent or subsidiary of the applicant.

D. List every control person of the applicant in the table below. Attach additional sheets if necessary. For every person listed, complete a Biographical Summary, attach a resume, and submit fingerprints to a live-scan vendor approved by the Florida Department of Law Enforcement. (Refer to page 2 in the instructions for addition guidance).

Name	**Title or Position**	**% of ownership**	**Date Title or Position Acquired**

E. Provide the website of the business that will be provided to consumers to access the financial/product service.

____
Website URL

6. Preventive Laws

Specify the law(s), as enumerated in Chapter 559.952(4)(a), which currently prevent the innovative product or service from being made available:

☐ **559.952(4)(a)1., F.S.**	☐ **559.952(4)(a)2., F.S.**	☐ **559.952(4)(a)3., F.S.**
☐ **559.952(4)(a)4., F.S.**	☐ **559.952(4)(a)5., F.S.**	☐ **559.952(4)(a)6., F.S.**
☐ **559.952(4)(a)7., F.S.**	☐ **559.952(4)(a)8., F.S.**	☐ **559.952(4)(a)9., F.S.**
☐ **559.952(4)(a)10., F.S.**	☐ **559.952(4)(a)11., F.S.**	☐ **559.952(4)(a)12., F.S.**
☐ **559.952(4)(a)13., F.S.**	☐ **559.952(4)(a)14., F.S.**	

NOTE: Documentation explaining the reason why the law(s) selected above prevent the innovative product or service from being made available to consumers must be attached.

7. Statement to Florida Consumers

Attach a copy of the statement that will be provided to Florida consumers pursuant to section 559.952(6)(b), F.S.

8. Financial Technology Documentation

A. Provide all documentation required by Rule 69V-559.1021(2)(a)-(d), F.A.C.

B. Specify the number of Florida consumers the applicant proposes to make the product/service available to consumers. An applicant may propose a maximum of 15,000 Florida consumers. ________________________________

C. List all Financial Technology Sandbox Innovator licenses (or equivalent licenses) currently or previously held by the applicant.

State of Issuance	License Number	Date License Issued

9. Disclosure Questions – Financial Responsibility

Does the applicant have a history of unpaid liens, unpaid judgments, or other general history of nonpayment of legal debts, including, but not limited to, having been the subject of a petition for bankruptcy under the United States Bankruptcy Code with the past 7 calendar years?

☐Yes ☐ No (If yes, attach a completed Disclosure Reporting Page (DRP) for each unrelated event).

<u>QUESTIONS 10 – 11 ARE ONLY REQUIRED OF CHAPTER 516 – CONSUMER FINANCE PRODUCT/SERVICE APPLICANTS/LICENSEES</u>

10. Does the applicant have liquid assets in the amount of $25,000 for the proposed location listed in this application?

☐ Yes ☐ No

A. Attach a letter from an insured financial institution that the liquid assets are on deposit with the institution and held solely for the purposes of licensure.

11. Does the applicant presently operate as a pawnbroker or hold a registration from the Florida Department of Agriculture as a pawnbroker or second-hand dealer?

☐ Yes ☐ No

NOTE: Section 516.05(6), Florida Statutes, provides that "no license shall be granted to or renewed for any person or organization engaged in the pawnbroker business."

<u>QUESTIONS 12-15 ARE ONLY REQUIRED OF CHAPTER 560 – MONEY SERVICES BUSINESS PRODUCT/SERVICE APPLICANTS/LICENSEES</u>

12. Is the applicant, parent or subsidiary of the applicant publicly traded on any stock exchange? Yes ☐ No ☐

(1) If yes, provide the name of the exchange or similar regulator and stock symbol(s):

13. Is the applicant registered with the Financial Crimes Enforcement Network (FinCEN) as a Money Services Business ("MSB")?

Yes ☐ No ☐ (If no, then read page 3 of the instructions for information regarding registration requirements)

14. Provide a copy of the applicant's written anti-money laundering program as required under section 560.1235, F.S.

15. Does the applicant propose to engage in licensed activities at any location other than the main office or through an authorized vendor?

Yes ☐ No ☐ (If yes, read page 3 in the instructions for requirements regarding notification of locations and authorized vendors and attach a copy of your vendor contract.)

16. Financial Information

A. Provide a list of accounts, to include the following, through which licensed activities are being or will be conducted:

Name of Institution	Address	Name on Account	Type of Account	Account No.(s)

17. When is the applicant's/licensee's Fiscal Year End? ________ / __________
(Month/Day)

18. Attach a copy of the applicant's financial audit report prepared in accordance with U.S. Generally Accepted Accounting Principles for the most recent fiscal year end (compiled or reviewed audit reports are not acceptable).

Net worth Requirement – A licensee engaging in a Chapter 560 – Money Services Business Product/Service must maintain a minimum net worth. The minimum amount of net worth is determined based on the number of consumers the Office authorizes the licensee to make the innovative financial product or service available to. See table below to determine the minimum amount of net worth:

Total Number of Consumers	Required Amount of Net Worth
0 – 7,500	$25,000
7,501 – 15,000	$50,000
15,001 – 20,000	$75,000
20,001 – 25,000	$100,000

19. Enter the total number of consumers specified in Question 8E. ______________________

Based on your answer above, use the chart below to determine the required amount of your security device and enter the amount on this line $_______________.

Total Number of Consumers	Required Amount of Collateral
0 – 7,500	$ 75,000
7,501 – 15,000	$150,000
15,001 – 20,000	$200,000
20,001 – 25,000	$250,000

NOTE: A bond or alternative security device between $75,000 and $250,000 is required.

20. A bond or alternative security device between $75,000 and $250,000 is required. Complete question 19 of this application to determine the required security device amount. Indicate below the type of security device you are submitting with your application. Attach evidence from a federally insured financial institution to confirm that the security is on deposit or in safekeeping and is pledged to the Office of Financial Regulation.

Type of security device provided with application:

☐ **Certificate of Deposit (Attach originally executed pledge agreement, Form OFR-559-FTS-005, along with a copy of the item pledged)**
☐ **Bond (Attach originally executed bond form, Form OFR-559-FTS-006)**
☐ **Letter of Credit (Provide originally executed Letter of Credit)**
☐ **Other (Please list)** ____

21. Signature

I, the undersigned authorized person, hereby swear or affirm, under penalties of perjury, that I have full authority to sign and verify this application, that I have read this application and disclosure reporting pages and have knowledge of the facts stated herein, and that this application, and all information submitted in connection herewith, is complete and accurate and contains no misstatements, misrepresentations, or omissions of material facts, to the best of my knowledge and belief. I further acknowledge that any misstatement may cause the Office to deny the application or initiate proceedings against the licensee. I also represent that to the extent any information previously submitted is not amended such information is currently accurate and complete.

The authorized person or authorized person's agent has typed his or her name under this section to attest to the completeness and accuracy of this form. The authorized person recognizes that this typed name constitutes, in every way, use or aspect, his or her legally binding signature.

Signature	Title
Print Name	Date

Disclosure Reporting Pages (OFR-559-FTS-001)
This Disclosure Reporting Form is an ☐ **INITIAL OR** ☐ **AMENDED** response to report details for an affirmative response to **Question 9** in Form OFR-559-FTS-001**.**
1. Action initiated against: ☐ Applicant/Licensee ☐ Authorized Vendor ☐ Affiliated Party Name of Authorized Vendor/Affiliated Party: ____________________
2. Action initiated by: (Name of Regulator, Law Enforcement or Prosecutorial Agency, Creditor/Lien Holder, Private Plaintiff, Applicant/Licensee, etc.)
3. Filing Date of Action (MM/DD/YYYY): ____________ ☐ Exact ☐ Explanation If not exact, provide explanation:
4. Formal Action was brought in (include name of Federal, Military, State or Foreign Court, Location of Court – City or County and State or Country, Docket/Case Number):
5. Employing Business when activity occurred: ____________________
8. Describe the allegations related to this action. (Attach a separate sheet if necessary):
9. Current status of action? ☐ **Pending** ☐ **On Appeal** ☐ **Final**
10. If on appeal, action appealed to (provide name of court): Date Appeal Filed (MM/DD/YYYY):
11. If Pending, date notice/process was served (MM/DD/YYYY): ____________ ☐ **Exact** ☐ **Explanation** If not exact, provide explanation:
If Final or On Appeal, complete items below. For Pending Actions, complete item 14 only.
12. Provide a detailed explanation of how the matter was resolved (Attach a separate sheet if necessary):
13. Resolution Date (MM/DD/YYYY): ____________ ☐ **Exact** ☐ **Explanation** If not exact, provide explanation:
14. Comments. Use this section to provide a summary of the circumstances leading to the action, as well as the status or disposition and/or finding(s).
15. In addition to the information requested in this DRP, provide documentation pertaining to each matter. Such documentation includes but is not limited to, certified copies of criminal convictions or administrative orders entered against the applicant.

State of Florida
Office of Financial Regulation

Biographical Summary

Check the box that indicates what you would like to do:

☐ **Submit an initial biographical summary.**
☐ **Submit an amendment to a biographical summary.**

1. Applicant/Licensee Information

A. Business Name of Applicant/Licensee (Same as Question 3A on page 1 of Application):

Business Name of Applicant/Licensee

2. Individual Biographical Summary

A. *Identifying Information

Provide your Social Security Number below the signature section at the end of this summary.

B. *Name

First Name	Middle Name	Last Name	Suffix	Date of Birth

C. Surnames and/or Aliases

First Name	Middle Name	Last Name	Suffix (Sr., Jr., II, or III)

D. *Are you a U. S. Citizen? (Chapter 560 Financial Product/Service Providers Only) ☐Yes ☐No

(If "No", or naturalized citizen less than five years, complete Addendum (1) applicable to non-U.S. Citizens.
If naturalized, indicate date of naturalization and certificate number.)

Date of Naturalization	Certificate Number

E. *Residential Address

Number and Street	City, Town, etc.	State	Country	Postal Code

F. *Mailing Address (☐ Check box if mailing address the same as residential)

Number and Street	City, Town, etc.	State	Country	Postal Code

G. *Phone Number

Residence Telephone Number	Daytime Telephone Number
( ) -	( ) -

H. *Residential History (Start with the current address, give all addresses for last 5 years. Report changes as they occur)

Number and Street	City, Town, etc.	State/Providence	Country	From		To	
				Mo.	Yr.	Mo.	Yr.

I. *Employment History (Start with current employer, give all employments for the last 5 years. Report changes as they occur)

Name of Company	City, Town, etc.	State/Providence	Position Held	From		To	
				Mo.	Yr.	Mo.	Yr.

J. *Professional Licenses and Certifications

Type of License/Certification	Name of Licensing Authority/City/State	Date Issued		Status	Status Date	
		Mo.	Yr.		Mo.	Yr.

K. Are you presently an officer, director, representative, member, principal, agent, or shareholder of 10% or more of the outstanding stock of any firm, company, corporation, partnership or other business organization?

☐Yes ☐No If yes, complete the chart below.

Name and Address	State of Incorporation	Type of Business	Position Held

3. Disclosure Questions (If you answer "yes" to any question, complete a separate Disclosure Reporting Page (DRP) for each event)

A. Criminal Disclosure

1) Have you, regardless of adjudication, pled no contest to, been convicted or found guilty of, or are you currently under investigation for fraud, a state or federal securities violation, a property-based offense, or a crime involving moral turpitude or dishonest dealing?

☐ Yes ☐No (If yes, complete a Disclosure Reporting Page (DRP) for each unrelated event)

B. Financial Responsibility

1) Does the applicant have a history of unpaid liens, unpaid judgments, or other general history of nonpayment of legal debts, including, but not limited to, having been subject of a petition for bankruptcy under the United States Bankruptcy Code with the past 7 calendar years?

☐Yes ☐No (If yes, complete a Disclosure Reporting Page (DRP) for each unrelated event).

4. *Signature

In assuming the position for which this form is being submitted, I am undertaking a commitment to be fully informed as to the affairs of the applicant/licensee with which I will be associated and to exercise my independent judgment with respect to any matters that may come before me.

Certificate

I hereby certify that this form, attached addenda, and applicable disclosure reporting pages have been carefully examined by me and that the information is true, correct and complete to the best of my knowledge and belief. I agree and understand that any false or misleading statements or omissions of material fact herein may be cause for the Office to deny my participation in the application for which this summary is submitted.

The individual person or individual person's agent has typed his or her name under this section to attest to the completeness and accuracy of this form. The individual person recognizes that this typed name constitutes, in every way, use or aspect, his or her legally binding signature.

____________________ ____

(Date) (Signature)

***SSN Section**

Social Security Number _ _ _- _ _-_ _ _ _

Addendum (1) to Form OFR-559-FTS-001
Non-U. S. Citizen Supplemental Information

**This page is only required to be completed for applicants/licensees whose financial product or service is related to money services business activity.

If you are ***NOT*** a United States citizen, please provide the following:

1. Visa Type and Number: ____

2. Passport Type and Number: ____________________________________

3. National or Alien Identification Number(s): ______________________________

4. Other Identification Number(s) (Please indicate the type of identification numbers listed): ______________

____

If you are exempt from holding a visa, please explain why _____________________________________

____

5. Mother's maiden name: _________________________________

****

Instructions:

Any and all documents which are presented in a language other than the English language are to be translated into English and duly certified by the translator to be true and accurate. All certified copies and statements submitted with this application must be certified in accordance with the provisions of section 90.902(3), Florida Statutes, for the purpose of admissibility in a court of law in the State of Florida.

If you are unable to secure certified statements from the government of your country, a statement from the government attesting that it will not issue certificates or sworn statements must be submitted. However, if not available from the government, a certification from the United States Embassy Secretary or Consular Agent attesting that the government does not or will not issue certifications or sworn statements is required.

A United States Embassy Secretary or Consular Agent in the foreign country must certify each final copy and statement to be submitted with this application.

Disclosure Reporting Pages (Form OFR-559-FTS-001)
This Disclosure Reporting Form is an ☐ **INITIAL OR** ☐ **AMENDED** response to report details for an affirmative response to **Question 3** of the biographical summary section in Form OFR-559-FTS-001. **Check question(s) you are responding to:** ☐**3A(1)** ☐**3B(1)** Use only one DRP to report details to the same event. Unrelated actions must be reported on separate DRPs.
1. Action initiated by: (Name of Regulator, Law Enforcement or Prosecutorial Agency, Creditor/Lien Holder, Private Plaintiff, Applicant/Licensee, etc.)
2. Filing Date of Action (MM/DD/YYYY): ________________ ☐ Exact ☐ Explanation If not exact, provide explanation:
3. Formal Action was brought in (include name of Federal, Military, State or Foreign Court, Location of Court – City or County and State or Country, Docket/Case Number):
6. Employing Business when activity occurred: ____
7. Describe the allegations related to this action. (Attach a separate sheet if necessary.):
8. Current status of action? ☐ **Pending** ☐ **On Appeal** ☐ **Final**
9. If on appeal, action appealed to (provide name of court): Date Appeal Filed (MM/DD/YYYY):
10. If Pending, date notice/process was served (MM/DD/YYYY): ______________________ ☐ **Exact** ☐ **Explanation** If not exact, provide explanation:
If Final or On Appeal, complete items below. For Pending Actions, complete item 13 only.
11. Provide a detailed explanation of how the matter was resolved (Attach a separate sheet if necessary):
12. Resolution Date (MM/DD/YYYY): ____________________ ☐ **Exact** ☐ **Explanation** If not exact, provide explanation:
13. Comments. Use this section to provide a summary of the circumstances leading to the action, as well as the status or disposition and/or finding(s).
14. In addition to the information requested in this DRP, provide documentation pertaining to each matter. Such documentation includes but is not limited to, certified copies of criminal convictions or administrative orders entered against you.

STATE OF FLORIDA
OFFICE OF FINANCIAL REGULATION

Financial Technology Sandbox Innovator Location Notification Form
Chapter 559, Part XII, Florida Statutes

GENERAL INSTRUCTIONS

Form OFR-FTS-559-002 is the form used by Financial Technology Sandbox Innovator (Chapter 560 Money Services Business Product/Services only) licensees to notify the Office that a licensee intends to open or close a branch office or has added or terminated an authorized vendor.

For branch offices, the licensee must file this form prior to opening or closing a branch office. For authorized vendors, the licensee must file this form no later than sixty (60) calendar days from the date an authorized vendor commences or ceases activities on behalf of the licensee. The sixty (60) day time-frame begins from the date of the first/last transaction initiated by the authorized vendor.

Do not file this form for the licensee's main office.

This form is divided into the following sections:

- Type of Notification (Add or Terminate)
- Date Branch/Vendor commenced or ceased operations
- Licensee Information
- Vendor Information
- Signature/Title/Date of Signature

1. Type of Notification
Check the appropriate box for the type of notification. Check only one box. **NOTE: A $38 fee per branch/vendor is required when adding new branches or vendors.**

2. Date Branch/Vendor Commenced or Ceased Operations
When adding or terminating a branch office, enter the filing date of the application. When adding a new vendor, enter the effective date the vendor commenced operations on behalf of the licensee. When terminating a vendor, enter the effective date the vendor ceased operating on behalf of the licensee. **Enter the date in the following format: MM/DD/YYYY**

3. Licensee Information
File number – This number is assigned by the Office of Financial Regulation.
Licensee's FEID# – This is a nine-digit number assigned by the IRS.
Name of the Licensee – Name under which license is issued.
Fictitious (D/B/A) Name – Name the business operates under other than the legal entity name.
Contact Person – Provide the name of the person who can answer questions about the information provided in the form.
Telephone and Fax Number – Provide the telephone and fax number of the contact person for questions regarding the form.

4. Branch/Vendor Information
Authorized Vendor's FEID# – This is a nine-digit number assigned by the IRS. If the authorized vendor is a sole proprietor using a social security number in lieu of an FEID#, then enter the social security number in the box at the bottom of the form in the space labeled "Authorized Vendor's SSN#".
Name of Authorized Vendor – Enter the **full legal business name** of the authorized vendor. The business name should be identical to the name filed with the state of incorporation. If a sole proprietor, enter the full legal name of the individual owner.
Vendor's D/B/A or Fictitious Name – Enter the entire D/B/A or fictitious name as registered with the appropriate registering authority. **If the vendor is not using a D/B/A or fictitious name, answer "N/A" for this question.**
Physical Address of Branch/Vendor – Provide the street address on file with the postal service. **Street addresses only - do not use a P.O. Box. Licensees are not required to file location forms for branches or authorized vendors outside the State of Florida.**
Mobile Unit Information – If the location is a mobile unit, provide the last six (6) digits of the vehicle identification number.

5. Signature/Print Name/Title/Date
The report must be signed by an authorized person of the licensee. Include the authorized signor's printed name, title, and date signed.

STATE OF FLORIDA
OFFICE OF FINANCIAL REGULATION

Financial Technology Sandbox Innovator Location Notification Form
Chapter 559, Part XII, Florida Statutes

TYPE OF NOTIFICATION:

☐ **Add New Branch/Vendor Appointment**

☐ **Terminate Branch/Vendor Appointment**

DATE BRANCH/VENDOR COMMENCED OR TERMINATED OPERATIONS: ______________________
(MM/DD/YYYY)

TYPE OF LOCATION:

☐ **Branch**

☐ **(Check this box if the branch is a mobile unit.)**

☐ **Authorized Vendor**

LICENSEE INFORMATION (Answer all questions listed below)

1. **FILE NUMBER:** ___________________________

2. **LICENSEE'S FEID #:** ____________________________________

3. **NAME OF LICENSEE:** ____

4. **CONTACT PERSON REGARDING THIS FORM:** ____

5. **CONTACT PERSON PHONE #:** (____)_____--_____ **FAX #:** (____)____--_______

BRANCH/VENDOR INFORMATION (Answer all questions listed below)

6. **AUTHORIZED VENDOR'S FEID #:** _______________________________

7. **NAME OF AUTHORIZED VENDOR (FULL LEGAL BUSINESS NAME):**

____

8. **VENDOR'S D/B/A OR FICTITIOUS NAME:**

____

9. **PHYSICAL ADDRESS OF BRANCH/VENDOR (**Street address only - do not use a P.O. Box**):**

____
(Number and Street) (City) (State) (Zip Code)

10. **IF A MOBILE LOCATION, PROVIDE THE FOLLOWING INFORMATION ABOUT THE MOBILE UNIT: LAST SIX (6) DIGITS OF THE VEHICLE IDENTIFICATION NUMBER** __ __ __ __ __ __

I, the undersigned authorized person, hereby swear/affirm that I have full authority to sign and verify this notification, that I have read this notification and have knowledge of the information stated herein, and that this notification, and all information submitted in connection herewith, is complete and accurate, to the best of my knowledge and belief.

______________________	______________________	______________	______________
Signature	**Print Name**	**Title**	**Date**

SSN Section

(Only for vendors who are sole proprietors)

Licensee's SSN # _ _ _ - _ _ - _ _ _ _

Authorized Vendor's SSN # _ _ _ - _ _ - _ _ _ _

STATE OF FLORIDA
OFFICE OF FINANCIAL REGULATION

Financial Technology Sandbox Innovator Extension Request
Chapter 559, Part XII, Florida Statutes

GENERAL INSTRUCTIONS

Form OFR-559-FTS-003 is the form used by Financial Technology Sandbox Innovator licensees to apply for an extension of 12 additional months of their initial sandbox period.

The licensee must file this form no later than ninety (90) calendar days before the conclusion of the initial sandbox period.

This form is divided into the following sections:

- Licensee Information
- Reason for Extension
- Supporting Documentation
- Signature/Title/Date of Signature

Licensee Information

Licensee's FEID# – This is a nine-digit number assigned by the IRS.
Name of the Licensee – Name under which license is issued.
Fictitious (D/B/A) Name – Name the business operates under other than the legal entity name.
Licensee Address – Provide the address of the main business location.
Contact Person – Provide the name of the person who can answer questions about the information provided on the form.
Telephone and Fax Number – Provide the telephone and fax number of the contact person for questions regarding the form.
File number – This number is assigned by the Office of Financial Regulation.

Reason for Extension

Section 559.952(7)(b), F.S., requires a financial technology sandbox licensee to select a reason for why they are requesting an extension. At least one option must be selected.

Signature/Print Name/Title/Date

The report must be signed by an authorized person of the licensee. Include the authorized signor's printed name, title and date signed.

STATE OF FLORIDA
OFFICE OF FINANCIAL REGULATION

Financial Technology Sandbox Innovator Extension Request
Chapter 559, Part XII, Florida Statutes

EXPIRATION DATE OF INITIAL SANDBOX PERIOD: _______________
(MM/DD/YYYY)

LICENSEE INFORMATION

1. **LICENSEE FEID#:** ___________________________________
2. **LICENSEE NAME:** ___________________________________
3. **FICTICIOUS (D/B/A) NAME:** ___________________________________
4. **LICENSEE ADDRESS:**

____
(Number and Street) (City) (State) (Zip Code)

5. **CONTACT PERSON:** ___________________________________
6. **LICENSEE PHONE #:** ___________________________________
7. **FILE NUMBER:** ___________________________________

REASON FOR EXTENSION

☐ **1. Amendments to general law or rules are necessary to offer the innovative financial product or service in this state permanently.**

If this box is checked, attach all relevant supporting information to this filing, including what laws or rules amendments are necessary to offer the innovative product in this state permanently.

☐ **2. An application for a license that is required in order to offer the innovative financial product or service in this state permanently has been filed with the office and approval is pending.**

If this box is checked, provide the following information:
License Type Applied For: ______________________
License Application Filing #: _________________________
License Application Filing Date: __________________________

I, the undersigned authorized person, hereby swear/affirm that I have full authority to sign and verify this notification, that I have read this notification and have knowledge of the information stated herein, and that this notification, and all information submitted in connection herewith, is complete and accurate, to the best of my knowledge and belief.

___________________________	____________________	______________	______________
Signature	**Print Name**	**Title**	**Date**

STATE OF FLORIDA
OFFICE OF FINANCIAL REGULATION

FINANCIAL TECHNOLOGY SANDBOX INNOVATOR BI-ANNUAL REPORT
Chapter 559, PART XII, Florida Statutes

General Instructions

Form OFR-559-FTS-004 is the form used by Financial Technology Sandbox licensees to file their Bi-Annual Report.

After the first 180 days of licensure and every 180 days thereafter, each licensee shall submit a complete and accurate Bi-Annual Report to the Office no later than forty-five (45) days after the conclusion of each 180-day period.

****

1. Bi-Annual Reporting Period

Provide the start date of the Bi-Annual Period and the end date of the Bi-Annual Period. The date range provided should equal 180 days.

2. Licensee Information

File number – This is a number assigned by the Office of Financial Regulation.
Name of the Licensee – Name under which license is issued.
D/B/A or Fictitious Name – Name the business operates under other than the entity name.
Contact Person – Provide the name of the person who can answer questions about the information provided in the report.
Telephone and Fax Number – Provide the telephone and fax number of the contact person for questions regarding the report.

3. Declaration

The form must be signed by an authorized person of the licensee. This includes, but is not limited to, an officer, partner, member, joint venture, controlling shareholder or responsible person of the licensee. Include the authorized signor's printed name, title and date signed.

4. Bi-Annual Report – Required Information

This section is divided into four sections:

Section A – Licensees offering a Chapter 516 product/service are required to complete this section.

Section B – All licensees must complete this section.

Section C – Licensees offering a Chapter 560 product/service are required to complete this section.

*** Please note that each question is only regarding Florida consumers in the applicable Bi-Annual period.

STATE OF FLORIDA
OFFICE OF FINANCIAL REGULATION

FINANCIAL TECHNOLOGY SANDBOX INNOVATOR BI-ANNUAL REPORT
Chapter 559, PART XII, Florida Statutes

Bi-Annual Period Start Date: ___________________________

Bi-Annual Period End Date: ___________________________

LICENSEE INFORMATION (Answer all questions listed below)

FILE NUMBER: __________________________

NAME OF LICENSEE: ____

D/B/A or FICTITIOUS NAME: ____

CONTACT PERSON REGARDING THIS FORM: ______________________________________

TELEPHONE #: (_____)______--____________ **FAX #: (_____)______-- ___________**

Declaration

I, the undersigned authorized person, hereby swear/affirm that I have full authority to sign and verify this form, that I have read this report and have knowledge of the facts stated herein, and that this form, and all information submitted in connection herewith, is complete and accurate and contains no misstatements, misrepresentations, or omissions of material facts, to the best of my knowledge and belief.

____
Signature

____
Print Name

____
Title

____
Date

File Number _________

Section A

The following information shall be provided by a licensee that is offering a Chapter 516 Consumer Finance product or service:

Row ID	Reporting Information	Enter Data Here
CF1	# of consumers that received the product/service	
CF2	# of transactions conducted with consumers	
CF3	Total $ amount of the product/service provided/originated to consumers	
CF4	Total $ amount of the product/service outstanding with consumers	
CF5	# of transactions that incurred a 1st payment default	
CF6	# of transactions that are currently 30 to 60 days delinquent	
CF7	# of transactions that are currently 61 to 90 days delinquent	
CF8	# of transactions that are currently 91 or more days delinquent	
CF9	# of transactions that were secured	
CF10	# of transactions that were unsecured	
CF11	# of written consumer complaints received by the licensee	

Section B

The following information shall be provided by all licensees.

ASSETS		
ROW ID		
FC10	Cash on Hand and in Bank	
FC20	Due from agents (net of allowance for doubtful accounts)	
FC30	Amount of allowance for doubtful accounts	
FC40	Accounts receivable (net of allowance for doubtful accounts)	
FC50	Amount of allowance for doubtful accounts	
FC60	Inter-company receivables	
FC70	Notes/other receivables	
FC80	Investments (including government securities)	
FC90	Virtual currency (in U.S. dollars)	
FC100	Other current assets (Attach details and supporting documents if amount exceeds 20% of total current assets)	
FC110	**Total current assets**	Total of FC10+FC20+FC40+FC60+ FC70+FC80+FC90+FC100
FC120	Premises, furniture, fixtures and equipment (net of accumulated depreciation)	
FC130	Investments in subsidiaries not consolidated	
FC140	Goodwill and other intangibles	
FC150	Other assets (Attach details and supporting documents if amount exceeds 20% of total other assets)	
FC160	**Total other assets**	Total of FC120 Through FC150
FC170	**TOTAL ASSETS**	Total FC110 and FC160

LIABILITIES AND EQUITY		
FC180	Accounts payable	
FC190	Inter-company payables	
FC200	Notes/other payables	
FC210	Outstanding money received for transmission liability	
FC220	Outstanding payment instruments	
FC230	Outstanding stored value	
FC240	Outstanding virtual currency liability (in U.S. dollars)	
FC250	Other current liabilities (i.e., Accrued expenses, income tax payable, current portion of long-term debt, etc.)(Attach details and supporting documents if amount exceeds 20% of total current liabilities)	
FC260	**Total Current Liabilities**	Total FC180 Through FC250
FC270	Long term notes payable	
FC280	Other liabilities (Attach details and supporting documents if amount exceeds 20% of total other liabilities)	
FC290	**Total Other Liabilities**	Total FC270 and FC280
FC300	**TOTAL LIABILITIES**	Total FC260 and FC290

SHAREHOLDERS' EQUITY		
FC310	Preferred stock	
FC320	Number of shares outstanding (as actual number)	
FC330	Common stock	
FC340	Number of shares authorized (as actual number)	
FC350	Number of shares outstanding (as actual number)	
FC360	Paid-in-capital in excess of par	
FC370	**Total Contributed Capital**	Total FC310+FC330+FC360
FC380	Retained earnings	
FC390	Other comprehensive income	
FC400	Shareholder distribution	
FC410	**TOTAL SHAREHOLDERS' EQUITY**	Total FC370 through FC400
FC420	**TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY**	Total of FC300 + FC410

INCOME STATEMENT		
REVENUES		
FC430	Fee income from money received for transmission	
FC440	Fee income from sale issuance of payments instruments	
FC450	Fee income from sale issuance of stored value	
FC460	Fee income from currency exchange services	
FC470	Interest and dividends	
FC480	Foreign exchange gains or losses	
FC490	Other income (Attach details and supporting documents if amount exceeds 20% of total revenue)	
FC500	**TOTAL REVENUE**	Total FC430 through FC490
EXPENSES		
FC510	Salaries and employee benefits	
FC520	Agent fees	
FC530	Rent	
FC540	Interest expense	
FC550	Depreciation and amortization	
FC560	Communication expense	
FC570	Professional services expense	
FC580	Marketing and promotion	
FC590	Insurance expense	
FC600	Other expenses (Attach details and supporting documents if amount exceeds 20% of total expenses)	
FC610	**TOTAL EXPENSES**	Total FC510 through FC600
FC620	Income from Continuing Operations before Income Tax	
FC630	Income tax	
FC640	Income from continuing operations	
FC650	Discontinued operations, Net of tax effect	
FC660	Other comprehensive income/currency translation adjustments	
FC670	Income before extraordinary items	
FC680	Extraordinary items, net of tax effect	
FC690	Net Income (loss)	

Section C

The following information shall be provided by a licensee that is offering a Chapter 560 Money Service Business product or service:

MONEY TRANSMISSION		
ST 10	# of transactions from in-state to U.S. states and territories	
ST 20	$ amount received for transmission (outbound) from in-state to U.S. states and territories	
ST 30	# of transmission transactions from in-state to Foreign Countries	
ST 40	$ amount received for transmission (outbound) from in-state to Foreign Countries	
ST 50	TOTAL # of Money Transmission Transactions initiated in-state	Total of ST10+ST30
ST 60	TOTAL $ Amount of Money Transmission Transactions initiated in-state	Total of ST20+ST40
PAYMENT INSTRUMENTS (MONEY ORDERS, TRAVELERS CHECKS, DRAFTS)		
ST 70	# of payment instruments issued/sold in-state	
ST 80	$ amounts of payment instruments issued/sold in-state	
STORED VALUE		
ST 90	# of stored value transactions in-state	
ST 100	$ amount of stored value transactions in-state	
FIAT CURRENCY EXCHANGE		
ST 110	# of currency transactions completed in-state	
ST 120	$ amount of currency transactions completed in-state	
ST 130	$ amount of fees collected in-state	
VIRTUAL CURRENCY		
ST 140	# of Virtual Currency to Virtual Currency Transactions Initiated In-State	
ST 150	$ amount of Virtual Currency to Virtual Currency Transactions Initiated In-State	
ST 160	# of Virtual Currency to U.S. Dollar Transactions Initiated In-State	
ST 170	$ amount of Virtual Currency to U.S. Dollar Transactions Initiated In-State	
ST 180	# of U.S. Dollar to Virtual Currency Transactions Initiated In-State	
ST 190	$ amount of U.S. Dollar to Virtual Currency Transactions Initiated In-State	
ST 200	TOTAL # of Virtual Currency Transactions Initiated In-State	Total of ST140+ST160+ST180
ST 210	TOTAL $ Amount of Virtual Currency Transactions Initiated In-State	Total of ST150+ST170+ST190

STATE OF FLORIDA
OFFICE OF FINANCIAL REGULATION

FINANCIAL TECHNOLOGY SANDBOX INNOVATOR PLEDGE AGREEMENT

1. Parties. This Pledge Agreement is between the State of Florida, Office of Financial Regulation (the "Office"), ________ ____(the "Licensee ") and ____(The "Financial Institution") located at ____.

2. Delivery of Custody. The Licensee has placed in the custody of the Financial Institution the following collateral deposit:____(the "Collateral Deposit"). The principal amount of the Collateral Deposit as of______________, 20________, is $________. The market value of the Collateral Deposit as of______________________, 20___, is $______.

3. Default. The Collateral Deposit hereby pledged to the State of Florida, Office of Financial Regulation, is for the benefit of any claimants against the Licensee or its authorized vendors, to secure the performance of the obligations of the Licensee and its authorized vendors with respect to the receipt, handling, transmission, and payment of funds. Such claimants against the Licensee or its authorized vendors may themselves bring suit directly on the Collateral Deposit, or the Office may bring suit thereon on behalf of such claimants, in either one action or in successive actions.

4. Duty of Financial Institution. The Financial Institution agrees to take reasonable care of the Collateral Deposit in its possession.

5. Continuance of Custody. The Financial Institution shall retain custody of the Collateral Deposit and shall not release such items without the written authorization of the Office or on the order of a court of competent jurisdiction.

6. Interest and Dividends. The Licensee shall be entitled to receive all interest and dividends from the collateral deposit items.

7. Termination of Liability of Financial Institution. The Financial Institution's obligations as to the Collateral Deposit shall cease when it has released such items pursuant to paragraph 5 herein.

______________________	______________________	__________
LICENSEE	Signature of Principal of Licensee	Title

WITNESS:______________________ WITNESS: ______________________

STATE OF: (____________________)
COUNTY OF: (______________________)
The foregoing instrument was acknowledged before me by means of ☐ physical presence or ☐ online notarization, this ________________________day of______________, by____________, who is personally known to me or who has produced______________________as identification and who did/did not take an oath.
(SEAL)

____
Notary Public -- State of________________at Large
My Commission Expires: ______________________

______________________	______________________	__________	(_______) ______________
FINANCIAL INSTITUTION	Signature of Officer	Title	Telephone #

WITNESS:______________________ WITNESS: ______________________
STATE OF (______________________)
COUNTY OF (________________)
The foregoing instrument was acknowledged before me by means of ☐ physical presence or ☐ online notarization, this ________________________day of______________, by____________, who is personally known to me or who has produced______________________as identification and who did/did not take an oath.
(SEAL)

____
Notary Public - State of________________at Large
My Commission Expires: ______________________

STATE OF FLORIDA
OFFICE OF FINANCIAL REGULATION

FINANCIAL TECHNOLOGY SANDBOX INNOVATOR SURETY BOND

BOND No.: ______________________

We, ____, of ____
(Name of Applicant) (Street Address)

____ County of _______________ , State of ________________________ ,

principal and ____ , a corporation incorporated under the laws of
(Name of Surety Corporation)

the State of ______________________________, and duly licensed to transact a surety business in the State of Florida,

are bound to the Financial Services Commission of the State of Florida as Head of the Office of Financial Regulation,

("Office") and the successors in the office of said Financial Services Commission, for the use and benefit of any claimant

in the State of Florida in the sum of _____________________________________ dollars ($__________________

_______), for which payment we bind ourselves and our respective heirs, legal representatives, successors, and assigns,

jointly and severally.

Principal is acting as a Financial Technology Sandbox Innovator pursuant to Chapter 559, Part XII, Florida Statutes. Pursuant to Section 559.952(4)(a)14., Florida Statutes, principal must provide to the Office of Financial Regulation a corporate surety bond by a bonding company or insurance company authorized to do business in Florida in such amount as may be determined by the Commission by rule, conditioned on conformance with Chapter 559, Part XII, Florida Statutes.

This bond is issued subject to the following conditions:

1. The principal shall file the original surety bond with the State of Florida, Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0376, or its successors, upon applying for registration.

2. The surety bond filed with the Office of Financial Regulation may not be cancelled by either the principal or the surety except upon written notice to the Office of Financial Regulation by registered or certified mail with return receipt requested. A cancellation shall not take effect less than thirty (30) days after receipt by the Office of Financial Regulation of such written notice. The surety shall remain liable for all or any part of obligations covered by this bond which may have accrued by default of the principal prior to the effective date of cancellation.

3. The Office of Financial Regulation and any claimant may bring an action in a proper court on this bond resulting from the failure of the principal or its authorized vendors to faithfully perform obligations with respect to the receipt, handling, transmission, and payment of funds.

4. The surety must, within 10 days after it pays any claim to any claimant, give written notice to the Office of Financial Regulation by registered or certified mail with details sufficient to identify the claimant, the claim, and the judgment paid.

THE BOND IS EFFECTIVE THIS ____________ DAY OF ___________________________ , ______________.

IN WITNESS WHEREOF the said principal has caused these presents to be executed by affixing hereto the signature of its duly authorized representative and its corporate seal to be affixed hereto attested by its duly authorized representative, and the said surety has caused these presents to be executed by the signature of its duly authorized representative and its corporate seal to be affixed hereto attested by its duly authorized representative this ____________ day of _____________________ , ______________ and shall be deemed continuous; subject to cancellation as hereinabove provided.

________________________________ Witness as to Principal (Signature)	________________________________ Name of Principal (Licensee)
________________________________ Witness as to Principal (type name)	________________________________ Signature of duly authorized representative of Principal
	________________________________ Name of duly authorized representative of Principal

(SEAL)

____ Name of Surety	(_______) ______ -- __________ Telephone Number of Surety Company

____

Signature of duly authorized representative of Surety

____

Name of duly authorized representative of Surety (type name)

NOTE: SIGNATURE OF PRINCIPAL MUST BE WITNESSED.

Violation #	Statute or Code	Short Description	1st Citation	2nd Citation	3rd Citation
1	Section 559.952(6)(b)1.	Failure to provide the consumer a written statement; obtain acknowledgement by the consumer; or retain the written statement and/or acknowledgement; for the duration of the sandbox period.	Suspension: A Revocation	Suspension: B Revocation	Suspension: C Revocation
2	Section 559.952(8)	Failure to timely and accurately submit to the Office a Bi-Annual Report.	Suspension: A Revocation	Suspension: B Revocation	Suspension: C Revocation
3	Section 559.952(10)(b)1.a.	Failure to comply with section 559.952, F.S., and Rule Chapter 69V-559, F.A.C.	Suspension: A Revocation	Suspension: B Revocation	Suspension: C Revocation
4	Section 559.952(10)(b)1.b.	A fact or condition exists that, if it had existed or become known at the time that the Financial Technology Sandbox application was pending, would have warranted denial of the application or the impositions of material conditions.	Revocation	Revocation	Revocation

ATTACHMENT 2

FINANCIAL SERVICES COMMISSION

OFFICE OF FINANCIAL REGULATION

AGENDA ITEM # 2: REQUEST APPROVAL TO PUBLISH NOTICE OF PROPOSED RULE

Action Requested:

The Office of Financial Regulation (OFR) respectfully requests approval to publish a Notice of Proposed Rule to adopt Rule 69W-600.0141, Florida Administrative Code (F.A.C.), relating to the protection of specified adults.

Summary and Justification of Rule:

Rule 69W-600.0141, F.A.C.: The OFR proposes to adopt Rule 69W-600.0141, F.A.C., to implement section 517.34, Florida Statutes, which requires any dealer or investment adviser (firm) who delays a disbursement or transaction of funds or securities from an account of a specified adult, or an account for which a specified adult is a beneficiary or beneficial owner, to notify the OFR of the delay electronically on a form prescribed by commission rule. The proposed rule will incorporate by reference Form OFR-DLY, Notification of Delay of Disbursement/Transaction from Account of Specified Adult. Form OFR-DLY shall be completed by firms delaying a disbursement or transaction pursuant to section 517.34, Florida Statutes, and filed with the OFR via e-mail.

Proposed Text of Rules:

69W-600.0141 Notification of Delay of Disbursement/Transaction from Account of Specified Adult

Any dealer or investment adviser who delays a disbursement or transaction of funds or securities from an account of a specified adult or an account for which a specified adult is a beneficiary or beneficial owner shall, not later than three (3) business days after the date on which the delay was first placed or extension of the delay applied, notify the Office of the delay or extension of the delay by submitting Form OFR-DLY, Notification of Delay of Disbursement/Transaction from Account of Specified Adult, effective XXXX. A sample form is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.

Rulemaking Authority 517.03(1), 517.034(3), (4) FS. Law Implemented 517.34 FS. History–New XX-XX-20.

Material Incorporated by Reference:

A copy of the incorporated material is provided as an attachment.

Office of Financial Regulation
Notification of Delay of Disbursement/Transaction from Account of Specified Adult
Form OFR-DLY

Notification to the Office by Firms Delaying a Disbursement or Transaction from an Account of a Specified Adult
This form shall be used by any dealer or investment adviser (“firm”) who delays a disbursement or transaction of funds or securities from an account of a specified adult, as defined in section 517.34, Florida Statutes, or an account for which a specified adult is a beneficiary or beneficial owner to notify the Office of Financial Regulation (“Office”) of the delay as required by section 517.34, Florida Statutes.

Notification forms shall be submitted to the following e-mail address: OFR-Delay@flofr.com.

Instructions
*If you have any questions or need assistance in completing this notification form, please contact the Office of Financial Regulation at **(850) 487-9687.***

Complete each section of the form in its entirety.

Section I – Information on Firm Placing Delay

- Identify the date you are submitting this form to the Office.
- Indicate, by checking the appropriate box, whether the form being submitted is notifying the Office of an initial delay or that an extension has been applied to a delay.
- Identify the firm placing the delay.
- Identify the date the delay was first made and the date a delay extension was first applied, if applicable.
- List the firm’s system registration number (i.e., Central Registration Depository (“CRD”), Investment Adviser Registration Depository (“IARD”), or Regulatory Enforcement and Licensing (“REAL”) number.
- Identify the individual at the firm with the authority to make the delay. Use the name as it appears on the individual’s Social Security card. Do not use nicknames or initials.
- Provide the title of the individual at the firm with the authority to make the delay.
- Under Business Address, provide the business address for the individual at the firm with the authority to make the delay.

Section II – Information about the Specified Adult

- Identify the gender, age, and residential zip code of the specified adult.
- NOTE: **DO NOT** include other information on this form which would identify the specified adult, including but not limited to, the specified adult’s name, social security number, address, contact information, or account number. **THIS FORM IS NOT EXEMPT FROM PRODUCTION UNDER FLORIDA’S PUBLIC RECORD LAWS.**

Section III – Questions

- Indicate the proper “yes” or “no” response by placing an “X” in the appropriate box.

Office of Financial Regulation
Notification of Delay of Funds/Securities from an Account of a Specified Adult
Form OFR-DLY

Section I – Information on Firm Placing the Delay

Date Notice Submitted to the Office:			
❑ Notification of Initial Delay		❑ Notification of Delay Extension	
FIRM			
Firm Name:		System Registration Number:	
Date Delay First Placed:			
Date Delay Extension Applied:			
INDIVIDUAL AUTHORIZING THE DELAY			
Last/Surname:	First:	Middle:	Suffix:
Title:			
BUSINESS ADDRESS			
Street Address or P.O. Box:			
City:	State:	Zip Code:	
Country:			

Section II – Information about the Specified Adult

SPECIFIED ADULT INFORMATION
Gender:
Age:
Residential Address Zip Code:

Section III - Questions

PLEASE ANSWER *YES* OR *NO* TO THE FOLLOWING QUESTIONS		
YES	**NO**	
		Is financial exploitation of a specified adult suspected in connection with a disbursement or transaction?
		Are funds currently at risk of being lost?

THE OFFICE MAY TAKE DISCIPLINARY ACTION AGAINST ANY PERSON MAKING A KNOWING AND WILLFUL MISREPRESENTATION ON THIS FORM.

ATTACHMENT 3

FINANCIAL SERVICES COMMISSION
OFFICE OF FINANCIAL REGULATION
AGENDA ITEM # 3: REQUEST APPROVAL TO PUBLISH NOTICES OF PROPOSED RULE

Action Requested:

The OFR respectfully requests approval to publish Notices of Proposed Rule to amend Rules 69W-200.001, 69W-200.002, 69W-500.010, 69W-600.001, 69W-600.0012, 69W-600.0013, 69W-600.0015, 69W-600.0016, 69W-600.0017, 69W-600.0019, 69W-600.002, 69W-600.0022, 69W-600.0023, 69W-600.0024, 69W-600.013, 69W-600.0131, 69W-600.0132, 69W-600.014, 69W-700.001, and 69W-1000.001, Florida Administrative Code (F.A.C.).

Summary and Justification of Rules:

The OFR incorporates by reference a number of general industry standards into its rules. Over time these industry standards are revised and updated, consequently OFR now proposes to amend Rules 69W-200.001, 69W-200.002, 69W-600.013, 69W-600.014, F.A.C., to incorporate the current versions of those industry standards. Additionally, the OFR proposes to amend the disciplinary guidelines in Rule 69W-1000.001, F.A.C., in order to add or revise guidelines, as appropriate, for the current version of industry standards it is proposing be incorporated by reference.

The OFR proposes to amend Rule 69W-200.002, F.A.C., to incorporate SEC Rule 17a-14 (17 C.F.R. §240.17a-14) which requires every broker or dealer registered with the Securities and Exchange Commission ("SEC") to prepare, file, and amend Form CRS and deliver it to retail investors. Form CRS is a disclosure document prescribed by the SEC. Further, the OFR proposes to amend Rule 69W-600.013, F.A.C., and the disciplinary guidelines to add failing to deliver a current FORM CRS to any retail investor in violation of SEC Rule 17a-14 (17 C.F.R. §240.17a-14) to the list of prohibited business practices for dealers and their associated persons.

The OFR proposes to amend Rule 69W-600.014, F.A.C., to clarify that investment advisers' records requirements do not include Form CRS.

The OFR proposes to amend Rule 69W-500.010, F.A.C., to remove securities manuals published by Standard & Poor's Financial Services LLC from the list of recognized securities manuals as those manuals are no longer published.

OFR incorporates by reference a number of uniform forms into its rules. Over time these forms are revised and updated, consequently OFR now proposes to amend the following rules to incorporate the current version of Form ADV, Uniform Application for Investment Adviser Registration (09-19) and the instructions and explanation of terms for Form U4, Uniform Application for Securities Industry Registration or Transfer (05-09) and Form U5, Uniform Termination Notice for Securities Industry Registration (05-09): Rules 69W-600.001, 69W-600.0012, 69W-600.0013, 69W-600.0016, 69W-600.0017, 69W-600.002, 69W-600.0022, 69W-600.0023, 69W-600.0024, 69W-600.0132, F.A.C.

The OFR proposes to amend Rules 69W-600.001, 69W-600.0012, 69W-6000.0013, 69W-600.0016, 69W-600.002, 69W-600.0022, 69W-600.0023, 69W-600.0024, 69W-600.0131, 69W-600.0132, 69W-600.014, F.A.C., to replace the term "representative" or "investment adviser representative" with the term "associated person" or "associated person of an investment adviser" to harmonize language with other chapter 69W-600, F.A.C., rules.

The OFR proposes to amend Rules 69W-600.0016 and 69W-600.0024, F.A.C., to clarify which applicants shall not be required to satisfy the examination requirements of those rules pursuant to the "grandfathering provisions" of the same.

The OFR proposes to amend Rules 69W-600.001, 69W-600.0012, 69W-600.0013, 69W-600.0015, 69W-600.0016, 69W-600.0019, 69W-600.002, 69W-600.0022, 69W-600.0023, and 69W-600.0024, 69W-700.001, F.A.C., to grant applicants for registration under chapter 517, Florida Statutes, an additional 30 days to submit requested information, to allow the Office to abandon an application if an applicant fails to provide timely additional information, and to remove duplicative language authorizing the Office to request certified documentation.

***Note: Material proposed to be incorporated by reference produced by FINRA, NASAA, and the MSRB may be copyrighted material. The OFR has requested permission to reproduce and publish these materials on the Department of State's website for the purpose of providing public access via a hyperlink to an electronic copy of the same. In the event the permission is not granted the information will be available to the public upon request.

Proposed Text of Rules:

69W-200.001 Definitions.
As used in the Rules and Regulations of the Financial Services Commission and Office of Financial Regulation, pursuant to chapter 517, F.S., unless the context otherwise specifically requires:

(1) through (7) No change.

(8)(a) Except as otherwise provided in this subsection, the term "Branch Office" shall mean any location in this state of a dealer or investment adviser at which one or more associated persons regularly conduct the business of rendering investment advice or effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security or any location that is held out as such. Pursuant to section 517.021(4), F.S., the Financial Services Commission may adopt exceptions to this definition. The following locations shall not be deemed branch offices for purposes of section 517.12(5), F.S., and are considered exceptions to the definition of a branch office under section 517.021(4), F.S.:

1. No change.

2. Any location that is the associated person's primary residence; provided that:

a. through d. No change.

e. The associated person's correspondence and communications with the public are subject to the firm's supervision in accordance with FINRA ~~NASD~~ Rule 3110 ~~3010~~, as incorporated in rule 69W-200.002, F.A.C.;

f. through i. No change.

3. through 9. No change

(b) through (c) No change.

(9) through (30) No change.

Rulemaking Authority 517.03(1) FS. Law Implemented 517.07, 517.12, 517.021, 517.051, 517.061, 517.081, 517.161 FS. History–New 12-5-79, Amended 9-20-82, Formerly 3E-200.01, Amended 12-8-87, 10-14-90, 7-31-91, 6-16-92, 1-10-93, 5-5-94, 10-20-97, 8-9-98, 8-19-99, 10-30-03, Formerly 3E-200.001, Amended 5-15-07, 9-30-10, 11-11-13, 9-22-14, 11-15-16,__________.

69W-200.002 General Industry Standards Incorporated by Reference.
The following general industry standards as expressed in the statutes, rules and regulations of the various federal and self-regulatory agencies and regulatory associations and referenced in Division 69W, F.A.C., are hereby incorporated by reference and adopted by this rule. The material incorporated by reference in this rule may also be obtained from the Florida Office of Financial Regulation (Office), Division of Securities' website at http://www.flofr.com/sitePages/MaterialsDS.htm, except where noted for copyright restrictions. Materials subject to copyright restrictions may be inspected and examined by contacting the Florida Office of Financial Regulation, Division of Securities, at 200 E. Gaines Street, Tallahassee, Florida 32399, (850)487-9687 or the Florida Department of State at 500 S. Bronough Street, Tallahassee, Florida 32399, (850)245-6500.

(1) through (15) No change.

(16) Regulation A (17 C.F.R. §§230.251 through 230.263) (4-1-19 ~~4-1-18~~ edition), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11289.~~

(17) through (18) No change.

(19) SEC Rule 701 (17 C.F.R. §230.701) (4-1-19 ~~4-1-13~~ edition), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.

~~http://www.flrules.org/Gateway/reference.asp?No=Ref-04530.~~

(20) through (25) No change.

(26) SEC Rules 15c2-1, 15c2-4, 15c2-5, 15c2-7, 15c2-8, 15c2-11, and 15c2-12 (17 C.F.R. §§240.15c2-1, 240.15c2-4, 240.15c2-5, 240.15c2-7, 240.15c2-8, 240.15c2-11, and 240.15c2-12) (4-1-19 ~~4-1-18~~ edition), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11292.~~

(27) SEC Rule 15c3-1 and appendices (17 C.F.R. §§240.15c3-1 ~~(7-7-14); 17 C.F.R.~~ §240.15c3-1a; ~~(7-7-14); 17 C.F.R.~~ §240.15c3-1b; ~~(8-9-84); 17 C.F.R.~~ §240.15c3-1c; ~~(12-2-92); 17 C.F.R.~~ §240.15c3-1d; ~~(6-5-08); 17 C.F.R.~~ §240.15c3-1e; ~~(7-7-14); 17 C.F.R.~~ §240.15c3-1f; ~~(7-7-14); 17 C.F.R.~~ §240.15c3-1g ~~(7-7-14)~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-04571.~~

(28) through (29) No change.

(30) SEC Rules 17a-3 and 17a-4 (17 C.F.R. §§240.17a-3 and 240.17a-4) (current as of 7-7-20 ~~4-1-14 edition~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-04568.~~

(31) No change.

(32) SEC Rules ~~Rule~~ 17a-11 and 17a-14 (17 C.F.R. §§240.17a-11 and 240.17a-14) (current as of 7-17-20 ~~6-1-14~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-04572.~~

(33) No change.

(34) Regulation M (17 C.F.R. §§242.100 through 242.105) (4-1-19 ~~4-1-14~~ edition), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-04542~~.

(35) Regulation SHO (17 C.F.R. §§242.200 through 242.203) (4-1-19 ~~4-1-14~~ edition), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-04559.~~

(36) through (37) No change.

(38) SEC Rules 204-1, 204-2, 204-3, 205-1, 205-2, 205-3, 206(3)-1, 206(3)-2, 206(4)-1, 206(4)-3 (17 C.F.R. §§275.204-1; ~~17 C.F.R. §~~275.204-2; ~~17 C.F.R. §~~275.204-3; ~~17 C.F.R. §~~275.205-1; ~~17 C.F.R. §~~275.205-2; ~~17 C.F.R. §~~275.205-3; ~~17 C.F.R. §~~275.206(3)-1; ~~17 C.F.R. §~~275.206(3)-2; ~~17 C.F.R. §~~275.206(4)-1; ~~17 C.F.R. §~~275.206(4)-3) (current as of 7-8-20 ~~4-1-18 edition~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11295.~~

(39) No change.

(40) FINRA Rules ~~Rule~~ 1020 and 1240 (existing as of 6-26-20 ~~2-22-19~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11296.~~

(41) FINRA Rule 2000 Series (2010 through 2370) (existing as of 6-24-20 ~~3-8-19~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11297.~~

(42) FINRA Rule 3000 Series (3110 through 3310) (existing as of 6-24-20 ~~3-8-19~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11298.~~

(43) FINRA Rule 4000 Series (4110 through 4590) (existing as of 6-24-20 ~~3-8-19~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11299.~~

(44) FINRA Rule 5000 Series (5110 through 5350) (existing as of 6-24-20 ~~3-8-19~~), accessible at

http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.
~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11300.~~

(45) FINRA Rule 6000 Series (6110 through 6898) (existing as of 6-25-20 ~~3-8-19~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.
~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11301.~~

(46) FINRA Rule 7000 Series (7110 through 7730) (existing as of 6-25-20 ~~3-8-19~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.
~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11302.~~

(47) FINRA Rule 11000 Series (11100 through 11900) (existing as of 6-26-20 ~~3-8-19~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.
~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11303.~~

~~(48) NASD Conduct Rules 2340 and 2510 (existing as of 3-8-19), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-11304.~~

~~(49) NASD Conduct Rules 3140, 3150, and IM-3150 (existing as of 3-8-19), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-11305.~~

(48) ~~(50)~~ MSRB Definitional Rules D-1 to D-15, and General Rules G-1 to G-48 (existing as of 10-1-19 ~~10-1-18~~), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.
~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11306.~~

(49) ~~(51)~~ NYSE American Rule 341A (existing as of 3-11-19), available for inspection at the Office due to copyright restrictions.

(50) ~~(52)~~ NYSE Rule 345A (existing as of 3-10-19), available for inspection at the Office due to copyright restrictions.

(51) ~~(53)~~ NYSE Rules 412 and 435 (existing as of 2-21-19), available for inspection at the Office due to copyright restrictions.

(52) ~~(54)~~ NYSE Chicago Inc. Article 6, Rule 11 (existing as of 3-11-19), available for inspection at the Office due to copyright restrictions.

Rulemaking Authority 517.03(1), 517.1215(2), 517.1217 FS. Law Implemented 517.081, 517.12(4), 517.1215, 517.1217, 517.161(1) FS. History–New 9-22-14, Amended 5-6-15, 11-26-19, ________.

69W-500.010 Recognized Manuals of Securities.

The following publications are hereby approved as recognized securities manuals: Securities manuals published by Mergent, Inc.~~, and all commonly recognized formats of Mergent's Manuals, including CD-ROM and electronic dissemination over the Internet and securities manuals published by Standards & Poor's Financial Services LLC.~~

Rulemaking Authority 517.03(1) FS. Law Implemented 517.061(20)(d) FS. History–(Formerly 3E-20.21), New 9-20-82, Formerly 3E-500.10, Amended 7-31-91, 5-10-00, Formerly 3E-500.010, Amended ______________.

69W-600.001 Application for Registration as a Dealer (FINRA).

(1) New Applications.

(a) No change

(b) An application shall include the following:

1. through 2. No change.

3. A Uniform Application for Securities Industry Registration or Transfer (Form U4) (05/2009), to register at least one principal as set forth in this rule. A sample form is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06089.~~ In conjunction with filing its Form

BD with the Office, the dealer shall provide the Office written notification of the principal's name and CRD number or social security number,

4. through 7. No change.

(2) Request for Additional Information. All information required by subsection (1) of this rule, shall be submitted with the original application filing. Any request for additional documents or information shall be made by the Office within thirty (30) days after receipt of the application. ~~The Office may require documentation to be certified by its issuer based upon the Office's review of the nature and substance of the disciplinary history of the applicant and any officer, director, or ultimate owner in the case of a corporation or association, and any partner, co-partner, or member of the partnership in the case of a partnership. For purposes of this rule, "certified" means that there must be an original certification or attestation by the issuer of the record that the document is a true copy of a record contained in its office and its seal, if any.~~ Additional information shall be submitted directly with the Office within sixty (60) days after a request has been made by the Office. The Office shall grant a request for an additional thirty (30) days to submit the additional information. The Office shall not grant a request after the original sixty (60) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which shall result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to such request within sixty (60) days after the date of the request may be construed by the Office as grounds for denial of an application in accordance with the provisions of Section 120.60(1), F.S.~~

(3) through (5) No change.

(6) Examinations/Qualifications Requirements.

(a) No change.

(b) Every applicant for initial registration as a principal or agent of a dealer shall evidence securities general knowledge by:

1. through 3. No change.

4. Submitting to the Office proof of passing, within two years of the date of application for registration, an examination relating to the position to be filled administered by a national securities association and proof of passing, within four years of the date of application for registration, the Securities Industry Essentials (SIE) Examination. The following individuals will be considered to have passed the SIE Examination:

a. Individuals whose registration as an associated person ~~a representative~~ was terminated between October 1, 2014, and September 30, 2018, provided they re-register as an associated person ~~a representative~~ within four years from the date of their last registration;

b. Individuals who registered as an associated person ~~representatives~~ prior to October 1, 2018, and who continue to maintain those registrations on or after October 1, 2018.

(7) through (8) No change.

(9) Termination of Registration as Dealer, Principal or Agent, or Notification of Branch Office.

(a) through (b) No change.

(c) The forms to be utilized for providing notice to the Office under paragraph (9)(a) are:

1. through 2. No change.

3. Uniform Termination Notice for Securities Industry Registration (Form U5) (05-09). A sample form is hereby incorporated by reference and is available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06090.~~

(10) through (11) No change.

Rulemaking Authority 517.03(1), 517.12 FS. Law Implemented 517.12 FS. History–New 12-5-79, Amended 9-20-82, Formerly 3E-600.01, Amended 7-29-90, 8-1-91, 6-16-92, 1-11-93, 11-14-93, 4-30-96, 6-22-98, 5-10-00, 9-19-00, 7-31-02, Formerly 3E-600.001, Amended 3-16-06, 5-15-07, 11-22-10, 10-29-12, 11-11-13, 12-29-15, 11-26-19<u>,________</u>.

69W-600.0012 Application for Registration as a Dealer (Non-FINRA).

(1) New Applications.

(a) No change.

(b) An application shall include the following:

1. and 2. No change.

3. A Uniform Application for Securities Industry Registration or Transfer (Form U4) (05/2009), to register at least one principal as set forth in this rule. The Form U4 is hereby incorporated by reference and available at <u>http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.</u> ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06089.~~ In conjunction with filing its Form BD with the Office, the dealer shall provide the Office written notification of the principal's name and social security number. Social security numbers are collected by the Office pursuant to Section 517.12(7)(a), F.S., and are used to verify the identity of individuals;

4. and 7. No change.

(2) Request for Additional Information. All information required by subsection (1) of this rule, shall be submitted with the original application filing. Any request for additional documents or information shall be made by the Office within thirty (30) days after receipt of the application. ~~The Office may require documentation to be certified by its issuer based upon the Office's review of the nature and substance of the disciplinary history of the applicant and any officer, director, or ultimate owner in the case of a corporation or association, and any partner, co-partner, or member of the partnership in the case of a partnership. For purposes of this rule, "certified" means that there must be an original certification or attestation by the issuer of the record that the document is a true copy of a record contained in its office and its seal, if any.~~ Additional information shall be submitted directly with the Office within sixty (60) days after a request has been made by the Office. <u>The Office shall grant a request for an additional thirty (30) days to submit the additional information. The Office shall not grant a request after the original sixty (60) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which shall result in the application being removed from further consideration by the Office and closed.</u> ~~Failure to respond to such request within sixty (60) days after the date of the request may be construed by the Office as grounds for denial of an application in accordance with the provisions of Section 120.60(1), F.S.~~

(3) through (5) No change.

(6) Examinations/Qualifications Requirements.

(a) No change.

(b) Every applicant for initial registration as a principal or agent of a dealer shall evidence securities general knowledge by:

1. through 3. No change.

4. Submitting to the Office proof of passing, within two years of the date of application for registration, an examination relating to the position to be filled administered by a national securities association and proof of passing, within four years of the date of application for registration, the Securities Industry Essentials (SIE) Examination. The following individuals will be considered to have passed the SIE Examination:

a. Individuals whose registration as <u>an associated person</u> ~~a representative~~ was terminated between October 1, 2014, and September 30, 2018, provided they re-register as <u>an associated</u>

person ~~a representative~~ within four years from the date of their last registration;

b. Individuals who registered as an associated person ~~representatives~~ prior to October 1, 2018, and who continue to maintain those registrations on or after October 1, 2018.

(7) through (8) No change.

(9) Termination of Registration as Dealer, Principal or Agent, or Notification of Branch Office.

(a) through (b) No change.

(c) The forms to be utilized for providing notice to the Office under paragraph (9)(a), and which are hereby incorporated by reference are:

1. through 2. No change.

3. Uniform Termination Notice for Securities Industry Registration (Form U5) (05-09), which is hereby incorporated by reference and is available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06090.~~

(10) through (11) No change.

Rulemaking Authority 517.03(1), 517.12 FS. Law Implemented 517.12 FS. History–New 12-29-15, Amended 11-26-19,____________.

69W-600.0013 Application for Registration as an Issuer/Dealer.

(1) New Applications.

(a) No change.

(b) An application shall include the following:

1. through 2. No change.

3. A Uniform Application for Securities Industry Registration or Transfer (Form U4) (05/2009), to register at least one principal as set forth in this rule. The Form U4 is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06089.~~ In conjunction with filing its Form BD with the Office, the issuer/dealer shall provide the Office written notification of the principal's name and social security number. Social security numbers are collected by the Office pursuant to Section 517.12(7)(a), F.S., and are used to verify the identity of individuals;

4. through 7. No change.

(2) Request for Additional Information. All information required by subsection (1) of this rule, shall be submitted with the original application filing. Any request for additional documents or information shall be made by the Office within thirty (30) days after receipt of the application. ~~The Office may require documentation to be certified by its issuer based upon the Office's review of the nature and substance of the disciplinary history of the applicant and any officer, director, or ultimate owner in the case of a corporation or association, and any partner, co-partner, or member of the partnership in the case of a partnership. For purposes of this rule, "certified" means that there must be an original certification or attestation by the issuer of the record that the document is a true copy of a record contained in its office and its seal, if any.~~ Additional information shall be submitted directly with the Office within thirty (30) days after a request has been made by the Office. The Office shall grant a request for an additional thirty (30) days to submit the additional information. The Office shall not grant a request after the original sixty (60) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which shall result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to such request within sixty (60) days after the date of the request may be construed by the Office as grounds for denial of an application in accordance with the provisions of Section 120.60(1), F.S.~~

(3) through (5) No change.

(6) Examinations/Qualifications Requirements.

(a) No change.

(b) Every applicant for initial registration as a principal or agent of an issuer/dealer shall evidence securities general knowledge by:

1. through 4. No change.

5. Submitting to the Office proof of passing, within two years of the date of application for registration, an examination relating to the position to be filled administered by a national securities association and proof of passing, within four years of the date of application for registration, the Securities Industry Essentials (SIE) Examination. The following individuals will be considered to have passed the SIE Examination:

a. Individuals whose registration as an associated person ~~a representative~~ was terminated between October 1, 2014, and September 30, 2018, provided they re-register as an associated person ~~a representative~~ within four years from the date of their last registration;

b. Individuals who registered as an associated person ~~representatives~~ prior to October 1, 2018, and who continue to maintain those registrations on or after October 1, 2018.

(c) No change.

(7) through (8) No change.

(9) Termination of Registration as Issuer/Dealer, Principal or Agent, or Notification of Branch Office.

(a) through (b) No change.

(c) The forms to be utilized for providing notice to the Office under paragraphs (9)(a) and (9)(b) are:

1. through 2. No change.

3. Uniform Termination Notice for Securities Industry Registration (Form U5) (05-09), which is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06090.~~

(10) through (11) No change.

Rulemaking Authority 517.03(1), 517.12 FS. Law Implemented 517.12 FS. History–New 12-29-15, Amended 11-26-19,_________.

69W-600.0015 Canadian Dealer Notice-Filing.

(1) No change.

(2) Request for Additional Information. All information required by subsection (1) of this rule, shall be submitted with the original notice-filing. Any request for additional documents or information shall be made by the Office within thirty (30) days after receipt of the notice-filing. ~~The Office may require documentation to be certified by its issuer based upon the Office's review of the nature and substance of the disciplinary history of the notice-filer. For purposes of this rule, "certified" means that there must be an original certification or attestation by the issuer of the record that the document is a true copy of a record contained in its office and its seal, if any.~~ Additional information shall be submitted directly with the Office within sixty (60) days after a request has been made by the Office. The Office shall grant a request for an additional thirty (30) days to submit the additional information. The Office shall not grant a request after the original sixty (60) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which shall result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to such request within sixty (60)~~

~~days after the date of the request may be construed by the Office as grounds for denial of a notice-filing in accordance with the provisions of Section 120.60(1), F.S.~~

(3) through (6) No change.

Rulemaking Authority 517.03, 517.12 FS. Law Implemented 517.12 FS. History–New 5-15-07, Amended 11-22-10, 12-29-15, Amended ______.

69W-600.0016 Application for Registration as an Investment Adviser (State Registered).

(1) New Applications.

(a) No change.

(b) An application shall include the following:

1. Form ADV, Uniform Application for Investment Adviser Registration (09-19 ~~07-17~~). A sample form is hereby incorporated by reference and is available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX; ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11280;~~

2. No change.

3. A Uniform Application for Securities Industry Registration or Transfer (Form U4) to register at least one agent to designate as a principal as set forth in this rule. Form U4 (05-09) is hereby incorporated by reference and a sample form is available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06089.~~ In conjunction with filing its Form ADV with the Office, the investment adviser shall provide the Office written notification of the principal's name and CRD number or social security number;

4. through 6. No change.

(2) Request for Additional Information. All information required by subsection (1) of this rule, shall be submitted with the original application filing. Any request for additional documents or information shall be made by the Office within thirty (30) days after receipt of the application. ~~The Office may require documentation to be certified by its issuer based upon the Office's review of the nature and substance of the disciplinary history of the applicant and any officer, director, or ultimate owner in the case of a corporation or association, and any partner, co-partner, or member of the partnership in the case of a partnership. For purposes of this rule, "certified" means that there must be an original certification or attestation by the issuer of the record that the document is a true copy of a record contained in its office and its seal, if any.~~ Additional information shall be submitted directly with the Office within sixty (60) days after a request has been made by the Office. The Office shall grant a request for an additional thirty (30) days to submit the additional information. The Office shall not grant a request after the original sixty (60) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which shall result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to such request within sixty (60) days after the date of the request may be construed by the Office as grounds for denial of an application in accordance with the provisions of Section 120.60(1), F.S.~~

(3) through (5) No change.

(6) Examinations/Qualifications Requirements.

(a) No change.

(b) An individual applying to be registered as an investment adviser shall provide the Office with one of the following:

1. No change.

2. Proof of passing, within two years of the date of application for registration, the General Securities Representative Examination (Series 7), the Uniform Combined State Law Examination (Series 66), and proof of passing, within four years of the date of application for registration, the Securities Industry Essentials (SIE) Examination. The following individuals will be considered to have passed the SIE Examination:

a. Individuals whose registration as an associated person ~~a representative~~ was terminated between October 1, 2014, and September 30, 2018, provided they re-register as an associated person ~~a representative~~ within four years from the date of their last registration;

b. Individuals who registered as an associated person ~~representatives~~ prior to October 1, 2018, and who continue to maintain those registrations on or after October 1, 2018.

(c) Grandfathering Provisions:

1. Any individual who is or has been registered as an investment adviser or associated person of an investment adviser ~~representative~~ in any jurisdiction in the United States requiring examinations designated in paragraph (6)(b), within two years of the date of application for registration shall not be required to satisfy the examination requirements for continued registration except that the Office may require additional examinations for any individual found to have violated any state or federal securities law.

2. An individual who obtained registration as an associated person of an investment adviser or a federal covered adviser in any jurisdiction in the United States requiring examinations designated in paragraph (6)(b), by such jurisdiction waiving those examination requirements, shall be required to satisfy the examination requirements of this rule. ~~An individual who has not been registered in any jurisdiction in the United States requiring examinations designated in paragraph (6)(b), as an investment adviser or investment adviser representative within two years of the date of application for registration shall be required to comply with the examination requirements of this rule.~~

(d) No change.

(7) through (8) No change.

(9) Termination of Registration as an Investment Adviser, Agent, or Notification of Branch Office.

(a) through (c) No change.

(d) The forms to be utilized for providing notice to the Office under paragraphs (9)(a) and (9)(b) are:

1. No change.

2. Uniform Termination Notice for Securities Industry Registration (Form U5) (05/09). A sample form is hereby incorporated by reference and is available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06090.~~

3. No change.

(10) through (12) No change.

Rulemaking Authority 517.03(1), 517.12 FS. Law Implemented 517.12 FS. History–New 12-29-15, Amended 11-26-19,__________.

69W-600.0017 Notice-Filing for Federal Covered Advisers.

(1) New Notice-Filings.

(a) No change.

(b) All federal covered advisers making or amending a notice-filing in this state shall file the Form ADV, Part 1, including copies of any amendments filed or required to be filed with the SEC, and the assessment fee required by Section 517.1201(1) or (2), F.S., with the IARD in accordance with subsection (1). Form ADV (09-19 ~~07-17~~) is hereby incorporated by reference, and a sample form is available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11280.~~

(2) Registration of Associated Persons. All federal covered advisers who notice-file in this state and who request initial registration or amendment of an associated person of the federal covered adviser shall file the Uniform Application for Securities Industry Registration or Transfer (Form U4) and the assessment fee required by Section 517.12(10) or (11), F.S., with the CRD in accordance with Rule 69W-600.0024, F.A.C. However, responses to requests by the Office for additional information shall be filed directly with the Office. Form U4 (05/2009) is hereby incorporated by reference and a sample form is available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06089.~~

(3) No change.

(4) Termination of Notification as Investment Adviser or Registration as Agent.

(a) through (b) No change.

(c) The forms to be utilized for providing notice to the Office under paragraphs (4)(a) and (4)(b) above, are:

1. No change.

2. Uniform Termination Notice for Securities Industry Registration (Form U5) (05/09). A sample form is hereby incorporated by reference and is available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06090.~~

Rulemaking Authority 517.03(1), 517.1201 FS. Law Implemented 517.1201 FS. History–New 12-29-15, Amended 11-26-19,____________.

69W-600.0019 Registration of Florida Intrastate Crowdfunding Intermediaries.

(1) No change.

(2) Request for Additional Information. All information required by subsection (1) of this rule, shall be submitted with the original application filing. Any request for additional documents or information shall be made by the Office within thirty (30) days after receipt of the application. ~~The Office may require documentation to be certified by its issuer based upon the Office's review of the nature and substance of the disciplinary history of the applicant and any officer, director, or ultimate owner in the case of a corporation or association, and any partner, co-partner, or member of the partnership in the case of a partnership. For purposes of this rule, "certified" means that there must be an original certification or attestation by the issuer of the record that the document is a true copy of a record contained in its office and its seal, if any.~~ Additional information shall be submitted directly with the Office within sixty (60) days after a request has been made by the Office. The Office shall grant a request for an additional thirty (30) days to submit the additional information. The Office shall not grant a request after the original sixty (60) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which shall result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to such request within sixty (60) days after the date of the request may be construed by the Office as grounds for denial of an application in accordance with the provisions of Section 120.60(1), F.S.~~

(3) through (7) No change.

Rulemaking Authority 517.03(1), 517.12(20), 517.1611 FS. Law Implemented 517.12(20), 517.1611 FS. History–New 12-29-15, Amended _______.

69W-600.002 Application for Registration as Associated Person (FINRA Dealer).

(1) New Applications.

(a) No change.

(b) An application shall include the following:

1. Form U4 (05/2009). A sample form is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06089.~~

2. through 5. No change.

(2) Request for Additional Information. All information required by subsection (1) of this rule, shall be submitted with the original application filing. Any request for additional documents or information shall be made by the Office within thirty (30) days after receipt of the application. ~~The Office may require documentation to be certified by its issuer based upon the Office's review of the nature and substance of the disciplinary history of the applicant. For purposes of this rule, "certified" means that there must be an original certification or attestation by the issuer of the record that the document is a true copy of a record contained in its office and its seal, if any.~~ Additional information shall be submitted directly with the Office within sixty (60) days after a request has been made by the Office. The Office shall grant a request for an additional thirty (30) days to submit the additional information. The Office shall not grant a request after the original sixty (60) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which shall result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to such request within sixty (60) days after the date of the request may be construed by the Office as grounds for denial of an application in accordance with the provisions of Section 120.60(1), F.S.~~

(3) through (5) No change.

(6) Examinations/Qualifications.

(a) No change.

(b) Every applicant for initial registration as a principal or agent of a dealer shall evidence securities general knowledge by:

1. through 3. No change.

4. Submitting to the Office proof of passing, within two years of the date of application for registration, an examination relating to the position to be filled administered by a national securities association and proof of passing, within four years of the date of application for registration, the Securities Industry Essentials (SIE) Examination. The following individuals will be considered to have passed the SIE Examination:

a. Individuals whose registration as an associated person ~~a representative~~ was terminated between October 1, 2014, and September 30, 2018, provided they re-register as an associated person ~~a representative~~ within four years from the date of their last registration;

b. Individuals who registered as an associated person ~~a representative~~ prior to October 1, 2018, and who continue to maintain those registrations on or after October 1, 2018.

(7) through (8) No change.

(9) Termination of Registration of Principal or Agent.

(a) Where a registrant withdraws, cancels, or otherwise terminates registration, or is terminated for any reason, notice of such fact shall be filed with the Office within thirty (30) calendar days of the date of termination by electronically filing a Uniform Termination Notice for Securities Industry Registration (Form U5) (05/2009) with the Office through the CRD. A sample form is hereby incorporated by reference and is available at

http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.
~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06090.~~

(b) No change.

(10) No change.

Rulemaking Authority 517.03(1), 517.12 FS. Law Implemented 517.12 FS. History–New 9-20-82, Formerly 3E-301.02, Amended 10-15-86, 10-4-88, 6-24-90, 7-29-90, 10-14-90, 8-1-91, 6-16-92, 6-28-93, 11-14-93, 3-13-94, 4-30-96, 12-29-96, 6-22-98, 5-10-00, 9-19-00, 7-31-02, 12-11-03, Formerly 3E-600.002, Amended 3-16-06, 5-15-07, 12-24-07, 12-25-08, 11-22-10, 5-29-12, 11-11-13, 12-29-15, 9-25-18, 11-26-19,________.

69W-600.0022 Application for Registration as Associated Person (Non-FINRA Dealer).

(1) New Applications.

(a) No change.

(b) An application shall include the following:

1. Form U4 (05/2009), which is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06089.~~

2. through 5. No change.

(2) Request for Additional Information. All information required by subsection (1) of this rule, shall be submitted with the original application filing. Any request for additional documents or information shall be made by the Office within thirty (30) days after receipt of the application. ~~The Office may require documentation to be certified by its issuer based upon the Office's review of the nature and substance of the disciplinary history of the applicant. For purposes of this rule, "certified" means that there must be an original certification or attestation by the issuer of the record that the document is a true copy of a record contained in its office and its seal, if any.~~ Additional information shall be submitted directly with the Office within sixty (60) days after a request has been made by the Office. The Office shall grant a request for an additional thirty (30) days to submit the additional information. The Office shall not grant a request after the original sixty (60) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which shall result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to such request within sixty (60) days after the date of the request may be construed by the Office as grounds for denial of an application in accordance with the provisions of Section 120.60(1), F.S.~~

(3) through (5) No change.

(6) Examinations/Qualifications.

(a) No change.

(b) Every applicant for initial registration as a principal or agent of a dealer shall evidence securities general knowledge by:

1. through 3. No change.

4. Submitting to the Office proof of passing, within two years of the date of application for registration, an examination relating to the position to be filled administered by a national securities association and proof of passing, within four years of the date of application for registration, the Securities Industry Essentials (SIE) Examination. The following individuals will be considered to have passed the SIE Examination:

a. Individuals whose registration as an associated person ~~a representative~~ was terminated between October 1, 2014, and September 30, 2018, provided they re-register as an associated person ~~a representative~~ within four years from the date of their last registration;

b. Individuals who registered as an associated person ~~representatives~~ prior to October 1, 2018, and who continue to maintain those registrations on or after October 1, 2018.

(7) through (8) No change.

(9) Termination of Registration of Principal or Agent.

(a) Where a registrant withdraws, cancels, or otherwise terminates registration, or is terminated for any reason, notice of such fact shall be filed with the Office within thirty (30) calendar days of the date of termination by electronically filing a Uniform Termination Notice for Securities Industry Registration (Form U5) (05/2009) with the Office through the CRD. A sample form is hereby incorporated by reference and is available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06090.~~

(b) No change.

(10) No change.

Rulemaking Authority 517.03(1), 517.12 FS. Law Implemented 517.12 FS. History–New 12-29-15, Amended 9-25-18, 11-26-19,________.

69W-600.0023 Application for Registration as Associated Person (Issuer/Dealer).

(1) New Applications.

(a) No change.

(b) An application shall include the following:

1. Form U4 (05/2009), which is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06089.~~

2. through 5. No change.

(2) Request for Additional Information. All information required by subsection (1) of this rule, shall be submitted with the original application filing. Any request for additional documents or information shall be made by the Office within thirty (30) days after receipt of the application. ~~The Office may require documentation to be certified by its issuer based upon the Office's review of the nature and substance of the disciplinary history of the applicant. For purposes of this rule, "certified" means that there must be an original certification or attestation by the issuer of the record that the document is a true copy of a record contained in its office and its seal, if any.~~ Additional information shall be submitted directly with the Office within sixty (60) days after a request has been made by the Office. The Office shall grant a request for an additional thirty (30) days to submit the additional information. The Office shall not grant a request after the original sixty (60) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which shall result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to such request within sixty (60) days after the date of the request may be construed by the Office as grounds for denial of an application in accordance with the provisions of Section 120.60(1), F.S.~~

(3) through (5) No change.

(6) Examinations/Qualifications.

(a) No change.

(b) Every applicant for initial registration as a principal or agent of a dealer shall evidence securities general knowledge by:

1. through 4. No change.

5. Submitting to the Office proof of passing, within two years of the date of application for registration, an examination relating to the position to be filled administered by a national securities

association and proof of passing, within four years of the date of application for registration, the Securities Industry Essentials (SIE) Examination. The following individuals will be considered to have passed the SIE Examination:

a. Individuals whose registration as an associated person ~~a representative~~ was terminated between October 1, 2014, and September 30, 2018, provided they re-register as an associated person ~~a representative~~ within four years from the date of their last registration;

b. Individuals who registered as an associated person ~~representatives~~ prior to October 1, 2018, and who continue to maintain those registrations on or after October 1, 2018.

(c) No change.

(7) through (8) No change.

(9) Termination of Registration of Principal or Agent.

(a) Where a registrant withdraws, cancels, or otherwise terminates registration, or is terminated for any reason, notice of such fact shall be filed with the Office within thirty (30) calendar days of the date of termination by electronically filing a Uniform Termination Notice for Securities Industry Registration (Form U5) (05/2009) with the Office through the CRD. A sample form is hereby incorporated by reference and is available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06090.~~

(b) No change.

(10) No change.

Rulemaking Authority 517.03(1), 517.12 FS. Law Implemented 517.12 FS. History–New 12-29-15, Amended 9-25-18, 11-26-19,____________.

69W-600.0024 Application for Registration as Associated Person (Investment Adviser and Federal Covered Adviser).

(1) New Applications.

(a) No change.

(b) An application shall include the following:

1. Form U4 (05/2009). A sample form is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06089.~~

2. through 5. No change.

(2) Request for Additional Information. All information required by subsection (1) of this rule shall be submitted with the original application filing. Any request for additional documents or information shall be made by the Office within thirty (30) days after receipt of the application. ~~The Office may require documentation to be certified by its issuer based upon the Office's review of the nature and substance of the disciplinary history of the applicant. For purposes of this rule, "certified" means that there must be an original certification or attestation by the issuer of the record that the document is a true copy of a record contained in its office and its seal, if any.~~ Additional information shall be submitted directly with the Office within sixty (60) days after a request has been made by the Office. The Office shall grant a request for an additional thirty (30) days to submit the additional information. The Office shall not grant a request after the original sixty (60) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which shall result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to such request within sixty (60) days after the date of the request may be construed by the Office as grounds for denial of an application in accordance with the provisions of Section 120.60(1), F.S.~~

(3) through (5) No change.

(6) Examinations/Qualifications.

(a) No change.

(b) An individual applying to be registered as an associated person of an investment adviser or federal covered adviser shall provide the Office with one of the following:

1. No change.

2. Proof of passing, within two years of the date of application for registration, the General Securities Representative Examination (Series 7), the Uniform Combined State Law Examination (Series 66), and proof of passing within four years of the date of application for registration, the Securities Industry Essentials (SIE) Examination. The following individuals will be considered to have passed the SIE Examination:

a. Individuals whose registration as an associated person ~~a representative~~ was terminated between October 1, 2014, and September 30, 2018, provided they re-register as an associated person ~~a representative~~ within four years from the date of their last registration;

b. Individuals who registered as an associated person ~~representatives~~ prior to October 1, 2018, and who continue to maintain those registrations on or after October 1, 2018.

(c) Grandfathering Provisions:

1. No change.

2. An individual who obtained registration as an associated person of an investment adviser or a federal covered adviser in any jurisdiction in the United States requiring examinations designated in paragraph (6)(b), by such jurisdiction waiving those examination requirements, shall be required to satisfy the examination requirements of this rule. ~~An individual who has not been registered in any jurisdiction in the United States requiring examinations designated in paragraph (6)(b), as an associated person of an investment adviser or federal covered adviser within two years of the date of application for registration shall be required to comply with the examination requirements of this rule.~~

(d) No change.

(7) through (8) No change.

(9) Termination of Registration of Principal or Agent.

(a) Where a registrant withdraws, cancels, or otherwise terminates registration or is terminated for any reason, notice of such fact shall be filed with the Office within thirty (30) calendar days of the date of termination by electronically filing a Uniform Termination Notice for Securities Industry Registration (Form U5) (05/2009) with the Office through the CRD. A sample form is hereby incorporated by reference and is available at
http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.
~~http://www.flrules.org/Gateway/reference.asp?No=Ref-06090.~~

(b) No change.

(10) No change.

Rulemaking Authority 517.03(1), 517.12 FS. Law Implemented 517.12 FS. History–New 12-29-15, Amended 9-25-18, 11-26-19,________.

69W-600.013 Prohibited Business Practices for Dealers and Their Associated Persons.

(1) The following are deemed demonstrations of unworthiness by a dealer under Section 517.161(1)(h), F.S., without limiting that term to the practices specified herein:

(a) through (g) No change.

(h) With respect to any customer, transaction or business in this state, violating any of the following:

1. Financial Industry Regulatory Authority (FINRA) rules contained in the Rule 2000 Series (Duties and Conflicts), Rule 3000 Series (Supervision and Responsibilities Relating to Associated Persons), Rule 4000 Series (Financial and Operational Rules), Rule 5000 Series (Securities Offering and Trading Standards and Practices), Rule 6000 Series (Quotation and Transaction Reporting Facilities), Rule 7000 Series (Clearing, Transaction and Order Data Requirements, and Facility Charges), or Rule 11000 Series (Uniform Practice Code)~~; or National Association of Securities Dealers (NASD) Conduct Rules contained in Rule 2340 or 2510 (Business Conduct), or Rule 3140, 3150, or IM-3150 (Responsibilities Relating to Associated Persons, Employees, and Others' Employees)~~. The foregoing rules are incorporated by reference in Rule 69W-200.002, F.A.C.

2. through 6. No change.

7. To the extent that any of the rules described in subparagraphs 1. through 6. of this section or their interpretation by the FINRA, ~~NASD,~~ NYSE, MSRB, or SEC, as appropriate, conflict or are inconsistent with other provisions of the Florida Securities and Investor Protection Act or rules promulgated pursuant thereto, this paragraph of this rule shall not be deemed controlling.

(i) through (o) No change.

(p) Failing to deliver a current Form CRS to any retail investor in violation of SEC Rule 17a-14 (17 C.F.R. §240.17a-14), which is incorporated by reference in Rule 69W-200.002, F.A.C.

(2) No change.

Rulemaking Authority 517.03(1), 517.1217 FS. Law Implemented 517.081, 517.1217, 517.161(1) FS. History–New 12-5-79, Amended 9-20-82, Formerly 3E-600.13, Amended 8-1-91, 6-16-92, 1-11-93, 11-7-93, 5-5-94, 9-9-96, 10-20-97, 1-25-00, 10-30-03, Formerly 3E-600.013, Amended 10-23-06, 1-18-09, 11-22-10, 9-22-14, 11-15-16, 11-26-19,__________.

69W-600.0131 Prohibited Business Practices for Investment Advisers and Their Associated Persons.

(1) The following are prohibited business practices for investment advisers and associated persons pursuant to Section 517.1215(2), F.S., and are deemed demonstrations of unworthiness by an investment adviser or an associated person of an investment adviser under Section 517.161(1)(h), F.S., without limiting that term to the practices specified herein:

(a) through (q) No change.

(r) Entering into, extending or renewing any investment advisory contract contrary to the provisions of Section 205 of the Investment Advisers Act of 1940, 15 U.S.C. §80b-5. This provision shall apply to all advisers and associated persons of investment advisers ~~representatives~~ registered or required to be registered under this Act, notwithstanding whether such adviser or associated person ~~representative~~ would be exempt from federal registration pursuant to Section 203(b) of the Investment Advisers Act of 1940, (15 U.S.C. §80b-3(b)), which is incorporated by reference in Rule 69W-200.002, F.A.C.

(s) through (x) No change.

(2) The federal statutory and regulatory provisions referenced herein shall apply to investment advisers, associated persons of investment advisers ~~representatives~~ and federal covered advisers, to the extent permitted by the National Securities Markets Improvement Act of 1996 (Pub. L. 104-290), which is incorporated by reference in Rule 69W-200.002, F.A.C.

Rulemaking Authority 517.03(1), 517.1215 FS. Law Implemented 517.12(4), 517.1215, 517.161(1) FS. History–New 1-25-00, Amended 10-30-03, Formerly 3E-600.0131, Amended 10-23-06, 1-18-09, 11-22-10, 9-22-14, 5-6-15, 11-15-16, 11-26-19,__________.

69W-600.0132 Custody Requirements for Investment Advisers.

(1) No change.

(2) Safekeeping required. If the investment adviser is registered or required to be registered, it is unlawful for the investment adviser to have custody of client funds or securities unless the following requirements in paragraphs (2)(a)-(i) are met:

(a) Notice to Office. The investment adviser notifies the Office of Financial Regulation (Office) within thirty (30) days in writing that the investment adviser has or may have custody. Such notification is required to be given on Form ADV, Uniform Application for Investment Adviser Registration (09-19 ~~07-17~~), which is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11280.~~

(b) through (h) No change.

(i) Direct Fee Deduction. An investment adviser who has custody as defined in sub-subparagraph (1)(a)1.b. of this rule, as a consequence of its authority to make withdrawals from client accounts to pay its advisory fee must also provide the following safeguards:

1. through 2. No change.

3. The investment adviser must notify the Office in writing that the investment adviser intends to use the safeguards provided above. Such notification is required to be given on Form ADV, Uniform Application for Investment Adviser Registration (09-19 ~~07-17~~), which is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11280.~~

(3) Exceptions to certain safekeeping requirements.

(a) No change.

(b) Certain privately offered securities.

1. No change.

2. Notwithstanding subparagraph (3)(b)1. of this rule, the provisions of paragraph (3)(b) of this rule are available with respect to securities held for the account of a limited partnership (or limited liability company, or other type of pooled investment vehicle) only if the limited partnership is audited, the audited financial statements are distributed, as described in paragraph (3)(d) of this rule, and the investment adviser notifies the Office in writing that the investment adviser intends to provide audited financial statements, as described above. Such notification is required to be given on Form ADV, Uniform Application for Investment Adviser Registration (09-19 ~~07-17~~), which is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11280.~~

(c) No change.

(d) Limited partnerships subject to annual audit. An investment adviser is not required to comply with paragraphs (2)(c) and (2)(d), and shall be deemed to have complied with paragraph (2)(f) of this rule, with respect to the account of a limited partnership (or limited liability company, or any other type of pooled investment vehicle) if each of the following conditions in subparagraphs 1. through 6. are met:

1. through 5. No change.

6. The investment adviser must also notify the Office in writing that the investment adviser intends to employ the use of the statement delivery and audit safeguards described above. Such notification is required to be given on Form ADV, Uniform Application for Investment Adviser Registration (09-19 ~~07-17~~), which is hereby incorporated by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-11280.~~

7. No change.

(e) Investment Adviser as Trustee. When a trust retains an investment adviser, associated person of an investment adviser ~~representative~~ or employee, director or owner of an investment adviser as trustee and the investment adviser acts as the investment adviser to that trust, an investment adviser is not required to obtain an independent verification of client funds and securities maintained by a qualified custodian under paragraph (2)(f) of this rule, if the investment adviser instructs the qualified custodian of the trust as follows in subparagraphs 1. through 3.:

1. Payment of fees. The qualified custodian will not deliver trust securities to the investment adviser, any associated person of the investment adviser ~~representative~~ or employee, director or owner of the investment adviser, nor will the investment adviser instruct the qualified custodian to transmit any funds to the investment adviser, any associated person of the investment adviser ~~representative~~ or employee, director or owner of the investment adviser, except that the qualified custodian may pay trustees' fees to the trustee and investment management or advisory fees to investment adviser, provided that:

a. The grantor of the trust or attorneys for the trust, if it is a testamentary trust, the co-trustee (other than the investment adviser, associated person of the investment adviser ~~representative~~ or employee, director or owner of the investment adviser), or a defined beneficiary of the trust has authorized the qualified custodian in writing to pay those fees,

b. No change.

c. The qualified custodian agrees to send to the grantor of the trust, the attorneys for a testamentary trust, the co-trustee (other than the investment adviser, associated person of the investment adviser ~~representative~~ or employee, director or owner of the investment adviser), or a defined beneficiary of the trust, at least quarterly, a statement of all disbursements from the account of the trust, including the amount of investment management fees paid to the investment adviser and the amount of trustees' fees paid to the trustee.

2. Distribution of Assets. Except as otherwise set forth in sub-subparagraph a. below, the qualified custodian may transfer funds or securities, or both, of the trust only upon the direction of the trustee. The grantor of the trust or attorneys for the trust, if it is a testamentary trust, the co-trustee (other than the investment adviser, associated person of the investment adviser ~~representative~~ or employee, director or owner of the investment adviser), or a defined beneficiary of the trust, must designate the authorized signatory for management of the trust. The direction to transfer funds or securities, or both, can only be made to the following:

a. through e. No change.

3. Statements. If the qualified custodian agrees to these instructions and is authorized to pay the fees, the investment adviser will send to the grantor of the trust, the attorney of the trust if it is a testamentary trust, the co-trustee (other than the investment adviser, associated person of the investment adviser ~~representative~~ or employee, director or owner of the investment adviser), or a defined beneficiary of the trust, at the same time that it sends any statement to the qualified custodian, a statement showing the amount of the trustees' fees or investment management or advisory fee, the value of the assets on which the fees were based, and the specific manner in which the fees were calculated.

4. No change.

(f) Beneficial Trusts. The investment adviser is not required to comply with safekeeping requirements of subsection (2) of this rule, if the investment adviser has custody solely because the investment adviser, associated person of the investment adviser ~~representative~~ or employee, director or owner of the investment adviser is the trustee for a beneficial trust, and if all of the following conditions in subparagraphs 1. and 2., are met for each trust:

1. through 3. No change.

(g) No change.
(4) No change.

Rulemaking Authority 517.03(1), 517.1215 FS. Law Implemented 517.1215 FS. History–New 10-23-06, Amended 11-22-10, 9-22-14, 5-6-15, 11-26-19,__________.

69W-600.014 Books and Records Requirements.

Except as otherwise provided herein, every dealer, investment adviser, branch office, and associated person conducting business in this state shall prepare and maintain on a current basis, and preserve for the periods of time specified, such records, prescribed herein, as are appropriate for said dealer's, investment adviser's, branch office's, or associated person's course of business, and are sufficient to provide an audit trail of all business transactions by said dealer, investment adviser, associated person, or branch office. Associated persons who conduct business from a branch office notice-filed in this state shall be exempt from the provisions of this rule.

(1) All dealers are required to prepare and maintain appropriate books and records relating to their business as described in SEC Rules 17a-3 or 17a, (17 C.F.R. §§240.17a-3, 240.17a-4), section 248.30 of Regulation S-P (17 C.F.R. §248.30), and MSRB Rules G-7, G-8 and G-9; and records evidencing compliance with ~~NASD Rules 3140, 3150, and IM-3150 and~~ Financial Industry Regulatory Authority (FINRA) Rule 1020 and FINRA rules contained in the Rule 2000 Series (Duties and Conflicts), Rule 3000 Series (Supervision and Responsibilities Relating to Associated Persons), Rule 4000 Series (Financial and Operational Rules), and Rule 5000 Series (Securities Offering and Trading Standards and Practices). The foregoing rules are incorporated by reference in Rule 69W-200.002, F.A.C.

(2) No change.

(3) All investment advisers, notwithstanding the fact that the investment adviser is not registered or required to be registered under the Investment Advisers Act of 1940, shall prepare and maintain true, accurate and current records relating to their business as described in SEC Rule 204-2, (17 C.F.R. §275.204-2), which is incorporated by reference in Rule 69W-200.002, F.A.C.~~;~~ Notwithstanding SEC Rule 204-2, (17 C.F.R. §275.204-2), investment adviser records requirements do not include Form CRS. Investment advisers shall ~~and~~ have available for the Office of Financial Regulation at least the following records:

(a) through (g) No change.

(h) A file containing a copy of all communications received or sent regarding any litigation involving the investment adviser or any associated person of the investment adviser ~~representative~~ or employee, and regarding any customer or client complaint.

(i) No change.

(j) Written procedures to supervise the activities of employees and associated persons of the investment adviser ~~representative~~ that are reasonably designed to achieve compliance with applicable securities laws and regulations.

(k) A file containing a copy of each document, other than any notices of general dissemination, that was filed with or received from any state or federal agency or self regulatory organization and that pertains to the registrant or its associated persons ~~investment adviser representatives~~. Such file should contain, but is not limited to, all applications, amendments, renewal filings, and correspondence.

(l) No change.

(4) Notwithstanding other record preservation requirements of this rule, the following records or copies shall be required to be maintained in the business location of the investment adviser from

which the customer or client is being provided or has been provided with investment advisory services:

(a) No change.

(b) Records or copies required under the provision of paragraphs (a)(11) and (a)(16) of SEC Rule 204-2 of the Investment Advisers Act of 1940 (17 C.F.R. §275.204-2), which records or related records identify the name of the associated person of the investment adviser ~~representative~~ providing investment advice from that business location, or which identify the business location's physical address, mailing address, electronic mailing address, or telephone number.

(5) through (6) No change.

(7) All books and records described in this rule shall be preserved in accordance with the following:

(a) through (d) No change.

(e) Each investment adviser registered or required to be registered in this state and which has a business location in this state shall maintain at such business location:

1. No change.

2. The records or copies required under the provisions of paragraphs (3)(a)-(k), above, related to customers or clients for whom the associated person of the investment adviser ~~representative~~ provides or has provided investment advisory services; and~~,~~

3. The records or copies required under the provisions of paragraphs (a)(11) and (a)(16) of SEC Rule 204-2, (17 C.F.R. §275.204-2), which records or related records identify the name of the associated person of the investment adviser ~~representative~~ or which identify the business location's physical address, mailing address, electronic mailing address, or telephone number. The records will be maintained for the period described in subsections (d) and (e), of SEC Rule 204-2, (17 C.F.R. §275.204-2). The investment adviser shall be responsible for ensuring compliance with the provision of this subsection. SEC Rule 204-2, (17 C.F.R. §275-204-2).

(8) No change.

Rulemaking Authority 517.03(1), 517.121(1), 517.1215 FS. Law Implemented 517.121(1), 517.1215 FS. History–New 12-5-79, Amended 9-20-82, Formerly 3E-600.14, Amended 10-14-90, 8-1-91, 6-16-92, 1-11-93, 9-9-96, 6-22-98, 1-25-00, 10-30-03, Formerly 3E-600.014, Amended 10-23-06, 5-15-07, 11-22-10, 11-11-13, 9-22-14, 5-6-15, 11-15-16, 11-26-19,____________.

69W-700.001 Registration of Securities.

(1) No change.

(2) Request for Additional Information. All information required by subsection (1) of this rule, shall be submitted with the original application filing. The required exhibits in the application forms are not intended to limit the applicant's presentation of any of the requirements, but merely represent the minimum information to be filed. Any request for additional documents or information shall be made by the Office within thirty (30) days after receipt of the application. Additional information shall be submitted directly with the Office within sixty (60) days after a request has been made by the Office. The Office shall grant a request for an additional thirty (30) days to submit the additional information. The Office shall not grant a request after the original sixty (60) day deadline has passed. Failure to provide timely all additional information shall result in the application being deemed abandoned, which shall result in the application being removed from further consideration by the Office and closed. ~~Failure to respond to such request within sixty (60) days after the date of the request may be construed by the Office as grounds for denial of an application in accordance with the provisions of Section 120.60(1), F.S.~~

(3) No change.

Rulemaking Authority 517.03 FS. Law Implemented 517.07, 517.081, 517.101 FS. History–New 9-20-82, Formerly 3E-20.011, 3E-700.01, Amended 7-31-91, Formerly 3E-700.001, Amended 9-22-14, 12-29-15, 11-25-19,__________.

69W-1000.001 Disciplinary Guidelines.

(1) Pursuant to section 517.1611, F.S., disciplinary guidelines applicable to each ground for which disciplinary action may be imposed by the Office against an individual or a firm under chapter 517, F.S., are hereby adopted. The disciplinary guidelines are contained in the Office of Financial Regulation Disciplinary Guidelines for chapter 517, Florida Statutes (F.S.) and Division 69W, Florida Administrative Code (F.A.C.) (effective XX-20 ~~10-16~~), which is hereby incorporated by reference. A copy of the disciplinary guidelines may be obtained by mail from the Florida Office of Financial Regulation, Division of Securities, 200 E. Gaines Street, Tallahassee, Florida 32399, or may be obtained electronically through the following website: http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~http://www.flrules.org/Gateway/reference.asp?No=Ref-07396.~~

(2) through (9) No change.

Rulemaking Authority 517.1611(1) FS. Law Implemented 517.111, 517.121, 517.161, 517.1202, 517.1611(1), 517.191(4), 517.221(3), (4) FS. History–New 11-22-10, Amended 11-14-13, 5-6-15, 11-15-16, 12-10-19,_________.

Material Incorporated by Reference:

A copy of the incorporated material is provided as an attachment.

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
1	Securities Registration	517.07	Registration of Securities	Notice of Non-Compliance, Fine B to Fine C, Restriction, Suspension A to Suspension C	Fine B to Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
2	Dealer/Adviser/Agent Registration	517.12	Registration of Dealers, Associated Persons, and Branch Offices	Notice of Non-Compliance, Fine A to Fine C, Restriction, Suspension A to Suspension C	Fine A to Fine C, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
3	Dealer/Adviser Branch Office Notification	517.1202	Branch Office Notice Filing	Fine C to Fine D and Summary Suspension of Branch, Revocation	$10,000 Fine and Summary Suspension of Branch, Revocation	$10,000 Fine and Summary Suspension of Branch, Revocation
4	Dealer/Adviser/Agent/ Branch Office Books and Records	517.121(3)	Books and Records Requirements; Examinations	Summary Suspension	Summary Suspension	Summary Suspension
5	Dealer/Adviser/Agent Registration	517.161	Revocation, Denial, or Suspension of Registration of Dealer, Investment Adviser, Associated Person, or Branch Office	Denial, Restriction, Suspension, Summary Suspension, Revocation, Bar	Denial, Restriction, Suspension, Summary Suspension, Revocation, Bar	Denial, Restriction, Suspension, Summary Suspension, Revocation, Bar
6	Anti-Fraud	517.275	Commodities; Prohibited Practices	Restriction, Fine A to Fine D, Suspension A to Suspension C, Revocation, Bar	Restriction, Fine A to Fine D, Suspension A to Suspension C, Revocation, Bar	Restriction, Fine A to Fine D, Suspension A to Suspension C, Revocation, Bar
7	Anti-Fraud	517.301	Fraudulent Transactions; Falsification or Concealment of Facts	Fine D, Revocation, Bar	Fine D, Revocation, Bar	Fine D, Revocation, Bar
8	Anti-Fraud	517.311	False Representations; Deceptive Words; Enforcement.	Fine D, Revocation, Bar	Fine D, Revocation, Bar	Fine D, Revocation, Bar
9	Anti-Fraud	517.312	Securities, Investments, Boiler Rooms; Prohibited Practices; Remedies.	Fine D, Revocation, Bar	Fine D, Revocation, Bar	Fine D, Revocation, Bar
10	Issuers	69W-100.006	Projected Financial Statements or Presentations	Notice of Non-Compliance, Fine A to Fine B, Restriction	Fine A to Fine B, Restriction	Fine A to Fine C, Restriction

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
11	Issuers	69W-100.007	Advertising and Sales Literature	Notice of Non-Compliance, Fine A	Fine A to Fine B, Restriction, Suspension A	Fine A to Fine C, Restriction, Suspension B
12	Dealer Registration	69W-600.001	Application for Registration as a Dealer (FINRA)	Notice of Non-Compliance, Fine A to Fine B, Restriction, Suspension B to C	Fine B to Fine D, Restriction, Suspension B to C, Revocation	Fine C to Fine D, Restriction, Suspension B to C, Revocation
13	Dealer Registration	69W-600.0012	Application for Registration as a Dealer (non-FINRA)	Notice of Non-Compliance, Fine A to Fine B, Restriction, Suspension B to C	Fine B to Fine D, Restriction, Suspension B to C, Revocation	Fine C to Fine D, Restriction, Suspension B to C, Revocation
14	Issuer/Dealer Registration	69W-600.0013	Application for Registration as an Issuer/Dealer	Notice of Non-Compliance, Fine A to B, Suspension A to Suspension C, Revocation	Fine B, Suspension A to Suspension C, Revocation	Fine B, Suspension B to Suspension C, Revocation
15	Dealer Registration	69W-600.0015	Canadian Dealer Notice-Filing	Notice of Non-Compliance, Fine A to B, Suspension A to Suspension C, Revocation	Fine B, Suspension A to Suspension C, Revocation	Fine B, Suspension B to Suspension C, Revocation
16	Adviser Registration	69W-600.0016	Application for Registration as an Investment Adviser (State Registered)	Notice of Non-Compliance, Fine A to Fine B, Restriction, Suspension B to C	Fine B to Fine D, Restriction, Suspension B to C, Revocation	Fine C to Fine D, Restriction, Suspension B to C, Revocation
17	Adviser Registration	69W-600.0017	Notice-Filing for Federal Covered Advisers	Notice of Non-Compliance, Fine A to Fine B, Restriction, Suspension B to C	Fine B to Fine D, Restriction, Suspension B to C, Revocation	Fine C to Fine D, Restriction, Suspension B to C, Revocation
18	Dealer Agent Registration	69W-600.002	Application for Registration as an Associated Person (FINRA Dealer)	Notice of Non-Compliance, Fine A to Fine B, Restriction, Suspension B to C	Fine B to Fine D, Restriction, Suspension B to C, Revocation	Fine C to Fine D, Restriction, Suspension B to C, Revocation
19	Dealer/Agent Registration	69W-600.002(11)	Continuing Education Requirements	Fine A to Fine B, Suspension A to Suspension C	Fine B to Fine C, Suspension B to Suspension C	Fine C to Fine D, Suspension B to Suspension C
20	Dealer Agent Registration	69W-600.0022	Application for Registration as an Associated Person (Non-FINRA Dealer)	Notice of Non-Compliance, Fine A to Fine B, Restriction, Suspension B to C	Fine B to Fine D, Restriction, Suspension B to C, Revocation	Fine C to Fine D, Restriction, Suspension B to C, Revocation

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
21	Dealer Agent Registration	69W-600.0023	Application for Registration as an Associated Person (Issuer/Dealer)	Notice of Non-Compliance, Fine A to Fine B, Restriction, Suspension B to C	Fine B to Fine D, Restriction, Suspension B to C, Revocation	Fine C to Fine D, Restriction, Suspension B to C, Revocation
22	Adviser Agent Registration	69W-600.0024	Application for Registration as an Associated Person (Investment Adviser)	Notice of Non-Compliance, Fine A to Fine B, Restriction, Suspension B to C	Fine B to Fine D, Restriction, Suspension B to C, Revocation	Fine C to Fine D, Restriction, Suspension B to C, Revocation
23	Dealer Branch Office Registration	69W-600.0031	Notice-Filing of Branch Office (FINRA Dealer)	Fine C to Fine D and Summary Suspension of Branch, Revocation	$10,000 Fine and Summary Suspension of Branch, Revocation	$10,000 Fine and Summary Suspension of Branch, Revocation
24	Dealer Branch Office Registration	69W-600.0032	Notice-Filing of Branch Office (Non-FINRA Dealer)	Fine C to Fine D and Summary Suspension of Branch, Revocation	$10,000 Fine and Summary Suspension of Branch, Revocation	$10,000 Fine and Summary Suspension of Branch, Revocation
25	Dealer Branch Office Registration	69W-600.0033	Notice Filing of Branch Office (Issuer/Dealer)	Fine C to Fine D and Summary Suspension of Branch, Revocation	$10,000 Fine and Summary Suspension of Branch, Revocation	$10,000 Fine and Summary Suspension of Branch, Revocation
26	Adviser Branch Office Registration	69W-600.0034	Notice-Filing of Branch Office (Investment Adviser)	Fine C to Fine D and Summary Suspension of Branch, Revocation	$10,000 Fine and Summary Suspension of Branch, Revocation	$10,000 Fine and Summary Suspension of Branch, Revocation
27	Dealer/Issuer Rules of Conduct	69W-600.012(1)	Confirmation of Transactions	Notice of Non-Compliance, Fine A to Fine B	Fine A to Fine B, Restriction, Suspension A to Suspension B	Fine A to Fine C, Restriction, Suspension A to Suspension C, Revocation
28	Dealer Rules of Conduct	69W-600.012(2)	Customer Contracts - Prohibitions	Notice of Non-Compliance, Fine A to Fine C	Fine A to Fine C, Restriction, Suspension A to Suspension B	Fine A to Fine C, Restriction, Suspension A to Suspension C, Revocation
29	Dealer/Adviser Rules of Conduct	69W-600.012(3)	Withdrawal of Net Worth	Fine A to Fine C, Suspension A to Suspension B	Fine B to Fine C, Suspension A to Suspension C	Fine B to Fine C, Suspension A to Suspension C, Revocation
30	Dealer/Adviser Rules of Conduct	69W-600.012(4)	Copies of Contracts to be Provided to Customers	Notice of Non-Compliance, Fine A to Fine C, Suspension A to Suspension B	Fine B to Fine C, Suspension A to Suspension C	Fine B to Fine C, Suspension A to Suspension C, Revocation

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
31	Dealer/Agent Rules of Conduct	69W-600.012(5)	Anti-Fraud	Fine D, Revocation, Bar	Fine D, Revocation, Bar	Fine D, Revocation, Bar
32	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(a)	Extension of Credit	Notice of Non-Compliance, Fine B to Fine C	Fine B to Fine D, Suspension A to Suspension B, Revocation	Fine C to Fine D, Suspension B to Suspension C, Revocation, Bar
33	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(b)	Margin Agreement	Notice of Non-Compliance, Fine B to Fine C	Fine B to Fine D, Suspension A to Suspension B, Restriction	Fine C to Fine D, Suspension B to Suspension C, Revocation, Bar
34	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(c)	Segregation of Securities	Notice of Non-Compliance, Fine B to Fine C	Fine B to Fine D, Suspension A to Suspension B	Fine C to Fine D, Suspension B to Suspension C, Revocation
35	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(d)	Hypothecating of Securities	Notice of Non-Compliance, Fine B to Fine D	Fine C to Fine D, Suspension B to Suspension C, Restriction	Fine D, Suspension C, Revocation
36	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(e)	Failing to Execute an Order	Notice of Non-Compliance, Fine B to Fine D, Restriction	Fine B to Fine D, Suspension A to Suspension C, Restriction	Fine D, Suspension A to Suspension C, Revocation, Bar
37	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(f)	Unregistered Securities	Notice of Non-Compliance, Fine B to Fine C, Restriction, Suspension A to Suspension C	Fine B to Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
38	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(g)	Representation of Qualifications	Notice of Non-Compliance, Fine C to Fine D, Suspension A to Suspension B, Restriction	Fine C to Fine D, Suspension B to Suspension C, Restriction, Revocation	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
39	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2010	Standards of Commercial Honor and Principles of Trade	Notice of Non-Compliance, Fine B to Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine D, Restriction, Suspension C, Revocation, Bar	Fine D, Revocation, Bar
40	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2020	Use of Manipulative, Deceptive or Other Fraudulent Devices	Fine D, Suspension C, Revocation, Bar	Fine D, Revocation, Bar	Fine D, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
41	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2040	Payments to Unregistered Persons	Fine D, Restriction, Suspension A to Suspension B	Fine D, Restriction, Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar
42	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 1020 and FINRA Rule Series 2000-5000	Books and Records	Notice of Non-Compliance, Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar
43	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2081	Prohibited Conditions Relating to Expungement of Customer Dispute	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation	Fine D, Revocation, Bar
44	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2090	Know Your Customer	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation	Fine D, Revocation, Bar
45	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2111	Recommendations to Customers (Suitability)	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation	Fine D, Revocation, Bar
46	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2114(a)	Recommendations to Customers in OTC Equity Securities	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation	Fine D, Revocation, Bar
47	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2114(c)	Recommendations to Customers in OTC Equity Securities	Notice of Non-Compliance, Fine C to Fine D, Restriction	Fine C to Fine D, Restriction, Suspension A	Fine D, Suspension C,
48	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2114(d)	Recommendations to Customers in OTC Equity Securities	Fine B to Fine C, Restriction, Suspension A	Fine C to Fine D, Restriction, Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar
49	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2121	Fair Prices and Commissions	Fine B to Fine D, Restriction, Suspension A to C, Revocation, Bar	Fine D, Restriction, Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
50	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2122	Charges for Services Performed	Notice of Non-Compliance, Fine B to Fine C, Restriction, Suspension A	Fine B to Fine D, Restriction, Suspension B	Fine C to Fine D, Suspension C, Revocation, Bar
51	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2124	Net Transactions with Customers	Fine C to Fine D, Restriction	Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar
52	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2130	Approval Procedures for Day-Trading Accounts	Notice of Non-Compliance, Fine B to Fine C, Restriction	Fine C to Fine D, Suspension A to B	Fine C to Fine D, Suspension B to C
53	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2140	Interfering With the Transfer of Customer Accounts in the Context of Employment Disputes	Notice of Non-Compliance, Fine B to Fine C	Fine C to Fine D	Fine D, Suspension A to Suspension B
54	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2150(a)	Improper Use of Customers' Securities or Funds; Prohibition Against Guarantees and Sharing in Accounts	Fine D, Restriction, Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
55	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2150(b)	Improper Use of Customers' Securities or Funds; Prohibition Against Guarantees and Sharing in Accounts	Fine C to Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
56	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2150(c)	Improper Use of Customers' Securities or Funds; Prohibition Against Guarantees and Sharing in Accounts	Fine C, Restriction, Suspension B to Suspension C	Fine D, Restriction, Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar
57	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2210(b), (c)	Communications with the Public	Notice of Non-Compliance, Fine A to Fine C, Restriction	Fine A to Fine C, Restriction	Fine C to Fine D, Suspension A to Suspension B
58	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2210(d), (e), (f)	Communications with the Public	Notice of Non-Compliance, Fine B to Fine C, Suspension A to Suspension B, Restriction	Fine B to Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar
59	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2212	Use of Investment Companies Rankings in Retail Communications	Notice of Non-Compliance, Fine B to Fine C, Suspension A to Suspension B, Restriction	Fine B to Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar

Violation #	Violatio n	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
60	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2220(b), (c)	Options Communication	Fine B to Fine C, Restriction	Fine C to Fine D, Restriction, Suspension B to Suspension C	Fine D, Suspension C
61	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2220(d)	Options Communication	Notice of Non-Compliance, Fine B to Fine C, Suspension A to Suspension B, Restriction	Fine B to Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar
62	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2231	Customer Account Statements	Notice of Non-Compliance, Fine A to Fine B	Fine A to Fine C, Suspension A	Fine C to Fine D, Suspension B to Suspension C
63	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2241	Research Analysts and Research Reports	Notice of Non-Compliance, Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine D, Restriction, Suspension C, Revocation, Bar
64	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2242	Debt Research Analysts and Debt Research Reports	Notice of Non-Compliance, Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine D, Restriction, Suspension C, Revocation, Bar
65	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2251	Forwarding of Proxy and Other Materials	Notice of Non-Compliance, Fine A to Fine	Fine B to Fine C	Fine C to Fine D
66	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2262	Disclosure of Control Relationship with Issuer	Fine D, Restriction, Suspension B to Suspension C,	Fine D, Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
67	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h)) FINRA Rule 2264	Margin Disclosure Statement	Fine B to Fine C, Restriction	Fine D, Restriction, Suspension A to Suspension B	Fine D, Suspension C, Revocation, Bar
68	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2265	Extended Hours Trading Risk Disclosure	Notice of Non-Compliance, Fine B to Fine	Fine B to Fine D, Restriction	Fine C to Fine D, Suspension B to Suspension C
69	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2266	SIPC Information	Notice of Non-Compliance, Fine A	Fine A	Fine B
70	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2267	Investor Education and Protection	Notice of Non-Compliance, Fine A	Fine A	Fine B

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
71	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2269	Disclosure of Participation or Interest in Primary or Secondary Distribution	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
72	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2272	Sales and Offers of Sales of Securities on Military Installations	Notice of Non-Compliance, Fine B to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation	Fine D, Revocation, Bar
73	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2273	Educational Communication Related to Recruitment Practices and Account Transfers	Notice of Non-Compliance, Fine A to Fine C, Restriction	Fine A to Fine C, Restriction	Fine C to Fine D, Suspension A to Suspension B
74	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2310(b)	Direct Participation Programs	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation	Fine D, Revocation, Bar
75	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2310(c)	Direct Participation Programs	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar
76	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2320	Variable Contracts of an Insurance Company	Notice of Non-Compliance, Fine C to Fine D, Restriction, Suspension A to Suspension C	Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine D, Suspension C, Revocation
77	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2330	Members' Responsibilities Regarding Deferred Variable Annuities	Notice of Non-Compliance, Fine C to Fine D, Restriction, Suspension A to Suspension C	Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine D, Suspension C, Revocation
78	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2341	Investment Company Securities	Fine C to Fine D, Restriction, Suspension A	Fine D, Restriction, Suspension A to Suspension C	Fine D, Suspension C, Revocation, Bar
79	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2342	"Breakpoint" Sales	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation	Fine D, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
80	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2352	Account Approval - Trading in Index Warrants, Currency Index Warrants and Currency Warrants	Notice of Non-Compliance, Fine B to Fine C	Fine B to Fine D, Restriction, Suspension A	Fine C to Fine D, Suspension A to Suspension C
81	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2353	Suitability - Trading in Index Warrants, Currency Index Warrants and Currency Warrants	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation	Fine D, Revocation, Bar
82	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2354	Discretionary Accounts - Trading in Index Warrants, Currency Index Warrants and Currency Warrants	Notice of Non-Compliance, Fine B to Fine C, Restriction	Fine B to D, Restriction, Suspension B	Fine D, Suspension C, Revocation
83	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2355	Supervision of Accounts - Trading in Index Warrants, Currency Index Warrants and Currency Warrants	Notice of Non-Compliance, Fine B to Fine D, Restriction	Fine B to Fine D, Restriction	Fine C to Fine D, Suspension A, Restriction
84	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2357	Communications with the Public and Customers Concerning Index Warrants, Currency Index Warrants and Currency Warrants	Notice of Non-Compliance, Fine B to Fine C, Restriction	Fine C to Fine D, Restriction, Suspension B to Suspension C	Fine D, Suspension C
85	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2358	Maintenance of Records - Trading in Index Warrants, Currency Index Warrants and Currency Warrants	Notice of Non-Compliance, Fine A to Fine B	Fine A to Fine C, Restriction	Fine C to Fine D, Suspension A to Suspension C
86	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2359	Position and Exercise Limits; Liquidations - Trading in Index Warrants, Currency Index Warrants and Currency Warrants	Fine C to Fine D, Restriction	Fine D, Restriction, Suspension B to Suspension C	Fine D, Suspension C, Revocation, Bar
87	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2360	Options	Notice of Non-Compliance, Fine B to Fine D, Restriction, Suspension A to Suspension B	Fine B to D, Restriction, Suspension B	Fine D, Suspension C, Revocation
88	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 2370(b)	Security Futures	Notice of Non-Compliance, Fine B to Fine C, Restriction	Fine B to D, Restriction, Suspension A to Suspension B	Fine D, Suspension B to Suspension C, Revocation
89	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3110	Supervision	Notice of Non-Compliance Fine C to Fine D, Restriction,	Fine D, Restriction, Suspension A to Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
				Suspension A to Suspension C, Revocation		
90	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3120	Supervisory Control System	Notice of Non-Compliance, Fine D, Restriction	Fine D, Restriction, Suspension A to Suspension B	Fine D, Suspension C, Restriction, Revocation, Bar
91	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h), FINRA Rule 3130	Annual Certification of Compliance and Supervisory Processes	Notice of Non-Compliance, Fine C to Fine D, Restriction	Fine C to Fine D, Restriction, Suspension A to Suspension B	Fine D, Suspension B to Suspension C, Restriction
92	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3160(a)	Broker/Dealer Conduct on the Premises of Financial Institutions	Notice of Non-Compliance, Fine B to Fine C, Restriction	Fine B to Fine D, Restriction, Suspension A	Fine D, Suspension C, Revocation, Bar
93	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3170	Tape Recording of Registered Persons by Certain Firms	Notice of Non-Compliance, Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension A to Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
94	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3210	Accounts at Other Broker-Dealers and Financial Institutions	Notice of Non-Compliance, Fine A to Fine C, Restriction, Suspension A to Suspension C	Fine C to Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine C to Fine D, Suspension B to Suspension C, Revocation, Bar
95	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3230(a), (b), (e)-(l)	Telemarketing	Notice of Non-Compliance, Fine A to Fine B, Restriction	Fine B to Fine D, Restriction	Fine D
96	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3230(d)	Telemarketing	Notice of Non-Compliance, Fine C, Restriction	Fine D, Restriction	Fine D, Suspension A
97	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3240	Borrowing From or Lending to Customers	Notice of Non-Compliance, Fine B to Fine C, Restriction, Suspension A to Suspension C	Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
98	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3260(a)	Discretionary Accounts	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation	Fine D, Revocation, Bar

99	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3260(b), (c)	Discretionary Accounts	Notice of Non-Compliance, Fine A to Fine C, Restriction	Fine B to Fine C, Restriction, Suspension A to Suspension B	Fine C to Fine D, Suspension B to Suspension C, Revocation, Bar
100	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3270	Outside Business Activity	Notice of Non-Compliance, Fine A to Fine C, Restriction, Suspension A to Suspension C	Fine C to Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine C to Fine D, Suspension B to Suspension C, Revocation, Bar
101	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3280	Private Securities Transactions	Fine B to Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
102	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 3310	Anti-Money Laundering Compliance Program	Notice of Non-Compliance, Fine C to Fine D, Restriction, Suspension A to Suspension C,	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
103	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 4210	Margin Requirements	Notice of Non-Compliance, Fine B to Fine C	Fine B to Fine D, Suspension A to Suspension B, Revocation	Fine C to Fine D, Suspension B to Suspension C, Revocation, Bar
104	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 4311	Carrying Agreements	Fine C to Fine D	Fine D	Fine D, Suspension A to Suspension B
105	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h), FINRA Rule 4360	Fidelity Bonds	Fine C to Fine D, Restriction	Fine D, Restriction, Suspension A to Suspension C	Fine D, Suspension C, Revocation, Bar
106	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 4530	Reporting Requirements	Notice of Non-Compliance, Fine A to Fine D, Restriction, Suspension B to C	Fine B to D, Restriction, Suspension B to Suspension C, Revocation	Fine C to D, Restriction, Suspension B to C, Revocation
107	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 5121	Public Offerings of Securities With Conflicts of Interest	Notice of Non-Compliance, Fine C to Fine D, Restriction, Suspension A to Suspension C,	Fine C to Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine D, Restriction, Suspension C, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
108	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 5141	Sale of Securities in a Fixed Price Offering	Fine C to Fine D, Restriction, Suspension A	Fine D, Restriction, Suspension A to B, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
109	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 5160	Disclosure of Price and Concessions in Selling Agreements	Fine C to Fine D, Restriction, Suspension A	Fine D, Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
110	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 5230	Payments Involving Publications that Influence the Market Price of a Security	Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar	Fine D, Revocation, Bar
111	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 5240	Anti-Intimidation /Coordination	Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar	Fine D, Revocation, Bar
112	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 5250	Payments for Market Making	Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar	Fine D, Revocation, Bar
113	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 5280	Trading Ahead of Research Reports	Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar	Fine D, Revocation, Bar
114	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 5310	Best Execution and Interpositioning	Notice of Non-Compliance, Fine A to Fine B, Restriction, Suspension A to B, Revocation	Fine A to Fine C, Restriction, Suspension A to B, Revocation	Fine B to Fine D, Restriction, Suspension B to C, Revocation, Bar
115	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h), FINRA Rule 5320	Trading Ahead of Customer Market Orders	Fine B to Fine D, Restriction, Suspension A to Suspension C, Revocation, Bar	Fine D, Suspension A to Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
116	Dealer/Agent Prohibited Business Practices	69W-600.013(1)(h)1 and (2)(h) FINRA Rule 5330	Adjustment of Open Orders	Fine B to Fine C	Fine C to Fine D, Suspension A	Fine D, Suspension C

117	Dealer Prohibited Business Practices	69W-600.013(1)(h)2, New York Stock Exchange Rule 435	Circulation of Rumors	Fine C to Fine D, Suspension B to Suspension C, Revocation	Fine D, Restriction, Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
118	Dealer Prohibited Business Practices	69W-600.013(1)(h)3, Section 5 of the Securities Act of 1933	Prohibitions Relating to Interstate Commerce and the Mails	Notice of Non-Compliance, Fine B to Fine C, Restriction, Suspension A to Suspension C	Fine B to Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
119	Dealer Prohibited Business Practices	69W-600.013(1)(h)3, Section 6 of the Securities Act of 1933	Registration of Securities	Notice of Non-Compliance, Fine B to Fine C, Restriction, Suspension A to Suspension C	Fine B to Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
120	Dealer Prohibited Business Practices	69W-600.013(1)(h)3, 17 CFR 230.134, 17 CFR 230.134a	Communications Deemed Not to be a Prospectus	Notice of Non-Compliance, Fine A to Fine C, Restriction, Suspension A to Suspension C	Fine A to Fine C, Restriction, Suspension B to Suspension C, Bar	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
121	Dealer Prohibited Business Practices	69W-600.013(1)(h)3, 17 CFR 230.144, 17 CFR 230.144A	Persons Not Engaged in Distributions or an Underwriter	Notice of Non-Compliance, Fine A to Fine C, Restriction, Suspension A to Suspension C	Fine A to Fine C, Restriction, Suspension B to Suspension C, Bar	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
122	Dealer Prohibited Business Practices	69W-600.013(1)(h)3, 17 CFR 230.156	Investment Company Sales Literature	Notice of Non-Compliance, Fine A to Fine C, Restriction	Fine A to Fine C, Restriction	Fine C to Fine D, Suspension A to Suspension B
123	Dealer Prohibited Business Practices	69W-600.013(1)(h)3, 17 CFR 230.419	Blank Check Offerings	Fine C to Fine D, Restriction, Suspension A to Suspension C	Fine D, Suspension B to Suspension C, Revocation, Bar	Fine D, Suspension B to Suspension C, Revocation, Bar
124	Dealer Prohibited Business Practices	69W-600.013(1)(h)3, 17 CFR 230.481	Information Required in a Prospectus	Notice of Non-Compliance, Fine B to Fine C, Restriction, Suspension A to Suspension C	Fine B to Fine C, Restriction, Suspension B to Suspension C	Fine B to Fine D, Restriction, Suspension C, Revocation
125	Dealer Prohibited Business Practices	69W-600.013(1)(h)3, 17 CFR 230.482	Advertising by an Investment Company	Notice of Non-Compliance, Fine A to Fine C, Restriction	Fine A to Fine C, Restriction	Fine C to Fine D, Suspension A to Suspension B
126	Dealer Prohibited Business Practices	69W-600.013(1)(h)4, 17 CFR 242.200-242.203, FINRA Rule 4320	Short Sale Delivery Requirements	Notice of Non-Compliance, Fine B to Fine C, Restriction, Suspension A	Fine C to Fine D, Restriction, Suspension A to Suspension C	Fine D, Suspension B to Suspension C, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
127	Dealer Prohibited Business Practices	69W-600.013(1)(h)5, Section 15B of the Securities Exchange Act of 1934 , MSRB Definitional Rules D1-12, MSRB General Rules G-1 through G-6, G-11 through G-14, G-17 through G-28, G-30 through G-33, G-37, G-38	Prohibited Business Practices for Dealers and Their Associated Persons	Notice of Non-Compliance, Fine B to Fine D, Restriction	Fine B to Fine D, Suspension A	Fine B to Fine D, Suspension B to Suspension C
128	Dealer Prohibited Business Practices	69W-600.013(1)(h)5, MSRB General Rules G-7 through G-9	Books and Records	Notice of Non-Compliance, Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar
129	Dealer Prohibited Business Practices	69W-600.013(1)(h)5, MSRB General Rule G-10	Investor and Municipal Advisory Client Education and Protection	Notice of Non-Compliance, Fine A	Fine A	Fine B, Suspension A
130	Dealer Prohibited Business Practices	69W-600.013(1)(h)5, MSRB General Rule G-15	Confirmation, Clearance, Settlement and Other Uniform Practice Requirements with Respect to Transactions with Customers	Notice of Non-Compliance, Fine A	Fine A	Fine B, Suspension A
131	Dealer Prohibited Business Practices	69W-600.013(1)(h)5, MSRB General Rule G-29	Availability of Board Rules	Notice of Non-Compliance, Fine A	Fine A	Fine B, Suspension A
132	Dealer Prohibited Business Practices	69W-600.013(1)(h)5, MSRB General Rule G-34	CUSIP Numbers, New Issue, and Market Information Requirements	Notice of Non-Compliance, Fine A	Fine A	Fine B, Suspension A
133	Dealer Prohibited Business Practices	69W-600.013(1)(h)5, MSRB General Rule G-39	Telemarketing	Notice of Non-Compliance, Fine A to Fine B, Restriction	Fine B to Fine D, Restriction	Fine D

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
134	Dealer Prohibited Business Practices	69W-600.013(1)(h)5, MSRB General Rule G-41	Anti-Money Laundering Compliance Program	Notice of Non-Compliance, Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation	Fine C to Fine D, Restriction, Suspension A to Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
135	Dealer Prohibited Business Practices	69W-600.013(1)(h)6, Regulation S-P 17 C.F.R. §248.30	Procedures to Safeguard Customer Records and Information	Notice of Non-Compliance, Fine B to Fine D, Restriction, Suspension A to Suspension C, Revocation, Bar	Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine D, Revocation, Bar
136	Dealer Prohibited Business Practices	69W-600.013(1)(i)	Prospectuses	Notice of Non-Compliance, Fine B to Fine C	Fine B to Fine D, Suspension A to Suspension B	Fine C to Fine D, Restriction, Suspension C
137	Dealer Prohibited Business Practices	69W-600.013(1)(j)	Using Unregistered Clearing Dealer	Notice of Non-Compliance, Fine C to Fine D, Restriction	Fine C to Fine D, Suspension A to Suspension B	Fine D, Restriction, Suspension C
138	Dealer Prohibited Business Practices	69W-600.013(1)(k)	Recommending Use of an Unregistered Investment Adviser	Notice of Non-Compliance, Fine B to Fine D, Restriction	Fine C to Fine D, Suspension A to Suspension B, Restriction	Fine D, Restriction, Suspension C
139	Dealer Prohibited Business Practices	69W-600.013(1)(l)	Receiving Compensation from an Adviser	Notice of Non-Compliance, Fine B to Fine D, Restriction	Fine C to Fine D, Suspension A to Suspension B, Restriction	Fine D, Restriction, Suspension C, Revocation
140	Dealer Prohibited Business Practices	69W-600.013(1)(m)	Sale of Non-Exempt Securities	Notice of Non-Compliance, Fine A to Fine C, Restriction, Suspension A to Suspension C	Fine A to Fine C, Restriction, Suspension B to Suspension C, Bar	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
141	Dealer Prohibited Business Practices	69W-600.013(1)(m) Section 13 of the Securities Exchange Act of 1934	Periodic and Other Reports	Notice of Non-Compliance, Fine C to Fine D	Fine D	Fine D
142	Dealer Prohibited Business Practices	69W-600.013(1)(m) Section 15D of the Securities Exchange Act of 1934	Securities Analyst and Research Reports	Notice of Non-Compliance, Fine C to Fine D, Restriction,	Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine D, Restriction, Suspension C, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
				Suspension A to Suspension C, Revocation		
143	Dealer Prohibited Business Practices	69W-600.013(1)(n)	Providing False Client Data	Notice of Non-Compliance, Fine C to Fine D, Suspension B to Suspension C, Restriction, Revocation, Bar	Fine C to Fine D, Suspension B to Suspension C, Restriction, Revocation, Bar	Fine D, Revocation, Bar
144	Dealer Prohibited Business Practices	69W-600.013(1)(o)	Senior - Specific Certifications and Professional Designations	Notice of Non-Compliance, Fine C to Fine D, Suspension A to Suspension B, Restriction	Fine C to Fine D, Suspension B to Suspension C, Restriction, Revocation, Bar	Fine D, Revocation, Bar
145	Dealer Prohibited Business Practices	69W-600.013(1)(p)	Failure to deliver a current Form CRS to any retail investor	Notice of Non-Compliance, Fine A to Fine B	Fine A to Fine B	Fine A to Fine B
146	Dealer Agent Prohibited Business Practices	69W-600.013(2)(a)	Borrowing from or Lending to Customers	Notice of Non-Compliance, Fine B to Fine C, Restriction, Suspension A to Suspension C	Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar
147	Dealer Agent Prohibited Business Practices	69W-600.013(2)(b) – (f)	Demonstrations of Unworthiness	Fine C to Fine D, Suspension A to Suspension C, Revocation	Fine C to Fine D, Revocation, Bar	Fine C to Fine D, Revocation, Bar
148	Dealer Agent Prohibited Business Practices	69W-600.013(2)(g)	Failure to Provide Florida Guide to Small Business Investments (SCOR)	Notice of Non-Compliance, Fine A to Fine B	Fine A to Fine B	Fine A to Fine B
149	Dealer Agent Prohibited Business Practices	69W-600.013(2)(h) - [(1)(a)]	Extension of Credit	Notice of Non-Compliance, Fine B to Fine C	Fine B to Fine D, Suspension A to Suspension B, Revocation	Fine C to Fine D, Suspension B to Suspension C, Revocation, Bar
150	Dealer Agent Prohibited Business Practices	69W-600.013(2)(h) - [(1)(b)]	Margin Agreement	Notice of Non-Compliance, Fine B to Fine C	Fine B to Fine D, Suspension A to Suspension B, Restriction	Fine C to Fine D, Suspension B to Suspension C, Revocation, Bar
151	Dealer Agent Prohibited Business Practices	69W-600.013(2)(h) - [(1)(e)]	Failing to Execute an Order	Notice of Non-Compliance, Fine B to Fine D, Restriction	Fine B to Fine D, Suspension A to Suspension C, Restriction	Fine D, Suspension A to Suspension C, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
152	Dealer Agent Prohibited Business Practices	69W-600.013(2)(h) - [(1)(f)]	Unregistered Securities	Notice of Non-Compliance, Fine A to Fine C, Restriction, Suspension A to Suspension C	Fine A to Fine C, Restriction, Suspension B to Suspension C, Bar	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
153	Dealer Agent Prohibited Business Practices	69W-600.013(2)(h) - [(1)(g)]	Representation of Qualifications	Notice of Non-Compliance, Fine C to Fine D, Restriction	Fine C to Fine D, Suspension B to Suspension C, Restriction, Revocation	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
154	Dealer Agent Prohibited Business Practices	69W-600.013(2)(h) - [(1)(j)]	Using Unregistered Clearing Dealer	Notice of Non-Compliance, Fine C to Fine D, Restriction, Suspension A to Suspension C	Fine C to Fine D, Suspension A to Suspension C	Fine D, Restriction, Suspension C, Revocation
155	Dealer Agent Prohibited Business Practices	69W-600.013(2)(h) - [(1)(k)]	Recommending Use of an Unregistered Investment Adviser	Notice of Non-Compliance, Fine B to Fine D, Restriction	Fine C to Fine D, Suspension A to Suspension B, Restriction	Fine D, Restriction, Suspension C
156	Dealer Agent Prohibited Business Practices	69W-600.013(2)(h) - [(1)(l)]	Receiving Compensation from an Adviser	Notice of Non-Compliance, Fine B to Fine D, Restriction	Fine C to Fine D, Suspension A to Suspension B, Restriction	Fine D, Restriction, Suspension C
157	Dealer Agent Prohibited Business Practices	69W-600.013(2)(h) - [(1)(m)]	Sale of Non-Exempt Securities	Notice of Non-Compliance, Fine A to Fine C, Restriction, Suspension A to Suspension C	Fine A to Fine C, Restriction, Suspension B to Suspension C, Bar	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
158	Dealer Agent Prohibited Business Practices	69W-600.013(2)(h) - [(1)(n)]	Providing False Client Data	Notice of Non-Compliance, Fine C to Fine D, Suspension B to Suspension C, Restriction, Revocation, Bar	Fine C to Fine D, Suspension B to Suspension C, Restriction, Revocation, Bar	Fine D, Revocation, Bar
159	Dealer Agent Prohibited Business Practices	69W-600.013(2)(h) - [(1)(o)]	Senior - Specific Certifications and Professional Designations	Notice of Non-Compliance, Fine C to Fine D, Suspension A to Suspension B, Restriction	Fine C to Fine D, Suspension B to Suspension C, Restriction, Revocation, Bar	Fine D, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
160	Adviser/Agent Prohibited Business Practices	69W-600.0131(1)(a) (15 USC 80b-4)	Reports by Investment Advisers	Notice of Non-Compliance, Fine A to Fine B, Suspension B to Suspension C, Summary Suspension, Revocation, Bar	Fine A to Fine C, Suspension B to Suspension C, Summary Suspension, Revocation, Bar	Fine B to Fine D, Suspension B to Suspension C, Summary Suspension, Revocation, Bar
161	Adviser/Agent Prohibited Business Practices	69W-600.0131(1)(a) (15 USC 80b-4a)	Prevention of Misuse of Nonpublic Information	Notice of Non-Compliance, Fine A to Fine C, Restriction, Suspension A to Suspension C	Fine A to Fine C, Restriction, Suspension B to Suspension C, Bar	Fine B to Fine D, Restriction, Suspension C, Revocation, Bar
162	Adviser/Agent Prohibited Business Practices	69W-600.0131(1)(a) (15 USC 80b-5)	Investment Advisory Contracts	Notice of Non-Compliance, Restriction, Fine B to Fine D	Fine B to Fine D, Suspension A to Suspension B	Fine C to Fine D, Suspension B to Suspension C
163	Adviser/Agent Prohibited Business Practices	69W-600.0131(1)(a) (15 USC 80b-6)	Prohibited Transactions by Investment Advisers	Fine D, Revocation, Bar	Fine D, Revocation, Bar	Fine D, Revocation, Bar
164	Adviser/Agent Prohibited Business Practices	69W-600.0131(1)(a) (15 USC 80b-7)	Material Misstatement	Denial, Restriction, Suspension, Summary Suspension, Revocation, Bar	Denial, Restriction, Suspension, Summary Suspension, Revocation, Bar	Denial, Restriction, Suspension, Summary Suspension, Revocation, Bar
165	Adviser/Agent Prohibited Business Practices	69W-600.0131(1)(a) (15 USC 80b-8)	General Prohibitions	Fine D, Revocation, Bar	Fine D, Revocation, Bar	Fine D, Revocation, Bar
166	Adviser/Agent Prohibited Business Practices	69W-600.0131(1)(a) (17 CFR 275.204-1 and 17 CFR 275.204-3)	Amendments to Form ADV and Delivery of Brochures and Supplements	Notice of Non-Compliance, Fine A to Fine B	Fine A to Fine C, Suspension A to Suspension B	Fine B to Fine D, Suspension B to Suspension C, Revocation, Bar
167	Adviser/Agent Prohibited Business Practices	69W-600.0131(1)(a) (17 CFR 275.205-1, 17 CFR 275.205-2, and 17 CFR 275.205-3)	Contracts	Notice of Non-Compliance, Fine A to Fine B	Fine A to Fine C, Suspension A	Fine C to Fine D, Suspension B to Suspension C, Revocation, Bar
168	Adviser/Agent Prohibited Business Practices	69W-600.0131(1)(a) (17 CFR 275.206(3)-1, 17 CFR 275.206(3)-2, 17 CFR 275.206(4)-1, and 17 CFR 275.206(4)-3)	Prohibited Transactions	Notice of Non-Compliance, Fine B to Fine D, Suspension A to Suspension C, Revocation, Bar	Fine A to Fine D, Suspension A to Suspension C, Revocation, Bar	Fine B to Fine D, Suspension B to Suspension C, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
169	Adviser/Agent Prohibited Business Practices	69W-600.0131(1) (paragraphs (b), (d), (f), (g), (i), (j), (k), (l), (n), (o), (p), (t), (u), (v), (w), and (x))	Prohibited Business Practices for Investment Advisers and Their Associated Persons	Notice of Non-Compliance, Fine B to Fine D, Restriction, Suspension A to Suspension C, Revocation, Bar	Fine D, Restriction, Suspension B to Suspension C, Revocation, Bar	Fine D, Revocation, Bar
170	Adviser/Agent Prohibited Business Practices	69W-600.0131(1) (paragraphs (c), (e), (h), (m), (q), (r), and (s))	Prohibited Business Practices for Investment Advisers and Their Associated Persons	Notice of Non-Compliance, Restriction, Fine B to Fine D	Fine B to Fine D, Suspension A to Suspension B	Fine C to Fine D, Suspension B to Suspension C
171	Adviser Custody Requirements	69W-600.0132(2)	Custody Requirements for Investment Advisers	Notice of Non-Compliance, Fine B to Fine D, Suspension A to Suspension C	Fine C to Fine D, Restriction, Suspension B to Suspension C	Fine D, Suspension C, Revocation, Bar
172	Dealer/Adviser/Agent Business Practices	69W-600.0133(1)	Use of Senior-Specific Certifications and Professional Designations by Associated Persons and Investment Advisers	Notice of Non-Compliance, Fine C to Fine D, Suspension A to Suspension B, Restriction	Fine C to Fine D, Suspension B to Suspension C, Restriction, Revocation, Bar	Fine D, Revocation, Bar
173	Dealer Books and Records	69W-600.014(1)	Books and Records Requirements	Notice of Non-Compliance, Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar
174	Issuer Books and Records	69W-600.014(2)	Books and Records Requirements	Notice of Non-Compliance, Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar
175	Adviser Books and Records	69W-600.014(3)	Books and Records Requirements	Notice of Non-Compliance, Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar
176	Dealer/Issuer/Adviser Books and Records	69W-600.014(7)	Books and Records Preservation Requirements	Notice of Non-Compliance, Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar	Fine A to Fine B, Suspension B to Suspension C, Revocation, Bar

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
177	Dealer and Issuer/Dealer Financial Reporting	69W-600.0151	Net Capital Requirements for Dealers	Notice of Non-Compliance, Fine A to Fine D, Restriction, Suspension A to Suspension B, Revocation	Fine B to Fine D, Suspension A to Suspension C, Revocation	Fine C to Fine D, Suspension B to Suspension C, Revocation, Bar
178	Adviser Financial Reporting	69W-600.0161	Net Capital and Financial Reporting Requirements for Investment Advisers	Notice of Non-Compliance, Fine A to Fine C, Restriction, Suspension A to Suspension B, Revocation	Fine B to Fine D, Suspension A to Suspension C, Revocation	Fine C to Fine D, Suspension B to Suspension C, Revocation, Bar
179	Dealer Financial Reporting	69W-600.017	Customer Protection Rule - Reserve Requirements and Custody of Customer Funds and Securities	Fine C to Fine D, Restriction, Suspension A	Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar
180	Securities Registration	69W-700.009	Escrow of Proceeds from Sale of Securities	Fine C to Fine D	Fine C to Fine D, Suspension A to Suspension B	Fine D, Suspension C, Revocation, Bar
181	Securities Registration	69W-700.012(5)	Oil and Gas Participation Plans	Notice of Non-Compliance, Fine C to Fine D, Suspension B to Suspension C, Restriction, Revocation, Bar	Fine D, Restriction, Suspension B to Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar
182	Securities Registration	69W-700.015	Offering Price of Equity Securities	Notice of Non-Compliance, Fine C to Fine D	Fine C to Fine D, Suspension A to Suspension B	Fine D, Suspension C, Revocation, Bar
183	Securities Registration	69W-700.019	Submission of Sales Reports	Notice of Non-Compliance, Fine A to Fine B	Fine B to Fine C	Fine D
184	Securities Registration	69W-700.020	Termination Date of Registration, Prospectuses not to be Used after Certain Date	Notice of Non-Compliance, Fine A to Fine B	Fine B to Fine C	Fine D
185	Dealer Books and Records	69W-700.021	Independent Transfer Agent and/or Registrar	Notice of Non-Compliance, Fine A to Fine C	Fine B to Fine C	Fine D

Violation #	Violation Category	Statute or Code	Short Description	1st Occurrence	2nd Occurrence	3rd and Subsequent Occurrence(s)
186	Dealer Securities Registration	69W-700.027	Loans and Other Affiliated Transactions	Fine C to Fine D, Suspension B to Suspension C, Revocation	Fine D, Suspension C, Revocation, Bar	Fine D, Suspension C, Revocation, Bar
187	Issuer Securities Registration	69W-900.001	Disclosure of Business Activities in Cuba	Notice of Non-Compliance, Fine B to Fine C	Fine B to Fine D	Fine D, Suspension B to Suspension C, Revocation

SOURCE: 57 FR 36468, Aug. 13, 1992, unless otherwise noted.

§ 230.251 Scope of exemption.

(a) *Tier 1 and Tier 2.* A public offer or sale of eligible securities, as defined in Rule 261 (§ 230.261), pursuant to Regulation A shall be exempt under section 3(b) from the registration requirements of the Securities Act of 1933 (the ''Securities Act'') (15 U.S.C. 77a *et seq.*).

(1) *Tier 1.* Offerings pursuant to Regulation A in which the sum of all cash and other consideration to be received for the securities being offered (''aggregate offering price'') plus the gross proceeds for all securities sold pursuant to other offering statements within the 12 months before the start of and during the current offering of securities (''aggregate sales'') does not exceed $20,000,000, including not more than $6,000,000 offered by all selling securityholders that are affiliates of the issuer (''Tier 1 offerings'').

(2) *Tier 2.* Offerings pursuant to Regulation A in which the sum of the aggregate offering price and aggregate sales does not exceed $50,000,000, including not more than $15,000,000 offered by all selling securityholders that are affiliates of the issuer (''Tier 2 offerings'').

(3) *Additional limitation on secondary sales in first year.* The portion of the aggregate offering price attributable to the securities of selling securityholders shall not exceed 30% of the aggregate offering price of a particular offering in:

(i) The issuer's first offering pursuant to Regulation A; or

(ii) Any subsequent Regulation A offering that is qualified within one year of the qualification date of the issuer's first offering.

NOTE TO PARAGRAPH (a). Where a mixture of cash and non-cash consideration is to be received, the aggregate offering price must be based on the price at which the securities are offered for cash. Any portion of the aggregate offering price or aggregate sales attributable to cash received in a foreign currency must be translated into United States currency at a currency exchange rate in effect on, or at a reasonable time before, the date of the sale of the securities. If securities are not offered for cash, the aggregate offering price or aggregate sales must be based on the value of the consideration as established by bona fide sales of that consideration made within a reasonable time, or, in the absence of sales, on the fair value as determined by an accepted standard. Valuations of non-cash consideration must be reasonable at the time made. If convertible securities or warrants are being offered and such securities are convertible, exercisable, or exchangeable within one year of the offering statement's qualification or at the discretion of the issuer, the underlying securities must also be qualified and the aggregate offering price must include the actual or maximum estimated conversion, exercise, or exchange price of such securities.

(b) *Issuer.* The issuer of the securities:

(1) Is an entity organized under the laws of the United States or Canada, or any State, Province, Territory or possession thereof, or the District of Columbia, with its principal place of business in the United States or Canada;

(2) [Reserved]

(3) Is not a development stage company that either has no specific business plan or purpose, or has indicated that its business plan is to merge with or acquire an unidentified company or companies;

(4) Is not an investment company registered or required to be registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) or a business development company as defined in section 2(a)(48) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(48));

(5) Is not issuing fractional undivided interests in oil or gas rights, or a similar interest in other mineral rights;

(6) Is not, and has not been, subject to any order of the Commission entered pursuant to Section 12(j) (15 U.S.C. 78l(j)) of the Securities Exchange Act of 1934 (the ''Exchange Act'') (15 U.S.C. 78a *et seq.*) within five years before the filing of the offering statement;

(7) Has filed with the Commission all reports required to be filed, if any, pursuant to Rule 257 (§ 230.257) during the two years before the filing of the offering statement (or for such shorter period that the issuer was required to file such reports); and

(8) Is not disqualified under Rule 262 (§ 230.262).

(c) *Integration with other offerings.* Offers or sales made in reliance on this Regulation A will not be integrated with:

(1) Prior offers or sales of securities; or

(2) Subsequent offers or sales of securities that are:

(i) Registered under the Securities Act, except as provided in Rule 255(e) (§ 230.255(e));

(ii) Exempt from registration under Rule 701 (§ 230.701);

(iii) Made pursuant to an employee benefit plan;

(iv) Exempt from registration under Regulation S (§§ 230.901 through 203.905);

(v) Made more than six months after the completion of the Regulation A offering; or

(vi) Exempt from registration under Section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6)).

NOTE TO PARAGRAPH (c). If these safe harbors do not apply, whether subsequent offers and sales of securities will be integrated with the Regulation A offering will depend on the particular facts and circumstances.

(d) *Offering conditions*—(1) *Offers*. (i) Except as allowed by Rule 255 (§ 230.255), no offer of securities may be made unless an offering statement has been filed with the Commission.

(ii) After the offering statement has been filed, but before it is qualified:

(A) Oral offers may be made;

(B) Written offers pursuant to Rule 254 (§ 230.254) may be made; and

(C) Solicitations of interest and other communications pursuant to Rule 255 (§ 230.255) may be made.

(iii) Offers may be made after the offering statement has been qualified, but any written offers must be accompanied with or preceded by the most recent offering circular filed with the Commission for such offering.

(2) *Sales*. (i) No sale of securities may be made:

(A) Until the offering statement has been qualified;

(B) By issuers that are not currently required to file reports pursuant to Rule 257(b) (§ 230.257(b)), until a Preliminary Offering Circular is delivered at least 48 hours before the sale to any person that before qualification of the offering statement had indicated an interest in purchasing securities in the offering, including those persons that responded to an issuer's solicitation of interest materials; and

(C) In a Tier 2 offering of securities that are not listed on a registered national securities exchange upon qualification, unless the purchaser is either an accredited investor (as defined in Rule 501 (§ 230.501)) or the aggregate purchase price to be paid by the purchaser for the securities (including the actual or maximum estimated conversion, exercise, or exchange price for any underlying securities that have been qualified) is no more than ten percent (10%) of the greater of such purchaser's:

(*1*) Annual income or net worth if a natural person (with annual income and net worth for such natural person purchasers determined as provided in Rule 501 (§ 230.501)); or

(*2*) Revenue or net assets for such purchaser's most recently completed fiscal year end if a non-natural person.

NOTE TO PARAGRAPH (d)(2)(i)(C). When securities underlying warrants or convertible securities are being qualified pursuant to Tier 2 of Regulation A one year or more after the qualification of an offering for which investment limitations previously applied, purchasers of the underlying securities for which investment limitations would apply at that later date may determine compliance with the ten percent (10%) investment limitation using the conversion, exercise, or exchange price to acquire the underlying securities at that later time without aggregating such price with the price of the overlying warrants or convertible securities.

(D) The issuer may rely on a representation of the purchaser when determining compliance with the ten percent (10%) investment limitation in this paragraph (d)(2)(i)(C), provided that the issuer does not know at the time of sale that any such representation is untrue.

(ii) In a transaction that represents a sale by the issuer or an underwriter, or a sale by a dealer within 90 calendar days after qualification of the offering statement, each underwriter or dealer selling in such transaction must deliver to each purchaser from it, not later than two business days following the completion of such sale, a copy of the Final Offering Circular, subject to the following provisions:

(A) If the sale was by the issuer and was not effected by or through an underwriter or dealer, the issuer is responsible for delivering the Final Offering Circular as if the issuer were an underwriter;

(B) For continuous or delayed offerings pursuant to paragraph (d)(3) of this section, the 90 calendar day period for dealers shall commence on the day of the first bona fide offering of securities under such offering statement;

(C) If the security is listed on a registered national securities exchange, no offering circular need be delivered by a dealer more than 25 calendar days after the later of the qualification date of the offering statement or the first date on which the security was bona fide offered to the public;

(D) No offering circular need be delivered by a dealer if the issuer is subject, immediately prior to the time of the filing of the offering statement, to the reporting requirements of Rule 257(b) (§ 230.257(b)); and

(E) The Final Offering Circular delivery requirements set forth in paragraph (d)(2)(ii) of this section may be satisfied by delivering a notice to the effect that the sale was made pursuant to a qualified offering statement that includes the uniform resource locator (''URL''), which, in the case of an electronic-only offering, must be an active hyperlink, where the Final Offering Circular, or the offering statement of which such Final Offering Circular is part, may be obtained on the Commission's Electronic Data Gathering, Analysis and Retrieval System (''EDGAR'') and contact information sufficient to notify a purchaser where a request for a Final Offering Circular can be sent and received in response.

(3) *Continuous or delayed offerings.* (i) Continuous or delayed offerings may be made under this Regulation A, so long as the offering statement pertains only to:

(A) Securities that are to be offered or sold solely by or on behalf of a person or persons other than the issuer, a subsidiary of the issuer, or a person of which the issuer is a subsidiary;

(B) Securities that are to be offered and sold pursuant to a dividend or interest reinvestment plan or an employee benefit plan of the issuer;

(C) Securities that are to be issued upon the exercise of outstanding options, warrants, or rights;

(D) Securities that are to be issued upon conversion of other outstanding securities;

(E) Securities that are pledged as collateral; or

(F) Securities the offering of which will be commenced within two calendar days after the qualification date, will be made on a continuous basis, may continue for a period in excess of 30 calendar days from the date of initial qualification, and will be offered in an amount that, at the time the offering statement is qualified, is reasonably expected to be offered and sold within two years from the initial qualification date. These securities may be offered and sold only if not more than three years have elapsed since the initial qualification date of the offering statement under which they are being offered and sold; provided, however, that if a new offering statement has been filed pursuant to this paragraph (d)(3)(i)(F), securities covered by the prior offering statement may continue to be offered and sold until the earlier of the qualification date of the new offering statement or 180 calendar days after the third anniversary of the initial qualification date of the prior offering statement. Before the end of such three-year period, an issuer may file a new offering statement covering the securities. The new offering statement must include all the information that would be required at that time in an offering statement relating to all offerings that it covers. Before the qualification date of the new offering statement, the issuer may include as part of such new offering statement any unsold securities covered by the earlier offering statement by identifying on the cover page of the new offering circular, or the latest amendment, the amount of such unsold securities being included. The offering of securities on the earlier offering statement will be deemed terminated as of the date of qualification of the new offering statement. Securities may be sold pursuant to this paragraph (d)(3)(i)(F) only if the issuer is current in its annual and semiannual filings pursuant to Rule 257(b) (§ 230.257(b)), at the time of such sale.

(ii) At the market offerings, by or on behalf of the issuer or otherwise, are not permitted under this Regulation A. As used in this paragraph (d)(3)(ii), the term *at the market offering* means an offering of equity securities into an existing trading market for outstanding shares of the same class at other than a fixed price.

(e) *Confidential treatment.* A request for confidential treatment may be made under Rule 406 (§ 230.406) for information required to be filed, and Rule 83 (§ 200.83) for information not required to be filed.

(f) *Electronic filing.* Documents filed or otherwise provided to the Commission pursuant to this Regulation A must be submitted in electronic format by means of EDGAR in accordance with the EDGAR rules set forth in Regulation S–T (17 CFR part 232).

[80 FR 21895, Apr. 20, 2015, as amended at 84 FR 529, Jan. 31, 2019]

§ 230.252 Offering statement.

(a) *Documents to be included.* The offering statement consists of the contents required by Form 1–A (§ 239.90 of this chapter) and any other material information necessary to make the required statements, in light of the circumstances under which they are made, not misleading.

(b) *Paper, printing, language and pagination.* Except as otherwise specified in this rule, the requirements for offering statements are the same as those specified in Rule 403 (§ 230.403) for registration statements under the Act. No fee is payable to the Commission upon either the submission or filing of an offering statement on Form 1–A, or any amendment to an offering statement.

(c) *Signatures.* The issuer, its principal executive officer, principal financial officer, principal accounting officer, and a majority of the members of its board of directors or other governing body, must sign the offering statement in the manner prescribed by Form 1–A. If a signature is by a person on behalf of any other person, evidence of authority to sign must be filed, except where an executive officer signs for the issuer.

(d) *Non-public submission.* An issuer whose securities have not been previously sold pursuant to a qualified offering statement under this Regulation A or an effective registration statement under the Securities Act may submit a draft offering statement to the Commission for non-public review by the staff of the Commission before public filing, provided that the offering statement shall not be qualified less than 21 calendar days after the public filing with the Commission of:

(1) The initial non-public submission;

(2) All non-public amendments; and

(3) All non-public correspondence submitted by or on behalf of the issuer to the Commission staff regarding such submissions (subject to any separately approved confidential treatment request under Rule 251(e) (§ 230.251(e)).

(e) *Qualification.* An offering statement and any amendment thereto can be qualified only at such date and time as the Commission may determine.

(f) *Amendments.* (1)(i) Amendments to an offering statement must be signed and filed with the Commission in the same manner as the initial filing. Amendments to an offering statement must be filed under cover of Form 1–A and must be numbered consecutively in the order in which filed.

(ii) Every amendment that includes amended audited financial statements must include the consent of the certifying accountant to the use of such accountant's certification in connection with the amended financial statements in the offering statement or offering circular and to being named as having audited such financial statements.

(iii) Amendments solely relating to Part III of Form 1–A must comply with the requirements of paragraph (f)(1)(i) of this section, except that such amendments may be limited to Part I of Form 1–A, an explanatory note, and all of the information required by Part III of Form 1–A.

(2) Post-qualification amendments must be filed in the following circumstances for ongoing offerings:

(i) At least every 12 months after the qualification date to include the financial statements that would be required by Form 1–A as of such date; or

(ii) To reflect any facts or events arising after the qualification date of the offering statement (or the most recent post-qualification amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the offering statement.

[80 FR 21895, Apr. 20, 2015]

§ 230.253 Offering circular.

(a) *Contents.* An offering circular must include the information required by Form 1–A for offering circulars.

(b) *Information that may be omitted.* Notwithstanding paragraph (a) of this section, a qualified offering circular may omit information with respect to the public offering price, underwriting syndicate (including any material relationships between the issuer or selling securityholders and the unnamed underwriters, brokers or dealers), underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion rates, call prices and other items dependent upon the offering price, delivery dates, and terms of the securities dependent upon the offering date; provided, that the following conditions are met:

(1) The securities to be qualified are offered for cash.

(2) The outside front cover page of the offering circular includes a bona fide estimate of the range of the maximum offering price and the maximum number of shares or other units of securities to be offered or a bona fide estimate of the principal amount of debt securities offered, subject to the following conditions:

(i) The range must not exceed $2 for offerings where the upper end of the range is $10 or less or 20% if the upper end of the price range is over $10; and

(ii) The upper end of the range must be used in determining the aggregate offering price under Rule 251(a) (§ 230.251(a)).

(3) The offering statement does not relate to securities to be offered by competitive bidding.

(4) The volume of securities (the number of equity securities or aggregate principal amount of debt securities) to be offered may not be omitted in reliance on this paragraph (b).

NOTE TO PARAGRAPH (b). A decrease in the volume of securities offered or a change in the bona fide estimate of the offering price range from that indicated in the offering circular filed as part of a qualified offering statement may be disclosed in the offering circular filed with the Commission pursuant to Rule 253(g) (§ 230.253(g)), so long as the decrease in the volume of securities offered or change in the price range would not materially change the disclosure contained in the offering statement at qualification. Notwithstanding the foregoing, any decrease in the volume of securities offered and any deviation from the low or high end of the price range may be reflected in the offering circular supplement filed with the Commission pursuant to Rule 253(g)(1) or (3) (§ 230.253(g)(1) or (3)) if, in the aggregate, the decrease in volume and/or change in price represent no more than a 20% change from the maximum aggregate offering price calculable using the information in the qualified offering statement. In no circumstances may this paragraph be used to offer securities where the maximum aggregate offering price would result in the offering exceeding the limit set forth in Rule 251(a) (§ 230.251(a)) or if the change would result in a Tier 1 offering becoming a Tier 2 offering. An offering circular supplement may not be used to increase the volume of securities being offered. Additional securities may only be offered pursuant to a new offering statement or post-qualification amendment qualified by the Commission.

(c) *Filing of omitted information.* The information omitted from the offering circular in reliance upon paragraph (b) of this section must be contained in an offering circular filed with the Commission pursuant to paragraph (g) of this section; except that if such offering circular is not so filed by the later of 15 business days after the qualification date of the offering statement or 15 business days after the qualification of a post-qualification amendment thereto that contains an offering circular, the information omitted in reliance upon paragraph (b) of this section must be contained in a qualified post-qualification amendment to the offering statement.

(d) *Presentation of information.* (1) Information in the offering circular must be presented in a clear, concise and understandable manner and in a type size that is easily readable. Repetition of information should be avoided; cross-referencing of information within the document is permitted.

(2) Where an offering circular is distributed through an electronic medium, issuers may satisfy legibility requirements applicable to printed documents by presenting all required information in a format readily communicated to investors.

(e) *Date*. An offering circular must be dated approximately as of the date it was filed with the Commission.

(f) *Cover page legend*. The cover page of every offering circular must display the following statement highlighted by prominent type or in another manner:

The United States Securities and Exchange Commission does not pass upon the merits of or give its approval to any securities offered or the terms of the offering, nor does it pass upon the accuracy or completeness of any offering circular or other solicitation materials. These securities are offered pursuant to an exemption from registration with the Commission; however, the Commission has not made an independent determination that the securities offered are exempt from registration.

(g) *Offering circular supplements*. (1) An offering circular that discloses information previously omitted from the offering circular in reliance upon Rule 253(b) (§ 230.253(b)) must be filed with the Commission no later than two business days following the earlier of the date of determination of the offering price or the date such offering circular is first used after qualification in connection with a public offering or sale.

(2) An offering circular that reflects information other than that covered in paragraph (g)(1) of this section that constitutes a substantive change from or addition to the information set forth in the last offering circular filed with the Commission must be filed with the Commission no later than five business days after the date it is first used after qualification in connection with a public offering or sale. If an offering circular filed pursuant to this paragraph (g)(2) consists of an offering circular supplement attached to an offering circular that previously had been filed or was not required to be filed pursuant to paragraph (g) of this section because it did not contain substantive changes from an offering circular that previously was filed, only the offering circular supplement need be filed under paragraph (g) of this section, provided that the cover page of the offering circular supplement identifies the date(s) of the related offering circular and any offering circular supplements thereto that together constitute the offering circular with respect to the securities currently being offered or sold.

(3) An offering circular that discloses information, facts or events covered in both paragraphs (g)(1) and (2) of this section must be filed with the Commission no later than two business days following the earlier of the date of the determination of the offering price or the date it is first used after qualification in connection with a public offering or sale.

(4) An offering circular required to be filed pursuant to paragraph (g) of this section that is not filed within the time frames specified in paragraphs (g)(1) through (3) of this section, as applicable, must be filed pursuant to this paragraph (g)(4) as soon as practicable after the discovery of such failure to file.

(5) Each offering circular filed under this section must contain in the upper right corner of the cover page the paragraphs of paragraphs (g)(1) through (4) of this section under which the filing is made, and the file number of the offering statement to which the offering circular relates.

[80 FR 21895, Apr. 20, 2015]

§ 230.254 Preliminary offering circular.

After the filing of an offering statement, but before its qualification, written offers of securities may be made if they meet the following requirements:

(a) *Outside front cover page*. The outside front cover page of the material bears the caption *Preliminary Offering Circular*, the date of issuance, and the following legend, which must be highlighted by prominent type or in another manner:

An offering statement pursuant to Regulation A relating to these securities has been filed with the Securities and Exchange Commission. Information contained in this Preliminary Offering Circular is subject to completion or amendment. These securities may not be sold nor may offers to buy be accepted before the offering statement filed with the Commission is qualified. This Preliminary Offering Circular shall not constitute an offer to sell or the solicitation of an offer to buy nor may there be any sales of these securities in any state in which such offer, solicitation or sale would be unlawful before registration or qualification under the laws of any such state. We may elect to satisfy our obligation to deliver a Final Offering Circular by sending you a notice within two business days after the completion of our sale to you that contains the URL where the Final Offering Circular or the offering statement in which such Final Offering Circular was filed may be obtained.

(b) *Other contents.* The Preliminary Offering Circular contains substantially the information required to be in an offering circular by Form 1–A (§ 239.90 of this chapter), except that certain information may be omitted under Rule 253(b) (§ 230.253(b)) subject to the conditions set forth in such rule.

(c) *Filing.* The Preliminary Offering Circular is filed as a part of the offering statement.

[80 FR 21895, Apr. 20, 2015]

§ 230.255 Solicitations of interest and other communications.

(a) *Solicitation of interest.* At any time before the qualification of an offering statement, including before the non-public submission or public filing of such offering statement, an issuer or any person authorized to act on behalf of an issuer may communicate orally or in writing to determine whether there is any interest in a contemplated securities offering. Such communications are deemed to be an offer of a security for sale for purposes of the antifraud provisions of the federal securities laws. No solicitation or acceptance of money or other consideration, nor of any commitment, binding or otherwise, from any person is permitted until qualification of the offering statement.

(b) *Conditions.* The communications must:

(1) State that no money or other consideration is being solicited, and if sent in response, will not be accepted;

(2) State that no offer to buy the securities can be accepted and no part of the purchase price can be received until the offering statement is qualified, and any such offer may be withdrawn or revoked, without obligation or commitment of any kind, at any time before notice of its acceptance given after the qualification date;

(3) State that a person's indication of interest involves no obligation or commitment of any kind; and

(4) After the public filing of the offering statement:

(i) State from whom a copy of the most recent version of the Preliminary Offering Circular may be obtained, including a phone number and address of such person;

(ii) Provide the URL where such Preliminary Offering Circular, or the offering statement in which such Preliminary Offering Circular was filed, may be obtained; or

(iii) Include a complete copy of the Preliminary Offering Circular.

(c) *Indications of interest.* Any written communication under this rule may include a means by which a person may indicate to the issuer that such person is interested in a potential offering. This issuer may require the name, address, telephone number, and/or email address in any response form included pursuant to this paragraph (c).

(d) *Revised solicitations of interest.* If solicitation of interest materials are used after the public filing of the offering statement and such solicitation of interest materials contain information that is inaccurate or inadequate in any material respect, revised solicitation of interest materials must be redistributed in a substantially similar manner as such materials were originally distributed. Notwithstanding the foregoing in this paragraph (d), if the only information that is inaccurate or inadequate is contained in a Preliminary Offering Circular provided with the solicitation of interest materials pursuant to paragraphs (b)(4)(i) or (ii) of this section, no such redistribution is required in the following circumstances:

(1) in the case of paragraph (b)(4)(i) of this section, the revised Preliminary Offering Circular will be provided to any persons making new inquiries and will be recirculated to any persons making any previous inquiries; or

(2) in the case of paragraph (b)(4)(ii) of this section, the URL continues to

link directly to the most recent Preliminary Offering Circular or to the offering statement in which such revised Preliminary Offering Circular was filed.

(e) *Abandoned offerings.* Where an issuer decides to register an offering under the Securities Act after soliciting interest in a contemplated, but subsequently abandoned, Regulation A offering, the abandoned Regulation A offering would not be subject to integration with the registered offering if the issuer engaged in solicitations of interest pursuant to this rule only to qualified institutional buyers and institutional accredited investors permitted by Section 5(d) of the Securities Act. If the issuer engaged in solicitations of interest to persons other than qualified institutional buyers and institutional accredited investors, an abandoned Regulation A offering would not be subject to integration if the issuer (and any underwriter, broker, dealer, or agent used by the issuer in connection with the proposed offering) waits at least 30 calendar days between the last such solicitation of interest in the Regulation A offering and the filing of the registration statement with the Commission.

[80 FR 21895, Apr. 20, 2015]

§ 230.256 Definition of "qualified purchaser".

For purposes of Section 18(b)(3) of the Securities Act [15 U.S.C. 77r(b)(3)], a ''qualified purchaser'' means any person to whom securities are offered or sold pursuant to a Tier 2 offering of this Regulation A.

[80 FR 21895, Apr. 20, 2015]

§ 230.257 Periodic and current reporting; exit report.

(a) *Tier 1: Exit report.* Each issuer that has filed an offering statement for a Tier 1 offering that has been qualified pursuant to this Regulation A must file an exit report on Form 1–Z (§ 239.94 of this chapter) not later than 30 calendar days after the termination or completion of the offering.

(b) *Tier 2: Periodic and current reporting.* Each issuer that has filed an offering statement for a Tier 2 offering that has been qualified pursuant to this Regulation A must file with the Commission the following periodic and current reports:

(1) *Annual reports.* An annual report on Form 1–K (§ 239.91 of this chapter) for the fiscal year in which the offering statement became qualified and for any fiscal year thereafter, unless the issuer's obligation to file such annual report is suspended under paragraph (d) of this section. Annual reports must be filed within the period specified in Form 1–K.

(2) *Special financial report.* (i) A special financial report on Form 1–K or Form 1–SA if the offering statement did not contain the following:

(A) Audited financial statements for the issuer's most recent fiscal year (or for the life of the issuer if less than a full fiscal year) preceding the fiscal year in which the issuer's offering statement became qualified; or

(B) unaudited financial statements covering the first six months of the issuer's current fiscal year if the offering statement was qualified during the last six months of that fiscal year.

(ii) The special financial report described in paragraph (b)(2)(i)(A) of this section must be filed under cover of Form 1–K within 120 calendar days after the qualification date of the offering statement and must include audited financial statements for such fiscal year or other period specified in that paragraph, as the case may be. The special financial report described in paragraph (b)(2)(i)(B) of this section must be filed under cover of Form 1–SA within 90 calendar days after the qualification date of the offering statement and must include the semiannual financial statements for the first six months of the issuer's fiscal year, which may be unaudited.

(iii) A special financial report must be signed in accordance with the requirements of the form on which it is filed.

(3) *Semiannual report.* A semiannual report on Form 1–SA (§ 239.92 of this chapter) within the period specified in Form 1–SA. Semiannual reports must cover the first six months of each fiscal year of the issuer, commencing with the first six months of the fiscal year immediately following the most recent fiscal year for which full financial

statements were included in the offering statement, or, if the offering statement included financial statements for the first six months of the fiscal year following the most recent full fiscal year, for the first six months of the following fiscal year.

(4) *Current reports.* Current reports on Form 1–U (§ 239.93 of this chapter) with respect to the matters and within the period specified in that form, unless substantially the same information has been previously reported to the Commission by the issuer under cover of Form 1–K or Form 1–SA.

(5) *Reporting by successor issuers.* Where in connection with a succession by merger, consolidation, exchange of securities, acquisition of assets or otherwise, securities of any issuer that is not required to file reports pursuant to paragraph (b) of this section are issued to the holders of any class of securities of another issuer that is required to file such reports, the duty to file reports pursuant to paragraph (b) of this section shall be deemed to have been assumed by the issuer of the class of securities so issued. The successor issuer must, after the consummation of the succession, file reports in accordance with paragraph (b) of this section, unless that issuer is exempt from filing such reports or the duty to file such reports is terminated or suspended under paragraph (d) of this section.

(6) *Exchange Act reporting requirements.* The duty to file reports under this rule shall be deemed to have been met if the issuer is subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m or 15 U.S.C. 78o) and, as of each Form 1–K and Form 1–SA due date, has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m or 15 U.S.C. 78o) during the 12 months (or such shorter period that the registrant was required to file such reports) preceding such due date.

(c) *Amendments.* All amendments to the reports described in paragraphs (a) and (b) of this section must be filed under cover of the form amended, marked with the letter *A* to designate the document as an amendment, e.g., ''1–K/A,'' and in compliance with pertinent requirements applicable to such reports. Amendments filed pursuant to this paragraph (c) must set forth the complete text of each item as amended, but need not include any items that were not amended. Amendments must be numbered sequentially and be filed separately for each report amended. Amendments must be signed on behalf of the issuer by a duly authorized representative of the issuer. An amendment to any report required to include certifications as specified in the applicable form must include new certifications by the appropriate persons.

(d) *Suspension of duty to file reports.*

(1) [Reserved]

(2) The duty to file reports under paragraph (b) of this section with respect to a class of securities held of record (as defined in Rule 12g5–1 (§ 240.12g5–1 of this chapter)) by less than 300 persons, or less than 1,200 persons for a bank (as defined in Section 3(a)(6) of the Exchange Act (15 U.S.C. 78c(a)(6)), or a bank holding company (as defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841)), shall be suspended for such class of securities immediately upon filing with the Commission an exit report on Form 1–Z (§ 239.94 of this chapter) if the issuer of such class has filed all reports due pursuant to this rule before the date of such Form 1–Z filing for the shorter of:

(i) The period since the issuer became subject to such reporting obligation; or

(ii) Its most recent three fiscal years and the portion of the current year preceding the date of filing Form 1–Z.

(3) For the purposes of paragraph (d)(2) of this section, the term *class* shall be construed to include all securities of an issuer that are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. If the Form 1–Z is subsequently withdrawn or if it is denied because the issuer was ineligible to use the form, the issuer must, within 60 calendar days, file with the Commission all reports which would have been required if such exit report had not been filed. If the suspension resulted from the issuer's merger into, or consolidation with, another issuer or issuers, the notice must be filed by the successor issuer.

(4) The ability to suspend reporting, as described in paragraph (d)(2) of this

section, is not available for any class of securities if:

(i) During that fiscal year a Tier 2 offering statement was qualified;

(ii) The issuer has not filed an annual report under this rule or the Exchange Act for the fiscal year in which a Tier 2 offering statement was qualified; or

(iii) Offers or sales of securities of that class are being made pursuant to a Tier 2 Regulation A offering.

(e) *Termination of duty to file reports.* If the duty to file reports is deemed to have been met pursuant to paragraph (b)(6) of this section and such status ends because the issuer terminates or suspends its duty to file reports under the Exchange Act, the issuer's obligation to file reports under paragraph (b) of this section shall:

(1) Automatically terminate if the issuer is eligible to suspend its duty to file reports under paragraphs (d)(2) and (3) of this section; or

(2) Recommence with the report covering the most recent financial period after that included in any effective registration statement or filed Exchange Act report.

[80 FR 21895, Apr. 20, 2015, as amended at 82 FR 45725, Oct. 2, 2017; 83 FR 47836, Sept. 21, 2018; 83 FR 52964, Oct. 19, 2018; 84 FR 529, Jan. 31, 2019]

§ 230.258 Suspension of the exemption.

(a) *Suspension.* The Commission may at any time enter an order temporarily suspending a Regulation A exemption if it has reason to believe that:

(1) No exemption is available or any of the terms, conditions or requirements of Regulation A have not been complied with;

(2) The offering statement, any sales or solicitation of interest material, or any report filed pursuant to Rule 257 (§ 230.257) contains any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading;

(3) The offering is being made or would be made in violation of section 17 of the Securities Act;

(4) An event has occurred after the filing of the offering statement that would have rendered the exemption hereunder unavailable if it had occurred before such filing;

(5) Any person specified in Rule 262(a) (§ 230.262(a)) has been indicted for any crime or offense of the character specified in Rule 262(a)(1) (§ 230.262(a)(1)), or any proceeding has been initiated for the purpose of enjoining any such person from engaging in or continuing any conduct or practice of the character specified in Rule 262(a)(2) (§ 230.262(a)(2)), or any proceeding has been initiated for the purposes of Rule 262(a)(3)–(8) (§ 230.262(a)(3) through (8)); or

(6) The issuer or any promoter, officer, director, or underwriter has failed to cooperate, or has obstructed or refused to permit the making of an investigation by the Commission in connection with any offering made or proposed to be made in reliance on Regulation A.

(b) *Notice and hearing.* Upon the entry of an order under paragraph (a) of this section, the Commission will promptly give notice to the issuer, any underwriter, and any selling securityholder:

(1) That such order has been entered, together with a brief statement of the reasons for the entry of the order; and

(2) That the Commission, upon receipt of a written request within 30 calendar days after the entry of the order, will, within 20 calendar days after receiving the request, order a hearing at a place to be designated by the Commission.

(c) *Suspension order.* If no hearing is requested and none is ordered by the Commission, an order entered under paragraph (a) of this section shall become permanent on the 30th calendar day after its entry and shall remain in effect unless or until it is modified or vacated by the Commission. Where a hearing is requested or is ordered by the Commission, the Commission will, after notice of and opportunity for such hearing, either vacate the order or enter an order permanently suspending the exemption.

(d) *Permanent suspension.* The Commission may, at any time after notice of and opportunity for hearing, enter an order permanently suspending the exemption for any reason upon which it could have entered a temporary suspension order under paragraph (a) of this section. Any such order shall remain in effect until vacated by the Commission.

(e) *Notice procedures*. All notices required by this rule must be given by personal service, registered or certified mail to the addresses given by the issuer, any underwriter and any selling securityholder in the offering statement.

[80 FR 21895, Apr. 20, 2015]

§ 230.259 Withdrawal or abandonment of offering statements.

(a) *Withdrawal*. If none of the securities that are the subject of an offering statement has been sold and such offering statement is not the subject of a proceeding under Rule 258 (§ 230.258), the offering statement may be withdrawn with the Commission's consent. The application for withdrawal must state the reason the offering statement is to be withdrawn and must be signed by an authorized representative of the issuer. Any withdrawn document will remain in the Commission's files, as well as the related request for withdrawal.

(b) *Abandonment*. When an offering statement has been on file with the Commission for nine months without amendment and has not become qualified, the Commission may, in its discretion, declare the offering statement abandoned. If the offering statement has been amended, the nine-month period shall be computed from the date of the latest amendment.

[80 FR 21895, Apr. 20, 2015]

§ 230.260 Insignificant deviations from a term, condition or requirement of Regulation A.

(a) *Failure to comply*. A failure to comply with a term, condition or requirement of Regulation A will not result in the loss of the exemption from the requirements of section 5 of the Securities Act for any offer or sale to a particular individual or entity, if the person relying on the exemption establishes that:

(1) The failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity;

(2) The failure to comply was insignificant with respect to the offering as a whole, provided that any failure to comply with Rule 251(a), (b), and (d)(1) and (3) (§ 230.251(a), (b), and (d)(1) and (3)) shall be deemed to be significant to the offering as a whole; and

(3) A good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements of Regulation A.

(b) *Action by Commission*. A transaction made in reliance upon Regulation A must comply with all applicable terms, conditions and requirements of the regulation. Where an exemption is established only through reliance upon paragraph (a) of this section, the failure to comply shall nonetheless be actionable by the Commission under section 20 of the Securities Act.

(c) *Suspension*. This provision provides no relief or protection from a proceeding under Rule 258 (§ 230.258).

[80 FR 21895, Apr. 20, 2015]

§ 230.261 Definitions.

As used in this Regulation A, all terms have the same meanings as in Rule 405 (§ 230.405), except that all references to *registrant* in those definitions shall refer to the issuer of the securities to be offered and sold under Regulation A. In addition, these terms have the following meanings:

(a) *Affiliated issuer*. An affiliate (as defined in Rule 501 (§ 230.501)) of the issuer that is issuing securities in the same offering.

(b) *Business day*. Any day except Saturdays, Sundays or United States federal holidays.

(c) *Eligible securities*. Equity securities, debt securities, and securities convertible or exchangeable to equity interests, including any guarantees of such securities, but not including asset-backed securities as such term is defined in Item 1101(c) of Regulation AB.

(d) *Final order*. A written directive or declaratory statement issued by a federal or state agency described in Rule 262(a)(3) (§ 230.262(a)(3)) under applicable statutory authority that provides for notice and an opportunity for hearing, which constitutes a final disposition or action by that federal or state agency.

(e) *Final offering circular*. The more recent of: the current offering circular contained in a qualified offering statement; and any offering circular filed pursuant to Rule 253(g) (§ 230.253(g)). If, however, the issuer is relying on Rule 253(b) ((§ 230.253(b)), the Final Offering Circular is the most recent of the offering circular filed pursuant to Rule 253(g)(1) or (3) (§ 230.253(g)(1) or (3)) and any subsequent offering circular filed pursuant to Rule 253(g) (§ 230.253(g)).

(f) *Offering statement*. An offering statement prepared pursuant to Regulation A.

(g) *Preliminary offering circular*. The offering circular described in Rule 254 (§ 230.254).

[80 FR 21895, Apr. 20, 2015]

§ 230.262 Disqualification provisions.

(a) *Disqualification events*. No exemption under this Regulation A shall be available for a sale of securities if the issuer; any predecessor of the issuer; any affiliated issuer; any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer; any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power; any promoter connected with the issuer in any capacity at the time of filing, any offer after qualification, or such sale; any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; any general partner or managing member of any such solicitor; or any director, executive officer or other officer participating in the offering of any such solicitor or general partner or managing member of such solicitor:

(1) Has been convicted, within ten years before the filing of the offering statement (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:

(i) In connection with the purchase or sale of any security;

(ii) Involving the making of any false filing with the Commission; or

(iii) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

(2) Is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before the filing of the offering statement, that, at the time of such filing, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice:

(i) In connection with the purchase or sale of any security;

(ii) Involving the making of any false filing with the Commission; or

(iii) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

(3) Is subject to a final order (as defined in Rule 261 (§ 230.261)) of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; the U.S. Commodity Futures Trading Commission; or the National Credit Union Administration that:

(i) At the time of the filing of the offering statement, bars the person from:

(A) Association with an entity regulated by such commission, authority, agency, or officer;

(B) Engaging in the business of securities, insurance or banking; or

(C) Engaging in savings association or credit union activities; or

(ii) Constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such filing of the offering statement;

(4) Is subject to an order of the Commission entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(b) or 78*o*–4(c)) or section 203(e) or (f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3(e) or (f)) that, at the time of the filing of the offering statement:

(i) Suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser;

(ii) Places limitations on the activities, functions or operations of such person; or

(iii) Bars such person from being associated with any entity or from participating in the offering of any penny stock;

(5) Is subject to any order of the Commission entered within five years before the filing of the offering statement that, at the time of such filing, orders the person to cease and desist from committing or causing a violation or future violation of:

(i) Any scienter-based anti-fraud provision of the federal securities laws, including without limitation section 17(a)(1) of the Securities Act of 1933 (15 U.S.C. 77q(a)(1)), section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and 17 CFR 240.10b–5, section 15(c)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(c)(1)) and section 206(1) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–6(1)), or any other rule or regulation thereunder; or

(ii) Section 5 of the Securities Act of 1933 (15 U.S.C. 77e).

(6) Is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;

(7) Has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or offering statement filed with the Commission that, within five years before the filing of the offering statement, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such filing, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; or

(8) Is subject to a United States Postal Service false representation order entered within five years before the filing of the offering statement, or is, at the time of such filing, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

(b) *Transition, waivers, reasonable care exception.* Paragraph (a) of this section shall not apply:

(1) With respect to any order under § 230.262(a)(3) or (5) that occurred or was issued before June 19, 2015;

(2) Upon a showing of good cause and without prejudice to any other action by the Commission, if the Commission determines that it is not necessary under the circumstances that an exemption be denied;

(3) If, before the filing of the offering statement, the court or regulatory authority that entered the relevant order, judgment or decree advises in writing (whether contained in the relevant judgment, order or decree or separately to the Commission or its staff) that disqualification under paragraph (a) of this section should not arise as a consequence of such order, judgment or decree; or

(4) If the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed under paragraph (a) of this section.

NOTE TO PARAGRAPH (b)(4). An issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualifications exist. The nature and scope of the factual inquiry will vary based on the facts and circumstances concerning, among other things, the issuer and the other offering participants.

(c) *Affiliated issuers.* For purposes of paragraph (a) of this section, events relating to any affiliated issuer that occurred before the affiliation arose will be not considered disqualifying if the affiliated entity is not:

(1) In control of the issuer; or

(2) Under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.

(d) *Disclosure of prior "bad actor" events.* The issuer must include in the offering circular a description of any matters that would have triggered disqualification under paragraphs (a)(3) and (5) of this section but occurred before June 19, 2015. The failure to provide such information shall not prevent an issuer from relying on Regulation A if the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known of the existence of the undisclosed matter or matters.

[80 FR 21895, Apr. 20, 2015]

§ 230.263 Consent to service of process.

(a) If the issuer is not organized under the laws of any of the states or territories of the United States of America, it shall furnish to the Commission a written irrevocable consent and power of attorney on Form F–X (§ 239.42 of this chapter) at the time of filing the offering statement required by Rule 252 (§ 230.252).

(b) Any change to the name or address of the agent for service of the issuer shall be communicated promptly to the Commission through amendment of the requisite form and referencing the file number of the relevant offering statement.

[80 FR 21895, Apr. 20, 2015]

§§ 230.300–230.346 [Reserved]

ATTENTION ELECTRONIC FILERS

THIS REGULATION SHOULD BE READ IN CONJUNCTION WITH REGULATION S-T (PART 232 OF THIS CHAPTER), WHICH GOVERNS THE PREPARATION AND SUBMISSION OF DOCUMENTS IN ELECTRONIC FORMAT. MANY PROVISIONS RELATING TO THE PREPARATION AND SUBMISSION OF DOCUMENTS IN PAPER FORMAT CONTAINED IN THIS REGULATION ARE SUPERSEDED BY THE PROVISIONS OF REGULATION S-T FOR DOCUMENTS REQUIRED TO BE FILED IN ELECTRONIC FORMAT.

REGULATION C—REGISTRATION

AUTHORITY: Sections 230.400 to 230.499 issued under secs. 6, 8, 10, 19, 48 Stat. 78 79, 81, and 85, as amended (15 U.S.C. 77f, 77h, 77j, 77s)

Sec. 230.457 also issued under secs. 6 and 7, 15 U.S.C. 77f and 77g.

NOTE: In §§ 230.400 to 230.499, the numbers to the right of the decimal point correspond with the respective rule number in Regulation C, under the Securities Act of 1933.

§ 230.400 Application of §§ 230.400 to 230.494, inclusive.

Sections 230.400 to 230.494 shall govern every registration of securities under the Act, except that any provision in a form, or an item of Regulation S-K (17 CFR 229.001 *et seq.*) referred to in such form, covering the same subject matter as any such rule shall be controlling unless otherwise specifically provided in §§ 230.400 to 230.494.

[47 FR 11434, Mar. 16, 1982, as amended at 76 FR 71876, Nov. 21, 2011]

GENERAL REQUIREMENTS

§ 230.401 Requirements as to proper form.

(a) The form and contents of a registration statement and prospectus shall conform to the applicable rules and forms as in effect on the initial filing date of such registration statement and prospectus.

(b) If an amendment to a registration statement and prospectus is filed for the purpose of meeting the requirements of section 10(a)(3) of the Act or pursuant to the provisions of section 24(e) or 24(f) of the Investment Company Act of 1940, the form and contents of such an amendment shall conform to the applicable rules and forms as in effect on the filing date of such amendment.

(c) An amendment to a registration statement and prospectus, other than an amendment described in paragraph (b) of this section, may be filed on any shorter Securities Act registration form for which it is eligible on the filing date of the amendment. At the issuer's option, the amendment also may be filed on the same Securities Act registration form used for the most recent amendment described in paragraph (b) of this section or, if no such amendment has been filed, the initial registration statement and prospectus.

(d) The form and contents of a prospectus forming part of a registration statement which is the subject of a stop order entered under section 8(d) of the Act, if used after the date such stop order ceases to be effective, shall conform to the applicable rules and forms as in effect on the date such stop order ceases to be effective.

(e) A prospectus filed as part of an amendment to an effective registration statement, or other amendment to such registration statement, on any form may be prepared in accordance with the requirements of any other

Item 2. General Description of Issuer

(a) Concisely discuss the organization and operation or proposed operation of the issuer. Include the following:

(i) Basic identifying information, including:

(A) The date and form of organization of the issuer and the name of the state under the laws of which it is organized; and

(B) A brief description of the nature of a business development company.

NOTE: A business development company having a wholly-owned small business investment company subsidiary should disclose how the subsidiary is regulated, e.g., as an investment company registered under the Investment Company Act of 1940, and what percentage of the parent company's assets are, or are expected to be, invested in the subsidiary. The business development company should also describe the small business investment company's operations, including any material difference in investment policies between the business development company and its small business investment company subsidiary.

(ii) A concise description of the investment objectives and policies of the issuer, including:

(A) If those objectives may be changed without a vote of the holders of the majority of the voting securities, a brief statement to that effect; and

(B) A brief discussion of how the issuer proposes to achieve such objectives, including:

(*1*) The types of securities (for example, bonds, convertible debentures, preferred stocks, common stock) in which it may invest, indicating the proportion of the assets which may be invested in each such type of security;

(*2*) The issuer proposes to have a policy of concentrating in a particular industry or group of industries, identification of such industry or industries. (Concentration, for purposes of this item, is deemed to be 25% or more of the value of the issuer's total assets invested or proposed to be invested in a particular industry or group of industries).

(*3*) In companies for the purpose of exercising control or management;

(*4*) The policy with respect to any assets that are not required to be invested in eligible portfolio companies or other companies qualifying under section 55 of the Investment Company Act of 1940;

(*5*) The policy with respect to rendering significant managerial assistance to eligible portfolio companies or other companies qualifying under section 55 of the Investment Company Act of 1940;

(*6*) The policy with respect to investing as part of a group.

(C) Identification of any other policies of the issuer that may not be changed without the vote of the majority of the outstanding voting securities, including the policy not to withdraw its election as a business development company without approval by the majority of the outstanding voting securities.

(D) A concise description of those significant investment policies or techniques (such as investing for control or management) that are not described pursuant to subparagraphs (B) or (C) above that the issuer employs or has the current intention of employing in the forseeable future.

(b) Discuss briefly the principal risk factors associated with investment in the issuer, including factors peculiar to the issuer as well as those generally attendant to investment in a business development company with investment policies and objectives similar to the issuer.

Item 3. Same as Item 3 of Schedule A.

Item 4. Same as Item 4 of Schedule A.

Item 5. Same as Item 5 of Schedule A.

Item 6. Same as Item 6 of Schedule A.

Item 7. Same as Item 7 of Schedule A.

(Secs. 3(b) and 3(c), Securities Act of 1933 (15 U.S.C. 77c (b) and (c)); sec. 38, Investment Company Act of 1940 (15 U.S.C. 80a–37))

[49 FR 35345, Sept. 7, 1984]

§§ 230.651–230.656 [Reserved]

§ 230.701 Exemption for offers and sales of securities pursuant to certain compensatory benefit plans and contracts relating to compensation.

PRELIMINARY NOTES: 1. This section relates to transactions exempted from the registration requirements of section 5 of the Act (15 U.S.C. 77e). These transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws. Issuers and persons acting on their behalf have an obligation to provide investors with disclosure adequate to satisfy the antifraud provisions of the federal securities laws.

2. In addition to complying with this section, the issuer also must comply with any applicable state law relating to the offer and sale of securities.

3. An issuer that attempts to comply with this section, but fails to do so, may claim any other exemption that is available.

4. This section is available only to the issuer of the securities. Affiliates of the issuer may not use this section to offer or sell securities. This section also does not cover resales of securities by any person. This section provides an exemption only for the transactions in which the securities are offered or sold by the issuer, not for the securities themselves.

5. The purpose of this section is to provide an exemption from the registration requirements of the Act for securities issued in compensatory circumstances. This section is not available for plans or schemes to circumvent this purpose, such as to raise capital. This section also is not available to exempt any transaction that is in technical compliance with this section but is part of a plan or scheme to evade the registration provisions of the Act. In any of these cases, registration under the Act is required unless another exemption is available.

(a) *Exemption.* Offers and sales made in compliance with all of the conditions of this section are exempt from section 5 of the Act (15 U.S.C. 77e).

(b) *Issuers eligible to use this section*—(1) *General.* This section is available to any issuer that is not subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934 (the ''Exchange Act'') (15 U.S.C. 78m or 78o(d)) and is not an investment company registered or required to be registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*).

(2) *Issuers that become subject to reporting.* If an issuer becomes subject to the reporting requirements of section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)) after it has made offers complying with this section, the issuer may nevertheless rely on this section to sell the securities previously offered to the persons to whom those offers were made.

(3) *Guarantees by reporting companies.* An issuer subject to the reporting requirements of section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m, 78o(d)) may rely on this section if it is merely guaranteeing the payment of a subsidiary's securities that are sold under this section.

(c) *Transactions exempted by this section.* This section exempts offers and sales of securities (including plan interests and guarantees pursuant to paragraph (d)(2)(ii) of this section) under a written compensatory benefit plan (or written compensation contract) established by the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parent, for the participation of their employees, directors, general partners, trustees (where the issuer is a business trust), officers, or consultants and advisors, and their family members who acquire such securities from such persons through gifts or domestic relations orders. This section exempts offers and sales to former employees, directors, general partners, trustees, officers, consultants and advisors only if such persons were employed by or providing services to the issuer at the time the securities were offered. In addition, the term ''employee'' includes insurance agents who are exclusive agents of the issuer, its subsidiaries or parents, or derive more than 50% of their annual income from those entities.

(1) *Special requirements for consultants and advisors.* This section is available to consultants and advisors only if:

(i) They are natural persons;

(ii) They provide *bona fide* services to the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parent; and

(iii) The services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the issuer's securities.

(2) *Definition of ''compensatory benefit plan.''* For purposes of this section, a *compensatory benefit plan* is any purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, deferred compensation, pension or similar plan.

(3) *Definition of ''family member.''* For purposes of this section, *family member* includes any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, former spouse, sibling, niece, nephew, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptive relationships, any person sharing the employee's household (other than a tenant or employee), a trust in which these persons have more than fifty percent of the beneficial interest, a foundation in which these persons (or the employee) control the management of assets, and any other entity in which these persons (or the employee) own more than fifty percent of the voting interests.

(d) *Amounts that may be sold*—(1) *Offers.* Any amount of securities may be offered in reliance on this section. However, for purposes of this section, sales of securities underlying options must be counted as sales on the date of the option grant.

(2) *Sales.* The aggregate sales price or amount of securities sold in reliance on this section during any consecutive 12-month period must not exceed the greatest of the following:

(i) $1,000,000;

(ii) 15% of the total assets of the issuer (or of the issuer's parent if the issuer is a wholly-owned subsidiary and the securities represent obligations that the parent fully and unconditionally guarantees), measured at the issuer's most recent balance sheet date (if no older than its last fiscal year end); or

(iii) 15% of the outstanding amount of the class of securities being offered and sold in reliance on this section, measured at the issuer's most recent balance sheet date (if no older than its last fiscal year end).

(3) *Rules for calculating prices and amounts*—(i) *Aggregate sales price.* The term *aggregate sales price* means the sum of all cash, property, notes, cancellation of debt or other consideration received or to be received by the issuer for the sale of the securities. Non-cash consideration must be valued by reference to *bona fide* sales of that consideration made within a reasonable time or, in the absence of such sales, on the fair value as determined by an accepted standard. The value of services exchanged for securities issued must be measured by reference to the value of the securities issued. Options must be valued based on the exercise price of the option.

(ii) *Time of the calculation.* With respect to options to purchase securities, the aggregate sales price is determined when an option grant is made (without regard to when the option becomes exercisable). With respect to other securities, the calculation is made on the date of sale. With respect to deferred compensation or similar plans, the calculation is made when the irrevocable election to defer is made.

(iii) *Derivative securities.* In calculating outstanding securities for purposes of paragraph (d)(2)(iii) of this section, treat the securities underlying all currently exercisable or convertible options, warrants, rights or other securities, other than those issued under this exemption, as outstanding. In calculating the amount of securities sold for other purposes of paragraph (d)(2) of this section, count the amount of securities that would be acquired upon exercise or conversion in connection with sales of options, warrants, rights or other exercisable or convertible securities, including those to be issued under this exemption.

(iv) *Other exemptions.* Amounts of securities sold in reliance on this section do not affect "aggregate offering prices" in other exemptions, and amounts of securities sold in reliance on other exemptions do not affect the amount that may be sold in reliance on this section.

(e) *Disclosure that must be provided.* The issuer must deliver to investors a copy of the compensatory benefit plan or the contract, as applicable. In addition, if the aggregate sales price or amount of securities sold during any consecutive 12-month period exceeds $10 million, the issuer must deliver the following disclosure to investors a reasonable period of time before the date of sale:

(1) If the plan is subject to the Employee Retirement Income Security Act of 1974 ("ERISA") (29 U.S.C. 1104–1107), a copy of the summary plan description required by ERISA;

(2) If the plan is not subject to ERISA, a summary of the material terms of the plan;

(3) Information about the risks associated with investment in the securities sold pursuant to the compensatory benefit plan or compensation contract; and

(4) Financial statements required to be furnished by Part F/S of Form 1–A (Regulation A Offering Statement) (§ 239.90 of this chapter) under Regulation A (§§ 230.251 through 230.263). Foreign private issuers as defined in Rule 405 must provide a reconciliation to generally accepted accounting principles in the United States (U.S. GAAP) if their financial statements are not prepared in accordance with U.S. GAAP or International Financial Reporting Standards as issued by the International Accounting Standards Board (Item 17 of Form 20–F (§ 249.220f

of this chapter)). The financial statements required by this section must be as of a date no more than 180 days before the sale of securities in reliance on this exemption.

(5) If the issuer is relying on paragraph (d)(2)(ii) of this section to use its parent's total assets to determine the amount of securities that may be sold, the parent's financial statements must be delivered. If the parent is subject to the reporting requirements of section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)), the financial statements of the parent required by Rule 10–01 of Regulation S-X (§ 210.10–01 of this chapter) and Item 310 of Regulation D-B (§ 228.310 of this chapter), as applicable, must be delivered.

(6) If the sale involves a stock option or other derivative security, the issuer must deliver disclosure a reasonable period of time before the date of exercise or conversion. For deferred compensation or similar plans, the issuer must deliver disclosure to investors a reasonable period of time before the date the irrevocable election to defer is made.

(f) *No integration with other offerings.* Offers and sales exempt under this section are deemed to be a part of a single, discrete offering and are not subject to integration with any other offers or sales, whether registered under the Act or otherwise exempt from the registration requirements of the Act.

(g) *Resale limitations.* (1) Securities issued under this section are deemed to be ''restricted securities'' as defined in § 230.144.

(2) Resales of securities issued pursuant to this section must be in compliance with the registration requirements of the Act or an exemption from those requirements.

(3) Ninety days after the issuer becomes subject to the reporting requirements of section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)), securities issued under this section may be resold by persons who are not affiliates (as defined in § 230.144) in reliance on § 230.144, without compliance with paragraphs (c) and (d) of § 230.144, and by affiliates without compliance with paragraph (d) of § 230.144.

[64 FR 11101, Mar. 8, 1999, as amended at 64 FR 61498, Nov. 12, 1999; 72 FR 71571, Dec. 17, 2007; 73 FR 1009, Jan. 4, 2008; 83 FR 34944, July 24, 2018]

§§ 230.702(T)–230.703(T) [Reserved]

EXEMPTIONS FOR CROSS-BORDER RIGHTS OFFERINGS, EXCHANGE OFFERS AND BUSINESS COMBINATIONS

SOURCE: Sections 230.800 through 230.802 appear at 64 FR 61400, Nov. 10, 1999, unless otherwise noted.

GENERAL NOTES TO §§ 230.800, 230.801 AND 230.802

1. Sections 230.801 and 230.802 relate only to the applicability of the registration provisions of the Act (15 U.S.C. 77e) and not to the applicability of the anti-fraud, civil liability or other provisions of the federal securities laws.

2. The exemptions provided by § 230.801 and § 230.802 are not available for any securities transaction or series of transactions that technically complies with § 230.801 and § 230.802 but are part of a plan or scheme to evade the registration provisions of the Act.

3. An issuer who relies on § 230.801 or an offeror who relies on § 230.802 must still comply with the securities registration or broker-dealer registration requirements of the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) and any other applicable provisions of the federal securities laws.

4. An issuer who relies on § 230.801 or an offeror who relies on § 230.802 must still comply with any applicable state laws relating to the offer and sale of securities.

5. Attempted compliance with § 230.801 or § 230.802 does not act as an exclusive election; an issuer making an offer or sale of securities in reliance on § 230.801 or § 230.802 may also rely on any other applicable exemption from the registration requirements of the Act.

6. Section 230.801 and § 230.802 provide exemptions only for the issuer of the securities and not for any affiliate of that issuer or for any other person for resales of the issuer's securities. These sections provide exemptions only for the transaction in which the issuer or other person offers or sells the securities, not for the securities themselves. Securities acquired in a § 230.801 or § 230.802 transaction may be resold in the United States only if they are registered under the Act or an exemption from registration is available.

§ 240.15c1–9 Use of pro forma balance sheets.

The term *manipulative, deceptive, or other fraudulent device or contrivance*, as used in section 15(c)(1) of the Act, is hereby defined to include the use of financial statements purporting to give effect to the receipt and application of any part of the proceeds from the sale or exchange of securities, unless the assumptions upon which each such financial statement is based are clearly set forth as part of the caption to each such statement in type at least as large as that used generally in the body of the statement.

(Sec. 2, 52 Stat. 1075; 15 U.S.C. 78*o*)

[13 FR 8205, Dec. 22, 1948]

§ 240.15c2–1 Hypothecation of customers' securities.

(a) *General provisions*. The term *fraudulent, deceptive, or manipulative act or practice*, as used in section 15(c) (2) of the Act, is hereby defined to include the direct or indirect hypothecation by a broker or dealer, or his arranging for or permitting, directly or indirectly, the continued hypothecation of any securities carried for the account of any customer under circumstances:

(1) That will permit the commingling of securities carried for the account of any such customer with securities carried for the account of any other customer, without first obtaining the written consent of each such customer to such hypothecation;

(2) That will permit such securities to be commingled with securities carried for the account of any person other than a bona fide customer of such broker or dealer under a lien for a loan made to such broker or dealer; or

(3) That will permit securities carried for the account of customers to be hypothecated, or subjected to any lien or liens or claims or claims of the pledgee or pledgees, for a sum which exceeds the aggregate indebtedness of all customers in respect of securities carried for their accounts; except that this clause shall not be deemed to be violated by reason of an excess arising on any day through the reduction of the aggregate indebtedness of customers on such day, provided that funds or securities in an amount sufficient to eliminate such excess are paid or placed in transfer to pledgees for the purpose of reducing the sum of the liens or claims to which securities carried for the account of customers are subject as promptly as practicable after such reduction occurs, but before the lapse of one half hour after the commencement of banking hours on the next banking day at the place where the largest principal amount of loans of such broker or dealer are payable and, in any event, before such broker or dealer on such day has obtained or increased any bank loan collateralized by securities carried for the account of customers.

(b) *Definitions*. For the purposes of this section:

(1) The term *customer* shall not include any general or special partner or any director or officer of such broker or dealer, or any participant, as such, in any joint, group or syndicate account with such broker or dealer or with any partner, officer or director thereof. The term also shall not include a counterparty who has delivered collateral to an OTC derivatives dealer pursuant to a transaction in an eligible OTC derivative instrument, or pursuant to the OTC derivatives dealer's cash management securities activities or ancillary portfolio management securities activities, and who has received a prominent written notice from the OTC derivatives dealer that:

(i) Except as otherwise agreed in writing by the OTC derivatives dealer and the counterparty, the dealer may repledge or otherwise use the collateral in its business;

(ii) In the event of the OTC derivatives dealer's failure, the counterparty will likely be considered an unsecured creditor of the dealer as to that collateral;

(iii) The Securities Investor Protection Act of 1970 (15 U.S.C 78aaa through 78lll) does not protect the counterparty; and

(iv) The collateral will not be subject to the requirements of § 240.8c–1, § 240.15c2–1, § 240.15c3–2, or § 240.15c3–3;

(2) The term *securities carried for the account of any customer* shall be deemed to mean:

(i) Securities received by or on behalf of such broker or dealer for the account of any customer;

(ii) Securities sold and appropriated by such broker or dealer to a customer, except that if such securities were subject to a lien when appropriated to a customer they shall not be deemed to be ''securities carried for the account of any customer'' pending their release from such lien as promptly as practicable;

(iii) Securities sold, but not appropriated, by such broker or dealer to a customer who has made any payment therefor, to the extent that such broker or dealer owns and has received delivery of securities of like kind, except that if such securities were subject to a lien when such payment was made they shall not be deemed to be ''securities carried for the account of any customer'' pending their release from such lien as promptly as practicable;

(3) *Aggregate indebtedness* shall not be deemed to be reduced by reason of uncollected items. In computing aggregate indebtedness, related guaranteed and guarantor accounts shall be treated as a single account and considered on a consolidated basis, and balances in accounts carrying both long and short positions shall be adjusted by treating the market value of the securities required to cover such short positions as though such market value were a debit; and

(4) In computing the sum of the liens or claims to which securities carried for the account of customers of a broker or dealer are subject, any rehypothecation of such securities by another broker or dealer who is subject to this section or to § 240.8c–1 shall be disregarded.

(c) *Exemption for cash accounts.* The provisions of paragraph (a)(1) of this section shall not apply to any hypothecation of securities carried for the account of a customer in a special cash account within the meaning of 12 CFR 220.4(c): *Provided,* That at or before the completion of the transaction of purchase of such securities for, or of sale of such securities to, such customer, written notice is given or sent to such customer disclosing that such securities are or may be hypothecated under circumstances which will permit the commingling thereof with securities carried for the account of other customers. The term *the completion of the transaction* shall have the meaning given to such term by § 240.15c1–1(b).

(d) *Exemption for clearing house liens.* The provisions of paragraphs (a)(2), (a)(3), and (f) of this section shall not apply to any lien or claim of the clearing corporation, or similar department or association, of a national securities exchange or a registered national securities association, for a loan made and to be repaid on the same calendar day, which is incidental to the clearing of transactions in securities or loans through such corporation, department, or association: *Provided, however,* That for the purpose of paragraph (a)(3) of this section, ''aggregate indebtedness of all customers in respect of securities carried for their accounts'' shall not include indebtedness in respect of any securities subject to any lien or claim exempted by this paragraph.

(e) *Exemption for certain liens on securities of noncustomers.* The provisions of paragraph (a)(2) of this section shall not be deemed to prevent such broker or dealer from permitting securities not carried for the account of a customer to be subjected (1) to a lien for a loan made against securities carried for the account of customers, or (2) to a lien for a loan made and to be repaid on the same calendar day. For the purpose of this exemption, a loan shall be deemed to be ''made against securities carried for the account of customers'' if only securities carried for the account of customers are used to obtain or to increase such loan or as substitutes for other securities carried for the account of customers.

(f) *Notice and certification requirements.* No person subject to this section shall hypothecate any security carried for the account of a customer unless, at or prior to the time of each such hypothecation, he gives written notice to the pledgee that the security pledged is carried for the account of a customer and that such hypothecation does not contravene any provision of this section, except that in the case of an omnibus account the broker or dealer for whom such account is carried may furnish a signed statement to the person carrying such account that all securities carried therein by such broker or dealer will be securities carried for the account of his customers and that the hypothecation thereof by such broker or dealer will not contravene any provision of this section. The provisions of this paragraph shall not apply to any hypothecation of securities under any lien or claim of a pledgee securing a loan made and to be repaid on the same calendar day.

(g) The fact that securities carried for the accounts of customers and securities carried for the accounts of others are represented by one or more certificates in the custody of a clearing corporation or other subsidiary organization of either a national securities exchange or of a registered national securities association, or of a custodian bank, in accordance with a system for the central handling of securities established by a national securities exchange or a registered national securities association, pursuant to which system the hypothecation of such securities is effected by bookkeeping entries without physical delivery of such securities, shall not, in and of itself, result in a commingling of securities prohibited by paragraph (a)(1) or (a)(2) of this section, whenever a participating member, broker or dealer hypothecates securities in accordance with such system: *Provided, however,* That (1) any such custodian of any securities held by or for such system shall agree that it will not for any reason, including the assertion of any claim, right or lien of any kind, refuse or refrain from promptly delivering any such securities (other than securities then hypothecated in accordance with such system) to such clearing corporation or other subsidiary organization or as directed by it, except that nothing in such agreement shall be deemed to require the custodian to deliver any securities in contravention of any notice of levy, seizure or similar notice, or order or judgment, issued or directed by a governmental agency or court, or officer thereof, having jurisdiction over such custodian, which on its face affects such securities; (2) such systems shall have safeguards in the handling, transfer and delivery of securities and provisions for fidelity bond coverage of the employees and agents of the clearing corporation or other subsidiary organization and for periodic examinations by independent public accountants; and (3) the provisions of this paragraph (g) shall not be effective with respect to any particular system unless the agreement required by paragraph (g)(1) of this section and the safeguards and provisions required by paragraph (g)(2) of this section shall have been deemed adequate by the Commission for the protection of investors, and unless any subsequent amendments to such agreement, safeguards or provisions shall have been deemed adequate by the Commission for the protection of investors.

(Secs. 8, 15, 48 Stat. 888, 895, sec. 2, 52 Stat. 1075; 15 U.S.C. 78b. 78*o*)

CROSS REFERENCE: For interpretative releases applicable to §240.15c2–1, see Nos. 2690 and 2822 in tabulation, part 241 of this chapter.

[13 FR 8205, Dec. 22, 1948, as amended at 31 FR 7741, June 1, 1966; 37 FR 73, Jan. 5, 1972; 63 FR 59397, Nov. 3, 1998]

§ 240.15c2–3 [Reserved]

§ 240.15c2–4 Transmission or maintenance of payments received in connection with underwritings.

It shall constitute a ''fraudulent, deceptive, or manipulative act or practice'' as used in section 15(c)(2) of the Act, for any broker, dealer or municipal securities dealer participating in any distribution of securities, other than a firm-commitment underwriting, to accept any part of the sale price of any security being distributed unless:

(a) The money or other consideration received is promptly transmitted to the persons entitled thereto; or

(b) If the distribution is being made on an ''all-or-none'' basis, or on any other basis which contemplates that payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs, (1) the money or other consideration received is promptly deposited in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, until the appropriate event or contingency has occurred, and then the funds are promptly transmitted or returned to the persons entitled thereto, or (2) all such funds are promptly transmitted to a bank which has agreed in writing to hold all such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred.

[41 FR 22826, June 7, 1976]

§ 240.15c2–5 Disclosure and other requirements when extending or arranging credit in certain transactions.

(a) It shall constitute a ''fraudulent, deceptive, or manipulative act or practice'' as used in section 15(c)(2) of the Act for any broker or dealer to offer or sell any security to, or to attempt to induce the purchase of any security by, any person, in connection with which such broker or dealer directly or indirectly offers to extend any credit to or to arrange any loan for such person, or extends to or participates in arranging any loan for such person, unless such broker or dealer, before any purchase, loan or other related element of the transaction is entered into:

(1) Delivers to such person a written statement setting forth the exact nature and extent of (i) such person's obligations under the particular loan arrangement, including among other things, the specific charges which such person will incur under such loan in each period during which the loan may continue or be extended, (ii) the risks and disadvantages which such person will incur in the entire transaction, including the loan arrangement, (iii) all commissions, discounts, and other remuneration received and to be received in connection with the entire transaction including the loan arrangment, by the broker or dealer, by any person controlling, controlled by, or under common control with the broker or dealer, and by any other person participating in the transaction; *Provided, however,* That the broker or dealer shall be deemed to be in compliance with this paragraph if the customer, before any purchase, loan, or other related element of the transaction is entered into in a manner legally binding upon the customer, receives a statement from the lender, or receives a prospectus or offering circular from the broker or dealer, which statement, prospectus or offering circular contains the information required by this paragraph; and

(2) Obtains from such person information concerning his financial situation and needs, reasonably determines that the entire transaction, including the loan arrangement, is suitable for such person, and retains in his files a written statement setting forth the basis upon which the broker or dealer made such determination; *Provided, however,* That the written statement referred to in this paragraph must be made available to the customer on request.

(b) This section shall not apply to any credit extended or any loan arranged by any broker or dealer subject to the provisions of Regulation T (12 CFR part 220) if such credit is extended or such loan is arranged, in compliance with the requirements of such regulation, only for the purpose of purchasing or carrying the security offered or sold: *Provided, however,* That notwithstanding this paragraph, the provisions of paragraph (a) shall apply in full force with respect to any transaction involving the extension of or arrangement for credit by a broker or dealer (i) in a special insurance premium funding account within the meaning of section 4(k) of Regulation T (12 CFR 220.4(k)) or (ii) in compliance with the terms of § 240.3a12–5 of this chapter.

(c) This section shall not apply to any offer to extend credit or arrange any loan, or to any credit extended or loan arranged, in connection with any offer or sale, or attempt to induce the purchase, of any municipal security.

(d) This section shall not apply to a transaction involving the extension of credit by an OTC derivatives dealer, as defined in § 240.3b–12, if the transaction is exempt from the provisions of Section 7(c) of the Act (15 U.S.C. 78g(c)) pursuant to § 240.36a1–1.

(Sec. 3(a)(12), 48 Stat. 882, as amended, 84 Stat. 718, 1435, 1499 (15 U.S.C. 78c(12)); sec. 7(c), 48 Stat. 886, as amended, 82 Stat. 452 (15 U.S.C. 78g(c)); sec. 11(d)(1), 48 Stat. 891 as amended, 68 Stat. 686 (15 U.S.C. 78k(d)(1)); sec. 15(c), 48 Stat. 895, as amended, 52 Stat. 1075, 84 Stat. 1653 (15 U.S.C. 78*o*(c)); sec. 23(a), 48 Stat. 901, as amended, 49 Stat. 704, 1379 (15 U.S.C. 78w(a))

[40 FR 6646, Feb. 13, 1975, as amended at 41 FR 22826, June 7, 1976; 63 FR 59397, Nov. 3, 1998]

§ 240.15c2–6 [Reserved]

§ 240.15c2–7 Identification of quotations.

(a) It shall constitute an attempt to induce the purchase or sale of a security by making a ''fictitious quotation'' within the meaning of section 15(c)(2) of the Act, for any broker or dealer to furnish or submit, directly or indirectly, any quotation for a security (other than a municipal security) to an inter-dealer quotation system unless:

(1) The inter-dealer-quotation-system is informed, if such is the case, that the quotation is furnished or submitted;

(i) By a correspondent broker or dealer for the account or in behalf of another broker or dealer, and if so, the identity of such other broker or dealer; and/or

(ii) In furtherance of one or more other arrangements (including a joint account, guarantee of profit, guarantee against loss, commission, markup, markdown, indication of interest and accommodation arrangement) between or among brokers or dealers, and if so, the identity of each broker or dealer participating in any such arrangement or arrangements: *Provided, however*, That the provisions of this subparagraph shall not apply if only one of the brokers or dealers participating in any such arrangment or arrangements furnishes or submits a quotation with respect to the security to an inter-dealer-quotation-system.

(2) The inter-dealer-quotation-system to which the quotation is furnished or submitted makes it a general practice to disclose with each published quotation, by appropriate symbol or otherwise, the category or categories (paragraph (a)(1)(i) and/or (ii) of this section) in furtherance of which the quotation is submitted, and the identities of all other brokers and dealers referred to in paragraph (a)(1) of this section where such information is supplied to the inter-dealer-quotation-system under the provisions of paragraph (a)(1) of this section.

(b) It shall constitute an attempt to induce the purchase or sale of a security by making a ''fictitious quotation,'' within the meaning of section 15(c)(2) of the Act, for a broker or dealer to enter into any correspondent or other arrangement (including a joint account, guarantee of profit, guarantee against loss, commission, markup, markdown, indication of interest and accommodation arrangement) in furtherance of which two or more brokers or dealers furnish or submit quotations with respect to a particular security unless such broker or dealer informs all brokers or dealers furnishing or submitting such quotations of the existence of such correspondent and other arrangments, and the identity of the parties thereto.

(c) For purposes of this section:

(1) The term *inter-dealer-quotation-system* shall mean any system of general circulation to brokers and dealers which regularly disseminates quotations of identified brokers or dealers but shall not include a quotation sheet prepared and distributed by a broker or dealer in the regular course of his business and containing only quotations of such broker or dealer.

(2) The term *quotation* shall mean any bid or offer, or any indication of interest (such as OW or BW) in any bid or offer.

(3) The term *correspondent* shall mean a broker or dealer who has a direct line of communication to another broker or dealer located in a different city or geographic area.

(Sec. 15, 48 Stat. 895, as amended; 15 U.S.C. 78o)

[29 FR 11530, Aug. 12, 1964, as amended at 41 FR 22826, June 7, 1976]

§ 240.15c2–8 Delivery of prospectus.

(a) It shall constitute a deceptive act or practice, as those terms are used in section 15(c)(2) of the Act, for a broker or dealer to participate in a distribution of securities with respect to which a registration statement has been filed under the Securities Act of 1933 unless he complies with the requirements set forth in paragraphs (b) through (h) of this section. For the purposes of this section, a broker or dealer participating in the distribution shall mean any underwriter and any member or proposed member of the selling group.

(b) In connection with an issue of securities, the issuer of which has not previously been required to file reports pursuant to sections 13(a) or 15(d) of the Securities Exchange Act of 1934, unless such issuer has been exempted from the requirement to file reports thereunder pursuant to section 12(h) of the Act, such broker or dealer shall deliver a copy of the preliminary prospectus to any person who is expected to receive a confirmation of sale at least 48 hours prior to the sending of such confirmation. This paragraph (b) does not apply with respect to asset-backed securities (as defined in §229.1101 of this chapter) that meet the requirements of General Instruction I.B.5 of Form S–3 (§239.13 of this chapter). Provided, however, this paragraph (b) shall apply to all issuances of asset-backed securities (as defined in §229.1101(c) of this chapter) regardless of whether the issuer has previously been required to file reports pursuant to sections 13(a) or 15(d) of the Securities Exchange Act of 1934, or exempted from the requirement to file reports thereunder pursuant to section 12(h) of the Act (15 U.S.C. 78l).

(c) Such broker or dealer shall take reasonable steps to furnish to any person who makes written request for a preliminary prospectus between the filing date and a reasonable time prior to the effective date of the registration statement to which such prospectus relates, a copy of the latest preliminary prospectus on file with the Commission. Reasonable steps shall include receiving an undertaking by the managing underwriter or underwriters to send such copy to the address given in the requests.

(d) Such broker or dealer shall take reasonable steps to comply promptly with the written request of any person for a copy of the final prospectus relating to such securities during the period between the effective date of the registration statement and the later of either the termination of such distribution, or the expiration of the applicable 40- or 90-day period under section 4(3) of the Securities Act of 1933. Reasonable steps shall include receiving an undertaking by the managing underwriter or underwriters to send such copy to the address given in the requests. (The 40-day and 90-day periods referred to above shall be deemed to apply for purposes of this rule irrespective of the provisions of paragraphs (b) and (d) of §230.174 of this chapter).

(e) Such broker or dealer shall take reasonable steps (1) to make available a copy of the preliminary prospectus relating to such securities to each of his associated persons who is expected, prior to the effective date, to solicit customers' order for such securities before the making of any such solicitation by such associated persons and (2) to make available to each such associated person a copy of any amended preliminary prospectus promptly after the filing thereof.

(f) Such broker or dealer shall take reasonable steps to make available a copy of the final prospectus relating to such securities to each of his associated persons who is expected, after the effective date, to solicit customers orders for such securities prior to the making of any such solicitation by such associated persons, unless a preliminary prospectus which is substantially the same as the final prospectus except for matters relating to the price of the stocks, has been so made available.

(g) If the broker or dealer is a managing underwriter of such distribution, he shall take reasonable steps to see to it that all other brokers or dealers participating in such distribution are promptly furnished with sufficient copies, as requested by them, of each preliminary prospectus, each amended preliminary prospectus and the final prospectus to enable them to comply with paragraphs (b), (c), (d), and (e) of this section.

(h) If the broker or dealer is a managing underwriter of such distribution, he shall take reasonable steps to see that any broker or dealer participating in the distribution or trading in the registered security is furnished reasonable quantities of the final prospectus relating to such securities, as requested by him, in order to enable him to comply with the prospectus delivery requirements of section 5(b) (1) and (2) of the Securities Act of 1933.

(i) This section shall not require the furnishing of prospectuses in any state where such furnishing would be unlawful under the laws of such state: *Provided, however,* That this provision is not to be construed to relieve a broker or dealer from complying with the requirements of section 5(b)(1) and (2) of the Securities Act of 1933.

[35 FR 18457, Dec. 4, 1970, as amended at 47 FR 11470, Mar. 16, 1982; 53 FR 11845, Apr. 11, 1988; 60 FR 26622, May 17, 1995; 70 FR 1622, Jan. 7, 2005; 79 FR 57344, Sept. 24, 2014]

§ 240.15c2–11 Initiation or resumption of quotations without specific information.

PRELIMINARY NOTE: Brokers and dealers may wish to refer to Securities Exchange Act Release No. 29094 (April 17, 1991), for a discussion of procedures for gathering and reviewing the information required by this rule and the requirement that a broker or dealer have a reasonable basis for believing that the information is accurate and obtained from reliable sources.

(a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for a broker or dealer to publish any quotation for a security or, directly or indirectly, to submit any such quotation for publication, in any quotation medium (as defined in this section) unless such broker or dealer has in its records the documents and information required by this paragraph (for purposes of this section, ''paragraph (a) information''), and, based upon a review of the paragraph (a) information together with any other documents and information required by paragraph (b) of this section, has a reasonable basis under the circumstances for believing that the paragraph (a) information is accurate in all material respects, and that the sources of the paragraph (a) information are reliable. The information required pursuant to this paragraph is:

(1) A copy of the prospectus specified by section 10(a) of the Securities Act of 1933 for an issuer that has filed a registration statement under the Securities Act of 1933, other than a registration statement on Form F–6, which became effective less than 90 calendar days prior to the day on which such broker or dealer publishes or submits the quotation to the quotation medium, *Provided* That such registration statement has not thereafter been the subject of a stop order which is still in effect when the quotation is published or submitted; or

(2) A copy of the offering circular provided for under Regulation A under the Securities Act of 1933 for an issuer that has filed a notification under Regulation A and was authorized to commence the offering less than 40 calendar days prior to the day on which such broker or dealer publishes or submits the quotation to the quotation medium, *Provided* That the offering circular provided for under Regulation A has not thereafter become the subject of a suspension order which is still in effect when the quotation is published or submitted; or

(3) A copy of the issuer's most recent annual report filed pursuant to section 13 or 15(d) of the Act or pursuant to Regulation A ((§§ 230.251 through 230.263 of this chapter), or a copy of the annual statement referred to in section 12(g)(2)(G)(i) of the Act in the case of an issuer required to file reports pursuant to section 13 or 15(d) of the Act or an issuer of a security covered by section 12(g)(2)(B) or (G) of the Act, together with any semiannual, quarterly and current reports that have been filed under the provisions of the Act or Regulation A by the issuer after such annual report or annual statement; *provided, however,* that until such issuer has filed its first annual report pursuant to section 13 or 15(d) of the Act or pursuant to Regulation A, or annual statement referred to in section 12(g)(2)(G)(i) of the Act, the broker or dealer has in its records a copy of the prospectus specified by section 10(a) of the Securities Act of 1933 included in a registration statement filed by the issuer under the Securities Act of 1933,

other than a registration statement on Form F–6, or a copy of the offering circular specified by Regulation A included in an offering statement filed by the issuer under Regulation A, that became effective or was qualified within the prior 16 months, or a copy of any registration statement filed by the issuer under section 12 of the Act that became effective within the prior 16 months, together with any semiannual, quarterly and current reports filed thereafter under section 13 or 15(d) of the Act or Regulation A; and *provided further*, that the broker or dealer has a reasonable basis under the circumstances for believing that the issuer is current in filing annual, semiannual, quarterly, and current reports filed pursuant to section 13 or 15(d) of the Act or Regulation A, or, in the case of an insurance company exempted from section 12(g) of the Act by reason of section 12(g)(2)(G) thereof, the annual statement referred to in section 12(g)(2)(G)(i) of the Act; or

(4) The information that, since the beginning of its last fiscal year, the issuer has published pursuant to §240.12g3–2(b), and which the broker or dealer shall make reasonably available upon the request of a person expressing an interest in a proposed transaction in the issuer's security with the broker or dealer, such as by providing the requesting person with appropriate instructions regarding how to obtain the information electronically; or

(5) The following information, which shall be reasonably current in relation to the day the quotation is submitted and which the broker or dealer shall make reasonably available upon request to any person expressing an interest in a proposed transaction in the security with such broker or dealer:

(i) The exact name of the issuer and its predecessor (if any);

(ii) The address of its principal executive offices;

(iii) The state of incorporation, if it is a corporation;

(iv) The exact title and class of the security;

(v) The par or stated value of the security;

(vi) The number of shares or total amount of the securities outstanding as of the end of the issuer's most recent fiscal year;

(vii) The name and address of the transfer agent;

(viii) The nature of the issuer's business;

(ix) The nature of products or services offered;

(x) The nature and extent of the issuer's facilities;

(xi) The name of the chief executive officer and members of the board of directors;

(xii) The issuer's most recent balance sheet and profit and loss and retained earnings statements;

(xiii) Similar financial information for such part of the 2 preceding fiscal years as the issuer or its predecessor has been in existence;

(xiv) Whether the broker or dealer or any associated person is affiliated, directly or indirectly with the issuer;

(xv) Whether the quotation is being published or submitted on behalf of any other broker or dealer, and, if so, the name of such broker or dealer; and

(xvi) Whether the quotation is being submitted or published directly or indirectly on behalf of the issuer, or any director, officer or any person, directly or indirectly the beneficial owner of more than 10 percent of the outstanding units or shares of any equity security of the issuer, and, if so, the name of such person, and the basis for any exemption under the federal securities laws for any sales of such securities on behalf of such person.

If such information is made available to others upon request pursuant to this paragraph, such delivery, unless otherwise represented, shall not constitute a representation by such broker or dealer that such information is accurate, but shall constitute a representation by such broker or dealer that the information is reasonably current in relation to the day the quotation is submitted, that the broker or dealer has a reasonable basis under the circumstances for believing the information is accurate in all material respects, and that the information was obtained from sources which the broker or dealer has a reasonable basis for believing are reliable. This paragraph (a)(5) shall not apply to any security of an issuer included in paragraph (a)(3) of this section unless a report or statement of such issuer described in paragraph (a)(3) of this section is not reasonably available to the broker or dealer. A report or statement of an issuer described in paragraph (a)(3) of this section shall be ''reasonably available'' when such report or statement is filed with the Commission.

(b) With respect to any security the quotation of which is within the provisions of this section, the broker or dealer submitting or publishing such quotation shall have in its records the following documents and information:

(1) A record of the circumstances involved in the submission of publication of such quotation, including the identity of the person or persons for whom the quotation is being submitted or published and any information regarding the transactions provided to the broker or dealer by such person or persons;

(2) A copy of any trading suspension order issued by the Commission pursuant to section 12(k) of the Act respecting any securities of the issuer or its predecessor (if any) during the 12 months preceding the date of the publication or submission of the quotation, or a copy of the public release issued by the Commission announcing such trading suspension order; and

(3) A copy or a written record of any other material information (including adverse information) regarding the issuer which comes to the broker's or dealer's knowledge or possession before the publication or submission of the quotation.

(c) The broker or dealer shall preserve the documents and information required under paragraphs (a) and (b) of this section for a period of not less than three years, the first two years in an easily accessible place.

(d)(1) For any security of an issuer included in paragraph (a)(5) of this section, the broker or dealer submitting the quotation shall furnish to the interdealer quotation system (as defined in paragraph (e)(2) of this section), in such form as such system shall prescribe, at least 3 business days before the quotation is published or submitted, the information regarding the security and the issuer which such broker or dealer is required to maintain pursuant to said paragraph (a)(5) of this section.

(2) For any security of an issuer included in paragraph (a)(3) of this section,

(i) A broker-dealer shall be in compliance with the requirement to obtain current reports filed by the issuer if the broker-dealer obtains all current reports filed with the Commission by the issuer as of a date up to five business days in advance of the earlier of the date of submission of the quotation to the quotation medium and the date of submission of the information in paragraph (a) of this section pursuant to the applicable rule of the Financial Industry Regulatory Authority, Inc. or its successor organization; and

(ii) A broker-dealer shall be in compliance with the requirement to obtain the annual, quarterly, and current reports filed by the issuer, if the broker-dealer has made arrangements to receive all such reports when filed by the issuer and it has regularly received reports from the issuer on a timely basis, unless the broker-dealer has a reasonable basis under the circumstances for believing that the issuer has failed to file a required report or has filed a report but has not sent it to the broker-dealer.

(e) For purposes of this section:

(1) *Quotation medium* shall mean any ''interdealer quotation system'' or any publication or electronic communications network or other device which is used by brokers or dealers to make known to others their interest in transactions in any security, including offers to buy or sell at a stated price or otherwise, or invitations of offers to buy or sell.

(2) *Interdealer quotation system* shall mean any system of general circulation to brokers or dealers which regularly disseminates quotations of identified brokers or dealers.

(3) Except as otherwise specified in this rule, *quotation* shall mean any bid or offer at a specified price with respect to a security, or any indication of interest by a broker or dealer in receiving bids or offers from others for a security, or any indication by a broker or dealer that he wishes to advertise his general interest in buying or selling a particular security.

(4) *Issuer*, in the case of quotations for American Depositary Receipts, shall mean the issuer of the deposited shares represented by such American Depositary Receipts.

(f) The provisions of this section shall not apply to:

(1) The publication or submission of a quotation respecting a security admitted to trading on a national securities exchange and which is traded on such an exchange on the same day as, or on the business day next preceding, the day the quotation is published or submitted.

(2) The publication or submission by a broker or dealer, solely on behalf of a customer (other than a person acting as or for a dealer), of a quotation that represents the customer's indication of interest and does not involve the solicitation of the customer's interest; *Provided, however*, That this paragraph (f)(2) shall not apply to a quotation consisting of both a bid and an offer, each of which is at a specified price, unless the quotation medium specifically identifies the quotation as representing such an unsolicited customer interest.

(3)(i) The publication or submission, in an interdealer quotation system that specifically identifies as such unsolicited customer indications of interest of the kind described in paragraph (f)(2) of this section, of a quotation respecting a security which has been the subject of quotations (exclusive of any identified customer interests) in such a system on each of at least 12 days within the previous 30 calendar days, with no more than 4 business days in succession without a quotation; or

(ii) The publication or submission, in an interdealer quotation system that does not so identify any such unsolicited customer indications of interest, of a quotation respecting a security which has been the subject of both bid and ask quotations in an interdealer quotation system at specified prices on each of at least 12 days within the previous 30 calendar days, with no more than 4 business days in succession without such a two-way quotation;

(iii) A dealer acting in the capacity of market maker, as defined in section 3(a)(38) of the Act, that has published or submitted a quotation respecting a security in an interdealer quotation system and such quotation has qualified for an exception provided in this paragraph (f)(3), may continue to publish or submit quotations for such security in the interdealer quotation system without compliance with this section unless and until such dealer ceases to submit or publish a quotation or ceases to act in the capacity of market maker respecting such security.

(4) The publication or submission of a quotation respecting a municipal security.

(5) The publication or submission of a quotation respecting a Nasdaq security (as defined in § 242.600 of this chapter), and such security's listing is not suspended, terminated, or prohibited.

(g) The requirement in paragraph (a)(5) of this section that the information with respect to the issuer be ''reasonably current'' will be presumed to be satisfied, unless the broker or dealer has information to the contrary, if:

(1) The balance sheet is as of a date less than 16 months before the publication or submission of the quotation, the statements of profit and loss and retained earnings are for the 12 months preceding the date of such balance sheet, and if such balance sheet is not as of a date less than 6 months before the publication or submission of the quotation, it shall be accompanied by additional statements of profit and loss and retained earnings for the period from the date of such balance sheet to a date less than 6 months before the publication or submission of the quotation.

(2) Other information regarding the issuer specified in paragraph (a)(5) of this section is as of a date within 12 months prior to the publication or submission of the quotation.

(h) This section shall not prohibit any publication or submission of any quotation if the Commission, upon written request or upon its own motion, exempts such quotation either unconditionally or on specified terms and conditions, as not constituting a fraudulent, manipulative or deceptive practice comprehended within the purpose of this section.

[36 FR 18641, Sept. 18, 1971, as amended at 41 FR 22826, June 7, 1976; 49 FR 45123, Nov. 15, 1984; 56 FR 19156, Apr. 25, 1991; 70 FR 37618, June 29, 2005; 73 FR 52768, Sept. 10, 2008; 80 FR 21923, Apr. 20, 2015]

§ 240.15c2–12 Municipal securities disclosure.

PRELIMINARY NOTE: For a discussion of disclosure obligations relating to municipal securities, issuers, brokers, dealers, and municipal securities dealers should refer to Securities Act Release No. 7049, Securities Exchange Act Release No. 33741, FR–42 (March 9, 1994). For a discussion of the obligations of underwriters to have a reasonable basis for recommending municipal securities, brokers, dealers, and municipal securities dealers should refer to Securities Exchange Act Release No. 26100 (Sept. 22, 1988) and Securities Exchange Act Release No. 26985 (June 28, 1989).

(a) *General.* As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer (a ''Participating Underwriter'' when used in connection with an Offering) to act as an underwriter in a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more (an ''Offering'') unless the Participating Underwriter complies with the requirements of this section or is exempted from the provisions of this section.

(b) *Requirements.* (1) Prior to the time the Participating Underwriter bids for, purchases, offers, or sells municipal securities in an Offering, the Participating Underwriter shall obtain and review an official statement that an issuer of such securities deems final as of its date, except for the omission of no more than the following information: The offering price(s), interest rate(s), selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, any other terms or provisions required by an issuer of such securities to be specified in a competitive bid, ratings, other terms of the securities depending on such matters, and the identity of the underwriter(s).

(2) Except in competitively bid offerings, from the time the Participating Underwriter has reached an understanding with an issuer of municipal securities that it will become a Participating Underwriter in an Offering until a final official statement is available, the Participating Underwriter shall send no later than the next business day, by first-class mail or other equally prompt means, to any potential customer, on request, a single copy of the most recent preliminary official statement, if any.

(3) The Participating Underwriter shall contract with an issuer of municipal securities or its designated agent to receive, within seven business days after any final agreement to purchase, offer, or sell the municipal securities in an Offering and in sufficient time to accompany any confirmation that requests payment from any customer, copies of a final official statement in sufficient quantity to comply with paragraph (b)(4) of this rule and the rules of the Municipal Securities Rulemaking Board.

(4) From the time the final official statement becomes available until the earlier of—

(i) Ninety days from the end of the underwriting period or

(ii) The time when the official statement is available to any person from the Municipal Securities Rulemaking Board, but in no case less than twenty-five days following the end of the underwriting period, the Participating Underwriter in an Offering shall send no later than the next business day, by first-class mail or other equally prompt means, to any potential customer, on request, a single copy of the final official statement.

(5)(i) A Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that an issuer of municipal securities, or an obligated person for whom financial or operating data is presented in the final official statement has undertaken, either individually or in combination with other issuers of such municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such securities, to provide the following to the Municipal Securities Rulemaking Board in an electronic format as prescribed by the Municipal Securities Rulemaking Board, either directly or indirectly through an indenture trustee or a designated agent:

(A) Annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement, except that, in the case of pooled obligations, the undertaking shall specify such objective criteria;

(B) If not submitted as part of the annual financial information, then when and if available, audited financial statements for each obligated person covered by paragraph (b)(5)(i)(A) of this section;

(C) In a timely manner not in excess of ten business days after the occurrence of the event, notice of any of the following events with respect to the securities being offered in the Offering:

(*1*) Principal and interest payment delinquencies;

(*2*) Non-payment related defaults, if material;

(*3*) Unscheduled draws on debt service reserves reflecting financial difficulties;

(*4*) Unscheduled draws on credit enhancements reflecting financial difficulties;

(*5*) Substitution of credit or liquidity providers, or their failure to perform;

(*6*) Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701–TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security;

(*7*) Modifications to rights of security holders, if material;

(*8*) Bond calls, if material, and tender offers;

(*9*) Defeasances;

(*10*) Release, substitution, or sale of property securing repayment of the securities, if material;

(*11*) Rating changes;

(*12*) Bankruptcy, insolvency, receivership or similar event of the obligated person;

NOTE TO PARAGRAPH (b)(5)(i)(C)(*12*): For the purposes of the event identified in paragraph (b)(5)(i)(C)(12) of this section, the event is considered to occur when any of the following occur: The appointment of a receiver, fiscal agent or similar officer for an obligated person in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the obligated person, or if such jurisdiction has been assumed by leaving the existing governing body and officials or officers in possession but subject to the supervision and orders of a court or governmental authority, or the entry of an order confirming a plan of reorganization, arrangement or liquidation by a court or governmental authority having supervision or jurisdiction over substantially all of the assets or business of the obligated person.

(*13*) The consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material;

(*14*) Appointment of a successor or additional trustee or the change of name of a trustee, if material;

(*15*) Incurrence of a financial obligation of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material; and

(*16*) Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties; and

(D) In a timely manner, notice of a failure of any person specified in paragraph (b)(5)(i)(A) of this section to provide required annual financial information, on or before the date specified in the written agreement or contract.

(ii) The written agreement or contract for the benefit of holders of such securities also shall identify each person for whom annual financial information and notices of material events will be provided, either by name or by the objective criteria used to select such persons, and, for each such person shall:

(A) Specify, in reasonable detail, the type of financial information and operating data to be provided as part of annual financial information;

(B) Specify, in reasonable detail, the accounting principles pursuant to which financial statements will be prepared, and whether the financial statements will be audited; and

(C) Specify the date on which the annual financial information for the preceding fiscal year will be provided.

(iii) Such written agreement or contract for the benefit of holders of such securities also may provide that the continuing obligation to provide annual financial information and notices of events may be terminated with respect to any obligated person, if and when such obligated person no longer remains an obligated person with respect to such municipal securities.

(iv) Such written agreement or contract for the benefit of holders of such securities also shall provide that all documents provided to the Municipal Securities Rulemaking Board shall be accompanied by identifying information as prescribed by the Municipal Securities Rulemaking Board.

(c) *Recommendations.* As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer to recommend the purchase or sale of a municipal security unless such broker, dealer, or municipal securities dealer has procedures in place that provide reasonable assurance that it will receive prompt notice of any event disclosed pursuant to paragraph (b)(5)(i)(C), paragraph (b)(5)(i)(D), and paragraph (d)(2)(ii)(B) of this section with respect to that security.

(d) *Exemptions.* (1) This section shall not apply to a primary offering of municipal securities in authorized denominations of $100,000 or more, if such securities:

(i) Are sold to no more than thirty-five persons each of whom the Participating Underwriter reasonably believes:

(A) Has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment; and

(B) Is not purchasing for more than one account or with a view to distributing the securities; or

(ii) Have a maturity of nine months or less.

(2) Paragraph (b)(5) of this section shall not apply to an Offering of municipal securities if, at such time as an issuer of such municipal securities delivers the securities to the Participating Underwriters:

(i) No obligated person will be an obligated person with respect to more than $10,000,000 in aggregate amount of outstanding municipal securities, including the offered securities and excluding municipal securities that were offered in a transaction exempt from this section pursuant to paragraph (d)(1) of this section;

(ii) An issuer of municipal securities or obligated person has undertaken, either individually or in combination with other issuers of municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such municipal securities, to provide the following to the Municipal Securities Rulemaking Board in an electronic format as prescribed by the Municipal Securities Rulemaking Board:

(A) At least annually, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, as specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available; and

(B) In a timely manner not in excess of ten business days after the occurrence of the event, notice of events specified in paragraph (b)(5)(i)(C) of this section with respect to the securities that are the subject of the Offering; and

(C) Such written agreement or contract for the benefit of holders of such securities also shall provide that all documents provided to the Municipal Securities Rulemaking Board shall be accompanied by identifying information as prescribed by the Municipal Securities Rulemaking Board; and

(iii) The final official statement identifies by name, address, and telephone number the persons from which the foregoing information, data, and notices can be obtained.

(3) The provisions of paragraph (b)(5) of this section, other than paragraph (b)(5)(i)(C) of this section, shall not apply to an Offering of municipal securities, if such municipal securities have a stated maturity of 18 months or less.

(4) The provisions of paragraph (c) of this section shall not apply to municipal securities:

(i) Sold in an Offering to which paragraph (b)(5) of this section did not apply, other than Offerings exempt under paragraph (d)(2)(ii) of this section; or

(ii) Sold in an Offering exempt from this section under paragraph (d)(1) of this section.

(5) With the exception of paragraphs (b)(1) through (b)(4), this section shall apply to a primary offering of municipal securities in authorized denominations of $100,000 or more if such securities may, at the option of the holder thereof, be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent; provided, however, that paragraphs (b)(5) and (c) of this section shall not apply to such securities outstanding on November 30, 2010, for so long as they continuously remain in authorized denominations of $100,000 or more and may, at the option of the holder thereof, be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent.

(e) *Exemptive authority*. The Commission, upon written request, or upon its own motion, may exempt any broker, dealer, or municipal securities dealer, whether acting in the capacity of a Participating Underwriter or otherwise, that is a participant in a transaction or class of transactions from any requirement of this section, either unconditionally or on specified terms and conditions, if the Commission determines that such an exemption is consistent with the public interest and the protection of investors.

(f) *Definitions*. For the purposes of this rule—

(1) The term *authorized denominations of $100,000 or more* means municipal securities with a principal amount of $100,000 or more and with restrictions that prevent the sale or transfer of such securities in principal amounts of less than $100,000 other than through a primary offering; except that, for municipal securities with an original issue discount of 10 percent or more, the term means municipal securities with a minimum purchase price of $100,000 or more and with restrictions that prevent the sale or transfer of such securities, in principal amounts that are less than the original principal amount at the time of the primary offering, other than through a primary offering.

(2) The term *end of the underwriting period* means the later of such time as

(i) The issuer of municipal securities delivers the securities to the Participating Underwriters or

(ii) The Participating Underwriter does not retain, directly or as a member or an underwriting syndicate, an unsold balance of the securities for sale to the public.

(3) The term *final official statement* means a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter(s) and that sets forth information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering; and a description of the undertakings to be provided pursuant to paragraph (b)(5)(i), paragraph (d)(2)(ii),

and paragraph (d)(2)(iii) of this section, if applicable, and of any instances in the previous five years in which each person specified pursuant to paragraph (b)(5)(ii) of this section failed to comply, in all material respects, with any previous undertakings in a written contract or agreement specified in paragraph (b)(5)(i) of this section. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents available to the public on the Municipal Securities Rulemaking Board's Internet Web site or filed with the Commission.

(4) The term *issuer of municipal securities* means the governmental issuer specified in section 3(a)(29) of the Act and the issuer of any separate security, including a sepatate security as defined in rule 3b–5(a) under the Act.

(5) The term *potential customer* means (i) Any person contacted by the Participating Underwriter concerning the purchase of municipal securities that are intended to be offered or have been sold in an offering, (ii) Any person who has expressed an interest to the Participating Underwriter in possibly purchasing such municipal securities, and (iii) Any person who has a customer account with the Participating Underwriter.

(6) The term *preliminary official statement* means an official statement prepared by or for an issuer of municipal securities for dissemination to potential customers prior to the availability of the final official statement.

(7) The term *primary offering* means an offering of municipal securities directly or indirectly by or on behalf of an issuer of such securities, including any remarketing of municipal securities.

(i) That is accompanied by a change in the authorized denomination of such securities from $100,000 or more to less than $100,000, or

(ii) That is accompanied by a change in the period during which such securities may be tendered to an issuer of such securities or its designated agent for redemption or purchase from a period of nine months or less to a period of more than nine months.

(8) The term *underwriter* means any person who has purchased from an issuer of municipal securities with a view to, or offers or sells for an issuer of municipal securities in connection with, the offering of any municipal security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; except, that such term shall not include a person whose interest is limited to a commission, concession, or allowance from an underwriter, broker, dealer, or municipal securities dealer not in excess of the usual and customary distributors' or sellers' commission, concession, or allowance.

(9) The term *annual financial information* means financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents available to the public on the Municipal Securities Rulemaking Board's Internet Web site or filed with the Commission.

(10) The term *obligated person* means any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).

(11)(i) The term *financial obligation* means a:

(A) Debt obligation;

(B) Derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or

(C) Guarantee of paragraph (f)(11)(i)(A) or (B).

(ii) The term *financial obligation* shall not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule.

(g) *Transitional provision.* If on July 28, 1989, a Participating Underwriter was contractually committed to act as underwriter in an Offering of municipal securities originally issued before July 29, 1989, the requirements of paragraphs (b)(3) and (b)(4) shall not apply to the Participating Underwriter in connection with such an Offering. Paragraph (b)(5) of this section shall not apply to a Participating Underwriter that has contractually committed to act as an underwriter in an Offering of municipal securities before July 3, 1995; *except that* paragraph (b)(5)(i)(A) and paragraph (b)(5)(i)(B) shall not apply with respect to fiscal years ending prior to January 1, 1996. Paragraph (c) shall become effective on January 1, 1996. Paragraph (d)(2)(ii) and paragraph (d)(2)(iii) of this section shall not apply to an Offering of municipal securities commencing prior to January 1, 1996.

[54 FR 28813, July 10, 1989, as amended at 59 FR 59609, Nov. 17, 1994; 73 FR 76132, Dec. 15, 2008; 75 FR 33155, June 10, 2010; 83 FR 44742, Aug. 31, 2018]

§ 240.15c3–1 Net capital requirements for brokers or dealers.

(a) Every broker or dealer must at all times have and maintain net capital no less than the greater of the highest minimum requirement applicable to its ratio requirement under paragraph (a)(1) of this section, or to any of its activities under paragraph (a)(2) of this section, and must otherwise not be ''insolvent'' as that term is defined in paragraph (c)(16) of this section. In lieu of applying paragraphs (a)(1) and (a)(2) of this section, an OTC derivatives dealer shall maintain net capital pursuant to paragraph (a)(5) of this section. Each broker or dealer also shall comply with the supplemental requirements of paragraphs (a)(4) and (a)(9) of this section, to the extent either paragraph is applicable to its activities. In addition, a broker or dealer shall maintain net capital of not less than its own net capital requirement plus the sum of each broker's or dealer's subsidiary or affiliate minimum net capital requirements, which is consolidated pursuant to appendix C, § 240.15c3–1c.

RATIO REQUIREMENTS

Aggregate Indebtedness Standard

(1)(i) No broker or dealer, other than one that elects the provisions of paragraph (a)(1)(ii) of this section, shall permit its aggregate indebtedness to all other persons to exceed 1500 percent of its net capital (or 800 percent of its net capital for 12 months after commencing business as a broker or dealer).

Alternative Standard

(ii) A broker or dealer may elect not to be subject to the Aggregate Indebtedness Standard of paragraph (a)(1)(i) of this section. That broker or dealer shall not permit its net capital to be less than the greater of $250,000 or 2 percent of aggregate debit items computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers (Exhibit A to Rule 15c3–3, § 240.15c3–3a). Such broker or dealer shall notify its Examining Authority, in writing, of its election to operate under this paragraph (a)(1)(ii). Once a broker or dealer has notified its Examining Authority, it shall continue to operate under this paragraph unless a change is approved upon application to the Commission. A broker or dealer that elects this standard and is not exempt from Rule 15c3–3 shall:

(A) Make the computation required by § 240.15c3–3(e) and set forth in Exhibit A, § 240.15c3–3a, on a weekly basis and, in lieu of the 1 percent reduction of certain debit items required by Note E (3) in the computation of its Exhibit A requirement, reduce aggregate debit items in such computation by 3 percent;

(B) Include in Items 7 and 8 of Exhibit A, § 240.15c3–3a, the market value of items specified therein more than 7 business days old;

(C) Exclude credit balances in accounts representing amounts payable for securities not yet received from the security or a source of payment for, an existing or planned debt obligation; or

(C) Guarantee of paragraph (f)(11)(i)(A) or (B).

(ii) The term *financial obligation* shall not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule.

(g) *Transitional provision.* If on July 28, 1989, a Participating Underwriter was contractually committed to act as underwriter in an Offering of municipal securities originally issued before July 29, 1989, the requirements of paragraphs (b)(3) and (b)(4) shall not apply to the Participating Underwriter in connection with such an Offering. Paragraph (b)(5) of this section shall not apply to a Participating Underwriter that has contractually committed to act as an underwriter in an Offering of municipal securities before July 3, 1995; *except that* paragraph (b)(5)(i)(A) and paragraph (b)(5)(i)(B) shall not apply with respect to fiscal years ending prior to January 1, 1996. Paragraph (c) shall become effective on January 1, 1996. Paragraph (d)(2)(ii) and paragraph (d)(2)(iii) of this section shall not apply to an Offering of municipal securities commencing prior to January 1, 1996.

[54 FR 28813, July 10, 1989, as amended at 59 FR 59609, Nov. 17, 1994; 73 FR 76132, Dec. 15, 2008; 75 FR 33155, June 10, 2010; 83 FR 44742, Aug. 31, 2018]

§ 240.15c3–1 Net capital requirements for brokers or dealers.

(a) Every broker or dealer must at all times have and maintain net capital no less than the greater of the highest minimum requirement applicable to its ratio requirement under paragraph (a)(1) of this section, or to any of its activities under paragraph (a)(2) of this section, and must otherwise not be ''insolvent'' as that term is defined in paragraph (c)(16) of this section. In lieu of applying paragraphs (a)(1) and (a)(2) of this section, an OTC derivatives dealer shall maintain net capital pursuant to paragraph (a)(5) of this section. Each broker or dealer also shall comply with the supplemental requirements of paragraphs (a)(4) and (a)(9) of this section, to the extent either paragraph is applicable to its activities. In addition, a broker or dealer shall maintain net capital of not less than its own net capital requirement plus the sum of each broker's or dealer's subsidiary or affiliate minimum net capital requirements, which is consolidated pursuant to appendix C, § 240.15c3–1c.

RATIO REQUIREMENTS

Aggregate Indebtedness Standard

(1)(i) No broker or dealer, other than one that elects the provisions of paragraph (a)(1)(ii) of this section, shall permit its aggregate indebtedness to all other persons to exceed 1500 percent of its net capital (or 800 percent of its net capital for 12 months after commencing business as a broker or dealer).

Alternative Standard

(ii) A broker or dealer may elect not to be subject to the Aggregate Indebtedness Standard of paragraph (a)(1)(i) of this section. That broker or dealer shall not permit its net capital to be less than the greater of $250,000 or 2 percent of aggregate debit items computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers (Exhibit A to Rule 15c3–3, § 240.15c3–3a). Such broker or dealer shall notify its Examining Authority, in writing, of its election to operate under this paragraph (a)(1)(ii). Once a broker or dealer has notified its Examining Authority, it shall continue to operate under this paragraph unless a change is approved upon application to the Commission. A broker or dealer that elects this standard and is not exempt from Rule 15c3–3 shall:

(A) Make the computation required by § 240.15c3–3(e) and set forth in Exhibit A, § 240.15c3–3a, on a weekly basis and, in lieu of the 1 percent reduction of certain debit items required by Note E (3) in the computation of its Exhibit A requirement, reduce aggregate debit items in such computation by 3 percent;

(B) Include in Items 7 and 8 of Exhibit A, § 240.15c3–3a, the market value of items specified therein more than 7 business days old;

(C) Exclude credit balances in accounts representing amounts payable for securities not yet received from the issuer or its agent which securities are specified in paragraphs (c)(2)(vi) (A) and (E) of this section and any related debit items from the Exhibit A requirement for 3 business days; and

(D) Deduct from net worth in computing net capital 1 percent of the contract value of all failed to deliver contracts or securities borrowed that were allocated to failed to receive contracts of the same issue and which thereby were excluded from Items 11 or 12 of Exhibit A, § 240.15c3–3a.

Futures Commission Merchants

(iii) No broker or dealer registered as a futures commission merchant shall permit its net capital to be less than the greater of its requirement under paragraph (a)(1) (i) or (ii) of this section, or 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the customer's account).

MINIMUM REQUIREMENTS

See Appendix E (§ 240.15c3–1E) for temporary minimum requirements.

Brokers or Dealers That Carry Customer Accounts

(2)(i) A broker or dealer (other than one described in paragraphs (a)(2)(ii) or (a)(8) of this section) shall maintain net capital of not less than $250,000 if it carries customer or broker or dealer accounts and receives or holds funds or securities for those persons. A broker or dealer shall be deemed to receive funds, or to carry customer or broker or dealer accounts and to receive funds from those persons if, in connection with its activities as a broker or dealer, it receives checks, drafts, or other evidences of indebtedness made payable to itself or persons other than the requisite registered broker or dealer carrying the account of a customer, escrow agent, issuer, underwriter, sponsor, or other distributor of securities. A broker or dealer shall be deemed to hold securities for, or to carry customer or broker or dealer accounts, and hold securities of, those persons if it does not promptly forward or promptly deliver all of the securities of customers or of other brokers or dealers received by the firm in connection with its activities as a broker or dealer. A broker or dealer, without complying with this paragraph (a)(2)(i), may receive securities only if its activities conform with the provisions of paragraphs (a)(2) (iv) or (v) of this section, and may receive funds only in connection with the activities described in paragraph (a)(2)(v) of this section.

(ii) A broker or dealer that is exempt from the provisions of § 240.15c3–3 pursuant to paragraph (k)(2)(i) thereof shall maintain net capital of not less than $100,000.

Dealers

(iii) A dealer shall maintain net capital of not less than $100,000. For the purposes of this section, the term ''dealer'' includes:

(A) Any broker or dealer that endorses or writes options otherwise than on a registered national securities exchange or a facility of a registered national securities association; and

(B) Any broker or dealer that effects more than ten transactions in any one calendar year for its own investment account. This section shall not apply to those persons engaging in activities described in paragraphs (a)(2)(v), (a)(2)(vi) or (a)(8) of this section, or to those persons whose underwriting activities are limited solely to acting as underwriters in best efforts or all or none underwritings in conformity with paragraph (b)(2) of § 240.15c2–4, so long as those persons engage in no other dealer activities.

Brokers or Dealers That Introduce Customer Accounts And Receive Securities

(iv) A broker or dealer shall maintain net capital of not less than $50,000 if it introduces transactions and accounts of customers or other brokers or dealers to another registered broker or dealer that carries such accounts on a fully disclosed basis, and if the broker or dealer receives but does not hold customer or other broker or dealer securities. A broker or dealer operating under this paragraph (a)(2)(iv) of this section may participate in a firm commitment underwriting without being subject to the provisions of paragraph (a)(2)(iii) of this section, but may not enter into a commitment for the purchase of shares related to that underwriting.

Brokers or Dealers Engaged in the Sale of Redeemable Shares of Registered Investment Companies and Certain Other Share Accounts

(v) A broker or dealer shall maintain net capital of not less than $25,000 if it acts as a broker or dealer with respect to the purchase, sale and redemption of redeemable shares of registered investment companies or of interests or participations in an insurance company separate account directly from or to the issuer on other than a subscription way basis. A broker or dealer operating under this section may sell securities for the account of a customer to obtain funds for the immediate reinvestment in redeemable securities of registered investment companies. A broker or dealer operating under this paragraph (a)(2)(v) must promptly transmit all funds and promptly deliver all securities received in connection with its activities as a broker or dealer, and may not otherwise hold funds or securities for, or owe money or securities to, customers.

Other Brokers or Dealers

(vi) A broker or dealer that does not receive, directly or indirectly, or hold funds or securities for, or owe funds or securities to, customers and does not carry accounts of, or for, customers and does not engage in any of the activities described in paragraphs (a)(2) (i) through (v) of this section shall maintain net capital of not less than $5,000. A broker or dealer operating under this paragraph may engage in the following dealer activities without being subject to the requirements of paragraph (a)(2)(iii) of this section:

(A) In the case of a buy order, prior to executing such customer's order, it purchases as principal the same number of shares or purchases shares to accumulate the number of shares necessary to complete the order, which shall be cleared through another registered broker or dealer or

(B) In the case of a sell order, prior to executing such customer's order, it sells as principal the same number of shares or a portion thereof, which shall be cleared through another registered broker or dealer.

(3) [Reserved]

Capital Requirements for Market Makers

(4) A broker or dealer engaged in activities as a market maker as defined in paragraph (c)(8) of this section shall maintain net capital in an amount not less than $2,500 for each security in which it makes a market (unless a security in which it makes a market has a market value of $5 or less, in which event the amount of net capital shall be not less than $1,000 for each such security) based on the average number of such markets made by such broker or dealer during the 30 days immediately preceding the computation date. Under no circumstances shall it have net capital less than that required by the provisions of paragraph (a) of this section, or be required to maintain net capital of more than $1,000,000 unless required by paragraph (a) of this section.

(5) In accordance with appendix F to this section (§ 240.15c3–1f), the Commission may grant an application by an OTC derivatives dealer when calculating net capital to use the market risk standards of appendix F as to some or all of its positions in lieu of the provisions of paragraph (c)(2)(vi) of this section and the credit risk standards of appendix F to its receivables (including counterparty net exposure) arising from transactions in eligible OTC derivative instruments in lieu of the requirements of paragraph (c)(2)(iv) of this section. An OTC derivatives dealer shall at all times maintain tentative net capital of not less than $100 million and net capital of not less than $20 million.

Market Makers, Specialists and Certain Other Dealers

(6)(i) A dealer who meets the conditions of paragraph (a)(6)(ii) of this section may elect to operate under this paragraph (a)(6) and thereby not apply, except to the extent required by this paragraph (a)(6), the provisions of paragraphs (c)(2)(vi) or appendix A (§ 240.15c3–1a) of this section to market maker and specialist transactions and, in lieu thereof, apply thereto the provisions of paragraph (a)(6)(iii) of this section.

(ii) This paragraph (a)(6) shall be available to a dealer who does not effect transactions with other than brokers or dealers, who does not carry customer accounts, who does not effect transactions in options not listed on a registered national securities exchange or facility of a registered national securities association, and whose market maker or specialist transactions are effected through and carried in a market maker or specialist account cleared by another broker or dealer as provided in paragraph (a)(6)(iv) of this section.

(iii) A dealer who elects to operate pursuant to this paragraph (a)(6) shall at all times maintain a liquidating equity in respect of securities positions in his market maker or specialist account at least equal to:

(A) An amount equal to 25 percent (5 percent in the case of exempted securities) of the market value of the long positions and 30 percent of the market value of the short positions; provided, however, in the case of long or short positions in options and long or short positions in securities other than options which relate to a bona fide hedged position as defined in paragraph (c)(2)(x)(C) of this section, such amount shall equal the deductions in respect of such positions specified by appendix A (§ 240.15c3–1a).

(B) Such lesser requirement as may be approved by the Commission under specified terms and conditions upon written application of the dealer and the carrying broker or dealer.

(C) For purposes of this paragraph (a)(6)(iii), equity in such specialist or market maker account shall be computed by (*1*) marking all securities positions long or short in the account to their respective current market values, (*2*) adding (deducting in the case of a debit balance) the credit balance carried in such specialist or market maker account, and (*3*) adding (deducting in the case of short positions) the market value of positions long in such account.

(iv) The dealer shall obtain from the broker or dealer carrying the market maker or specialist account a written undertaking which shall be designated "Notice Pursuant to § 240.15c3–1(a)(6) of Intention to Carry Specialist or Market Maker Account." Said undertaking shall contain the representations required by paragraph (a)(6) of this section and shall be filed with the Commission's Washington, DC, Office, the regional office of the Commission for the region in which the broker or dealer has its principal place of business and the Designated Examining Authorities of both firms prior to effecting any transactions in said account. The broker or dealer carrying such account:

(A) Shall mark the account to the market not less than daily and shall issue appropriate calls for additional equity which shall be met by noon of the following business day;

(B) Shall notify by telegraph the Commission and the Designated Examining Authorities pursuant to 17 CFR 240.17a–11, if the market maker or specialist fails to deposit any required equity within the time prescribed in paragraph (a)(6)(iv)(A) of this section; said telegraphic notice shall be received by the Commission and the Designated Examining Authorities not later than the close of business on the day said call is not met;

(C) Shall not extend further credit in the account if the equity in the account falls below that prescribed in paragraph (a)(6)(iii) of this section, and

(D) Shall take steps to liquidate promptly existing positions in the account in the event of a failure to meet a call for equity.

(v) No such carrying broker or dealer shall permit the sum of (A) the deductions required by paragraph (c)(2)(x)(A) of this section in respect of all transactions in market maker accounts guaranteed, indorsed or carried by such broker or dealer pursuant to paragraph (c)(2)(x) of this section and (B) the equity required by paragraph (iii) of this paragraph (a)(6) in respect of all transactions in the accounts of specialists of market makers in options carried by such broker or dealer pursuant to this paragraph (a)(6) to exceed 1,000 percent of such broker's or dealer's net capital as defined in paragraph (c)(2) of this section for any period exceeding five business days; *Provided*, That solely for purposes of this paragraph (a)(6)(v), deductions or equity required in a specialist or market maker account in respect of positions in fully paid securities (other than options), which do not underlie options listed on the national securities exchange or facility of a national securities association of which the specialist or market marker is a member, need not be recognized. *Provided further*, That if at any time such sum exceeds 1,000 percent of such broker's or dealer's net capital, then the broker or dealer shall immediately transmit telegraphic notice of such event to the principal office of the Commission in Washington, DC, the regional office of the Commission for the region in which the broker or dealer maintains its principal place of business, and such broker's or dealer's Designated Examining Authority. *Provided further*, That if at any time such sum exceeds 1,000 percent of such broker's or dealer's net capital, then such broker or dealer shall be subject to the prohibitions against withdrawal of equity capital set forth in paragraph (e) of this section, and to the prohibitions against reduction, prepayment and repayment of subordination agreements set forth in paragraph (b)(11) of §240.15c3–1d, as if such broker or dealer's net capital were below the minimum standards specified by each of the aforementioned paragraphs.

ALTERNATIVE NET CAPITAL COMPUTATION FOR BROKER-DEALERS THAT ELECT TO BE SUPERVISED ON A CONSOLIDATED BASIS

(7) In accordance with Appendix E to this section (§240.15c3–1e), the Commission may approve, in whole or in part, an application or an amendment to an application by a broker or dealer to calculate net capital using the market risk standards of appendix E to compute a deduction for market risk on some or all of its positions, instead of the provisions of paragraphs (c)(2)(vi) and (c)(2)(vii) of this section, and using the credit risk standards of Appendix E to compute a deduction for credit risk on certain credit exposures arising from transactions in derivatives instruments, instead of the provisions of paragraph (c)(2)(iv) of this section, subject to any conditions or limitations on the broker or dealer the Commission may require as necessary or appropriate in the public interest or for the protection of investors. A broker or dealer that has been approved to calculate its net capital under appendix E must:

(i) At all times maintain tentative net capital of not less than $1 billion and net capital of not less than $500 million;

(ii) Provide notice that same day in accordance with §240.17a–11(g) if the broker's or dealer's tentative net capital is less than $5 billion. The Commission may, upon written application, lower the threshold at which notification is necessary under this paragraph (a)(7)(ii), either unconditionally or on specified terms and conditions, if a broker or dealer satisfies the Commission that notification at the $5 billion threshold is unnecessary because of, among other factors, the special nature of its business, its financial position, its internal risk management system, or its compliance history; and

(iii) Comply with §240.15c3–4 as though it were an OTC derivatives dealer with respect to all of its business activities, except that paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8), and (d)(9) of §240.15c3–4 shall not apply.

(8) *Municipal securities brokers' brokers*. (i) A municipal securities brokers' brokers, as defined in subsection (ii) of this paragraph (a)(8), may elect not to be subject to the limitations of paragraph (c)(2)(ix) of this section provided that such brokers' broker complies with the requirements set out in paragraphs (a)(8) (iii), (iv) and (v) of this section.

(ii) The term municipal securities *brokers' broker* shall mean a municipal securities broker or dealer who acts exclusively as an undisclosed agent in the purchase or sale of municipal securities for a registered broker or dealer or registered municipal securities dealer, who has no ''customers'' as defined in this rule and who does not have or maintain any municipal securities in its proprietary or other accounts.

(iii) In order to qualify to operate under this paragraph (a)(8), a brokers' broker shall at all times have and maintain net capital of not less than $150,000.

(iv) For purposes of this paragraph (a)(8), a brokers' broker shall deduct from net worth 1% of the contract value of each municipal failed to deliver contract which is outstanding 21 business days or longer. Such deduction shall be increased by any excess of the contract price of the fail to deliver over the market value of the underlying security.

(v) For purposes of this paragraph (a)(8), a brokers' broker may exclude from its aggregate indebtedness computation indebtedness adequately collateralized by municipal securities outstanding for not more than one business day and offset by municipal securities failed to deliver of the same issue and quantity. In no event may a brokers' broker exclude any overnight bank loan attributable to the same municipal securities failed to deliver contract for more than one business day. A brokers' broker need not deduct from net worth the amount by which the market value of securities failed to receive outstanding longer than thirty (30) calendar days exceeds the contract value of those failed to receive as required by Rule 15c3–1(c)(2)(iv)(E).

Certain Additional Capital Requirements for Brokers or Dealers Engaging in Reverse Repurchase Agreements

(9) A broker or dealer shall maintain net capital in addition to the amounts required under paragraph (a) of this section in an amount equal to 10 percent of:

(i) The excess of the market value of United States Treasury Bills, Bonds and Notes subject to reverse repurchase agreements with any one party over 105 percent of the contract prices (including accrued interest) for reverse repurchase agreements with that party;

(ii) The excess of the market value of securities issued or guaranteed as to principal or interest by an agency of the United States or mortgage related securities as defined in section 3(a)(41) of the Act subject to reverse repurchase agreements with any one party over 110 percent of the contract prices (including accrued interest) for reverse repurchase agreements with that party; and

(iii) The excess of the market value of other securities subject to reverse repurchase agreements with any one party over 120 percent of the contract prices (including accrued interest) for reverse repurchase agreements with that party.

(b) Exemptions:

(1) The provisions of this section shall not apply to any specialist:

(i) Whose securities business, except for an occasional non-specialist related securities transaction for its own account, is limited to that of acting as an options market maker on a national securities exchange;

(ii) That is a member in good standing and subject to the capital requirements of a national securities exchange;

(iii) That does not transact a business in securities with other than a broker or dealer registered with the Commission under section 15 or section 15C of the Act or a member of a national securities exchange; and

(iv) That is not a clearing member of The Options Clearing Corporation and whose securities transactions are effected through and carried in an account cleared by another broker or dealer registered with the Commission under section 15 of the Act.

(2) A member in good standing of a national securities exchange who acts as a floor broker (and whose activities do not require compliance with other provisions of this rule), may elect to comply, in lieu of the other provisions of this section, with the following financial responsibility standard: The value of the exchange membership of the member (based on the lesser of the most recent sale price or current bid price for an exchange membership) is not less than $15,000, or an amount equal to the excess of $15,000 over the value of the exchange membership is held by an independent agent in escrow: *Provided*, That the rules of such exchange require that the proceeds from the sale of the exchange membership of the member and the amount held in escrow pursuant to this paragraph shall be subject to the prior claims of the exchange and its clearing corporation and those arising directly

from the closing out of contracts entered into on the floor of such exchanges.

(3) The Commission may, upon written application, exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any broker or dealer who satisfies the Commission that, because of the special nature of its business, its financial position, and the safeguards it has established for the protection of customers' funds and securities, it is not necessary in the public interest or for the protection of investors to subject the particular broker or dealer to the provisions of this section.

(c) *Definitions.* For the purpose of this section:

AGGREGATE INDEBTEDNESS

(1) The term *aggregate indebtedness* shall be deemed to mean the total money liabilities of a broker or dealer arising in connection with any transaction whatsoever and includes, among other things, money borrowed, money payable against securities loaned and securities ''failed to receive,'' the market value of securities borrowed to the extent to which no equivalent value is paid or credited (other than the market value of margin securities borrowed from customers in accordance with the provisions of 17 CFR 240.15c3–3 and margin securities borrowed from non-customers), customers' and non-customers' free credit balances, credit balances in customers' and non-customers' accounts having short positions in securities, equities in customers' and non-customers' future commodities accounts and credit balances in customers' and non-customers' commodities accounts, but excluding:

EXCLUSIONS FROM AGGREGATE INDEBTEDNESS

(i) Indebtedness adequately collateralized by securities which are carried long by the broker or dealer and which have not been sold or by securities which collateralize a secured demand note pursuant to appendix D to this section 17 CFR 240.15c3–1d; indebtedness adequately collateralized by spot commodities which are carried long by the broker or dealer and which have not been sold; or, until October 1, 1976, indebtedness adequately collateralized by municipal securities outstanding for not more than one business day and offset by municipal securities failed to deliver of the same issue and quantity, where such indebtedness is incurred by a broker or dealer effecting transactions solely in municipal securities who is either registered with the Commission or temporarily exempt from such registration pursuant to 17 CFR 240.15a–1(T) or 17 CFR 240.15Ba2–3(T);

(ii) Amounts payable against securities loaned, which securities are carried long by the broker or dealer and which have not been sold or which securities collateralize a secured demand note pursuant to Appendix (D) (17 CFR 240.15c)

(iii) Amounts payable against securities failed to receive which securities are carried long by the broker or dealer and which have not been sold or which securities collateralize a secured demand note pursuant to Appendix (D) (17 CFR 240.15c3–1d) or amounts payable against securities failed to receive for which the broker or dealer also has a receivable related to securities of the same issue and quantity thereof which are either fails to deliver or securities borrowed by the broker or dealer;

(iv) Credit balances in accounts representing amounts payable for securities or money market instruments not yet received from the issuer or its agent which securities are specified in paragraph (c)(2)(vi)(E) and which amounts are outstanding in such accounts not more than three (3) business days;

(v) Equities in customers' and non-customers' accounts segregated in accordance with the provisions of the Commodity Exchange Act and the rules and regulations thereunder;

(vi) Liability reserves established and maintained for refunds of charges required by section 27(d) of the Investment Company Act of 1940, but only to the extent of amounts on deposit in a segregated trust account in accordance with 17 CFR 270.27d–1 under the Investment Company Act of 1940;

(vii) Amounts payable to the extent funds and qualified securities are required to be on deposit and are deposited in a "Special Reserve Bank Account for the Exclusive Benefit of Customers" pursuant to 17 CFR 240.15c3–3 under the Securities Exchange Act of 1934;

(viii) Fixed liabilities adequately secured by assets acquired for use in the ordinary course of the trade or business of a broker or dealer but no other fixed liabilities secured by assets of the broker or dealer shall be so excluded unless the sole recourse of the creditor for nonpayment of such liability is to such asset;

(ix) Liabilities on open contractual commitments;

(x) Indebtedness subordinated to the claims of creditors pursuant to a satisfactory subordination agreement, as defined in Appendix (D) (17 CFR 240.15c3–1d);

(xi) Liabilities which are effectively subordinated to the claims of creditors (but which are not subject to a satisfactory subordination agreement as defined in Appendix (D) (17 CFR 240.15c3–1d)) by non-customers of the broker or dealer prior to such subordination, except such subordinations by customers as may be approved by the Examining Authority for such broker or dealer;

(xii) Credit balances in accounts of general partners;

(xiii) Deferred tax liabilities;

(xiv) Eighty-five percent of amounts payable to a registered investment company related to fail to deliver receivables of the same quantity arising out of purchases of shares of those registered investment companies; and

(xv) Eighty-five percent of amounts payable against securities loaned for which the broker or dealer has receivables related to securities of the same class and issue and quantity that are securities borrowed by the broker or dealer.

NET CAPITAL

(2) The term *net capital* shall be deemed to mean the net worth of a broker or dealer, adjusted by:

(i) *Adjustments to net worth related to unrealized profit or loss, deferred tax provisions, and certain liabilities.* (A) Adding unrealized profits (or deducting unrealized losses) in the accounts of the broker or dealer;

(B)(*1*) In determining net worth, all long and all short positions in listed options shall be marked to their market value and all long and all short securities and commodities positions shall be marked to their market value.

(*2*) In determining net worth, the value attributed to any unlisted option shall be the difference between the option's exercise value and the market value of the underlying security. In the case of an unlisted call, if the market value of the underlying security is less than the exercise value of such call it shall be given no value and in the case of an unlisted put if the market value of the underlying security is more than the exercise value of the unlisted put it shall be given no value.

(C) Adding to net worth the lesser of any deferred income tax liability related to the items in (*1*), (*2*), and (*3*) below, or the sum of (*1*), (*2*) and (*3*) below;

(*1*) The aggregate amount resulting from applying to the amount of the deductions computed in accordance with paragraph (c)(2)(vi) of this section and Appendices A and B, § 240.15c3–1a and 240.15c3–1b, the appropriate Federal and State tax rate(s) applicable to any unrealized gain on the asset on which the deduction was computed;

(*2*) Any deferred tax liability related to income accrued which is directly related to an asset otherwise deducted pursuant to this section;

(*3*) Any deferred tax liability related to unrealized appreciation in value of any asset(s) which has been otherwise deducted from net worth in accordance with the provisions of this section; and,

(D) Adding, in the case of future income tax benefits arising as a result of unrealized losses, the amount of such benefits not to exceed the amount of income tax liabilities accrued on the books and records of the broker or dealer, but only to the extent such benefits could have been applied to reduce accrued tax liabilities on the date of the capital computation, had the related unrealized losses been realized on that date.

(E) Adding to net worth any actual tax liability related to income accrued which is directly related to an asset otherwise deducted pursuant to this section.

(F) Subtracting from net worth any liability or expense relating to the business of the broker or dealer for which a third party has assumed the responsibility, unless the broker or dealer can demonstrate that the third party has adequate resources independent of the broker or dealer to pay the liability or expense.

(G) Subtracting from net worth any contribution of capital to the broker or dealer:

(*1*) Under an agreement that provides the investor with the option to withdraw the capital; or

(*2*) That is intended to be withdrawn within a period of one year of contribution. Any withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer.

(ii) *Subordinated liabilities.* Excluding liabilities of the broker or dealer which are subordinated to the claims of creditors pursuant to a satisfactory subordination agreement, as defined in appendix (D) (17 CFR 240.15c3–1d).

(iii) *Sole proprietors.* Deducting, in the case of a broker or dealer who is a sole proprietor, the excess of liabilities which have not been incurred in the course of business as a broker or dealer over assets not used in the business.

(iv) *Assets not readily convertible into cash.* Deducting fixed assets and assets which cannot be readily converted into cash (less any indebtedness excluded in accordance with subdivision (c)(1)(viii) of this section) including, among other things:

(A) *Fixed assets and prepaid items.* Real estate; furniture and fixtures; exchange memberships; prepaid rent, insurance and other expenses; goodwill, organization expenses;

Certain Unsecured and Partly Secured Receivables

(B) All unsecured advances and loans; deficits in customers' and non-customers' unsecured and partly secured notes; deficits in omnibus credit accounts maintained in compliance with the requirements of 12 CFR 220.7(f) of Regulation T under the Act, or similar accounts carried on behalf of another broker or dealer, after application of calls for margin, marks to the market or other required deposits that are outstanding 5 business days or less; deficits in customers' and non-customers' unsecured and partly secured accounts after application of calls for margin, marks to market or other required deposits that are outstanding 5 business days or less, except deficits in cash accounts as defined in 12 CFR 220.8 of Regulation T under the Act for which not more than one extension respecting a specified securities transaction has been requested and granted, and deducting for securities carried in any of such accounts the percentages specified in paragraph (c)(2)(vi) of this section or appendix A, § 240.15c3–1a; the market value of stock loaned in excess of the value of any collateral received therefor; receivables arising out of free shipments of securities (other than mutual fund redemptions) in excess of $5,000 per shipment and all free shipments (other than mutual fund redemptions) outstanding more than 7 business days, and mutual fund redemptions outstanding more than 16 business days; and any collateral deficiencies in secured demand notes as defined in appendix D, § 240.15c3–1d; a broker or dealer that participates in a loan of securities by one party to another party will be deemed a principal for the purpose of the deductions required under this section, unless the broker or dealer has fully disclosed the identity of each party to the other and each party has expressly agreed in writing that the obligations of the broker or dealer do not include a guarantee of performance by the other party and that such party's remedies in the event of a default by the other party do not include a right of setoff against obligations, if any, of the broker or dealer.

(C) Interest receivable, floor brokerage receivable, commissions receivable from other brokers or dealers (other than syndicate profits which shall be treated as required in paragraph (c)(2)(iv)(E) of this section), mutual fund concessions receivable and management fees receivable from registered investment companies, all of which receivables are outstanding longer than thirty (30) days from the date they arise; dividends receivable outstanding longer than thirty (30) days from the payable date; good faith deposits arising in connection with a non-municipal securities underwriting, outstanding longer than eleven (11) business days from the settlement of the underwriting with the issuer; receivables due from participation in municipal securities underwriting syndicates and municipal securities joint underwriting accounts which are outstanding longer than sixty (60) days from settlement of the underwriting with the issuer and good faith deposits arising in connection with an underwriting of municipal securities, outstanding longer than sixty (60) days from settlement of the underwriting with the issuer; and receivables due from participation in municipal securities secondary trading joint accounts, which are outstanding longer than sixty (60) days from the date all securities have been delivered by the account manager to the account members;

(D) *Insurance claims.* Insurance claims which, after seven (7) business days from the date the loss giving rise to the claim is discovered, are not covered by an opinion of outside counsel that the claim is valid and is covered by insurance policies presently in effect; insurance claims which after twenty (20) business days from the date the loss giving rise to the claim is discovered and which are accompanied by an opinion of outside counsel described above, have not been acknowledged in writing by the insurance carrier as due and payable; and insurance claims acknowledged in writing by the carrier as due and payable outstanding longer than twenty (20) business days from the date they are so acknowledged by the carrier; and,

(E) *Other deductions.* All other unsecured receivables; all assets doubtful of collection less any reserves established therefor; the amount by which the market value of securities failed to receive outstanding longer than thirty (30) calendar days exceeds the contract value of such fails to receive; and the funds on deposit in a ''segregated trust account'' in accordance with 17 CFR 270.27d–1 under the Investment Company Act of 1940, but only to the extent that the amount on deposit in such segregated trust account exceeds the amount of liability reserves established and maintained for refunds of charges required by sections 27(d) and 27(f) of the Investment Company Act of 1940; *Provided,* That the following need not be deducted:

(*1*) Any amounts deposited in a Customer Reserve Bank Account or PAB Reserve Bank Account pursuant to § 240.15c3–3(e),

(*2*) Cash and securities held in a securities account at a carrying broker or dealer (except where the account has been subordinated to the claims of creditors of the carrying broker or dealer), and

(*3*) Clearing deposits.

(F)(*1*) For purposes of this paragraph:

(*i*) The term *reverse repurchase agreement deficit* shall mean the difference between the contract price for resale of the securities under a reverse repurchase agreement and the market value of those securities (if less than the contract price).

(*ii*) The term *repurchase agreement deficit* shall mean the difference between the market value of securities subject to the repurchase agreement and the contract price for repurchase of the securities (if less than the market value of the securities).

(*iii*) As used in paragraph (c)(2)(iv)(F)(*1*) of this section, the term *contract price* shall include accrued interest.

(*iv*) Reverse repurchase agreement deficits and the repurchase agreement deficits where the counterparty is the Federal Reserve Bank of New York shall be disregarded.

(*2*)(*i*) In the case of a reverse repurchase agreement, the deduction shall be equal to the reverse repurchase agreement deficit.

(*ii*) In determining the required deductions under paragraph (c)(2)(iv)(F)(*2*)(*i*) of this section, the broker or dealer may reduce the reverse repurchase agreement deficit by:

(*A*) Any margin or other deposits held by the broker or dealer on account of the reverse repurchase agreement;

(*B*) Any excess market value of the securities over the contract price for resale of those securities under any other reverse repurchase agreement with the same party;

(*C*) The difference between the contract price for resale and the market value of securities subject to repurchase agreements with the same party (if the market value of those securities is less than the contract price); and

(*D*) Calls for margin, marks to the market, or other required deposits which are outstanding one business day or less.

(*3*) (*i*) In the case of repurchase agreements, the deduction shall be:

(*A*) The excess of the repurchase agreement deficit over 5 percent of the contract price for resale of United States Treasury Bills, Notes and Bonds, 10 percent of the contract price for the resale of securities issued or guaranteed as to principal or interest by an agency of the United States or mortgage related securities as defined in section 3(a)(41) of the Act and 20 percent of the contract price for the resale of other securities and;

(*B*) The excess of the aggregate repurchase agreement deficits with any one party over 25 percent of the broker or dealer's net capital before the application of paragraph (c)(2)(vi) of this section (less any deduction taken with respect to repurchase agreements with that party under paragraph (c)(2)(iv)(F)(*3*)(*i*)(*A*) of this section) or, if greater;

(*C*) The excess of the aggregate repurchase agreement deficits over 300 percent of the broker's or dealer's net capital before the application of paragraph (c)(2)(vi) of this section.

(*ii*) In determining the required deduction under paragraph (c)(2)(iv)(F)(*3*)(*i*) of this section, the broker or dealer may reduce a repurchase agreement deficit by:

(*A*) Any margin or other deposits held by the broker or dealer on account of a reverse repurchase agreement with the same party to the extent not otherwise used to reduce a reverse repurchase deficit;

(*B*) The difference between the contract price and the market value of securities subject to other repurchase agreements with the same party (if the market value of those securities is less than the contract price) not otherwise used to reduce a reverse repurchase agreement deficit; and

(*C*) Calls for margin, marks to the market, or other required deposits which are outstanding one business day or less to the extent not otherwise used to reduce a reverse repurchase agreement deficit.

(G) *Securities borrowed.* 1 percent of the market value of securities borrowed collateralized by an irrevocable letter of credit.

(H) Any receivable from an affiliate of the broker or dealer (not otherwise deducted from net worth) and the market value of any collateral given to an affiliate (not otherwise deducted from net worth) to secure a liability over the amount of the liability of the broker or dealer unless the books and records of the affiliate are made available for examination when requested by the representatives of the Commission or the Examining Authority for the broker or dealer in order to demonstrate the validity of the receivable or payable. The provisions of this subsection shall not apply where the affiliate is a registered broker or dealer, registered government securities broker or dealer or bank as defined in section 3(a)(6) of the Act or insurance company as defined in section 3(a)(19) of the Act or investment company registered under the Investment Company Act of 1940 or federally insured savings and loan association or futures commission merchant registered pursuant to the Commodity Exchange Act.

(v)(A) Deducting the market value of all short securities differences (which shall include securities positions reflected on the securities record which are not susceptible to either count or confirmation) unresolved after discovery in accordance with the following schedule:

Differences [1]	Numbers of business days after discovery
25 percent	7
50 percent	14
75 percent	21
100 percent	28

[1] Percentage of market value of short securities differences.

(B) Deducting the market value of any long securities differences, where such securities have been sold by the broker or dealer before they are adequately resolved, less any reserves established therefor;

(C) The designated examining authority for a broker or dealer may extend the periods in (v)(A) of this section for up to 10 business days if it finds that exceptional circumstances warrant an extension.

Securities Haircuts

(vi) Deducting the percentages specified in paragraphs (c)(2)(vi) (A) through (M) of this section (or the deductions prescribed for securities positions set forth in Appendix A (§ 240.15c3–1a) of the market value of all securities, money market instruments or options in the proprietary or other accounts of the broker or dealer.

(A)(*1*) In the case of a security issued or guaranteed as to principal or interest by the United States or any agency thereof, the applicable percentages of the market value of the net long or short position in each of the categories specified below are:

CATEGORY 1

(*i*) Less than 3 months to maturity—0 percent.

(*ii*) 3 months but less than 6 months to maturity—½ of 1 percent.

(*iii*) 6 months but less than 9 months to maturity—¾ of 1 percent.

(*iv*) 9 months but less than 12 months to maturity—1 percent.

CATEGORY 2

(*i*) 1 year but less than 2 years to maturity—1½ percent.

(*ii*) 2 years but less than 3 years to maturity—2 percent.

CATEGORY 3

(*i*) 3 years but less than 5 years to maturity—3%.

(*ii*) 5 years but less than 10 years to maturity—4%.

CATEGORY 4

(*i*) 10 years but less than 15 years to maturity—4½%.

(*ii*) 15 years but less than 20 years to maturity—5%.

(*iii*) 20 years but less than 25 years to maturity—5½%.

(*iv*) 25 years or more to maturity—6%.

Brokers or dealers shall compute a deduction for each category above as follows: Compute the deductions for the net long or short positions in each subcategory above. The deduction for the category shall be the net of the aggregate deductions on the long positions and the aggregate deductions on the short positions in each category plus 50% of the lesser of the aggregate deductions on the long or short positions.

(*2*) A broker or dealer may elect to deduct, in lieu of the computation required under paragraph (c)(2)(vi)(A)(*1*) of this section, the applicable percentages of the market value of the net long or short positions in each of the subcategories specified in paragraph (c)(2)(vi)(A)(*1*) of this section.

(*3*) In computing deductions under paragraph (c)(2)(vi)(A)(*1*) of this section, a broker or dealer may elect to exclude the market value of a long or short security from one category and a security from another category, *Provided,* That:

(*i*) Such securities have maturity dates:

(*A*) Between 9 months and 15 months and within 3 months of one another.

(*B*) Between 2 years and 4 years and within 1 year of one another; or

(*C*) Between 8 years and 12 years and within 2 years of one another.

(*ii*) The net market value of the two excluded securities shall remain in the category of the security with the higher market value.

(*4*) In computing deductions under paragraph (c)(2)(vi)(A)(*1*) of this section, a broker or dealer may include in the categories specified in paragraph (c)(2)(vi)(A)(*1*) of this section, long or short positions in securities issued by the United States or any agency thereof that are deliverable against long or short positions in futures contracts relating to Government securities, traded on a recognized contract market approved by the Commodity Futures Trading Commission, which are held in the proprietary or other accounts of the broker or dealer. The value of the long or short positions included in the categories shall be determined by the contract value of the futures contract held in the account. The provisions of Appendix B to Rule 15c3–1 (17 CFR 240.15c3–1b) will in any event apply to the positions in futures contracts.

(*5*) In the case of a Government securities dealer that reports to the Federal Reserve System, that transacts business directly with the Federal Reserve System, and that maintains at all times a minimum net capital of at least $50,000,000, before application of the deductions provided for in paragraph (c)(2)(vi) of this section, the deduction for a security issued or guaranteed as to principal or interest by the United States or any agency thereof shall be 75 percent of the deduction otherwise computed under paragraph (c)(2)(vi)(A) of this section.

(B)(*1*) In the case of any municipal security which has a scheduled maturity at date of issue of 731 days or less and which is issued at par value and pays interest at maturity, or which is issued at a discount, and which is not traded flat or in default as to principal or interest, the applicable percentages of the market value on the greater of the long or short position in each of the categories specified below are:

(*i*) Less than 30 days to maturity—0%.

(*ii*) 30 days but less than 91 days to maturity—⅛ of 1%.

(*iii*) 91 days but less than 181 days to maturity—¼ of 1%.

(*iv*) 181 days but less than 271 days to maturity—⅜ of 1%.

(*v*) 271 days but less than 366 days to maturity—½ of 1%.

(*vi*) 366 days but less than 456 days to maturity—¾ of 1%.

(*vii*) 456 days but less than 732 days to maturity—1%.

(*2*) In the case of any municipal security, other than those specified in paragraph (c)(2)(vi)(B)(*1*), which is not traded flat or in default as to principal or interest, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

(*i*) Less than 1 year to maturity—1%.

(*ii*) 1 year but less than 2 years to maturity—2%.

(*iii*) 2 years but less than 3½ years to maturity—3%.

(*iv*) 3½ years but less than 5 years to maturity—4%.

(*v*) 5 years but less than 7 years to maturity—5%.

(*vi*) 7 years but less than 10 years to maturity—5½%.

(*vii*) 10 years but less than 15 years to maturity—6%.

(*viii*) 15 years but less than 20 years to maturity—6½%.

(*ix*) 20 years or more to maturity—7%.

(C) *Canadian Debt Obligations.* In the case of any security issued or unconditionally guaranteed as to principal and interest by the Government of Canada, the percentages of market value to be deducted shall be the same as in paragraph (A) of this section.

(D)(*1*) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets consist of cash or money market instruments and which is described in § 270.2a–7 of this chapter, the deduction will be 2% of the market value of the greater of the long or short position.

(*2*) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments of any maturity which are described in paragraph (c)(2)(vi) (A) through (C) or (E) of this section, the deduction shall be 7% of the market value of the greater of the long or short positions.

(*3*) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments which are described in paragraphs (c)(2)(vi) (A) through (C) or (E) and (F) of this section, the deduction shall be 9% of the market value of the long or short position.

(E) *Commercial paper, bankers' acceptances and certificates of deposit.* In the case of any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited and has only a minimal amount of credit risk, or in the case of any negotiable certificates of deposit or bankers' acceptance or similar type of instrument issued or guaranteed by any bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(6)), the applicable percentage of the market value of the greater of the long or short position in each of the categories specified below are:

(*1*) Less than 30 days to maturity—0 percent.

(*2*) 30 days but less than 91 days to maturity ⅛ of 1 percent.

(*3*) 91 days but less than 181 days to maturity ¼ of 1 percent.

(*4*) 181 days but less than 271 days to maturity ⅜ of 1 percent.

(*5*) 271 days but less than 1 year to maturity ½ of 1 percent; and

(*6*) With respect to any negotiable certificate of deposit or bankers acceptance or similar type of instrument issued or guaranteed by any bank, as defined above, having 1 year or more to maturity, the deduction shall be on the greater of the long or short position and shall be the same percentage as that prescribed in paragraph (c)(2)(vi)(A) of this section.

(F)(*1*) *Nonconvertible debt securities.* In the case of nonconvertible debt securities having a fixed interest rate and a fixed maturity date, which are not traded flat or in default as to principal or interest and which have only a minimal amount of credit risk, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

(*i*) Less than 1 year to maturity—2%

(*ii*) 1 year but less than 2 years to maturity—3%

(*iii*) 2 years but less than 3 years to maturity—5%

(*iv*) 3 years but less than 5 years to maturity—6%

(*v*) 5 years but less than 10 years to maturity—7%

(*vi*) 10 years but less than 15 years to maturity—7½%

(*vii*) 15 years but less than 20 years to maturity—8%

(*viii*) 20 years but less than 25 years to maturity—8½%

(*ix*) 25 years or more to maturity—9%

(*2*) A broker or dealer may elect to exclude from the above categories long or short positions that are hedged with short or long positions in securities issued by the United States or any agency thereof or nonconvertible debt securities having a fixed interest rate and a fixed maturity date and which are not traded flat or in default as to principal or interest, and which have only a minimal amount of credit risk if such securities have maturity dates:

(*i*) Less than five years and within 6 months of each other;

(*ii*) Between 5 years and 10 years and within 9 months of each other;

(*iii*) Between 10 years and 15 years and within 2 years of each other; or

(*iv*) 15 years or more and within 10 years of each other.

The broker-dealer shall deduct the amounts specified in paragraphs (c)(2)(vi)(F) (*3*) and (*4*) of this section.

(*3*) With respect to those positions described in paragraph (c)(2)(vi)(F)(*2*) of this section that include a long or short position in securities issued by the United States or any agency thereof, the broker or dealer shall exclude the hedging short or long United States or agency securities position from the applicable haircut category under paragraph (c)(2)(vi)(A) of this section. The broker or dealer shall deduct the percentage of the market value of the hedged long or short position in nonconvertible debt securities as specified in each of the categories below:

(*i*) Less than 5 years to maturity—1½%

(*ii*) 5 years but less than 10 years to maturity—2½%

(*iii*) 10 years but less than 15 years to maturity—2¾%

(*iv*) 15 years or more to maturity—3%

(*4*) With respect to those positions described in paragraph (c)(2)(vi)(F)(*2*) of this section that include offsetting long and short positions in nonconvertible debt securities, the broker or dealer shall deduct a percentage of the market value of the hedged long or short position in nonconvertible debt securities as specified in each of the categories below:

(*i*) Less than 5 years to maturity—1¾%

(*ii*) 5 years but less than 10 years to maturity—3%

(*iii*) 10 years but less than 15 years to maturity—3¼%

(*iv*) 15 years or more to maturity—3½%

(*5*) In computing deductions under paragraph (c)(2)(vi)(F)(*3*) of this section, a broker or dealer may include in the categories specified in paragraph (c)(2)(vi)(F)(*3*) of this section, long or short positions in securities issued by the United States or any agency thereof that are deliverable against long or short positions in futures contracts relating to Government securities, traded on a recognized contract market approved by the Commodity Futures Trading Commission, which are held in the proprietary or other accounts of the broker or dealer. The value of the long or short positions included in the categories shall be determined by the contract value of the futures contract held in the account.

(*6*) The provisions of Appendix B to Rule 15c3–1 (17 CFR 240.15c3–1b) will in any event apply to the positions in futures contracts.

(G) *Convertible debt securities.* In the case of a debt security not in default which has a fixed rate of interest and a fixed maturity date and which is convertible into an equity security, the deductions shall be as follows: If the market value is 100 percent or more of the principal amount, the deduction shall be determined as specified in paragraph (c)(2)(vi)(J) of this section; if the market value is less than the principal amount, the deduction shall be determined as specified in paragraph (F) of this section; if such securities are rated as required of paragraph (F) of this section;

(H) In the case of cumulative, nonconvertible preferred stock ranking prior to all other classes of stock of the same issuer, which has only a minimal amount of credit risk and which are not in arrears as to dividends, the deduction shall be 10% of the market value of the greater of the long or short position.

(I) In order to apply a deduction under paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(*1*), (c)(2)(vi)(F)(*2*), or (c)(2)(vi)(H) of this section, the broker or dealer must assess the creditworthiness of the security or money market instrument pursuant to policies and procedures for assessing and monitoring creditworthiness that the broker or dealer establishes, documents, maintains, and enforces. The policies and procedures must be reasonably designed for the purpose of determining whether a security or money market instrument has only a minimal amount of credit risk. Policies and procedures that are reasonably designed for this purpose should result in assessments of creditworthiness that typically are consistent with market data. A broker-dealer that opts not to make an assessment of creditworthiness under this paragraph may not apply the deductions under paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), or (c)(2)(vi)(H) of this section.

NOTE TO PARAGRAPH (c)(2)(vi)(I): For a discussion of the ''minimal amount of credit risk'' standard, *see Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, Exchange Act Release No. 34–71194 (Dec. 27, 2013), at *http://www.sec.gov/rules/final.shtml.*

All Other Securities

(J) In the case of all securities or evidences of indebtedness, except those described in appendix A, §240.15c3–1a, which are not included in any of the percentage categories enumerated in paragraphs (c)(2)(vi) (A) through (H) of this section or paragraph (c)(2)(vi)(K)(ii) of this section, the deduction shall be 15 percent of the market value of the greater of the long or short positions and to the extent the market value of the lesser of the long or short positions exceeds 25 percent of the market value of the greater of the long or short positions, the percentage deduction on such excess shall be 15 percent of the market value of such excess. No deduction need be made in the case of:

(*1*) A security that is convertible into or exchangeable for another security within a period of 90 days, subject to no conditions other than the payment of money, and the other securities into which such security is convertible or for which it is exchangeable, are short in the accounts of such broker or dealer; or

(*2*) A security that has been called for redemption and that is redeemable within 90 days.

(K) *Securities with a limited market.* In the case of securities (other than exempted securities, nonconvertible debt securities, and cumulative nonconvertible preferred stock) which are not: (*1*) Traded on a national securities exchange; (*2*) designated as ''OTC Margin Stock'' pursuant to Regulation T under the Securities Exchange Act of 1934; (*3*) quoted on ''NASDAQ''; or (*4*) redeemable shares of investment companies registered under the Investment Company Act of 1940, the deduction shall be as follows:

(*i*) In the case where there are regular quotations in an inter-dealer quotations system for the securities by three or more independent market-makers (exclusive of the computing broker or dealer) and where each such quotation represents a bona fide offer to brokers or dealers to both buy and sell in reasonable quantities at stated prices, or where a ready market as defined in paragraph (c)(11) (ii) is deemed to exist, the deduction shall be determined in accordance with paragraph (c)(2)(vi)(J) of this section;

(*ii*) In the case where there are regular quotations in an inter-dealer quotations system for the securities by only one or two independent market-makers (exclusive of the computing broker or dealer) and where each such quotation represents a bona fide offer to brokers or dealers both to buy and sell in reasonable quantities, at stated prices, the deduction on both the long and short position shall be 40 percent.

(L) Where a broker or dealer demonstrates that there is sufficient liquidity for any securities long or short in the proprietary or other accounts of the broker or dealer which are subject to a deduction required by paragraph (c)(2)(vi)(K) of this section, such deduction, upon a proper showing to the Examining Authority for the broker or dealer, may be appropriately decreased, but in no case shall such deduction be less than that prescribed in paragraph (c)(2)(vi)(J) of this section.

Undue Concentration

(M)(*1*) In the case of money market instruments, or securities of a single class or series of an issuer, including any option written, endorsed or held to purchase or sell securities of such a single class or series of an issuer (other than ''exempted securities'' and redeemable securities of an investment company registered pursuant to the Investment Company Act of 1940), and securities underwritten (in which case the deduction provided for herein shall be applied after 11 business days), which are long or short in the proprietary or other accounts of a broker or dealer, including securities that are collateral to secured demand notes defined in appendix D, § 240.15c3–1d, and that have a market value of more than 10 percent of the ''net capital'' of a broker or dealer before the application of paragraph (c)(2)(vi) of this section or appendix A, § 240.15c3–1a, there shall be an additional deduction from net worth and/or the Collateral Value for securities collateralizing a secured demand note defined in appendix D, § 240.15c3–1d, equal to 50 percent of the percentage deduction otherwise provided by this paragraph (c)(2)(vi) of this section or appendix A, § 240.15c3–1a, on that portion of the securities position in excess of 10 percent of the ''net capital'' of the broker or dealer before the application of paragraph (c)(2)(vi) of this section and appendix A, § 240.15c3–1a. In the case of securities described in paragraph (c)(2)(vi)(J), the additional deduction required by this paragraph (c)(2)(vi)(M) shall be 15 percent.

(*2*) This paragraph (c)(2)(vi)(M) shall apply notwithstanding any long or short position exemption provided for in paragraph (c)(2)(vi)(J) of this section (except for long or short position exemptions arising out of the first proviso to paragraph (c)(2)(vi)(J)) and the deduction on any such exempted position shall be 15 percent of that portion of the securities position in excess of 10 percent of the broker or dealer's net capital before the application of paragraph (c)(2)(vi) of this section and appendix A, § 240.15c3–1a.

(*3*) This paragraph (c)(2)(vi)(M) shall be applied to an issue of equity securities only on the market value of such securities in excess of $10,000 or the market value of 500 shares, whichever is greater, or $25,000 in the case of a debt security.

(*4*) This paragraph (c)(2)(vi)(M) will be applied to an issue of municipal securities having the same security provisions, date of issue, interest rate, day, month and year of maturity only if such securities have a market value in excess of $500,000 in bonds ($5,000,000 in notes) or 10 percent of tentative net capital, whichever is greater, and are held in position longer than 20 business days from the date the securities are received by the syndicate manager from the issuer.

(*5*) Any specialist that is subject to a deduction required by this paragraph (c)(2)(vi)(M), respecting its specialty stock, that can demonstrate to the satisfaction of the Examining Authority for such broker or dealer that there is sufficient liquidity for such specialist's specialty stock and that such deduction need not be applied in the public interest for the protection of investors, may upon a proper showing to such Examining Authority have such undue concentration deduction appropriately decreased, but in no case shall the deduction prescribed in paragraph (c)(2)(vi)(J) of this section above be reduced. Each such Examining Authority shall make and preserve for a period of not less than 3 years a record of each application granted pursuant to this paragraph (c)(2)(vi)(M)(*5*), which shall contain a summary of the justification for the granting of the application.

(N) Any specialist that limits its securities business to that of a specialist (except for an occasional non-specialist related securities transaction for its own account), that does not transact a business in securities with other than a broker or dealer registered with the Commission under section 15 or 15C of the Act or a member of a national securities exchange, and that is not a clearing member of The Options Clearing Corporation need not deduct from net worth in computing net capital those deductions, as to its specialty securities, set forth in paragraph (c)(2)(vi) of this section or appendix A to this section, except for paragraph (e) of this section limiting withdrawals of equity capital and appendix D to this section relating to satisfactory subordination agreements. As to a specialist that is solely an options specialist, in paragraph (e) the term ''net capital'' shall be deemed to mean ''net capital before the application of paragraph (c)(2)(vi) of this section or appendix A to this section'' and ''excess net capital'' shall be deemed to be the amount of net capital before the application of paragraph (c)(2)(vi) of this section or appendix A to this section in excess of the amount of net capital required under paragraph (a) of this section. In reports filed pursuant to § 240.17a–5 and in making the record required by § 240.17a–3(a)(11) each specialists shall include the deductions that would otherwise have been required by paragraph (c)(2)(vi) of this section or appendix A to this section in the absence of this paragraph (c)(2)(vi)(N).

(vii) *Non-marketable securities.* Deducting 100 percent of the carrying value in the case of securities or evidence of indebtedness in the proprietary or other accounts of the broker or dealer, for which there is no ready market, as defined in paragraph (c)(11) of this section, and securities, in the proprietary or other accounts of the broker or dealer, which cannot be publicly offered or sold because of statutory, regulatory or contractual arrangements or other restrictions.

Open Contractual Commitments

(viii) Deducting, in the case of a broker or dealer that has open contractual commitments (other than those option positions subject to appendix A, § 240.15c3–1a), the respective deductions as specified in paragraph (c)(2)(vi) of this section or appendix B, § 240.15c3–1b, from the value (which shall be the market value whenever there is a market) of each net long and each net short position contemplated by any open contractual commitment in the proprietary or other accounts of the broker or dealer.

(A) The deduction for contractual commitments in those securities that are treated in paragraph (c)(2)(vi)(J) of this section shall be 30 percent unless the class and issue of the securities subject to the open contractual commitment deduction are listed for trading on a national securities exchange or are designated as NASDAQ National Market System Securities.

(B) A broker or dealer that maintains in excess of $250,000 of net capital may add back to net worth up to $150,000 of any deduction computed under this paragraph (c)(2)(viii)(B).

(C) The deduction with respect to any single commitment shall be reduced by the unrealized profit in such commitment, in an amount not greater than the deduction provided for by this paragraph (or increased by the unrealized loss), in such commitment, and in no event shall an unrealized profit on any closed transactions operate to increase net capital.

(ix) Deducting from the contract value of each failed to deliver contract that is outstanding five business days or longer (21 business days or longer in the case of municipal securities) the percentages of the market value of the underlying security that would be required by application of the deduction required by paragraph (c)(2)(vi) of this section. Such deduction, however, shall be increased by any excess of the contract price of the failed to deliver contract over the market value of the underlying security or reduced by any excess of the market value of the underlying security over the contract value of the failed to deliver contract, but not to exceed the amount of such deduction. The designated examining authority for the broker or dealer may, upon application of the broker or dealer, extend for a period up to 5 business days, any period herein specified when it is satisfied that the extension is warranted. The designated examining authority upon expiration of the extension may extend for one additional period of up to 5 business days, any period herein specified when it is satisfied that the extension is warranted.

Brokers or Dealers Carrying Accounts of Listed Options Specialists

(x)(A) With respect to any transaction of a specialist in listed options, who is either not otherwise subject to the provisions of this section or is described in paragraph (c)(2)(vi)(N) of this section, for whose specialist account a broker or dealer acts as a guarantor, endorser, or carrying broker or dealer, such broker or dealer shall adjust its net worth by deducting as of noon of each business day the amounts computed as of the prior business day pursuant to § 240.15c3–1a. The required deductions may be reduced by any liquidating equity that exists in such specialist's market-maker account as of that time and shall be increased to the extent of any liquidating deficit in such account. Noon shall be determined according to the local time where the broker or dealer is headquartered. In no event shall excess equity in the specialist's market-maker account result in an increase of the net capital of any such guarantor, endorser, or carrying broker or dealer.

(B) *Definitions.* (*1*) The term *listed option* shall mean any option traded on a registered national securities exchange or automated facility of a registered national securities association.

(*2*) For purposes of this section, the equity in an individual specialist's market-maker account shall be computed by:

(*i*) Marking all securities positions long or short in the account to their respective current market values;

(*ii*) Adding (deducting in the case of a debit balance) the credit balance carried in such specialist's market-maker account; and

(*iii*) Adding (deducting in the case of short positions) the market value of positions long in such account.

(C) No guarantor, endorser, or carrying broker or dealer shall permit the sum of the deductions required pursuant to § 240.15c3–1a in respect of all transactions in specialists' market-maker accounts guaranteed, endorsed, or carried by such broker or dealer to exceed 1,000 percent of such broker's or dealer's net capital as defined in § 240.15c3–1(c)(2) for any period exceeding three business days. If at any time such sum exceeds 1,000 percent of such broker's or dealer's net capital, then the broker or dealer shall:

(*1*) Immediately transmit telegraphic or facsimile notice of such event to the Division of Market Regulation in the headquarters office of the Commission in Washington, DC, to the regional office of the Commission for the region in which the broker or dealer maintains its principal place of business, and to its examining authority designated pursuant to section 17(d) of the Act (15 U.S.C. 78q(d)) (''Designated Examining Authority''); and

(*2*) Be subject to the prohibitions against withdrawal of equity capital set forth in § 240.15c3–1(e) and to the prohibitions against reduction, prepayment, and repayment of subordination agreements set forth in paragraph (b)(11) of § 240.15c3–1d, as if such broker or dealer's net capital were below the minimum standards specified by each of those paragraphs.

(D) If at any time there is a liquidating deficit in a specialist's market-maker account, then the broker or dealer guaranteeing, endorsing, or carrying listed options transactions in such specialist's market-maker account may not extend any further credit in that account, and shall take steps to liquidate promptly existing positions in the account. This paragraph shall not prevent the broker or dealer from, upon approval by the broker's or dealer's Designated Examining Authority, entering into hedging positions in the specialist's market-maker account. The broker or dealer also shall transmit telegraphic or facsimile notice of the deficit and its amount by the close of business of the following business day to its Designated Examining Authority and the Designated Examining Authority of the specialist, if different from its own.

(E) Upon written application to the Commission by the specialist and the broker or dealer guaranteeing, endorsing, or carrying options transactions in such specialist's market-maker account, the Commission may approve upon specified terms and conditions lesser adjustments to net worth than those specified in § 240.15c3–1a.

(xi) *Brokers or dealers carrying specialists or market makers accounts.* With respect to a broker or dealer who carries a market maker or specialist account, or with respect to any transaction in options listed on a registered national securities exchange for which a broker or dealer acts as a guarantor or endorser of options written by a specialist in a specialist account, the broker or dealer shall deduct, for each account carried or for each class or series of options guaranteed or endorsed, any deficiency in collateral required by paragraph (a)(6) of this section.

(xii) *Deduction from net worth for certain undermargined accounts.* Deducting the amount of cash required in each customer's or non-customer's account to meet the maintenance margin requirements of the Examining Authority for the broker or dealer, after application of calls for margin, marks to the market or other required deposits which are outstanding 5 business days or less.

(xiii) *Deduction from net worth for indebtedness collateralized by exempted securities.* Deducting, at the option of the broker or dealer, in lieu of including such amounts in aggregate indebtedness, 4 percent of the amount of any indebtedness secured by exempted securities or municipal securities if such indebtedness would otherwise be includable in aggregate indebtedness.

(xiv) *Deduction from net worth for excess deductible amounts related to fidelity bond coverage.* Deducting the amount specified by rule of the Examining Authority for the broker or dealer with respect to a requirement to maintain fidelity bond coverage.

EXEMPTED SECURITIES

(3) The term *exempted securities* shall mean those securities deemed exempted securities by section 3(a)(12) of the Securities Exchange Act of 1934 and rules thereunder.

CONTRACTUAL COMMITMENTS

(4) The term *contractual commitments* shall include underwriting, when issued, when distributed and delayed delivery contracts, the writing or endorsement of puts and calls and combinations thereof, commitments in foreign currencies, and spot (cash) commodities contracts, but shall not include uncleared regular way purchases and sales of securities and contracts in commodities futures. A series of contracts of purchase or sale of the same security conditioned, if at all, only upon issuance may be treated as an individual commitment.

ADEQUATELY SECURED

(5) Indebtedness shall be deemed to be adequately secured within the meaning of this section when the excess of the market value of the collateral over the amount of the indebtedness is sufficient to make the loan acceptable as a fully secured loan to banks regularly making secured loans to brokers or dealers.

CUSTOMER

(6) The term *customer* shall mean any person from whom, or on whose behalf, a broker or dealer has received, acquired or holds funds or securities for the account of such person, but shall not include a broker or dealer or a registered municipal securities dealer, or a general, special or limited partner or director or officer of the broker or dealer, or any person to the extent that such person has a claim for property or funds which by contract, agreement, or understanding, or by operation of law, is part of the capital of the broker or dealer. *Provided, however,* That the term ''customer'' shall also include a broker or dealer, but only insofar as such broker or dealer maintains a special omnibus account carried with another broker or dealer in compliance with 12 CFR 220.4(b) of Regulation T under the Securities Exchange Act of 1934.

NON-CUSTOMER

(7) The term *non-customer* means a broker or dealer, registered municipal securities dealer, general partner, limited partner, officer, director and persons to the extent their claims are subordinated to the claims of creditors of the broker or dealer.

MARKET MAKER

(8) The term *market maker* shall mean a dealer who, with respect to a particular security, (i) regularly publishes bona fide, competitive bid and offer quotations in a recognized interdealer quotation system; or (ii) furnishes bona fide competitive bid and offer quotations on request; and, (iii) is ready, willing and able to effect transactions in reasonable quantities at his quoted prices with other brokers or dealers.

PROMPTLY TRANSMIT AND DELIVER

(9) A broker or dealer is deemed to ''promptly transmit'' all funds and to ''promptly deliver'' all securities within the meaning of paragraphs (a)(2)(i) and (a)(2)(v) of this section where such transmission or delivery is made no later than noon of the next business day after the receipt of such funds or securities; provided, however, that such prompt transmission or delivery shall not be required to be effected prior to the settlement date for such transaction.

PROMPTLY FORWARD

(10) A broker or dealer is deemed to ''promptly forward'' funds or securities within the meaning of paragraph (a)(2)(i) of this section only when such forwarding occurs no later than noon of the next business day following receipt of such funds or securities.

READY MARKET

(11)(i) The term *ready market* shall include a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.

(ii) A *ready market* shall also be deemed to exist where securities have been accepted as collateral for a loan by a bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934 and where the broker or dealer demonstrates to its Examining Authority that such securities adequately secure such loans as that term is defined in paragraph (c)(5) of this section.

EXAMINING AUTHORITY

(12) The term *Examining Authority* of a broker or dealer shall mean for the purposes of 17 CFR 240.15c3-1 and 240.15c3-1a-d the national securities exchange or national securities association of which the broker or dealer is a member or, if the broker or dealer is a member of more than one such self-regulatory organization, the organization designated by the Commission as the Examining Authority for such broker or dealer, or if the broker or dealer is not a member of any such self-regulatory organization, the Regional Office of the Commission where such broker or dealer has its principal place of business.

ENTITIES THAT HAVE A PRINCIPAL REGULATOR

(13)(i) For purposes of § 240.15c3–1e and § 240.15c3–1g, the term *entity that has a principal regulator* shall mean a person (other than a natural person) that is not a registered broker or dealer (other than a broker or dealer registered under section 15(b)(11) of the Act (15 U.S.C. 78o(b)(11)), provided that the person is:

(A) An insured depository institution as defined in section 3(c)(2) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)(2));

(B) Registered as a futures commission merchant or an introducing broker with the Commodity Futures Trading Commission;

(C) Registered with or licensed by a State insurance regulator and issues any insurance, endowment, or annuity policy or contract;

(D) A foreign bank as defined in section 1(b)(7) of the International Banking Act of 1978 (12 U.S.C. 3101(7)) that has its headquarters in a jurisdiction for which any foreign bank has been approved by the Board of Governors of the Federal Reserve System to conduct business pursuant to the standards set forth in 12 CFR 211.24(c), provided such foreign bank represents to the Commission that it is subject to the same supervisory regime as the foreign bank previously approved by the Board of Governors of the Federal Reserve System;

(E) Not primarily in the securities business, and the person is:

(*1*) A corporation organized under section 25A of the Federal Reserve Act (12 U.S.C. 611 through 633); or

(*2*) A corporation having an agreement or undertaking with the Board of Governors of the Federal Reserve System under section 25 of the Federal Reserve Act (12 U.S.C. 601 through 604a); or

(F) A person that the Commission finds is another entity that is subject to comprehensive supervision, has in place appropriate arrangements so that information that the person provides to the Commission is sufficiently reliable for the purposes of determining compliance with § 240.15c3–1e and § 240.15c3–1g, and it is appropriate to consider the person to be an entity that has a principal regulator considering all relevant circumstances, including the person's mix of business.

(ii) For purposes of §§ 240.15c3–1e, 240.15c3–1g, 240.17h–1T, and 240.17h2T, the term *ultimate holding company that has a principal regulator* shall mean a person (other than a natural person) that:

(A) Is a financial holding company or a company that is treated as a financial holding company under the Bank Holding Company Act of 1956 (12 U.S.C. 1840 *et seq.*), or

(B) The Commission determines to be an ultimate holding company that has a principal regulator, if that person is subject to consolidated, comprehensive supervision; there are in place appropriate arrangements so that information that the person provides to the Commission is sufficiently reliable for the purposes of determining compliance with § 240.15c3–1e and § 240.15c3–1g; and it is appropriate to consider the person to be an ultimate holding company that has a principal regulator in view of all relevant circumstances, including the person's mix of business.

(14) The term *municipal securities* shall mean those securities included within the definition of ''municipal securities'' in section 3(a)(29) of the Securities Exchange Act of 1934.

(15) The term *tentative net capital* shall mean the net capital of a broker or dealer before deducting the securities haircuts computed pursuant to paragraph (c)(2)(vi) of this section and the charges on inventory computed pursuant to appendix B to this section (§ 240.15c3–1b). However, for purposes of paragraph (a)(5) of this section, the term *tentative net capital* means the net capital of an OTC derivatives dealer before deducting the charges for market and credit risk as computed pursuant to appendix F to this section (§ 240.15c3–1f) or paragraph (c)(2)(vi) of this section, if applicable, and increased by the balance sheet value (including counterparty net exposure) resulting from transactions in eligible OTC derivative instruments which would otherwise be deducted by virtue of paragraph (c)(2)(iv) of this section. For purposes of paragraph (a)(7) of this section, the term *tentative net capital* means the net capital of the broker or

dealer before deductions for market and credit risk computed pursuant to § 240.15c3–1e or paragraph (c)(2)(vi) of this section, if applicable, and increased by the balance sheet value (including counterparty net exposure) resulting from transactions in derivative instruments which would otherwise be deducted by virtue of paragraph (c)(2)(iv) of this section. Tentative net capital shall include securities for which there is no ready market, as defined in paragraph (c)(11) of this section, if the use of mathematical models has been approved for purposes of calculating deductions from net capital for those securities pursuant to § 240.15c3–1e.

INSOLVENT

(16) For the purposes of this section, a broker or dealer is insolvent if the broker or dealer:

(i) Is the subject of any bankruptcy, equity receivership proceeding or any other proceeding to reorganize, conserve, or liquidate such broker or dealer or its property or is applying for the appointment or election of a receiver, trustee, or liquidator or similar official for such broker or dealer or its property;

(ii) Has made a general assignment for the benefit of creditors;

(iii) Is insolvent within the meaning of section 101 of title 11 of the United States Code, or is unable to meet its obligations as they mature, and has made an admission to such effect in writing or in any court or before any agency of the United States or any State; or

(iv) Is unable to make such computations as may be necessary to establish compliance with this section or with § 240.15c3–3.

(d) *Debt-equity requirements.* No broker or dealer shall permit the total of outstanding principal amounts of its satisfactory subordination agreements (other than such agreements which qualify under this paragraph (d) as equity capital) to exceed 70 percent of its debt-equity total, as hereinafter defined, for a period in excess of 90 days or for such longer period which the Commission may, upon application of the broker or dealer, grant in the public interest or for the protection of investors. In the case of a corporation, the debt-equity total shall be the sum of its outstanding principal amounts of satisfactory subordination agreements, par or stated value of capital stock, paid in capital in excess of par, retained earnings, unrealized profit and loss or other capital accounts. In the case of a partnership, the debt-equity total shall be the sum of its outstanding principal amounts of satisfactory subordination agreements, capital accounts of partners (exclusive of such partners' securities accounts) subject to the provisions of paragraph (e) of this section, and unrealized profit and loss. In the case of a sole proprietorship, the debt-equity total shall include the sum of its outstanding principal amounts of satisfactory subordination agreements, capital accounts of the sole proprietorship and unrealized profit and loss. *Provided, however,* That a satisfactory subordination agreement entered into by a partner or stockholder which has an initial term of at least three years and has a remaining term of not less than 12 months shall be considered equity for the purposes of this paragraph (d) if:

(1) It does not have any of the provisions for accelerated maturity provided for by paragraphs (b)(9)(i), (10)(i) or (10)(ii) of Appendix (D) (17 CFR 240.15c3–1d) and is maintained as capital subject to the provisions restricting the withdrawal thereof required by paragraph (e) of this section or

(2) The partnership agreement provides that capital contributed pursuant to a satisfactory subordination agreement as defined in Appendix (D) (17 CFR 240.15c3–1d) shall in all respects be partnership capital subject to the provisions restricting the withdrawal thereof required by paragraph (e) of this section.

(e)(1) *Notice provisions relating to limitations on the withdrawal of equity capital.* No equity capital of the broker or dealer or a subsidiary or affiliate consolidated pursuant to appendix C (17 CFR 240.15c3–1c) may be withdrawn by action of a stockholder or a partner or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, sole proprietor, employee or affiliate without written notice given in accordance with paragraph (e)(1)(iv) of this section:

(i) Two business days prior to any withdrawals, advances or loans if those withdrawals, advances or loans on a net basis exceed in the aggregate in any 30 calendar day period, 30 percent of the broker or dealer's excess net capital. A broker or dealer, in an emergency situation, may make withdrawals, advances or loans that on a net basis exceed 30 percent of the broker or dealer's excess net capital in any 30 calendar day period without giving the advance notice required by this paragraph, with the prior approval of its Examining Authority. Where a broker or dealer makes a withdrawal with the consent of its Examining Authority, it shall in any event comply with paragraph (e)(1)(ii) of this section; or

(ii) Two business days after any withdrawals, advances or loans if those withdrawals, advances or loans on a net basis exceed in the aggregate in any 30 calendar day period, 20 percent of the broker or dealer's excess net capital.

(iii) This paragraph (e)(1) does not apply to:

(A) Securities or commodities transactions in the ordinary course of business between a broker or dealer and an affiliate where the broker or dealer makes payment to or on behalf of such affiliate for such transaction and then receives payment from such affiliate for the securities or commodities transaction within two business days from the date of the transaction; or

(B) Withdrawals, advances or loans which in the aggregate in any thirty calendar day period, on a net basis, equal $500,000 or less.

(iv) Each required notice shall be effective when received by the Commission in Washington, DC, the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the broker or dealer's Examining Authority and the Commodity Futures Trading Commission if such broker or dealer is registered with that Commission.

(2) *Limitations on Withdrawal of equity capital.* No equity capital of the broker or dealer or a subsidiary or affiliate consolidated pursuant to appendix C (17 CFR 240.15c3–1c) may be withdrawn by action of a stockholder or a partner or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, sole proprietor, employee or affiliate, if after giving effect thereto and to any other such withdrawals, advances or loans and any Payments of Payment Obligations (as defined in appendix D (17 CFR 240.15c3–1d)) under satisfactory subordination agreements which are scheduled to occur within 180 days following such withdrawal, advance or loan if:

(i) The broker or dealer's net capital would be less than 120 percent of the minimum dollar amount required by paragraph (a) of this section;

(ii) The broker-dealer is registered as a futures commission merchant, its net capital would be less than 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account);

(iii) The broker-dealer's net capital would be less than 25 percent of deductions from net worth in computing net capital required by paragraphs (c)(2)(vi), (f) and appendix A, of this section, unless the broker or dealer has the prior approval of the Commission to make such withdrawal;

(iv) The total outstanding principal amounts of satisfactory subordination agreements of the broker or dealer and any subsidiaries or affiliates consolidated pursuant to appendix C (17 CFR 240.15c3–1c) (other than such agreements which qualify as equity under paragraph (d) of this section) would exceed 70% of the debt-equity total as defined in paragraph (d) of this section;

(v) The broker or dealer is subject to the aggregate indebtedness limitations of paragraph (a) of this section, the aggregate indebtedness of any of the consolidated entities exceeds 1000 percent of its net capital; or

(vi) The broker or dealer is subject to the alternative net capital requirement of paragraph (f) of this section, its net capital would be less than 5 percent of aggregate debit items computed in accordance with 17 CFR 240.15c3–3a.

(3)(i) *Temporary restrictions on withdrawal of net capital.* The Commission may by order restrict, for a period of up to twenty business days, any withdrawal by the broker or dealer of equity capital or unsecured loan or advance to a stockholder, partner, sole proprietor, member, employee or affiliate under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors if the Commission, based on the information available, concludes that such withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection Act of 1970.

(ii) An order temporarily prohibiting the withdrawal of capital shall be rescinded if the Commission determines that the restriction on capital withdrawal should not remain in effect. A hearing on an order temporarily prohibiting the withdrawal of capital will be held within two business days from the date of the request in writing by the broker or dealer.

(4)(i) *Miscellaneous provisions.* Excess net capital is that amount in excess of the amount required under paragraph (a) of this section. For the purposes of paragraphs (e)(1) and (e)(2) of this section, a broker or dealer may use the amount of excess net capital and deductions required under paragraphs (c)(2)(vi), (f) and appendix A of this section reported in its most recently required filed Form X–17A–5 for the purposes of calculating the effect of a projected withdrawal, advance or loan relative to excess net capital or deductions. The broker or dealer must assure itself that the excess net capital or the deductions reported on the most recently required filed Form X–17A–5 have not materially changed since the time such report was filed.

(ii) The term equity capital includes capital contributions by partners, par or stated value of capital stock, paid-in capital in excess of par, retained earnings or other capital accounts. The term equity capital does not include securities in the securities accounts of partners and balances in limited partners' capital accounts in excess of their stated capital contributions.

(iii) Paragraphs (e)(1) and (e)(2) of this section shall not preclude a broker or dealer from making required tax payments or preclude the payment to partners of reasonable compensation, and such payments shall not be included in the calculation of withdrawals, advances, or loans for purposes of paragraphs (e)(1) and (e)(2) of this section.

(iv) For the purpose of this paragraph (e) of this section, any transaction between a broker or dealer and a stockholder, partner, sole proprietor, employee or affiliate that results in a diminution of the broker or dealer's net capital shall be deemed to be an advance or loan of net capital.

[40 FR 29799, July 16, 1975]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 240.15c3–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.govinfo.gov.*

§ 240.15c3–1a Options (Appendix A to 17 CFR 240.15c3–1).

(a) *Definitions.* (1) The term *unlisted option* shall mean any option not included in the definition of listed option provided in paragraph (c)(2)(x) of § 240.15c3–1.

(2) The term *option series* refers to listed option contracts of the same type (either a call or a put) and exercise style, covering the same underlying security with the same exercise price, expiration date, and number of underlying units.

(3) The term *related instrument* within an option class or product group refers

to futures contracts and options on futures contracts covering the same underlying instrument. In relation to options on foreign currencies a related instrument within an option class also shall include forward contracts on the same underlying currency.

(4) The term *underlying instrument* refers to long and short positions, as appropriate, covering the same foreign currency, the same security, or a security which is exchangeable for or convertible into the underlying security within a period of 90 days. If the exchange or conversion requires the payment of money or results in a loss upon conversion at the time when the security is deemed an underlying instrument for purposes of this Appendix A, the broker or dealer will deduct from net worth the full amount of the conversion loss. The term underlying instrument shall not be deemed to include securities options, futures contracts, options on futures contracts, qualified stock baskets, or unlisted instruments.

(5) The term *options class* refers to all options contracts covering the same underlying instrument.

(6) The term *product group* refers to two or more option classes, related instruments, underlying instruments, and qualified stock baskets in the same portfolio type (see paragraph (b)(1)(ii) of this section) for which it has been determined that a percentage of offsetting profits may be applied to losses at the same valuation point.

(b) The deduction under this Appendix A to § 240.15c3–1 shall equal the sum of the deductions specified in paragraphs (b)(1)(v)(C) or (b)(2) of this section.

THEORETICAL PRICING CHARGES

(1)(i) *Definitions.* (A) The terms *theoretical gains and losses* shall mean the gain and loss in the value of individual option series, the value of underlying instruments, related instruments, and qualified stock baskets within that option's class, at 10 equidistant intervals (valuation points) ranging from an assumed movement (both up and down) in the current market value of the underlying instrument equal to the percentage corresponding to the deductions otherwise required under § 240.15c3–1 for the underlying instrument (See paragraph (a)(1)(iii) of this section). Theoretical gains and losses shall be calculated using a theoretical options pricing model that satisfies the criteria set forth in paragraph (a)(1)(i)(B) of this section.

(B) The term *theoretical options pricing model* shall mean any mathematical model, other than a broker-dealer proprietary model, approved by a Designated Examining Authority. Such Designated Examining Authority shall submit the model to the Commission, together with a description of its methods for approving models. Any such model shall calculate theoretical gains and losses as described in paragraph (a)(1)(i)(A) of this section for all series and issues of equity, index and foreign currency options and related instruments, and shall be made available equally and on the same terms to all registered brokers or dealers. Its procedures shall include the arrangement of the vendor to supply accurate and timely data to each broker-dealer with respect to its services, and the fees for distribution of the services. The data provided to brokers or dealers shall also contain the minimum requirements set forth in paragraphs (b)(1)(v)(C) of this section and the product group offsets set forth in paragraphs (b)(1)(v)(B) of this section. At a minimum, the model shall consider the following factors in pricing the option:

(*1*) The current spot price of the underlying asset;

(*2*) The exercise price of the option;

(*3*) The remaining time until the option's expiration;

(*4*) The volatility of the underlying asset;

(*5*) Any cash flows associated with ownership of the underlying asset that can reasonably be expected to occur during the remaining life of the option; and

(*6*) The current term structure of interest rates.

(C) The term *major market foreign currency* shall mean the currency of a sovereign nation for which there is a substantial inter-bank forward currency market.

(D) The term *qualified stock basket* shall mean a set or basket of stock positions which represents no less than

50% of the capitalization for a high-capitalization or non-high-capitalization diversified market index, or, in the case of a narrow-based index, no less than 95% of the capitalization for such narrow-based index.

(ii) With respect to positions involving listed options in a single specialist's market-maker account, and, separately, with respect to positions involving listed option positions in its proprietary or other account, the broker or dealer shall group long and short positions into the following portfolio types:

(A) Equity options on the same underlying instrument and positions in that underlying instrument;

(B) Options on the same major market foreign currency, positions in that major market foreign currency, and related instruments within those options' classes;

(C) High-capitalization diversified market index options, related instruments within the option's class, and qualified stock baskets in the same index;

(D) Non-high-capitalization diversified index options, related instruments within the index option's class, and qualified stock baskets in the same index; and

(E) Narrow-based index options, related instruments within the index option's class, and qualified stock baskets in the same index.

(iii) Before making the computation, each broker or dealer shall obtain the theoretical gains and losses for each options series and for the related and underlying instruments within those options' class in each specialist's market-maker account guaranteed, endorsed, or carried by a broker or dealer, or in the proprietary or other accounts of that broker or dealer. For each option series, the theoretical options pricing model shall calculate theoretical prices at 10 equidistant valuation points within a range consisting of an increase or a decrease of the following percentages of the daily market price of the underlying instrument:

(A) + (−)15% for equity securities with a ready market, narrow-based indexes, and non-high-capitalization diversified indexes;

(B) + (−)6% for major market foreign currencies;

(C) + (−) 20% for all other currencies; and

(D) + (−)10% for high-capitalization diversified indexes.

(iv) As to non-clearing option specialists and market-makers, the percentages of the daily market price of the underlying instrument shall be:

(A) + (−) 4½% for major market foreign currencies; and

(B) + 6(−)8% for high-capitalization diversified indexes.

(C) + (−) 10% for a non-clearing market-maker, or specialist in non-high capitalization diversified index product group.

(v)(A) The broker or dealer shall multiply the corresponding theoretical gains and losses at each of the 10 equidistant valuation points by the number of positions held in a particular options series, the related instruments and qualified stock baskets within the option's class, and the positions in the same underlying instrument.

(B) In determining the aggregate profit or loss for each portfolio type, the broker or dealer will be allowed the following offsets in the following order, provided, that in the case of qualified stock baskets, the broker or dealer may elect to net individual stocks between qualified stock baskets and take the appropriate deduction on the remaining, if any, securities:

(*1*) First, a broker or dealer is allowed the following offsets within an option's class:

(*i*) Between options on the same underlying instrument, positions covering the same underlying instrument, and related instruments within the option's class, 100% of a position's gain shall offset another position's loss at the same valuation point;

(*ii*) Between index options, related instruments within the option's class, and qualified stock baskets on the same index, 95%, or such other amount as designated by the Commission, of gains shall offset losses at the same valuation point;

(*2*) Second, a broker-dealer is allowed the following offsets within an index product group:

(*i*) Among positions involving different high-capitalization diversified index option classes within the same product group, 90% of the gain in a high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in a different high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class;

(*ii*) Among positions involving different non-high-capitalization diversified index option classes within the same product group, 75% of the gain in a non-high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in another non-high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class or product group;

(*iii*) Among positions involving different narrow-based index option classes within the same product group, 90% of the gain in a narrow-based market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in another narrow-based market index option, related instruments, and qualified stock baskets within that index option's class or product group;

(*iv*) No qualified stock basket should offset another qualified stock basket; and

(*3*) Third, a broker-dealer is allowed the following offsets between product groups: Among positions involving different diversified index product groups within the same market group, 50% of the gain in a diversified market index option, a related instrument, or a qualified stock basket within that index option's product group shall offset the loss at the same valuation point in another product group;

(C) For each portfolio type, the total deduction shall be the larger of:

(*1*) The amount for any of the 10 equidistant valuation points representing the largest theoretical loss after applying the offsets provided in paragraph (b)(1)(v)(B) if this section; or

(*2*) A minimum charge equal to 25% times the multiplier for each equity and index option contract and each related instrument within the option's class or product group, or $25 for each option on a major market foreign currency with the minimum charge for futures contracts and options on futures contracts adjusted for contract size differentials, not to exceed market value in the case of long positions in options and options on futures contracts; plus

(*3*) In the case of portfolio types involving index options and related instruments offset by a qualified stock basket, there will be a minimum charge of 5% of the market value of the qualified stock basket for high-capitalization diversified and narrow-based indexes; and

(*4*) In the case of portfolio types involving index options and related instruments offset by a qualified stock basket, there will be a minimum charge of 7½% of the market value of the qualified stock basket for non-high-capitalization diversified indexes.

ALTERNATIVE STRATEGY BASED METHOD

(2) A broker or dealer may elect to apply the alternative strategy based method in accordance with the provisions of this paragraph (b)(2).

(i) *Definitions.* (A) The term *intrinsic value* or *in-the-money amount* shall mean the amount by which the exercise value, in the case of a call, is less than the current market value of the underlying instrument, and, in the case of a put, is greater than the current market value of the underlying instrument.

(B) The term *out-of-the-money amount* shall mean the amount by which the exercise value, in the case of a call, is greater than the current market value of the underlying instrument, and, in the case of a put, is less than the current market value of the underlying instrument.

(C) The term *time value* shall mean the current market value of an option contract that is in excess of its intrinsic value.

(ii) Every broker or dealer electing to calculate adjustments to net worth in accordance with the provisions of this paragraph (b)(2) must make the following adjustments to net worth:

(A) Add the time value of a short position in a listed option; and

(B) Deduct the time value of a long position in a listed option, which relates to a position in the same underlying instrument or in a related instrument within the option class or product group as recognized in the strategies enumerated in paragraph (b)(2)(iii)(D) of this section; and

(C) Add the net short market value or deduct the long market value of listed options as recognized in the strategies enumerated in paragraphs (b)(2)(iii)(E)(*1*) and (*2*) of this section.

(iii) In computing net capital after the adjustments provided for in paragraph (b)(2)(ii) of this section, every broker or dealer shall deduct the percentages specified in this paragraph (b)(2)(iii) for all listed option positions, positions covering the same underlying instrument and related instruments within the options' class or product group.

UNCOVERED CALLS

(A) Where a broker or dealer is short a call, deducting the percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1 of the current market value of the underlying instrument for such option reduced by its out-of-the-money amount, to the extent that such reduction does not operate to increase net capital. In no event shall this deduction be less than the greater of $250 for each short call option contract for 100 shares or 50% of the aforementioned percentage.

UNCOVERED PUTS

(B) Where a broker or dealer is short a put, deducting the percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1 of the current market value of the underlying instrument for such option reduced by its out-of-the-money amount, to the extent that such reduction does not operate to increase net capital. In no event shall the deduction provided by this paragraph be less than the greater of $250 for each short put option contract for 100 shares or 50% of the aforementioned percentage.

LONG POSITIONS

(C) Where a broker or dealer is long puts or calls, deducting 50 percent of the market value of the net long put and call positions in the same options series.

CERTAIN SECURITY POSITIONS WITH OFFSETTING OPTIONS

(D)(*1*) Where a broker or dealer is long a put for which it has an offsetting long position in the same number of units of the same underlying instrument, deducting the percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1 of the current market value of the underlying instrument for the long offsetting position, not to exceed the out-of-the-money amount of the option. In no event shall the deduction provided by this paragraph be less than $25 for each option contract for 100 shares, provided that the minimum charge need not exceed the intrinsic value of the option.

(*2*) Where a broker or dealer is long a call for which it has an offsetting short position in the same number of units of the same underlying instrument, deducting the percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1 of the current market value of the underlying instrument for the short offsetting position, not to exceed the out-of-the-money amount of the option. In no event shall the deduction provided by this paragraph be less than $25 for each option contract for 100 shares, provided that the minimum charge need not exceed the intrinsic value of the option.

(*3*) Where a broker or dealer is short a call for which it has an offsetting long position in the same number of units of the same underlying instrument, deducting the percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1 of the current market value of the underlying instrument for the offsetting long position reduced by the short call's intrinsic value. In no event shall the deduction provided by this paragraph be less than $25 for each option contract for 100 shares.

CERTAIN SPREAD POSITIONS

(E)(*1*) Where a broker or dealer is short a listed call and is also long a listed call in the same class of options contracts and the long option expires on the same date as or subsequent to the short option, the deduction, after adjustments required in paragraph (b) of this section, shall be the amount by which the exercise value of the long call exceeds the exercise value of the short call. If the exercise value of the long call is less than or equal to the exercise value of the short call, no deduction is required.

(*2*) Where a broker or dealer is short a listed put and is also long a listed put in the same class of options contracts and the long option expires on the same date as or subsequent to the short option, the deduction, after the adjustments required in paragraph (b) of this section, shall be the amount by which the exercise value of the short put exceeds the exercise value of the long put. If the exercise value of the long put is equal to or greater than the exercise value of the short put, no deduction is required.

(c) With respect to transactions involving unlisted options, every broker or dealer shall determine the value of unlisted option positions in accordance with the provision of paragraph (c)(2)(i) of § 240.15c3–1, and shall deduct the percentages of all securities positions or unlisted options in the proprietary or other accounts of the broker or dealer specified in this paragraph (c). However, where computing the deduction required for a security position as if the security position had no related unlisted option position and positions in unlisted options as if uncovered would result in a lesser deduction from net worth, the broker or dealer may compute such deductions separately.

UNCOVERED CALLS

(1) Where a broker or dealer is short a call, deducting 15 percent (or such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the current market value of the security underlying such option reduced by any excess of the exercise value of the call over the current market value of the underlying security. In no event shall the deduction provided by this paragraph be less than $250 for each option contract for 100 shares.

UNCOVERED PUTS

(2) Where a broker or dealer is short a put, deducting 15 percent (or such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the current market value of the security underlying the option reduced by any excess of the market value of the underlying security over the exercise value of the put. In no event shall the deduction provided by this paragraph be less than $250 for each option contract for 100 shares.

COVERED CALLS

(3) Where a broker or dealer is short a call and long equivalent units of the underlying security, deducting 15 percent (or such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the current market value of the underlying security reduced by any excess of the current market value of the underlying security over the exercise value of the call. No reduction under this paragraph shall have the effect of increasing net capital.

COVERED PUTS

(4) Where a broker or dealer is short a put and short equivalent units of the underlying security, deducting 15 percent (or such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the current market value of the underlying security reduced by any excess of the exercise value of the put over the market value of the underlying security. No such reduction shall have the effect of increasing net capital.

CONVERSION ACCOUNTS

(5) Where a broker or dealer is long equivalent units of the underlying security, long a put written or endorsed by a broker or dealer and short a call in its proprietary or other accounts, deducting 5 percent (or 50 percent of such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of

§ 240.15c3–1) of the current market value of the underlying security.

(6) Where a broker or dealer is short equivalent units of the underlying security, long a call written or endorsed by a broker or dealer and short a put in his proprietary or other accounts, deducting 5 percent (or 50 percent of such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the market value of the underlying security.

LONG OPTIONS

(7) Where a broker or dealer is long a put or call endorsed or written by a broker or dealer, deducting 15 percent (or such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the market value of the underlying security, not to exceed any value attributed to such option in paragraph (c)(2)(i) of § 240.15c3–1.

[62 FR 6481, Feb. 12, 1997, as amended at 78 FR 51901, Aug. 21, 2013; 79 FR 1549, Jan. 8, 2014]

§ 240.15c3–1b Adjustments to net worth and aggregate indebtedness for certain commodities transactions (appendix B to 17 CFR 240.15c3–1).

(a) Every broker or dealer in computing net capital pursuant to 17 CFR 240.15c3–1 shall comply with the following:

(1) Where a broker or dealer has an asset or liability which is treated or defined in paragraph (c) of 17 CFR 240.15c3–1, the inclusion or exclusion of all or part of such asset or liability for the computation of aggregate indebtedness and net capital shall be in accordance with paragraph (c) of 17 CFR 240.15c3–1, except as specifically provided otherwise in this appendix B. Where a commodity related asset or liability is specifically treated or defined in 17 CFR 1.17 and is not generally or specifically treated or defined in 17 CFR 240.15c3–1 or this appendix B, the inclusion or exclusion of all or part of such asset or liability for the computation of aggregate indebtedness and net capital shall be in accordance with 17 CFR 1.17.

AGGREGATE INDEBTEDNESS

(2) The term *aggregate indebtedness* as defined in paragraph (c)(1) of this section shall exclude with respect to commodity-related transactions:

(i) Indebtedness arising in connection with an advance to a non-proprietary account when such indebtedness is adequately collateralized by spot commodities eligible for delivery on a contract market and when such spot commodities are covered.

(ii) Advances received by the broker or dealer against bills of lading issued in connection with the shipment of commodities sold by the broker or dealer; and

(iii) Equity balances in the accounts of general partners.

NET CAPITAL

(3) In computing net capital as defined in paragraph (c)(2) of this section, the net worth of a broker or dealer shall be adjusted as follows with respect to commodity-related transactions:

(i) *Unrealized profit or loss for certain commodities transactions.* (A) Unrealized profits shall be added and unrealized losses shall be deducted in the commodities accounts of the broker or dealer, including unrealized profits and losses on fixed price commitments and forward contracts; and

(B) The value attributed to any commodity option which is not traded on a contract market shall be the difference between the option's strike price and the market value for the physical or futures contract which is the subject of the option. In the case of a long call commodity option, if the market value for the physical or futures contract which is the subject of the option is less than the strike price of the option, it shall be given no value. In the case of a long put commodity option, if the market value for the physical commodity or futures contract which is the subject of the option is more than the striking price of the option, it shall be given no value.

(ii) Deduct any unsecured commodity futures or option account containing a ledger balance and open trades, the combination of which liquidates to a deficit or containing a debit ledger balance only: *Provided, however,* Deficits or debit ledger balances in unsecured customers', non-customers' and proprietary accounts, which are the subject of calls for margin or other required deposits need not be deducted until the close of business on the business day following the date on which such deficit or debit ledger balance originated;

(iii) Deduct all unsecured receivables, advances and loans except for:

(A) Management fees receivable from commodity pools outstanding no longer than thirty (30) days from the date they are due;

(B) Receivables from foreign clearing organizations;

(C) Receivables from registered futures commission merchants or brokers, resulting from commodity futures or option transactions, except those specifically excluded under paragraph (3)(ii) of this appendix B. In the case of an introducing broker or an applicant for registration as an introducing broker, include 50 percent of the value of a guarantee or security deposit with a futures commission merchant which carries or intends to carry accounts for the customers of the introducing broker.

(iv) Deduct all inventories (including work in process, finished goods, raw materials and inventories held for resale) except for readily marketable spot commodities; or spot commodities which adequately collateralize indebtedness under paragraph (c)(7) of 17 CFR 1.17;

(v) Guarantee deposits with commodities clearing organizations are not required to be deducted from net worth;

(vi) Stock in commodities clearing organizations to the extent of its margin value is not required to be deducted from net worth;

(vii) Deduct from net worth the amount by which any advances paid by the broker or dealer on cash commodity contracts and used in computing net capital exceeds 95 percent of the market value of the commodities covered by such contracts.

(viii) Do not include equity in the commodity accounts of partners in net worth.

(ix) In the case of all inventory, fixed price commitments and forward contracts, except for inventory and forward contracts in the inter-bank market in those foreign currencies which are purchased or sold for further delivery on or subject to the rules of a contract market and covered by an open futures contract for which there will be no charge, deduct the applicable percentage of the net position specified below:

(A) Inventory which is currently registered as deliverable on a contract market and covered by an open futures contract or by a commodity option on a physical—No charge.

(B) Inventory which is covered by an open futures contract or commodity option—5% of the market value.

(C) Inventory which is not covered—20% of the market value.

(D) Fixed price commitments (open purchases and sales) and forward contracts which are covered by an open futures contract or commodity option—10% of the market value.

(E) Fixed price commitments (open purchases and sales) and forward contracts which are not covered by an open futures contract or commodity option—20% of the market value.

(x) Deduct 4% of the market value of commodity options granted (sold) by option customers on or subject to the rules of a contract market.

(xi) [Reserved]

(xii) Deduct for undermargined customer commodity futures accounts the amount of funds required in each such account to meet maintenance margin requirements of the applicable board of trade or, if there are no such maintenance margin requirements, clearing organization margin requirements applicable to such positions, after application of calls for margin, or other required deposits which are outstanding three business days or less. If there are no such maintenance margin requirements or clearing organization margin requirements on such accounts, then deduct the amount of funds required to provide margin equal to the amount necessary after application of calls for margin, or other required deposits outstanding three days or less to restore original margin when the original margin has been depleted by 50 percent or more. *Provided,* To the extent a deficit is deducted from net worth in accordance with paragraph (a)(3)(ii) of this appendix B, such amount shall not also be deducted under this paragraph (a)(3)(xii). In the event that an owner of a customer account has deposited an asset other than cash to margin, guarantee or secure his account, the value attributable to such asset for purposes of this paragraph shall be the lesser of (A) the value attributable to such asset pursuant to the margin rules of the applicable board of trade, or (B) the market value of such asset after application of the percentage deductions specified in paragraph (a)(3)(ix) of this appendix B or, where appropriate, specified in paragraph (c)(2)(vi) or (c)(2)(vii) of § 240.15c3–1 this chapter;

(xiii) Deduct for undermargined noncustomer and omnibus commodity futures accounts the amount of funds required in each such account to meet maintenance margin requirements of the applicable board of trade or, if there are no such maintenance margin requirements, clearing organization margin requirements applicable to such positions, after application of calls for margin, or other required deposits which are outstanding two business days or less. If there are no such maintenance margin requirements or clearing organization margin requirements, then deduct the amount of funds required to provide margin equal to the amount necessary after application of calls for margin, or other required deposits outstanding two days or less to restore original margin when the original margin has been depleted by 50 percent or more. *Provided,* To the extent a deficit is deducted from net worth in accordance with paragraph (a)(3)(ii) of this appendix B such amount shall not also be deducted under this paragraph (a)(3)(xiii). In the event that an owner of a non-customer or omnibus account has deposited an asset other than cash to margin, guarantee or secure his account, the value attributable to such asset for purposes of this paragraph shall be the lesser of (A) the value attributable to such asset pursuant to the margin rules of the applicable board of trade, or (B) the market value of such asset after application of the percentage deductions specified in paragraph (a)(3)(ix) of this appendix B or, where appropriate, specified in paragraph (c)(2)(vi) or (c)(2)(vii) of § 240.15c3–1 of this chapter;

(xiv) In the case of open futures contracts and granted (sold) commodity options held in proprietary accounts carried by the broker or dealer which are not covered by a position held by the broker or dealer or which are not the result of a ‘‘changer trade made in accordance with the rules of a contract market, deduct:

(A) For a broker or dealer which is a clearing member of a contract market for the positions on such contract market cleared by such member, the applicable margin requirement of the applicable clearing organization;

(B) For a broker or dealer which is a member of a self-regulatory organization 150% of the applicable maintenance margin requirement of the applicable board of trade or clearing organization, whichever is greater; or

(C) For all other brokers or dealers, 200% of the applicable maintenance margin requirement of the applicable board of trade or clearing organization, whichever is greater; or

(D) For open contracts or granted (sold) commodity options for which there are no applicable maintenance margin requirements, 200% of the applicable initial margin requirement;

Provided, the equity in any such proprietary account shall reduce the deduction required by this paragraph (a)(3)(xiv) if such equity is not otherwise includable in net capital.

(xv) In the case of a broker or dealer which is a purchaser of a commodity option which is traded on a contract market the deduction shall be the same safety factor as if the broker or dealer were the grantor of such option in accordance with paragraph (a)(3)(xiv), but in no event shall the safety factor be greater than the market value attributed to such option.

(xvi) In the case of a broker or dealer which is a purchaser of a commodity option not traded on a contract market which has value and such value is used to increase net capital, the deduction is ten percent of the market value of the physical or futures contract which is the subject of such option but in no event more than the value attributed to such option.

(xvii) Deduction 5% of all unsecured receivables includable under paragraph (a)(3)(iii)(C) of this appendix B used by the broker or dealer in computing ''net capital'' and which are not receivable from (A) a futures commission merchant registered as such with the Commodity Futures Trading Commission, or (B) a broker or dealer which is registered as such with the Securities and Exchange Commission.

(xviii) A loan or advance or any other form of receivable shall not be considered ''secured'' for the purposes of paragraph (a)(3) of this appendix B unless the following conditions exist:

(A) The receivable is secured by readily marketable collateral which is otherwise unencumbered and which can be readily converted into cash: *Provided, however,* That the receivable will be considered secured only to the extent of the market value of such collateral after application of the percentage deductions specified in paragraph (a)(3)(ix) of this appendix B; and

(B)(*1*) The readily marketable collateral is in the possession or control of the broker or dealer; or

(*2*) The broker or dealer has a legally enforceable, written security agreement, signed by the debtor, and has a perfected security interest in the readily marketable collateral within the meaning of the laws of the State in which the readily marketable collateral is located.

(xix) The term *cover* for purposes of this appendix B shall mean cover as defined in 17 CFR 1.17(j).

(xx) The term *customer* for purposes of this Appendix B shall mean customer as defined in 17 CFR 1.17(b)(2). The term ''non-customer'' for purposes of this appendix B shall mean non-customer as defined in 17 CFR 1.17(b)(4).

(Secs. 15(c)(3), 17(a) and 23(a), 15 U.S.C. 78o(c)(3), 78q(a), and 78w(a))

[44 FR 34886, June 15, 1979, as amended at 46 FR 37041, July 17, 1981; 49 FR 31848, Aug. 9, 1984]

§ 240.15c3–1c Consolidated computations of net capital and aggregate indebtedness for certain subsidiaries and affiliates (appendix C to 17 CFR 240.15c3–1).

(a) *Flow through capital benefits.* Every broker or dealer in computing its net capital and aggregate indebtedness pursuant to 17 CFR 240.15c3–1 shall, subject to the provisions of paragraphs (b) and (d) of this appendix, consolidate in a single computation assets and liabilities of any subsidiary or affiliate for which it guarantees, endorses or assumes directly or indirectly the obligations or liabilities. The assets and liabilities of a subsidiary or affiliate whose liabilities and obligations have not been guaranteed, endorsed, or assumed directly or indirectly by the broker or dealer may also be so consolidated if an opinion of counsel is obtained as provided for in paragraph (b) of this section.

(b) *Required counsel opinions.* (1) If the consolidation, provided for in paragraph (a) of this section, of any such subsidiary or affiliate results in the increase of the broker's or dealers's net capital and/or the decrease of the broker's or dealer's minimum net capital requirement under paragraph (a) of § 240.15c3–1 and an opinion of counsel described in paragraph (b)(2) of this section has not been obtained, such benefits shall not be recognized in the broker's or dealer's computation required by this section.

(2) Except as provided for in paragraph (b)(1) of this section, consolidation shall be permitted with respect to any subsidiaries or affiliates which are majority owned and controlled by the broker or dealer for which the broker or dealer can demonstrate to the satisfaction of the Commission, through the Examining Authority, by an opinion of counsel that the net asset values, or the portion thereof related to the parent's ownership interest in the subsidiary or affiliate may be caused by the broker or dealer or a trustee appointed pursuant to the Securities Investor Protection Act of 1970 or otherwise, to be distributed to the broker or dealer within 30 calendar days. Such opinion shall also set forth the actions necessary to cause such a distribution to be made, identify the parties having the authority to take such actions, identify and describe the rights of other parties or classes of parties, including but not limited to customers, general creditors, subordinated lenders, minority shareholders, employees, litigants and governmental or regulatory

authorities, who may delay or prevent such a distribution and such other assurances as the Commission or the Examining Authority by rule or interpretation may require. Such opinion shall be current and periodically renewed in connection with the broker's or dealer's annual audit pursuant to 17 CFR 240.17a–5 under the Securities Exchange Act of 1934 or upon any material change in circumstances.

(c) *Principles of consolidation.* In preparing a consolidated computation of net capital and/or aggregate indebtedness pursuant to this section, the following minimum and non-exclusive requirements shall be observed:

(1) Consolidated net worth shall be reduced by the estimated amount of any tax reasonably anticipated to be incurred upon distribution of the assets of the subsidiary or affiliate.

(2) Liabilities of a consolidated subsidiary or affiliate which are subordinated to the claims of present and future creditors pursuant to a satisfactory subordination agreement shall not be added to consolidated net worth unless such subordination extends also to the claims of present or future creditors of the parent broker or dealer and all consolidated subsidiaries.

(3) Subordinated liabilities of a consolidated subsidiary or affiliate which are consolidated in accordance with paragraph (c)(2) of this section may not be prepaid, repaid or accelerated if any of the entities included in such consolidation would otherwise be unable to comply with the provisions of Appendix (D), 17 CFR 240.15c3–1d.

(4) Each broker or dealer included within the consolidation shall at all times be in compliance with the net capital requirement to which it is subject.

(d) *Certain precluded acts.* No broker or dealer shall guarantee, endorse or assume directly or indirectly any obligation or liability of a subsidiary or affiliate unless the obligation or liability is reflected in the computation of net capital and/or aggregate indebtedness pursuant to 17 CFR 240.15c3–1 or this appendix (C), except as provided in paragraph (b)(1) of this section.

[40 FR 29808, July 16, 1975, as amended at 57 FR 56988, Dec. 2, 1992]

§240.15c3–1d Satisfactory Subordination Agreements (Appendix D to 17 CFR 240.15c3–1).

(a) *Introduction.* (1) This appendix sets forth minimum and non-exclusive requirements for satisfactory subordination agreements (hereinafter ''subordination agreement''). The Examining Authority may require or the broker or dealer may include such other provisions as deemed necessary or appropriate to the extent such provisions do not cause the subordination agreement to fail to meet the minimum requirements of this Appendix (D).

(2) *Certain definitions.* For purposes of 17 CFR 240.15c3–1 and this Appendix (D):

(i) A subordination agreement may be either a subordinated loan agreement or a secured demand note agreement.

(ii) The term *subordinated loan agreement* shall mean the agreement or agreements evidencing or governing a subordinated borrowing of cash.

(iii) The term *collateral value* of any securities pledged to secure a secured demand note shall mean the market value of such securities after giving effect to the percentage deductions set forth in paragraph (c)(2)(vi) of §240.15c3–1 except for paragraph (c)(2)(vi)(J). In lieu of the deduction under (c)(2)(vi)(J), the broker or dealer shall reduce the market value of the securities pledged to secure the secured demand note by 30 percent.

(iv) The term *payment obligation* shall mean the obligation of a broker or dealer in respect to any subordination agreement (A) to repay cash loaned to the broker or dealer pursuant to a subordinated loan agreement or (B) to return a secured demand note contributed to the broker or dealer or reduce the unpaid principal amount thereof and to return cash or securities pledged as collateral to secure the secured demand note and (C) ''Payment'' shall mean the performance by a broker or dealer of a Payment Obligation.

(v)(A) The term *secured demand note agreement* shall mean an agreement (including the related secured demand note) evidencing or governing the contribution of a secured demand note to a broker or dealer and the pledge of securities and/or cash with the broker or dealer as collateral to secure payment of such secured demand note. The secured demand note agreement may provide that neither the lender, his heirs, executors, administrators or assigns shall be personally liable on such note and that in the event of default the broker or dealer shall look for payment of such note solely to the collateral then pledged to secure the same.

(B) The secured demand note shall be a promissory note executed by the lender and shall be payable on the demand of the broker or dealer to which it is contributed; provided, however, that the making of such demand may be conditioned upon the occurrence of any of certain events which are acceptable to the Commission and to the Examining Authority for such broker or dealer.

(C) If such note is not paid upon presentment and demand as provided for therein, the broker or dealer shall have the right to liquidate all or any part of the securities then pledged as collateral to secure payment of the same and to apply the net proceeds of such liquidation, together with any cash then included in the collateral, in payment of such note. Subject to the prior rights of the broker or dealer as pledgee, the lender, as defined herein, may retain ownership of the collateral and have the benefit of any increases and bear the risks of any decreases in the value of the collateral and may retain the right to vote securities contained within the collateral and any right to income therefrom or distributions thereon, except the broker or dealer shall have the right to receive and hold as pledgee all dividends payable in securities and all partial and complete liquidating dividends.

(D) Subject to the prior rights of the broker or dealer as pledgee, the lender may have the right to direct the sale of any securities included in the collateral, to direct the purchases of securities with any cash included therein, to withdraw excess collateral or to substitute cash or other securities as collateral, provided that the net proceeds of any such sale and the cash so substituted and the securities so purchased or substituted are held by the broker or dealer, as pledgee, and are included within the collateral to secure payment of the secured demand note, and provided further that no such transaction shall be permitted if, after giving effect thereto, the sum of the amount of any cash, plus the Collateral Value of the securities, then pledged as collateral to secure the secured demand note would be less than the unpaid principal amount of the secured demand note.

(E) Upon payment by the lender, as distinguished from a reduction by the lender which is provided for in (b)(6)(iii) or reduction by the broker or dealer as provided for in subparagraph (b)(7) of this appendix (D), of all or any part of the unpaid principal amount of the secured demand note, a broker or dealer shall issue to the lender a subordinated loan agreement in the amount of such payment (or in the case of a broker or dealer that is a partnership credit a capital account of the lender) or issue preferred or common stock of the broker or dealer in the amount of such payment, or any combination of the foregoing, as provided for in the secured demand note agreement.

(F) The term *lender* shall mean the person who lends cash to a broker or dealer pursuant to a subordinated loan agreement and the person who contributes a secured demand note to a broker or dealer pursuant to a secured demand note agreement.

(b) *Minimum requirements for subordination agreements.* (1) Subject to paragraph (a) of this section, a subordination agreement shall mean a written agreement between the broker or dealer and the lender, which (i) has a minimum term of one year, except for temporary subordination agreements provided for in paragraph (c)(5) of this appendix (D), and (ii) is a valid and binding obligation enforceable in accordance with its terms (subject as to enforcement to applicable bankruptcy, insolvency, reorganization, moratorium and other similar laws) against the broker or dealer and the lender and their respective heirs, executors, administrators, successors and assigns.

(2) *Specific amount.* All subordination agreements shall be for a specific dollar amount which shall not be reduced

for the duration of the agreement except by installments as specifically provided for therein and except as otherwise provided in this appendix (D).

(3) *Effective subordination.* The subordination agreement shall effectively subordinate any right of the lender to receive any Payment with respect thereto, together with accrued interest or compensation, to the prior payment or provision for payment in full of all claims of all present and future creditors of the broker or dealer arising out of any matter occurring prior to the date on which the related Payment Obligation matures consistent with the provisions of 17 CFR 240.15c3–1 and 240.15c3–1d, except for claims which are the subject of subordination agreements which rank on the same priority as or junior to the claim of the lender under such subordination agreements.

(4) *Proceeds of subordinated loan agreements.* The subordinated loan agreement shall provide that the cash proceeds thereof shall be used and dealt with by the broker or dealer as part of its capital and shall be subject to the risks of the business.

(5) *Certain rights of the broker or dealer.* The subordination agreement shall provide that the broker or dealer shall have the right to:

(i) Deposit any cash proceeds of a subordinated loan agreement and any cash pledged as collateral to secure a secured demand note in an account or accounts in its own name in any bank or trust company;

(ii) Pledge, repledge, hypothecate and rehypothecate, any or all of the securities pledged as collateral to secure a secured demand note, without notice, separately or in common with other securities or property for the purpose of securing any indebtedness of the broker or dealer; and

(iii) Lend to itself or others any or all of the securities and cash pledged as collateral to secure a secured demand note.

(6) *Collateral for secured demand notes.* Only cash and securities which are fully paid for and which may be publicly offered or sold without registration under the Securities Act of 1933, and the offer, sale and transfer of which are not otherwise restricted, may be pledged as collateral to secure a secured demand note. The secured demand note agreement shall provide that if at any time the sum of the amount of any cash, plus the Collateral Value of any securities, then pledged as collateral to secure the secured demand note is less than the unpaid principal amount of the secured demand note, the broker or dealer must immediately transmit written notice to that effect to the lender and the Examining Authority for such broker or dealer. The secured demand note agreement shall also require that following such transmittal:

(i) The lender, prior to noon of the business day next succeeding the transmittal of such notice, may pledge as collateral additional cash or securities sufficient, after giving effect to such pledge, to bring the sum of the amount of any cash plus the Collateral Value of any securities, then pledged as collateral to secure the secured demand note, up to an amount not less than the unpaid principal amount of the secured demand note; and

(ii) Unless additional cash or securities are pledged by the lender as provided in paragraph (b)(6)(i) of this section, the broker or dealer at noon on the business day next succeeding the transmittal of notice to the lender must commence sale, for the account of the lender, of such of the securities then pledged as collateral to secure the secured demand note and apply so much of the net proceeds thereof, together with such of the cash then pledged as collateral to secure the secured demand note as may be necessary to eliminate the unpaid principal amount of the secured demand note; *Provided, however,* That the unpaid principal amount of the secured demand note need not be reduced below the sum of the amount of any remaining cash, plus the Collateral Value of the remaining securities, then pledged as collateral to secure the secured demand note. The broker or dealer may not purchase for its own account any securities subject to such a sale.

(iii) The secured demand note agreement also may provide that, in lieu of the procedures specified in the provisions required by paragraph (b)(6)(ii) of this section, the lender with the prior written consent of the broker or dealer and the Examining Authority for the broker or dealer may reduce the unpaid principal amount of the secured demand note. After giving effect to such reduction, the aggregate indebtedness of the broker or dealer may not exceed 1000 percent of its net capital or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3–1, net capital may not be less than 5 percent of aggregate debit items computed in accordance with § 240.15c3–3a, or, if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater. No single secured demand note shall be permitted to be reduced by more than 15 percent of its original principal amount and after such reduction no excess collateral may be withdrawn. No Examining Authority shall consent to a reduction of the principal amount of a secured demand note if, after giving effect to such reduction, net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3–1.

Permissive Prepayments

(7) A broker or dealer at its option but not at the option of the lender may, if the subordination agreement so provides, make a Payment of all or any portion of the Payment Obligation thereunder prior to the scheduled maturity date of such Payment Obligation (hereinafter referred to as a ''Prepayment''), but in no event may any Prepayment be made before the expiration of one year from the date such subordination agreement became effective. This restriction shall not apply to temporary subordination agreements that comply with the provisions of paragraph (c)(5) of this appendix D. No Prepayment shall be made, if, after giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements then outstanding the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such Prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such Prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the broker or dealer, either aggregate indebtedness of the broker or dealer would exceed 1000 percent of its net capital or its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3–1 or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3–1, its net capital would be less than 5 percent of its aggregate debit items computed in accordance with § 240.15c3–3a, or if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or its net capital would be less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of § 240.15c3–1. Notwithstanding the above, no Prepayment shall occur without the prior written approval of the Examining Authority for such broker or dealer.

Suspended Repayment

(8)(i) The Payment Obligation of the broker or dealer in respect of any subordination agreement shall be suspended and shall not mature if, after giving effect to Payment of such Payment Obligation (and to all Payments of Payment Obligations of such broker or dealer under any other subordination agreement(s) then outstanding that are scheduled to mature on or before such Payment Obligation) either (A) the aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital, or in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3–1, its net capital would be less than 5 percent of aggregate debit items computed in accordance with § 240.15c3–3a or, if registered as a futures commission merchant, 6 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or (B) its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3–1 including paragraph (a)(1)(ii), if applicable. The subordination agreement may provide that if the Payment Obligation of the broker or dealer thereunder does not mature and is suspended as a result of the requirement of this paragraph (b)(8) for a period of not less than six months, the broker or dealer shall thereupon commence the rapid and orderly liquidation of its business, but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of § 240.15c3–1 and § 240.15c3–1d.

(9) *Accelerated maturity-obligation to repay to remain subordinate.* (i) Subject to the provisions of paragraph (b)(8) of this appendix, a subordination agreement may provide that the lender may, upon prior written notice to the broker or dealer and the Examining Authority given not earlier than six months after the effective date of such subordination agreement, accelerate the date on which the Payment Obligation of the broker or dealer, together with accrued interest or compensation, is scheduled to mature to a date not earlier than six months after the giving of such notice, but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of 17 CFR 240.15c3–1 and 240.15c3–1d.

(ii) Notwithstanding the provisions of paragraph (b)(8) of this appendix, the Payment Obligation of the broker or dealer with respect to a subordination agreement, together with accrued interest and compensation, shall mature in the event of any receivership, insolvency, liquidation pursuant to the Securities Investor Protection Act of 1970 or otherwise, bankruptcy, assignment for the benefit of creditors, reorganization whether or not pursuant to the bankruptcy laws, or any other marshalling of the assets and liabilities of the broker or dealer but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of 17 CFR 240.15c3–1 and 240.15c3–1d.

(10)(i) *Accelerated maturity of subordination agreements on event of default and event of acceleration—obligation to repay to remain subordinate.* A subordination agreement may provide that the lender may, upon prior written notice to the broker or dealer and the Examining Authority of the broker or dealer of the occurrence of any Event of Acceleration (as hereinafter defined) given no sooner than six months after the effective date of such subordination agreement, accelerate the date on which the Payment Obligation of the broker or dealer, together with accrued interest or compensation, is scheduled to mature, to the last business day of a calendar month which is not less than six months after notice of acceleration is received by the broker or dealer and the Examining Authority for the broker or dealer. Any subordination agreement containing such Events of Acceleration may also provide, that if upon such accelerated maturity date the Payment Obligation of the broker or dealer is suspended as required by paragraph (b)(8) of this appendix (D) and liquidation of the broker or dealer has not commenced on or prior to such accelerated maturity date, then notwithstanding paragraph (b)(8) of this appendix the Payment Obligation of the broker or dealer with respect to such subordination agreement shall mature on the day immediately following such accelerated maturity date and in any such event the Payment Obligations of the broker or dealer with respect to all other subordination agreements then outstanding shall also mature at the same time but the rights of the respective lenders to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of this Appendix (D). Events of Acceleration which may be included in a subordination agreement complying with this paragraph (b)(10) shall be limited to:

(A) Failure to pay interest or any installment of principal on a subordination agreement as scheduled;

(B) Failure to pay when due other money obligations of a specified material amount;

(C) Discovery that any material, specified representation or warranty of the broker or dealer which is included in the subordination agreement and on which the subordination agreement was based or continued was inaccurate in a material respect at the time made;

(D) Any specified and clearly measurable event which is included in the subordination agreement and which the lender and the broker or dealer agree (*1*) is a significant indication that the financial position of the broker or dealer has changed materially and adversely from agreed upon specified norms or (*2*) could materially and adversely affect the ability of the broker or dealer to conduct its business as conducted on the date the subordination agreement was made; or (*3*) is a significant change in the senior management of the broker or dealer or in the general business conducted by the broker or dealer from that which obtained on the date the subordination agreement became effective;

(E) Any continued failure to perform agreed covenants included in the subordination agreement relating to the conduct of the business of the broker or dealer or relating to the maintenance and reporting of its financial position; and

(ii) Notwithstanding the provisions of paragraph (b)(8) of this appendix, a subordination agreement may provide that, if liquidation of the business of the broker or dealer has not already commenced, the Payment Obligation of the broker or dealer shall mature, together with accrued interest or compensation, upon the occurrence of an Event of Default (as hereinafter defined). Such agreement may also provide that, if liquidation of the business of the broker or dealer has not already commenced, the rapid and orderly liquidation of the business of the broker or dealer shall then commence upon the happening of an Event of Default. Any subordination agreement which so provides for maturity of the Payment Obligation upon the occurrence of an Event of Default shall also provide that the date on which such Event of Default occurs shall, if liquidation of the broker or dealer has not already commenced, be the date on which the Payment Obligations of the broker or dealer with respect to all other subordination agreements then outstanding shall mature but the rights of the respective lenders to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of this Appendix (D). Events of Default which may be included in a subordination agreement shall be limited to:

(A) The making of an application by the Securities Investor Protection Corporation for a decree adjudicating that customers of the broker or dealer are in need of protection under the Securities Investor Protection Act of 1970 and the failure of the broker or dealer to obtain the dismissal of such application within 30 days;

(B) The aggregate indebtedness of the broker or dealer exceeding 1500 percent of its net capital or, in the case of a broker or dealer that has elected to operate under paragraph (a)(1)(ii) of § 240.15c3–1, its net capital computed in accordance therewith is less than 2 percent of its aggregate debit items computed in accordance with § 240.15c3–3a or, if registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, throughout a period of 15 consecutive business days, commencing on the day the broker or dealer first determines and notifies the Examining Authority for the broker or dealer, or the Examining Authority or the Commission first determines and notifies the broker or dealer of such fact;

(C) The Commission shall revoke the registration of the broker or dealer;

(D) The Examining Authority shall suspend (and not reinstate within 10 days) or revoke the broker's or dealer's status as a member thereof;

(E) Any receivership, insolvency, liquidation pursuant to the Securities Investor Protection Act of 1970 or otherwise, bankruptcy, assignment for the benefit of creditors, reorganization whether or not pursuant to bankruptcy laws, or any other marshalling of the assets and liabilities of the broker or dealer.

A subordination agreement which contains any of the provisions permitted by this paragraph (b)(10) shall not contain the provision otherwise permitted by clause (i) of paragraph (b)(9).

BROKERS AND DEALERS CARRYING THE ACCOUNTS OF SPECIALISTS AND MARKET MAKERS IN LISTED OPTIONS

(11) A subordination agreement which becomes effective on or after August 1, 1977 in favor of a broker or dealer who guarantees, endorses, carries or clears specialist or market maker transactions in options listed on a national securities exchange or facility of a national securities association shall provide that reduction, prepayment or repayment of the unpaid principal amount thereof, pursuant to those terms of the agreement required or permitted by paragraphs (b)(6)(iii), (b)(7), or (b)(8)(i) of this section, shall not occur in contravention of paragraphs (a)(6)(v), (a)(7)(iv), or (c)(2)(x)(B)(*1*) of § 240.15c3–1 insofar as they apply to such broker or dealer.

(c) *Miscellaneous Provisions*—(1) *Prohibited Cancellation*. The subordination agreement shall not be subject to cancellation by either party; no Payment shall be made with respect thereto and the agreement shall not be terminated, rescinded or modified by mutual consent or otherwise if the effect thereof would be inconsistent with the requirements of 17 CFR 240.15c3–1 and 240.15c3–1d.

(2) Every broker or dealer shall immediately notify the Examining Authority for such broker or dealer if, after giving effect to all Payments of Payment Obligations under subordination agreements then outstanding that are then due or mature within the following six months without reference to any projected profit or loss of the broker or dealer either the aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital or its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3–1, or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3–1, its net capital would be less than 5 percent of aggregate debit items computed in accordance with § 240.15c3–3a, or, if registered as a futures commission merchant, 6 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of § 240.15c3–1.

(3) *Certain legends*. If all the provisions of a satisfactory subordination agreement do not appear in a single instrument, then the debenture or other evidence of indebtedness shall bear on its face an appropriate legend stating that it is issued subject to the provisions of a satisfactory subordination agreement which shall be adequately referred to and incorporated by reference.

(4) *Legal title to securities*. All securities pledged as collateral to secure a secured demand note must be in bearer form, or registered in the name of the broker or dealer or the name of its nominee or custodian.

Temporary and Revolving Subordination Agreements

(5)(i) For the purpose of enabling a broker or dealer to participate as an underwriter of securities or other extraordinary activities in compliance with the net capital requirements of § 240.15c3–1, a broker or dealer shall be permitted, on no more than three occasions in any 12 month period, to enter into a subordination agreement on a temporary basis that has a stated term of no more than 45 days from the date such subordination agreement became effective. This temporary relief shall not apply to a broker or dealer if, within the preceding thirty calendar days, it has given notice pursuant to § 240.17a–11, or if immediately prior to entering into such subordination agreement, either:

(A) The aggregate indebtedness of the broker or dealer exceeds 1000 percent of its net capital or its net capital is less than 120 percent of the minimum dollar amount required by § 240.15c3–1, or

(B) In the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3–1, its net capital is less than 5 percent of aggregate debits computed in accordance with § 240.15c3–1, or, if registered as a futures commission merchant, less than 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of this section, or

(C) The amount of its then outstanding subordination agreements exceeds the limits specified in paragraph (d) of § 240.15c3–1. Such temporary subordination agreement shall be subject to all other provisions of this appendix D.

(ii) A broker or dealer shall be permitted to enter into a revolving subordinated loan agreement which provides for prepayment within less than one year of all or any portion of the Payment Obligation thereunder at the option of the broker or dealer upon the prior written approval of the Examining Authority for the broker or dealer. The Examining Authority, however, shall not approve any prepayment if:

(A) After giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements then outstanding, the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the broker or dealer, either aggregate indebtedness of the broker or dealer would exceed 900 percent of its net capital or its net capital would be less than 200 percent of the minimum dollar amount required by § 240.15c3–1 or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3–1, its net capital would be less than 6 percent of aggregate debit items computed in accordance with § 240.15c3–3a, or, if registered as a futures commission merchant, 10 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or its net capital would be less than 200 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of this section or

(B) Pre-tax losses during the latest three-month period equalled more than 15% of current excess net capital.

Any subordination agreement entered into pursuant to this paragraph (c)(5)(ii) shall be subject to all the other provisions of this Appendix D. Any such subordination agreement shall not be considered equity for purposes of subsection (d) of section 15c3–1, despite the length of the initial term of the loan.

(6)(i) *Filing*. Two copies of any proposed subordination agreement (including nonconforming subordination agreements) shall be filed at least 10 days prior to the proposed execution date of the agreement with the Commission's Regional Office for the region in which the broker or dealer maintains its principal place of business or at such other time as the Regional Office for good cause shall accept such filing. Copies of the proposed agreement shall also be filed with the Examining Authority in such quantities and at such time as the Examining Authority may require. The broker or dealer shall also file with said parties a statement setting forth the name and address of the lender, the business relationship of the lender to the broker or dealer, and whether the broker or dealer carried funds or securities for the lender at or about the time the proposed agreement was so filed. All agreements shall be examined by the Commission's Regional Office or the Examining Authority with whom such agreement is required to be filed prior to their becoming effective. No proposed agreement shall be a satisfactory subordination agreement for the purposes of this section unless and until the Examining Authority has found the agreement acceptable and such agreement has become effective in the form found acceptable.

(ii) The broker or dealer need not file with the Regional Office for the region in which the broker or dealer maintains its principal place of business (if a Regional Office is not its Examining Authority) copies of any proposed subordination agreement or the statement described above if the Examining Authority for that broker or dealer has consented to file with the Commission periodic reports (not less than monthly) summarizing for the period, on a firm-by-firm basis, the subordination agreements it has approved for that period. Such reports should include at the minimum, the amount of the loan and its duration, the name of the lender and the business relationship of the lender to the broker or dealer.

(7) *Subordination agreements in effect prior to adoption.* Any subordination agreement which has been entered into prior to December 20, 1978 and which has been deemed to be satisfactorily subordinated pursuant to 17 CFR 240.15c3–1 as in effect prior to December 20, 1978, shall continue to be deemed a satisfactory subordination agreement until the maturity of such agreement. *Provided,* That no renewal of an agreement which provides for automatic or optional renewal by the broker or dealer or lender shall be deemed to be a satisfactory subordination agreement unless such renewed agreement meets the requirements of this appendix within 6 months from December 20, 1978. *Provided, further,* That all subordination agreements must meet the requirements of this appendix within 5 years of December 20, 1978.

[40 FR 29808, July 16, 1975, as amended at 42 FR 31778, June 23, 1977; 44 FR 34887, June 15, 1979; 46 FR 35635, July 10, 1981; 47 FR 21775, May 20, 1982; 49 FR 31848, Aug. 9, 1984; 57 FR 56988, Dec. 2, 1992; 58 FR 37657, July 13, 1993; 59 FR 5945, Feb. 9, 1994; 73 FR 32228, June 5, 2008]

§ 240.15c3–1e Deductions for market and credit risk for certain brokers or dealers (Appendix E to 17 CFR 240.15c3–1).

PRELIMINARY NOTE: Appendices E and G to the net capital rule set forth a program that allows a broker or dealer to use an alternative approach to computing net capital deductions, subject to the conditions described in the Appendices, including supervision of the broker's or dealer's ultimate holding company under the program. The program is designed to reduce the likelihood that financial and operational weakness in the holding company will destabilize the broker or dealer, or the broader financial system. The focus of this supervision of the ultimate holding company is its financial and operational condition and its risk management controls and methodologies.

Application

(a) A broker or dealer may apply to the Commission for authorization to compute deductions for market risk pursuant to this appendix E in lieu of computing deductions pursuant to §§ 240.15c3–1(c)(2)(vi) and (c)(2)(vii) and to compute deductions for credit risk pursuant to this appendix E on credit exposures arising from transactions in derivatives instruments (if this appendix E is used to calculate deductions for market risk on these instruments) in lieu of computing deductions pursuant to § 240.15c3–1(c)(2)(iv):

(1) A broker-dealer shall submit the following information to the Commission with its application:

(i) An executive summary of the information provided to the Commission with its application and an identification of the ultimate holding company of the broker or dealer;

(ii) A comprehensive description of the internal risk management control system of the broker or dealer and how that system satisfies the requirements set forth in § 240.15c3–4;

(iii) A list of the categories of positions that the broker or dealer holds in its proprietary accounts and a brief description of the methods that the broker or dealer will use to calculate deductions for market and credit risk on those categories of positions;

(iv) A description of the mathematical models to be used to price positions and to compute deductions for market risk, including those portions of the deductions attributable to specific risk, if applicable, and deductions for credit risk; a description of the creation, use, and maintenance of the mathematical models; a description of the broker's or dealer's internal risk management controls over those models, including a description of each category of persons who may input data into the models; if a mathematical model incorporates empirical correlations across risk categories, a description of the process for measuring correlations; a description of the backtesting procedures the broker or dealer will use to backtest the mathematical model used to calculate maximum potential exposure; a description of how each mathematical model satisfies the applicable qualitative and quantitative requirements set forth in paragraph (d) of this appendix E; and a statement describing the extent to which each mathematical model used to compute deductions for market and credit risk will be used as part of the risk analyses and reports presented to senior management;

(v) If the broker or dealer is applying to the Commission for approval to use scenario analysis to calculate deductions for market risk for certain positions, a list of those types of positions, a description of how those deductions will be calculated using scenario analysis, and an explanation of why each scenario analysis is appropriate to calculate deductions for market risk on those types of positions;

(vi) A description of how the broker or dealer will calculate current exposure;

(vii) A description of how the broker or dealer will determine internal credit ratings of counterparties and internal credit risk weights of counterparties, if applicable;

(viii) A written undertaking by the ultimate holding company of the broker or dealer, if it is not an ultimate holding company that has a principal regulator, in a form acceptable to the Commission, signed by a duly authorized person at the ultimate holding company, to the effect that, as a condition of Commission approval of the application of the broker or dealer to compute deductions for market and credit risk pursuant to this appendix E, the ultimate holding company agrees to:

(A) Comply with all applicable provisions of this appendix E;

(B) Comply with all applicable provisions of § 240.15c3–1g;

(C) Comply with the provisions of § 240.15c3–4 with respect to an internal risk management control system for the affiliate group as though it were an OTC derivatives dealer with respect to all of its business activities, except that paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8), and (d)(9) of § 240.15c3–4 shall not apply;

(D) As part of the internal risk management control system for the affiliate group, establish, document, and maintain procedures for the detection and prevention of money laundering and terrorist financing;

(E) Permit the Commission to examine the books and records of the ultimate holding company and any of its affiliates, if the affiliate is not an entity that has a principal regulator;

(F) If the disclosure to the Commission of any information required as a condition for the broker or dealer to compute deductions for market and credit risk pursuant to this appendix E could be prohibited by law or otherwise, cooperate with the Commission, to the extent permissible, including by describing any secrecy laws or other impediments that could restrict the ability of material affiliates to provide information on their operations or activities and by discussing the manner in which the ultimate holding company and the broker or dealer propose to provide the Commission with adequate information or assurances of access to information;

(G) Make available to the Commission information about the ultimate holding company or any of its material affiliates that the Commission finds is necessary to evaluate the financial and operational risk within the ultimate holding company and its material affiliates and to evaluate compliance with the conditions of eligibility of the broker or dealer to compute deductions to net capital under the alternative method of this appendix E;

(H) Make available examination reports of principal regulators for those affiliates of the ultimate holding company that are not subject to Commission examination; and

(I) Acknowledge that, if the ultimate holding company fails to comply in a material manner with any provision of its undertaking, the Commission may, in addition to any other conditions necessary or appropriate in the public interest or for the protection of investors, increase the multiplication factors the ultimate holding company uses to calculate allowances for market and credit risk, as defined in § 240.15c3–1g(a)(2) and (a)(3) or impose any condition with respect to the broker or dealer listed in paragraph (e) of this appendix E; and

(ix) A written undertaking by the ultimate holding company of the broker or dealer, if the ultimate holding company has a principal regulator, in a form acceptable to the Commission, signed by a duly authorized person at the ultimate holding company, to the effect that, as a condition of Commission approval of the application of the broker or dealer to compute deductions for market and credit risk pursuant to this appendix E, the ultimate holding company agrees to:

(A) Comply with all applicable provisions of this appendix E;

(B) Comply with all applicable provisions of § 240.15c3–1g;

(C) Make available to the Commission information about the ultimate holding company that the Commission finds is necessary to evaluate the financial and operational risk within the ultimate holding company and to evaluate compliance with the conditions of eligibility of the broker or dealer to compute net capital under the alternative method of this appendix E; and

(D) Acknowledge that if the ultimate holding company fails to comply in a material manner with any provision of its undertaking, the Commission may, in addition to any other conditions necessary or appropriate in the public interest or for the protection of investors, impose any condition with respect to the broker or dealer listed in paragraph (e) of this appendix E;

(2) As a condition of Commission approval, the ultimate holding company of the broker or dealer, if it is not an ultimate holding company that has a principal regulator, shall include the following information with the application:

(i) A narrative description of the business and organization of the ultimate holding company;

(ii) An alphabetical list of the affiliates of the ultimate holding company (referred to as the ''affiliate group,'' which shall include the ultimate holding company), with an identification of the financial regulator, if any, that regulates the affiliate, and a designation of the members of the affiliate group that are material to the ultimate holding company (''material affiliates'');

(iii) An organizational chart that identifies the ultimate holding company, the broker or dealer, and the material affiliates;

(iv) Consolidated and consolidating financial statements of the ultimate holding company as of the end of the quarter preceding the filing of the application;

(v) Sample computations for the ultimate holding company of allowable capital and allowances for market risk, credit risk, and operational risk, determined pursuant to § 240.15c3–1g(a)(1)–(a)(4);

(vi) A list of the categories of positions that the affiliate group holds in its proprietary accounts and a brief description of the method that the ultimate holding company proposes to use to calculate allowances for market and credit risk, pursuant to § 240.15c3–1g(a)(2) and (a)(3), on those categories of positions;

(vii) A description of the mathematical models to be used to price positions and to compute the allowance for market risk, including those portions of the allowance attributable to specific risk, if applicable, and the allowance for credit risk; a description of the creation, use, and maintenance of the mathematical models; a description of the ultimate holding company's internal risk management controls over those models, including a description of each category of persons who may input data into the models; if a mathematical model incorporates empirical correlations across risk categories, a description of the process for measuring correlations; a description of the backtesting procedures the ultimate holding company will use to backtest the mathematical model used to calculate maximum potential exposure; a description of how each mathematical model satisfies the applicable qualitative and quantitative requirements set forth in paragraph (d) of this appendix E; a statement describing the extent to which each mathematical model used to compute allowances for market and credit risk is used as part of the risk analyses and reports presented to senior management; and a description of any positions for which the ultimate holding company proposes to use a method other than VaR to compute an allowance for market risk and a description of how that allowance would be determined;

(viii) A description of how the ultimate holding company will calculate current exposure;

(ix) A description of how the ultimate holding company will determine the credit risk weights of counterparties and internal credit ratings of counterparties, if applicable;

(x) A description of how the ultimate holding company will calculate an allowance for operational risk under §240.15c3–1g(a)(4);

(xi) For each instance in which a mathematical model used by the broker or dealer to calculate a deduction for market risk or to calculate maximum potential exposure for a particular product or counterparty differs from the mathematical model used by the ultimate holding company to calculate an allowance for market risk or to calculate maximum potential exposure for that same product or counterparty, a description of the difference(s) between the mathematical models;

(xii) A comprehensive description of the risk management control system for the affiliate group that the ultimate holding company has established to manage affiliate group-wide risk, including market, credit, liquidity and funding, legal and compliance, and operational risks, and how that system satisfies the requirements of §240.15c3–4; and

(xiii) Sample risk reports that are provided to the persons at the ultimate holding company who are responsible for managing group-wide risk and that will be provided to the Commission pursuant to §240.15c3–1g(b)(1)(i)(H);

(3) As a condition of Commission approval, the ultimate holding company of the broker or dealer, if the ultimate holding company has a principal regulator, shall include the following information with the broker's or dealer's application:

(i) A narrative description of the business and organization of the ultimate holding company;

(ii) An alphabetical list of the affiliates of the ultimate holding company (referred to as the "affiliate group," which shall include the ultimate holding company), with an identification of the financial regulator, if any, that regulates the affiliate, and a designation of those affiliates that are material to the ultimate holding company ("material affiliates");

(iii) An organizational chart that identifies the ultimate holding company, the broker or dealer, and the material affiliates;

(iv) Consolidated and consolidating financial statements of the ultimate holding company as of the end of the quarter preceding the filing of the application;

(v) The most recent capital measurements of the ultimate holding company, as reported to its principal regulator, calculated in accordance with the standards published by the Basel Committee on Banking Supervision, as amended from time to time;

(vi) For each instance in which a mathematical model to be used by the broker or dealer to calculate a deduction for market risk or to calculate maximum potential exposure for a particular product or counterparty differs from the mathematical model used by the ultimate holding company to calculate an allowance for market risk or to calculate maximum potential exposure for that same product or counterparty, a description of the difference(s) between the mathematical models; and

(vii) Sample risk reports that are provided to the persons at the ultimate holding company who are responsible for managing group-wide risk and that will be provided to the Commission under § 240.15c3–1g(b)(1)(i)(H);

(4) The application of the broker or dealer shall be supplemented by other information relating to the internal risk management control system, mathematical models, and financial position of the broker or dealer or the ultimate holding company of the broker or dealer that the Commission may request to complete its review of the application;

(5) The application shall be considered filed when received at the Commission's principal office in Washington, DC. A person who files an application pursuant to this section for which it seeks confidential treatment may clearly mark each page or segregable portion of each page with the words ''Confidential Treatment Requested.'' All information submitted in connection with the application will be accorded confidential treatment, to the extent permitted by law;

(6) If any of the information filed with the Commission as part of the application of the broker or dealer is found to be or becomes inaccurate before the Commission approves the application, the broker or dealer must notify the Commission promptly and provide the Commission with a description of the circumstances in which the information was found to be or has become inaccurate along with updated, accurate information;

(7) The Commission may approve the application or an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission may require, if the Commission finds the approval to be necessary or appropriate in the public interest or for the protection of investors, after determining, among other things, whether the broker or dealer has met the requirements of this appendix E and is in compliance with other applicable rules promulgated under the Act and by self-regulatory organizations, and whether the ultimate holding company of the broker or dealer is in compliance with the terms of its undertakings, as provided to the Commission;

(8) A broker or dealer shall amend its application to calculate certain deductions for market and credit risk under this appendix E and submit the amendment to the Commission for approval before it may change materially a mathematical model used to calculate market or credit risk or before it may change materially its internal risk management control system;

(9) As a condition to the broker's or dealer's calculation of deductions for market and credit risk under this appendix E, an ultimate holding company that does not have a principal regulator shall submit to the Commission, as an amendment to the broker's or dealer's application, any material changes to a mathematical model or other methods used to calculate allowances for market, credit, and operational risk, and any material changes to the internal risk management control system for the affiliate group. The ultimate holding company must submit these material changes to the Commission before making them;

(10) As a condition for the broker or dealer to compute deductions for market and credit risk under this appendix E, the broker or dealer agrees that:

(i) It will notify the Commission 45 days before it ceases to compute deductions for market and credit risk under this appendix E; and

(ii) The Commission may determine by order that the notice will become effective after a shorter or longer period of time if the broker or dealer consents or if the Commission determines that a shorter or longer period of time is necessary or appropriate in the public interest or for the protection of investors; and

(11) Notwithstanding paragraph (a)(10) of this section, the Commission, by order, may revoke a broker's or dealer's exemption that allows it to use the market risk standards of this appendix E to calculate deductions for market risk, instead of the provisions of § 240.15c3–1(c)(2)(vi) and (c)(2)(vii), and the exemption to use the credit

risk standards of this appendix E to calculate deductions for credit risk on certain credit exposures arising from transactions in derivatives instruments, instead of the provisions of §240.15c3–1(c)(2)(iv), if the Commission finds that such exemption is no longer necessary or appropriate in the public interest or for the protection of investors. In making its finding, the Commission will consider the compliance history of the broker or dealer related to its use of models, the financial and operational strength of the broker or dealer and its ultimate holding company, the broker's or dealer's compliance with its internal risk management controls, and the ultimate holding company's compliance with its undertakings.

Market Risk

(b) A broker or dealer whose application, including amendments, has been approved under paragraph (a) of this appendix E shall compute a deduction for market risk in an amount equal to the sum of the following:

(1) For positions for which the Commission has approved the broker's or dealer's use of value-at risk (''VaR'') models, the VaR of the positions multiplied by the appropriate multiplication factor determined according to paragraph (d)(1)(iii) of this appendix E, except that the initial multiplication factor shall be three, unless the Commission determines, based on a review of the broker's or dealer's application or an amendment to the application under paragraph (a) of this appendix E, including a review of its internal risk management control system and practices and VaR models, that another multiplication factor is appropriate;

(2) For positions for which the VaR model does not incorporate specific risk, a deduction for specific risk to be determined by the Commission based on a review of the broker's or dealer's application or an amendment to the application under paragraph (a) of this appendix E and the positions involved;

(3) For positions for which the Commission has approved the broker's or dealer's application to use scenario analysis, the greatest loss resulting from a range of adverse movements in relevant risk factors, prices, or spreads designed to represent a negative movement greater than, or equal to, the worst ten-day movement over the four years preceding calculation of the greatest loss, or some multiple of the greatest loss based on the liquidity of the positions subject to scenario analysis. If historical data is insufficient, the deduction shall be the largest loss within a three standard deviation movement in those risk factors, prices, or spreads over a ten-day period, multiplied by an appropriate liquidity adjustment factor. Irrespective of the deduction otherwise indicated under scenario analysis, the resulting deduction for market risk must be at least $25 per 100 share equivalent contract for equity positions, or one-half of one percent of the face value of the contract for all other types of contracts, even if the scenario analysis indicates a lower amount. A qualifying scenario must include the following:

(i) A set of pricing equations for the positions based on, for example, arbitrage relations, statistical analysis, historic relationships, merger evaluation, or fundamental valuation of an offering of securities;

(ii) Auxiliary relationships mapping risk factors to prices; and

(iii) Data demonstrating the effectiveness of the scenario in capturing market risk, including specific risk; and

(4) For all remaining positions, the deductions specified in §§240.15c3–1(c)(2)(vi), (c)(2)(vii), and applicable appendices to §240.15c3–1.

Credit Risk

(c) A broker or dealer whose application, including amendments, has been approved under paragraph (a) of this appendix E shall compute a deduction for credit risk on transactions in derivative instruments (if this appendix E is used to calculate a deduction for market risk on those instruments) in an amount equal to the sum of the following:

(1) A counterparty exposure charge in an amount equal to the sum of the following:

(i) The net replacement value in the account of each counterparty that is insolvent, or in bankruptcy, or that has senior unsecured long-term debt in default; and

(ii) For a counterparty not otherwise described in paragraph (c)(1)(i) of this appendix E, the credit equivalent amount of the broker's or dealer's exposure to the counterparty, as defined in paragraph (c)(4)(i) of this appendix E, multiplied by the credit risk weight of the counterparty, as defined in paragraph (c)(4)(vi) of this appendix E, multiplied by 8%;

(2) A concentration charge by counterparty in an amount equal to the sum of the following:

(i) For each counterparty with a credit risk weight of 20% or less, 5% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the broker or dealer;

(ii) For each counterparty with a credit risk weight of greater than 20% but less than 50%, 20% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the broker or dealer; and

(iii) For each counterparty with a credit risk weight of greater than 50%, 50% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the broker or dealer; and

(3) A portfolio concentration charge of 100% of the amount of the broker's or dealer's aggregate current exposure for all counterparties in excess of 50% of the tentative net capital of the broker or dealer;

(4) *Terms.* (i) The *credit equivalent amount* of the broker's or dealer's exposure to a counterparty is the sum of the broker's or dealer's maximum potential exposure to the counterparty, as defined in paragraph (c)(4)(ii) of this appendix E, multiplied by the appropriate multiplication factor, and the broker's or dealer's current exposure to the counterparty, as defined in paragraph (c)(4)(iii) of this appendix E. The broker or dealer must use the multiplication factor determined according to paragraph (d)(1)(v) of this appendix E, except that the initial multiplication factor shall be one, unless the Commission determines, based on a review of the broker's or dealer's application or an amendment to the application approved under paragraph (a) of this appendix E, including a review of its internal risk management control system and practices and VaR models, that another multiplication factor is appropriate;

(ii) The *maximum potential exposure* is the VaR of the counterparty's positions with the broker or dealer, after applying netting agreements with the counterparty meeting the requirements of paragraph (c)(4)(iv) of this appendix E, taking into account the value of collateral from the counterparty held by the broker or dealer in accordance with paragraph (c)(4)(v) of this appendix E, and taking into account the current replacement value of the counterparty's positions with the broker or dealer;

(iii) The *current exposure* of the broker or dealer to a counterparty is the current replacement value of the counterparty's positions with the broker or dealer, after applying netting agreements with the counterparty meeting the requirements of paragraph (c)(4)(iv) of this appendix E and taking into account the value of collateral from the counterparty held by the broker or dealer in accordance with paragraph (c)(4)(v) of this appendix E;

(iv) *Netting agreements.* A broker or dealer may include the effect of a netting agreement that allows the broker or dealer to net gross receivables from and gross payables to a counterparty upon default of the counterparty if:

(A) The netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings;

(B) The gross receivables and gross payables that are subject to the netting agreement with a counterparty can be determined at any time; and

(C) For internal risk management purposes, the broker-dealer monitors and controls its exposure to the counterparty on a net basis;

(v) *Collateral.* When calculating maximum potential exposure and current exposure to a counterparty, the fair market value of collateral pledged and held may be taken into account provided:

(A) The collateral is marked to market each day and is subject to a daily margin maintenance requirement;

(B) The collateral is subject to the broker's or dealer's physical possession or control;

(C) The collateral is liquid and transferable;

(D) The collateral may be liquidated promptly by the firm without intervention by any other party;

(E) The collateral agreement is legally enforceable by the broker or dealer against the counterparty and any other parties to the agreement;

(F) The collateral does not consist of securities issued by the counterparty or a party related to the broker or dealer or to the counterparty;

(G) The Commission has approved the broker's or dealer's use of a VaR model to calculate deductions for market risk for the type of collateral in accordance with this appendix E; and

(H) The collateral is not used in determining the credit rating of the counterparty;

(vi) *Credit risk weights of counterparties.* A broker or dealer that computes its deductions for credit risk pursuant to this Appendix E shall apply a credit risk weight for transactions with a counterparty of either 20%, 50%, or 150% based on an internal credit rating the broker or dealer determines for the counterparty.

(A) As part of its initial application or in an amendment, the broker or dealer may request Commission approval to apply a credit risk weight of either 20%, 50%, or 150% based on internal calculations of credit ratings, including internal estimates of the maturity adjustment. Based on the strength of the broker's or dealer's internal credit risk management system, the Commission may approve the application. The broker or dealer must make and keep current a record of the basis for the credit rating of each counterparty;

(B) For the portion of a current exposure covered by a written guarantee where that guarantee is an unconditional and irrevocable guarantee of the due and punctual payment and performance of the obligation and the broker or dealer can demand immediate payment from the guarantor after any payment is missed without having to make collection efforts, the broker or dealer may substitute the credit risk weight of the guarantor for the credit risk weight of the counterparty; and

(C) As part of its initial application or in an amendment, the broker or dealer may request Commission approval to reduce deductions for credit risk through the use of credit derivatives.

VaR Models

(d) To be approved, each VaR model must meet the following minimum qualitative and quantitative requirements:

(1) *Qualitative requirements.* (i) The VaR model used to calculate market or credit risk for a position must be integrated into the daily internal risk management system of the broker or dealer;

(ii) The VaR model must be reviewed both periodically and annually. The periodic review may be conducted by the broker's or dealer's internal audit staff, but the annual review must be conducted by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq.*); and

(iii) For purposes of computing market risk, the broker or dealer must determine the appropriate multiplication factor as follows:

(A) Beginning three months after the broker or dealer begins using the VaR model to calculate market risk, the broker or dealer must conduct backtesting of the model by comparing its actual daily net trading profit or loss with the corresponding VaR measure generated by the VaR model, using a 99 percent, one-tailed confidence level with price changes equivalent to a one business-day movement in rates and prices, for each of the past 250 business days, or other period as may be appropriate for the first year of its use;

(B) On the last business day of each quarter, the broker or dealer must identify the number of backtesting exceptions of the VaR model, that is, the number of business days in the past 250 business days, or other period as may be appropriate for the first year of its use, for which the actual net trading loss, if any, exceeds the corresponding VaR measure; and

(C) The broker or dealer must use the multiplication factor indicated in Table 1 of this appendix E in determining its market risk until it obtains the next quarter's backtesting results;

TABLE 1—MULTIPLICATION FACTOR BASED ON THE NUMBER OF BACKTESTING EXCEPTIONS OF THE VAR MODEL

Number of exceptions	Multiplication factor
4 or fewer	3.00
5	3.40
6	3.50
7	3.65
8	3.75
9	3.85
10 or more	4.00

(iv) For purposes of incorporating specific risk into a VaR model, a broker or dealer must demonstrate that it has methodologies in place to capture liquidity, event, and default risk adequately for each position. Furthermore, the models used to calculate deductions for specific risk must:

(A) Explain the historical price variation in the portfolio;

(B) Capture concentration (magnitude and changes in composition);

(C) Be robust to an adverse environment; and

(D) Be validated through backtesting; and

(v) For purposes of computing the credit equivalent amount of the broker's or dealer's exposures to a counterparty, the broker or dealer must determine the appropriate multiplication factor as follows:

(A) Beginning three months after it begins using the VaR model to calculate maximum potential exposure, the broker or dealer must conduct backtesting of the model by comparing, for at least 80 counterparties with widely varying types and sizes of positions with the firm, the ten-business day change in its current exposure to the counterparty based on its positions held at the beginning of the ten-business day period with the corresponding ten-business day maximum potential exposure for the counterparty generated by the VaR model;

(B) As of the last business day of each quarter, the broker or dealer must identify the number of backtesting exceptions of the VaR model, that is, the number of ten-business day periods in the past 250 business days, or other period as may be appropriate for the first year of its use, for which the change in current exposure to a counterparty exceeds the corresponding maximum potential exposure; and

(C) The broker or dealer will propose, as part of its application, a schedule of multiplication factors, which must be approved by the Commission based on the number of backtesting exceptions of the VaR model. The broker or dealer must use the multiplication factor indicated in the approved schedule in determining the credit equivalent amount of its exposures to a counterparty until it obtains the next quarter's backtesting results, unless the Commission determines, based on, among other relevant factors, a review of the broker's or dealer's internal risk management control system, including a review of the VaR model, that a different adjustment or other action is appropriate;

(2) *Quantitative requirements.* (i) For purposes of determining market risk, the VaR model must use a 99 percent, one-tailed confidence level with price changes equivalent to a ten business-day movement in rates and prices;

(ii) For purposes of determining maximum potential exposure, the VaR model must use a 99 percent, one-tailed confidence level with price changes equivalent to a one-year movement in rates and prices; or based on a review of the broker's or dealer's procedures for managing collateral and if the collateral is marked to market daily and the broker or dealer has the ability to call for additional collateral daily, the Commission may approve a time horizon of not less than ten business days;

(iii) The VaR model must use an effective historical observation period of at least one year. The broker or dealer must consider the effects of market stress in its construction of the model. Historical data sets must be updated at least monthly and reassessed whenever market prices or volatilities change significantly; and

(iv) The VaR model must take into account and incorporate all significant, identifiable market risk factors applicable to positions in the accounts of the broker or dealer, including:

(A) Risks arising from the non-linear price characteristics of derivatives and the sensitivity of the market value of those positions to changes in the volatility of the derivatives' underlying rates and prices;

(B) Empirical correlations with and across risk factors or, alternatively, risk factors sufficient to cover all the market risk inherent in the positions in the proprietary or other trading accounts of the broker or dealer, including interest rate risk, equity price risk, foreign exchange risk, and commodity price risk;

(C) Spread risk, where applicable, and segments of the yield curve sufficient to capture differences in volatility and imperfect correlation of rates along the yield curve for securities and derivatives that are sensitive to different interest rates; and

(D) Specific risk for individual positions.

Additional Conditions

(e) As a condition for the broker or dealer to use this appendix E to calculate certain of its capital charges, the Commission may impose additional conditions on the broker or dealer, which may include, but are not limited to restricting the broker's or dealer's business on a product-specific, category-specific, or general basis; submitting to the Commission a plan to increase the broker's or dealer's net capital or tentative net capital; filing more frequent reports with the Commission; modifying the broker's or dealer's internal risk management control procedures; or computing the broker's or dealer's deductions for market and credit risk in accordance with § 240.15c3–1(c)(2)(vi), (c)(2)(vii), and (c)(2)(iv), as appropriate. If it is not an ultimate holding company that has a principal regulator, the Commission also may require, as a condition of continuation of the exemption, the ultimate holding company of the broker or dealer to file more frequent reports or to modify its group-wide internal risk management control procedures. If the Commission finds it is necessary or appropriate in the public interest or for the protection of investors, the Commission may impose additional conditions on either the broker-dealer, or the ultimate holding company, if it is an ultimate holding company that does not have a principal regulator, if:

(1) The broker or dealer is required by § 240.15c3–1(a)(7)(ii) to provide notice to the Commission that the broker's or dealer's tentative net capital is less than $5 billion;

(2) The broker or dealer or the ultimate holding company of the broker or dealer fails to meet the reporting requirements set forth in § 240.17a–5 or 240.15c3–1g(b), as applicable;

(3) Any event specified in § 240.17a–11 occurs;

(4) There is a material deficiency in the internal risk management control system or in the mathematical models used to price securities or to calculate deductions for market and credit risk or allowances for market and credit risk, as applicable, of the broker or dealer or the ultimate holding company of the broker or dealer;

(5) The ultimate holding company of the broker or dealer fails to comply with its undertakings that the broker or dealer has filed with its application pursuant to paragraph (a)(1)(viii) or (a)(1)(ix) of this appendix E;

(6) The broker or dealer fails to comply with this appendix E; or

(7) The Commission finds that imposition of other conditions is necessary or appropriate in the public interest or for the protection of investors.

[69 FR 34462, June 21, 2004, as amended at 79 FR 1549, Jan. 8, 2014; 79 FR 38451, July 8, 2014]

§ 240.15c3–1f Optional market and credit risk requirements for OTC derivatives dealers (Appendix F to 17 CFR 240.15c3–1).

Application Requirements

(a) An OTC derivatives dealer may apply to the Commission for authorization to compute capital charges for market and credit risk pursuant to this Appendix F in lieu of computing securities haircuts pursuant to § 240.15c3–1(c)(2)(vi).

(1) An OTC derivatives dealer's application shall contain the following information:

(i) *Executive summary*. An OTC derivatives dealer shall include in its application an Executive Summary of information provided to the Commission.

(ii) *Description of methods for computing market risk charges*. An OTC derivatives dealer shall provide a description of all statistical models used for pricing OTC derivative instruments and for computing value-at-risk (''VAR''), a description of the applicant's controls over those models, and a statement regarding whether the firm has developed its own internal VAR models. If the OTC derivatives dealer's VAR model incorporates empirical correlations across risk categories, the dealer shall describe its process for measuring correlations and describe the qualitative and quantitative aspects of the model which at a minimum must adhere to the criteria set forth in paragraph (e) of this appendix F. The application shall further state whether the OTC derivatives dealer intends to use an alternative method for computing its market risk charge for equity instruments and, if applicable, a description of how its own theoretical pricing model contains the minimum pricing factors set forth in appendix A (§ 240.15c3–1a). The application shall also describe any category of securities having no ready market or any category of debt securities which are below investment grade for which the OTC derivatives dealer wishes to use its VAR model to calculate its market risk charge or for which it wishes to use an alternative method for computing this charge and a description of how those charges would be determined.

(iii) *Internal risk management control systems*. An OTC derivatives dealer shall provide a comprehensive description of its internal risk management control systems and how those systems adhere to the requirements set forth in § 240.15c3–4(a) through (d).

(2) The Commission may approve the application after reviewing the application to determine whether the OTC derivatives dealer:

(i) Has adopted internal risk management control systems that meet the requirements set forth in § 240.15c3–4; and

(ii) Has adopted a VAR model that meets the requirements set forth in paragraphs (e)(1) and (e)(2) of this appendix F.

(3) If the OTC derivatives dealer materially amends its VAR model or internal risk management control systems as described in its application, including any material change in the categories of non-marketable securities that it wishes to include in its VAR model, the dealer shall file an application describing the changes which must be approved by the Commission before the changes may be implemented. After reviewing the application for changes to the dealer's VAR model or internal risk management control systems to determine whether, with the changes, the OTC derivatives dealer's VAR model and internal risk management control systems would meet the requirements set forth in this appendix F and § 240.15c3–4, the Commission may approve the application.

(4) The applications provided for in this paragraph (a) shall be considered filed when received at the Commission's principal office in Washington, DC. All applications filed pursuant to this paragraph (a) shall be deemed to be confidential.

Compliance With § 240.15c3–4

(b) An OTC derivatives dealer must be in compliance in all material respects with § 240.15c3–4 regarding its internal risk management control systems in order to be in compliance with § 240.15c3–1.

Market Risk

(c) An OTC derivatives dealer electing to apply this appendix F shall compute a capital charge for market risk which shall be the aggregate of the charges computed below:

(1) *Value-at-Risk*. An OTC derivatives dealer shall deduct from net worth an amount for market risk for eligible OTC derivative instruments and other positions in its proprietary or other accounts equal to the VAR of these positions obtained from its proprietary VAR model, multiplied by the appropriate multiplication factor in paragraph (e)(1)(iv)(C) of this appendix F. The OTC derivatives dealer may not elect to calculate its capital charges

under this paragraph (c)(1) until its application to use the VAR model has been approved by the Commission.

(2) *Alternative method for equities.* An OTC derivatives dealer may elect to use this alternative method to calculate its market risk for equity instruments, including OTC options, upon approval by the Commission on application by the dealer. Under this alternative method, the deduction for market risk must be the amount computed pursuant to appendix A to Rule 15c3–1

(§ 240.15c3–1a). In this computation, the OTC derivatives dealer may use its own theoretical pricing model provided that it contains the minimum pricing factors set forth in appendix A.

(3) *Non-marketable securities.* An OTC derivatives dealer may not use a VAR model to determine a capital charge for any category of securities having no ready market or any category of debt securities which are below investment grade or any derivative instrument based on the value of these categories of securities, unless the Commission has granted, pursuant to paragraph (a)(1) of this appendix F, its application to use its VAR model for any such category of securities. The dealer in any event may apply, pursuant to paragraph (a)(1) of this appendix F, for an alternative treatment for any such category of securities, rather than calculate the market risk capital charge for such category of securities under § 240.15c3–1(c)(2)(vi) and (vii).

(4) *Residual positions.* To the extent that a position has not been included in the calculation of the market risk charge in paragraphs (c)(1) through (c)(3) of this section, the market risk charge for the position shall be computed under § 240.15c3–1(c)(2)(vi).

Credit Risk

(d) The capital charge for credit risk arising from an OTC derivatives dealer's transactions in eligible OTC derivative instruments shall be:

(1) The net replacement value in the account of a counterparty (including the effect of legally enforceable netting agreements and the application of liquid collateral) that is insolvent, or in bankruptcy, or that has senior unsecured long-term debt in default;

(2) As to a counterparty not otherwise described in paragraph (d)(1) of this section, the net replacement value in the account of the counterparty (including the effect of legally enforceable netting agreements and the application of liquid collateral) multiplied by 8%, and further multiplied by a counterparty factor of 20%, 50%, or 100% based on an internal credit rating the OTC derivatives dealer determines for the counterparty; and

(3) A concentration charge where the net replacement value in the account of any one counterparty (other than a counterparty described in paragraph (d)(1) of this section) exceeds 25% of the OTC derivatives dealer's tentative net capital, calculated as follows:

(i) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt or commercial paper that would apply a 20% counterparty factor under paragraph (d)(2) of this section, 5% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(ii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 50% counterparty factor under paragraph (d)(2) of this section, 20% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(iii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 100% counterparty factor under paragraph (d)(2) of this section, 50% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital.

(4) Counterparties may be rated by the OTC derivatives dealer, or by an affiliated bank or affiliated broker-dealer of the OTC derivatives dealer, upon approval by the Commission on application by the OTC derivatives dealer. Based on the strength of the OTC derivatives dealer's internal credit risk management system, the Commission may approve the application. The OTC derivatives dealer must make and keep

current a record of the basis for the credit rating for each counterparty.

VAR Models

(e) An OTC derivatives dealer's VAR model must meet the following qualitative and quantitative requirements:

(1) *Qualitative requirements.* An OTC derivatives dealerapplying this appendix F must have a VAR model that meets the following minimum qualitative requirements:

(i) The OTC derivatives dealer's VAR model must be integrated into the firm's daily risk management process;

(ii) The OTC derivatives dealer must conduct appropriate stress tests of the VAR model, and develop appropriate procedures to follow in response to the results of such tests;

(iii) The OTC derivatives dealer must conduct periodic reviews (which may be performed by internal audit staff) of its VAR model. The OTC derivatives dealer's VAR model also must be subject to annual reviews conducted by independent public accountants; and

(iv) The OTC derivatives dealer must conduct backtesting of the VAR model pursuant to the following procedures:

(A) Beginning one year after the OTC derivatives dealer begins using its VAR model to calculate its net capital, the OTC derivatives dealer must conduct backtesting by comparing each of its most recent 250 business days' actual net trading profit or loss with the corresponding daily VAR measures generated for determining market risk capital charges and calibrated to a one-day holding period and a 99 percent, one-tailed confidence level;

(B) Once each quarter, the OTC derivatives dealer must identify the number of exceptions, that is, the number of business days for which the actual daily net trading loss, if any, exceeded the corresponding daily VAR measure; and

(C) An OTC derivatives dealer must use the multiplication factor indicated in Table 1 of this appendix F in determining its capital charge for market risk until it obtains the next quarter's backtesting results, unless the Commission determines that a different adjustment or other action is appropriate.

TABLE 5—MULTIPLICATION FACTOR BASED ON RESULTS OF BACKTESTING

Number of exceptions	Multiplication factor
4 or fewer	3.00
5	3.40
6	3.50
7	3.65
8	3.75
9	3.85
10 or more	4.00

(2) *Quantitative requirements.* An OTC derivatives dealer applying this appendix F must have a VAR model that meets the following minimum quantitative requirements:

(i) The VAR measures must be calculated on a daily basis using a 99 percent, one-tailed confidence level with a price change equivalent to a ten-business day movement in rates and prices;

(ii) The effective historical observation period for VAR measures must be at least one year, and the weighted average time lag of the individual observations cannot be less than six months. Historical data sets must be updated at least every three months and reassessed whenever market prices or volatilities are subject to large changes;

(iii) The VAR measures must include the risks arising from the non-linear price characteristics of options positions and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates or prices. An OTC derivatives dealer must measure the volatility of options positions by different maturities;

(iv) The VAR measures may incorporate empirical correlations within and across risk categories, provided that the OTC derivatives dealer has described its process for measuring correlations in its application to apply this appendix F and the Commission has approved its application. In the event that the VAR measures do not incorporate empirical correlations across risk categories, the OTC derivatives dealer must add the separate VAR measures for the four major risk categories in paragraph (e)(2)(v) of this appendix F to determine its aggregate VAR measure; and

(v) The OTC derivatives dealer's VAR model must use risk factors sufficient to measure the market risk inherent in all covered positions. The risk factors must address, at a minimum, the following major risk categories: interest rate risk, equity price risk, foreign exchange rate risk, and commodity price risk. For material exposures in the major currencies and markets, modeling techniques must capture, at a minimum, spread risk and must incorporate enough segments of the yield curve to capture differences in volatility and less-than-perfect correlation of rates along the yield curve. An OTC derivatives dealer must provide the Commission with evidence that the OTC derivatives dealer's VAR model takes account of specific risk in positions, including specific equity risk, if the OTC derivatives dealer intends to utilize its VAR model to compute capital charges for equity price risk.

[63 FR 59398, Nov. 3, 1998, as amended at 79 FR 1549, Jan. 8, 2014]

§ 240.15c3–1g Conditions for ultimate holding companies of certain brokers or dealers (Appendix G to 17 CFR 240.15c3–1).

As a condition for a broker or dealer to compute certain of its deductions to capital in accordance with § 240.15c3–1e, pursuant to its undertaking, the ultimate holding company of the broker or dealer shall:

CONDITIONS REGARDING COMPUTATION OF ALLOWABLE CAPITAL AND RISK ALLOWANCES

(a) If it is not an ultimate holding company that has a principal regulator, as that term is defined in § 240.15c3–1(c)(13), calculate allowable capital and allowances for market, credit, and operational risk on a consolidated basis as follows:

(1) *Allowable capital.* The ultimate holding company must compute allowable capital as the sum of:

(i) Common shareholders' equity on the consolidated balance sheet of the holding company less:

(A) Goodwill;

(B) Deferred tax assets, except those permitted for inclusion in Tier 1 capital by the Board of Governors of the Federal Reserve System (''Federal Reserve'') (12 CFR 225, appendix A);

(C) Other intangible assets; and

(D) Other deductions from common stockholders' equity as required by the Federal Reserve in calculating Tier 1 capital (as defined in 12 CFR 225, appendix A);

(ii) Cumulative and non-cumulative preferred stock, except that the amount of cumulative preferred stock may not exceed 33% of the items included in allowable capital pursuant to paragraph (a)(1)(i) of this appendix G, excluding cumulative preferred stock, provided that:

(A) The stock does not have a maturity date;

(B) The stock cannot be redeemed at the option of the holder of the instrument;

(C) The stock has no other provisions that will require future redemption of the issue; and

(D) The issuer of the stock can defer or eliminate dividends;

(iii) The sum of the following items on the consolidated balance sheet, to the extent that the sum does not exceed the sum of the items included in allowable capital pursuant to paragraphs (a)(1)(i) and (ii) of this Appendix G:

(A) Cumulative preferred stock in excess of the 33% limit specified in paragraph (a)(1)(ii) of this appendix G and subject to the conditions of paragraphs (a)(1)(ii)(A) through (D) of this appendix G;

(B) Subordinated debt if the original weighted average maturity of the subordinated debt is at least five years; each subordinated debt instrument states clearly on its face that repayment of the debt is not protected by any Federal agency or the Securities Investor Protection Corporation; the subordinated debt is unsecured and subordinated in right of payment to all senior indebtedness of the ultimate holding company; and the subordinated debt instrument permits acceleration only in the event of bankruptcy or reorganization of the ultimate holding company under Chapters 7 (liquidation) and 11 (reorganization) of the U.S. Bankruptcy Code; and

(C) As part of the broker's or dealer's application to calculate deductions for market and credit risk under § 240.15c3–1e, an ultimate holding company may request to include, for a period of three years after adoption of this appendix G, long-term debt that has an original weighted average maturity of at least five years and that cannot be accelerated, except upon the occurrence of certain events as the Commission may approve. As part of a subsequent amendment to the broker's or dealer's application, the broker or dealer may request permission for the ultimate holding company to include long-term debt that meets these criteria in allowable capital for up to an additional two years; and

(iv) Hybrid capital instruments that are permitted for inclusion in Tier 2 capital by the Federal Reserve (as defined in 12 CFR 225, appendix A);

(2) *Allowance for market risk.* The ultimate holding company shall compute an allowance for market risk for all proprietary positions, including debt instruments, equity instruments, commodity instruments, foreign exchange contracts, and derivative contracts, as the aggregate of the following:

(i) *Value at risk.* The VaR of its positions, multiplied by the appropriate multiplication factor as set forth in § 240.15c3–1e(d). The VaR of the positions must be obtained using approved VaR models meeting the applicable qualitative and quantitative requirements of § 240.15c3–1e(d); and

(ii) *Alternative method.* For positions for which there does not exist adequate historical data to support a VaR model, the ultimate holding company must propose a model that produces a suitable allowance for market risk for those positions;

(3) *Allowance for credit risk.* The ultimate holding company shall compute an allowance for credit risk for certain assets on the consolidated balance sheet and certain off-balance sheet items, including loans and loan commitments, exposures due to derivatives contracts, structured financial products, and other extensions of credit, and credit substitutes as follows:

(i) By multiplying the credit equivalent amount of the ultimate holding company's exposure to the counterparty, as defined in paragraphs (a)(3)(i)(A), (B) and (C) of this appendix G, by the appropriate credit risk weight, as defined in paragraph (a)(3)(i)(F) of this appendix G, of the asset, off-balance sheet item, or counterparty, then multiplying that product by 8%, in accordance with the following:

(A) For certain loans and loan commitments, the credit equivalent amount is determined by multiplying the nominal amount of the contract by the following credit conversion factors:

(*1*) 0% credit conversion factor for loan commitments that:

(*i*) May be unconditionally cancelled by the lender; or

(*ii*) May be cancelled by the lender due to credit deterioration of the borrower;

(*2*) 20% credit conversion factor for:

(*i*) Loan commitments of less than one year; or

(*ii*) Short-term self-liquidating trade related contingencies, including letters of credit;

(*3*) 50% credit conversion factor for loan commitments with an original maturity of greater than one year that contain transaction contingencies, including performance bonds, revolving underwriting facilities, note issuance facilities and bid bonds; and

(*4*) 100% credit conversion factor for bankers' acceptances, stand-by letters of credit, and forward purchases of assets, and similar direct credit substitutes;

(B) For derivatives contracts and for repurchase agreements, reverse repurchase agreements, stock lending and borrowing, and similar collateralized transactions, the credit equivalent amount is the sum of the ultimate holding company's maximum potential exposure to the counterparty, as defined in paragraph (a)(3)(i)(E) of this appendix G, multiplied by the appropriate multiplication factor, and the ultimate holding company's current exposure to the counterparty, as defined in paragraph (a)(3)(i)(D) of this appendix G. The ultimate holding company must use the multiplication factor determined according to § 240.15c3–1e(d)(1)(v), except that the initial multiplication factor shall be one, unless the Commission determines, based on a review of the group-wide internal risk management control system and practices, including a review of the VaR models, that another multiplication factor is appropriate;

(C) The credit equivalent amount for other assets shall be the asset's book value on the ultimate holding company's consolidated balance sheet or other amount as determined according to the standards published by the Basel Committee on Banking Supervision, as amended from time to time;

(D) The *current exposure* is the current replacement value of a counterparty's positions, after applying netting agreements with that counterparty meeting the requirements of § 240.15c3–1e(c)(4)(iv) and taking into account the value of collateral from the counterparty in accordance with § 240.15c3–1e(c)(4)(v);

(E) The *maximum potential exposure* is the VaR of the counterparty's positions with the member of the affiliate group, after applying netting agreements with the counterparty meeting the requirements of paragraph (c)(4)(iv) of § 240.15c3–1e, taking into account the value of collateral from the counterparty held by the member of the affiliate in accordance with paragraph (c)(4)(v) of § 240.15c3–1e, and taking into account the current replacement value of the counterparty's positions with the member of the affiliate group, except that for repurchase agreements, reverse repurchase agreements, stock lending and borrowing, and similar collateralized transactions, maximum potential exposure must be calculated using a time horizon of not less than five days;

(F) Credit ratings and credit risk weights shall be determined according to the provisions of paragraphs (c)(4)(vi)(A) and (c)(4)(vi)(B) of § 240.15c3–1e, respectively;

(G) As part of the broker's or dealer's initial application or in an amendment, the ultimate holding company may request Commission approval to reduce allowances for credit risk through the use of credit derivatives;

(H) For the portion of a current exposure covered by a written guarantee, where that guarantee is an unconditional and irrevocable guarantee of the due and punctual payment and performance of the obligation and the ultimate holding company or member of the affiliate group can demand payment after any payment is missed without having to make collection efforts, the ultimate holding company or member of the affiliate group may substitute the credit risk weight of the guarantor for the credit risk weight of the counterparty; or

(ii) As part of the broker's or dealer's initial application or in an amendment to the application, the ultimate holding company may request Commission approval to use a method of calculating credit risk that is consistent with standards published by the Basel Committee on Banking Supervision in International Convergence of Capital Measurement and Capital Standards (July 1988), as amended from time to time; and

(4) *Allowance for operational risk.* The ultimate holding company shall compute an allowance for operational risk in accordance with the standards published by the Basel Committee on Banking Supervision, as amended from time to time.

CONDITIONS REGARDING REPORTING REQUIREMENTS

(b) File reports with the Commission in accordance with the following:

(1) If it is not an ultimate holding company that has a principal regulator, as that term is defined in § 240.15c3–1(c)(13), the ultimate holding company shall file with the Commission:

(i) A report as of the end of each month, filed not later than 30 calendar days after the end of the month. A monthly report need not be filed for a month-end that coincides with a fiscal quarter-end. The monthly report shall include:

(A) A consolidated balance sheet and income statement (including notes to the financial statements) for the ultimate holding company and statements of allowable capital and allowances for market, credit, and operational risk computed pursuant to paragraph (a) of this appendix G, *except* that the consolidated balance sheet and income statement for the first month of the fiscal year may be filed at a later time to which the Commission agrees (when reviewing the affiliated broker's or dealer's application under § 240.15c3–1e(a)). A statement of comprehensive income (as defined in § 210.1–02 of Regulation S–X of this chapter) shall be included in place of an income statement, if required by the applicable generally accepted accounting principles.

(B) A graph reflecting, for each business line, the daily intra-month VaR;

(C) Consolidated credit risk information, including aggregate current exposure and current exposures (including commitments) listed by counterparty for the 15 largest exposures;

(D) The 10 largest commitments listed by counterparty;

(E) Maximum potential exposure listed by counterparty for the 15 largest exposures;

(F) The aggregate maximum potential exposure;

(G) A summary report reflecting the geographic distribution of the ultimate holding company's exposures on a consolidated basis for each of the top ten countries to which it is exposed (by residence of the main operating group of the counterparty); and

(H) Certain regular risk reports provided to the persons responsible for managing group-wide risk as the Commission may request from time to time;

(ii) A quarterly report as of the end of each fiscal quarter, filed not later than 35 calendar days after the end of the quarter. The quarterly report shall include, in addition to the information contained in the monthly report as required by paragraph (b)(1)(i) of this appendix G, the following:

(A) Consolidating balance sheets and income statements for the ultimate holding company. The consolidating balance sheet must provide information regarding each material affiliate of the ultimate holding company in a separate column, but may aggregate information regarding members of the affiliate group that are not material affiliates into one column. Statements of comprehensive income (as defined in § 210.1–02 of Regulation S–X) shall be included in place of an income statement, if required by the applicable generally accepted accounting principles;

(B) The results of backtesting of all internal models used to compute allowable capital and allowances for market and credit risk indicating, for each model, the number of backtesting exceptions;

(C) A description of all material pending legal or arbitration proceedings, involving either the ultimate holding company or any of its affiliates, that are required to be disclosed by the ultimate holding company under generally accepted accounting principles;

(D) The aggregate amount of unsecured borrowings and lines of credit, segregated into categories, scheduled to mature within twelve months from the most recent fiscal quarter as to each material affiliate; and

(E) For a quarter-end that coincides with the ultimate holding company's fiscal year-end, the ultimate holding company need not include consolidated and consolidating balance sheets and income statements (or statements of comprehensive income, as applicable) in its quarterly reports. The consolidating balance sheet and income statement (or statement of comprehensive income, as applicable) for the quarter-end that coincides with the fiscal year-end may be filed at a later time to which the Commission agrees (when reviewing the affiliated broker's or dealer's application under § 240.15c3–1e(a));

(iii) An annual audited report as of the end of the ultimate holding company's fiscal year, filed not later than 65 calendar days after the end of the fiscal year. The annual report shall include:

(A) Consolidated financial statements for the ultimate holding company audited by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq.*). The audit shall be made in accordance with the rules promulgated by the Public Company Accounting Oversight Board. The audited financial statements must include a supporting schedule containing statements of allowable capital and allowances for market, credit, and operational risk computed pursuant to paragraph (a) of this appendix G; and

(B) A supplemental report entitled "Accountant's Report on Internal Risk Management Control System" prepared by a registered public accounting firm, as that term is defined in section

2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq.*), indicating the results of the registered public accounting firm's review of the ultimate holding company's compliance with §240.15c3–4. The procedures are to be performed and the report is to be prepared in accordance with procedures agreed upon by the ultimate holding company and the registered public accounting firm conducting the review. The agreed-upon procedures are to be performed and the report is to be prepared in accordance with rules promulgated by the Public Company Accounting Oversight Board. The ultimate holding company must file, before commencement of the initial review, the procedures agreed upon by the ultimate holding company and the registered public accounting firm with the Division of Market Regulation, Office of Financial Responsibility, at Commission's principal office in Washington, DC. Before commencement of each subsequent review, the ultimate holding company must notify the Commission of any changes in the procedures;

(iv) An organizational chart, as of the ultimate holding company's fiscal year-end, concurrently with its quarterly report for the quarter-end that coincides with its fiscal year-end. The ultimate holding company must provide quarterly updates of the organizational chart if a material change in the information provided to the Commission has occurred;

(2) If the ultimate holding company is an entity that has a principal regulator, as that term is defined in §240.15c3–1(c)(13), the ultimate holding company must file with the Commission:

(i) A quarterly report as of the end of each fiscal quarter, filed not later than 35 calendar days after the end of the quarter, or a later time to which the Commission may agree upon application. The quarterly report shall include:

(A) Consolidated (including notes to the financial statements) and consolidating balance sheets and income statements for the ultimate holding company. Statements of comprehensive income (as defined in §210.1–02 of Regulation S–X) shall be included in place of income statements, if required by the applicable generally accepted accounting principles;

(B) Its most recent capital measurements computed in accordance with the standards published by the Basel Committee on Banking Supervision, as amended from time to time, as reported to its principal regulator;

(C) Certain regular risk reports provided to the persons responsible for managing group-wide risk as the Commission may request from time to time; and

(D) For a quarter-end that coincides with the ultimate holding company's fiscal year-end, the ultimate holding company need not include consolidated and consolidating balance sheets and income statements (or statements of comprehensive income, as applicable) in its quarterly reports. The consolidating balance sheet and income statement (or statement of comprehensive income, as applicable) for the quarter-end that coincides with the fiscal year-end may be filed at a later time to which the Commission agrees (when reviewing the affiliated broker's or dealer's application under §240.15c3–1e(a)).

(ii) An annual audited report as of the end of the ultimate holding company's fiscal year, filed with the Commission when required to be filed by any regulator;

(3) The reports that the ultimate holding company must file in accordance with paragraph (b) of this appendix G will be considered filed when two copies are received at the Commission's principal office in Washington, DC. A person who files reports pursuant to this section for which he or she seeks confidential treatment may clearly mark each page or segregable portion of each page with the words "Confidential Treatment Requested." The copies shall be addressed to the Division of Market Regulation, Risk Assessment Group; and

(4) The reports that the ultimate holding company must file with the Commission in accordance with paragraph (b) of this Appendix G will be accorded confidential treatment to the extent permitted by law.

CONDITIONS REGARDING RECORDS TO BE MADE

(c) If it is not an ultimate holding company that has a principal regulator, make and keep current the following records:

(1) A record of the results of funding and liquidity stress tests that the ultimate holding company has conducted in response to the following events at least once each quarter and a record of the contingency plan to respond to each of these events:

(i) A credit rating downgrade of the ultimate holding company;

(ii) An inability of the ultimate holding company to access capital markets for unsecured short-term funding;

(iii) An inability of the ultimate holding company to access liquid assets in regulated entities across international borders when the events described in paragraphs (c)(1)(i) or (ii) of this appendix G occur; and

(iv) An inability of the ultimate holding company to access credit or assets held at a particular institution when the events described in paragraphs (c)(1)(i) or (ii) of this appendix G occur;

(2) A record of the basis for the determination of credit risk weights for each counterparty;

(3) A record of the basis for the determination of internal credit ratings for each counterparty; and

(4) A record of the calculations of allowable capital and allowances for market, credit and operational risk computed currently at least once per month on a consolidated basis.

CONDITIONS REGARDING PRESERVATION OF RECORDS

(d)(1) Must preserve the following information, documents, and reports for a period of not less than three years in an easily accessible place using any media acceptable under § 240.17a–4(f):

(i) The documents created in accordance with paragraph (c) of this Appendix G;

(ii) Any application or documents filed with the Commission pursuant to § 240.15c3–1e and this appendix G and any written responses received from the Commission;

(iii) All reports and notices filed with the Commission pursuant to § 240.15c3–1e and this appendix G; and

(iv) If the ultimate holding company does not have a principal regulator, all written policies and procedures concerning the group-wide internal risk management control system established pursuant to § 240.15c3–1e(a)(1)(viii)(C); and

(2) The ultimate holding company may maintain the records referred to in paragraph (d)(1) of this appendix G either at the ultimate holding company, at an affiliate, or at a records storage facility, provided that the records are located within the United States. If the records are maintained by an entity other than the ultimate holding company, the ultimate holding company shall obtain and file with the Commission a written undertaking by the entity maintaining the records, in a form acceptable to the Commission, signed by a duly authorized person at the entity maintaining the records, to the effect that the records will be treated as if the ultimate holding company were maintaining the records pursuant to this section and that the entity maintaining the records will permit examination of such records at any time or from time to time during business hours by representatives or designees of the Commission and will promptly furnish the Commission or its designee a true, legible, complete, and current paper copy of any or all or any part of such records. The election to operate pursuant to the provisions of this paragraph shall not relieve the ultimate holding company that is required to maintain and preserve such records from any of its reporting or recordkeeping responsibilities under this section.

CONDITIONS REGARDING NOTIFICATION

(e) The ultimate holding company of a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3–1e shall:

(1) Send notice promptly (but within 24 hours) after the occurrence of the following events:

(i) The early warning indications of low capital as the Commission may agree;

(ii) The ultimate holding company files a Form 8–K (17 CFR 249.308) with the Commission; and

(iii) A material affiliate declares bankruptcy or otherwise becomes insolvent; and

(2) If it is not an ultimate holding company that has a principal regulator, as defined in § 240.15c3–1(c)(13), send notice promptly (but within 24 hours) after the occurrence of the following events:

(i) The ultimate holding company becomes aware that an NRSRO has determined to reduce materially its assessment of the creditworthiness of a material affiliate or the credit rating(s) assigned to one or more outstanding short or long-term obligations of a material affiliate;

(ii) The ultimate holding company becomes aware that any financial regulatory agency or self-regulatory organization has taken significant enforcement or regulatory action against a material affiliate; and

(iii) The occurrence of any backtesting exception under § 240.15c3–1e(d)(1)(iii) or (iv) that would require that the ultimate holding company use a higher multiplication factor in the calculation of its allowances for market or credit risk;

(3) Every notice given or transmitted by paragraph (e) of this appendix G will be given or transmitted to the Division of Market Regulation, Office of Financial Responsibility, at the principal office of the Commission in Washington, DC. A person who files notification pursuant to this section for which he or she seeks confidential treatment may clearly mark each page or segregable portion of each page with the words ''Confidential Treatment Request.'' For the purposes of this appendix G, ''notice'' shall be given or transmitted by telegraphic notice or facsimile transmission. The notice described by paragraph (e)(2) of this appendix G may be transmitted by overnight delivery. Notices filed pursuant to this paragraph will be accorded confidential treatment to the extent permitted by law; and

(4) Upon the written request of the ultimate holding company, or upon its own motion, the Commission may grant an extension of time or an exemption from any of the requirements of this paragraph (e) either unconditionally or on specified terms and conditions as are necessary or appropriate in the public interest or for the protection of investors.

[69 FR 34467, June 21, 2004, as amended at 79 FR 1550, Jan. 8, 2014; 83 FR 50222, Oct. 4, 2018]

§ 240.15c3–2 [Reserved]

§ 240.15c3–3 Customer protection—reserves and custody of securities.

(a) *Definitions*. For the purpose of this section:

(1) The term *customer* shall mean any person from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities for the account of that person. The term shall not include a broker or dealer, a municipal securities dealer, or a government securities broker or government securities dealer. The term shall, however, include another broker or dealer to the extent that broker or dealer maintains an omnibus account for the account of customers with the broker or dealer in compliance with Regulation T (12 CFR 220.1 through 220.12). The term shall not include a general partner or director or principal officer of the broker or dealer or any other person to the extent that person has a claim for property or funds which by contract, agreement or understanding, or by operation of law, is part of the capital of the broker or dealer or is subordinated to the claims of creditors of the broker or dealer. In addition, the term shall not include a person to the extent that the person has a claim for security futures products held in a futures account, or any security futures product and any futures product held in a ''proprietary account'' as defined by the Commodity Futures Trading Commission in § 1.3(y) of this chapter. The term also shall not include a counterparty who has delivered collateral to an OTC derivatives dealer pursuant to a transaction in an eligible OTC derivative instrument, or pursuant to the OTC derivatives dealer's cash management securities activities or ancillary portfolio management securities activities, and who has received a prominent written notice from the OTC derivatives dealer that:

(i) Except as otherwise agreed in writing by the OTC derivatives dealer and the counterparty, the dealer may repledge or otherwise use the collateral in its business;

(ii) In the event of the OTC derivatives dealer's failure, the counterparty will likely be considered an unsecured creditor of the dealer as to that collateral;

(iii) The Securities Investor Protection Act of 1970 (SIPA) does not protect the counterparty; and

(iv) The collateral will not be subject to the requirements of § 240.8c–1, § 240.15c2–1, § 240.15c3–2, or § 240.15c3–3.

(2) The term *securities carried for the account of a customer* (hereinafter also ''customer securities'') shall mean:

(i) Securities received by or on behalf of a broker or dealer for the account of any customer and securities carried long by a broker or dealer for the account of any customer; and

(ii) Securities sold to, or bought for, a customer by a broker or dealer.

(3) The term *fully paid securities* means all securities carried for the account of a customer in a cash account as defined in Regulation T (12 CFR 220.1 *et seq.*), as well as securities carried for the account of a customer in a margin account or any special account under Regulation T that have no loan value for margin purposes, and all margin equity securities in such accounts if they are fully paid: *Provided, however*, that the term *fully paid securities* does not apply to any securities purchased in transactions for which the customer has not made full payment.

(4) The term *margin securities* means those securities carried for the account of a customer in a margin account as defined in section 4 of Regulation T (12 CFR 220.4), as well as securities carried in any other account (such accounts hereinafter referred to as ''margin accounts'') other than the securities referred to in paragraph (a)(3) of this section.

(5) The term *excess margin securities* shall mean those securities referred to in paragraph (a)(4) of this section carried for the account of a customer having a market value in excess of 140 percent of the total of the debit balances in the customer's account or accounts encompassed by paragraph (a)(4) of this section which the broker or dealer identifies as not constituting margin securities.

(6) The term *qualified security* shall mean a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States.

(7) The term *bank* means a bank as defined in section 3(a)(6) of the Act and will also mean any building and loan, savings and loan or similar banking institution subject to supervision by a Federal banking authority. With respect to a broker or dealer that maintains its principal place of business in Canada, the term ''bank'' also means a Canadian bank subject to supervision by a Canadian authority.

(8) The term *free credit balances* means liabilities of a broker or dealer to customers which are subject to immediate cash payment to customers on demand, whether resulting from sales of securities, dividends, interest, deposits or otherwise, excluding, however, funds in commodity accounts which are segregated in accordance with the Commodity Exchange Act or in a similar manner, or which are funds carried in a proprietary account as that term is defined in regulations under the Commodity Exchange Act. The term ''free credit balances'' also includes, if subject to immediate cash payment to customers on demand, funds carried in a securities account pursuant to a self-regulatory organization portfolio margining rule approved by the Commission under section 19(b) of the Act (15 U.S.C. 78s(b)) (''SRO portfolio margining rule''), including variation margin or initial margin, marks to market, and proceeds resulting from margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon.

(9) The term *other credit balances* means cash liabilities of a broker or dealer to customers other than free credit balances and funds in commodity accounts which are segregated in accordance with the Commodity Exchange Act or in a similar manner, or funds carried in a proprietary account as that term is defined in regulations under the Commodity Exchange Act. The term ''other credit balances'' also includes funds that are cash liabilities

of a broker or dealer to customers other than free credit balances and are carried in a securities account pursuant to an SRO portfolio margining rule, including variation margin or initial margin, marks to market, and proceeds resulting from margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon.

(10) The term *funds carried for the account of any customer* (hereinafter also ''customer funds'') shall mean all free credit and other credit balances carried for the account of the customer.

(11) The term *principal officer* shall mean the president, executive vice president, treasurer, secretary or any other person performing a similar function with the broker or dealer.

(12) The term *household members and other persons related to principals* includes husbands or wives, children, sons-in-law or daughters-in-law and any household relative to whose support a principal contributes directly or indirectly. For purposes of this paragraph (a)(12), a principal shall be deemed to be a director, general partner, or principal officer of the broker or dealer.

(13) The term *affiliated person* includes any person who directly or indirectly controls a broker or dealer or any person who is directly or indirectly controlled by or under common control with the broker or dealer. Ownership of 10% or more of the common stock of the relevant entity will be deemed prima facie control of that entity for purposes of this paragraph.

(14) The term *securities account* shall mean an account that is maintained in accordance with the requirements of section 15(c)(3) of the Act (15 U.S.C. 78*o*(c)(3)) and § 240.15c3–3.

(15) The term *futures account* (also referred to as ''commodity account'') shall mean an account that is maintained in accordance with the segregation requirements of section 4d of the Commodity Exchange Act (7 U.S.C. 6d) and the rules thereunder.

(16) The term *PAB account* means a proprietary securities account of a broker or dealer (which includes a foreign broker or dealer, or a foreign bank acting as a broker or dealer) other than a delivery-versus-payment account or a receipt-versus-payment account. The term does not include an account that has been subordinated to the claims of creditors of the carrying broker or dealer.

(17) The term *Sweep Program* means a service provided by a broker or dealer where it offers to its customer the option to automatically transfer free credit balances in the securities account of the customer to either a money market mutual fund product as described in § 270.2a–7 of this chapter or an account at a bank whose deposits are insured by the Federal Deposit Insurance Corporation.

(b) *Physical possession or control of securities.* (1) A broker or dealer shall promptly obtain and shall thereafter maintain the physical possession or control of all fully-paid securities and excess margin securities carried by a broker or dealer for the account of customers.

(2) A broker or dealer shall not be deemed to be in violation of the provisions of paragraph (b)(1) of this section regarding physical possession or control of customers' securities if, solely as the result of normal business operations, temporary lags occur between the time when a security is required to be in the possession or control of the broker or dealer and the time that it is placed in the broker's or dealer's physical possession or under its control, provided that the broker or dealer takes timely steps in good faith to establish prompt physical possession or control. The burden of proof shall be on the broker or dealer to establish that the failure to obtain physical possession or control of securities carried for the account of customers as required by paragraph (b)(1) of this section is merely temporary and solely the result of normal business operations including same day receipt and redelivery (turnaround), and to establish that it has taken timely steps in good faith to place them in its physical possession or control.

(3) A broker or dealer shall not be deemed to be in violation of the provisions of paragraph (b)(1) of this section regarding physical possession or control of fully-paid or excess margin securities borrowed from any person, provided that the broker or dealer and the

lender, at or before the time of the loan, enter into a written agreement that, at a minimum;

(i) Sets forth in a separate schedule or schedules the basis of compensation for any loan and generally the rights and liabilities of the parties as to the borrowed securities;

(ii) Provides that the lender will be given a schedule of the securities actually borrowed at the time of the borrowing of the securities;

(iii) Specifies that the broker or dealer:

(A) Must provide to the lender, upon the execution of the agreement or by the close of the business day of the loan if the loan occurs subsequent to the execution of the agreement, collateral, which fully secures the loan of securities, consisting exclusively of cash or United States Treasury bills and Treasury notes or an irrevocable letter of credit issued by a bank as defined in section 3(a)(6)(A)–(C) of the Act (15 U.S.C. 78c(a)(6)(A)–(C)) or such other collateral as the Commission designates as permissible by order as necessary or appropriate in the public interest and consistent with the protection of investors after giving consideration to the collateral's liquidity, volatility, market depth and location, and the issuer's creditworthiness; and

(B) Must mark the loan to the market not less than daily and, in the event that the market value of all the outstanding securities loaned at the close of trading at the end of the business day exceeds 100 percent of the collateral then held by the lender, the borrowing broker or dealer must provide additional collateral of the type described in paragraph (b)(3)(iii)(A) of this section to the lender by the close of the next business day as necessary to equal, together with the collateral then held by the lender, not less than 100 percent of the market value of the securities loaned; and

(iv) Contains a prominent notice that the provisions of the SIPA may not protect the lender with respect to the securities loan transaction and that, therefore, the collateral delivered to the lender may constitute the only source of satisfaction of the broker's or dealer's obligation in the event the broker or dealer fails to return the securities.

(4)(i) Notwithstanding paragraph (k)(2)(i) of this section, a broker or dealer that retains custody of securities that are the subject of a repurchase agreement between the broker or dealer and a counterparty shall:

(A) Obtain the repurchase agreement in writing;

(B) Confirm in writing the specific securities that are the subject of a repurchase transaction pursuant to such agreement at the end of the trading day on which the transaction is intitiated and at the end of any other day during which other securities are substituted if the substitution results in a change to issuer, maturity date, par amount or coupon rate as specified in the previous confirmation;

(C) Advise the counterparty in the repurchase agreement that the Securities Investor Protection Corporation has taken the position that the provisions of the SIPA do not protect the counterparty with respect to the repurchase agreement; and

(D) Maintain possession or control of securities that are the subject of the agreement.

(ii) For purpose of this paragraph (b)(4), securities are in the broker's or dealer's control only if they are in the control of the broker or dealer within the meaning of §240.15c3–3 (c)(1), (c)(3), (c)(5) or (c)(6) of this title.

(iii) A broker or dealer shall not be in violation of the requirement to maintain possession or control pursuant to paragraph (b)(4)(i)(D) during the trading day if:

(A) In the written repurchase agreement, the counterparty grants the broker or dealer the right to substitute other securities for those subject to the agreement; and

(B) The provision in the written repurchase agreement governing the right, if any, to substitute is immediately preceded by the following disclosure statement, which must be prominently displayed:

REQUIRED DISCLOSURE

The [seller] is not permitted to substitute other securities for those subject to this agreement and therefore must keep the [buyer's] securities segregated at all times, unless in this agreement the [buyer] grants the [seller] the right to substitute other securities. If the [buyer] grants the right to substitute, this means that the [buyer's] securities will likely be commingled with the [seller's] own securities during the trading day. The [buyer] is advised that, during any trading day that the [buyer's] securities are commingled with the [seller's] securities, they will be subject to liens granted by the [seller] to its clearing bank and may be used by the [seller] for deliveries on other securities transactions. Whenever the securities are commingled, the [seller's] ability to resegregate substitute securities for the [buyer] will be subject to the [seller's] ability to satisfy the clearing lien or to obtain substitute securities.

(iv) A confirmation issued in accordance with paragraph (b)(4)(i)(B) of this section shall specify the issuer, maturity date, coupon rate, par amount and market value of the security and shall further identify a CUSIP or mortgage-backed security pool number, as appropriate, except that a CUSIP or a pool number is not required on the confirmation if it is identified in internal records of the broker or dealer that designate the specific security of the counterparty. For purposes of this paragraph (b)(4)(iv), the market value of any security that is the subject of the repurchase transaction shall be the most recently available bid price plus accrued interest, obtained by any reasonable and consistent methodology.

(v) This paragraph (b)(4) shall not apply to a repurchase agreement between the broker or dealer and another broker or dealer (including a government securities broker or dealer), a registered municipal securities dealer, or a general partner or director or principal officer of the broker or dealer or any person to the extent that the person's claim is explicitly subordinated to the claims of creditors of the broker or dealer.

(5) A broker or dealer is required to obtain and thereafter maintain the physical possession or control of securities carried for a PAB account, unless the broker or dealer has provided written notice to the account holder that the securities may be used in the ordinary course of its securities business, and has provided an opportunity for the account holder to object.

(c) *Control of securities.* Securities under the control of a broker or dealer shall be deemed to be securities which:

(1) Are represented by one or more certificates in the custody or control of a clearing corporation or other subsidiary organization of either national securities exchanges or of a registered national securities association, or of a custodian bank in accordance with a system for the central handling of securities complying with the provisions of §§ 240.8c–1(g) and 240.15c2–1(g) the delivery of which certificates to the broker or dealer does not require the payment of money or value, and if the books or records of the broker or dealer identify the customers entitled to receive specified quantities or units of the securities so held for such customers collectively; or

(2) Are carried for the account of any customer by a broker or dealer and are carried in an omnibus credit account in the name of such broker or dealer with another broker or dealer in compliance with the requirements of section 7(f) of Regulation T (12 CFR 220.7(f)), such securities being deemed to be under the control of such broker or dealer to the extent that it has instructed such carrying broker or dealer to maintain physical possession or control of them free of any charge, lien, or claim of any kind in favor of such carrying broker or dealer or any persons claiming through such carrying broker or dealer; or

(3) Are the subject of bona fide items of transfer; provided that securities shall be deemed not to be the subject of bona fide items of transfer if, within 40 calendar days after they have been transmitted for transfer by the broker or dealer to the issuer or its transfer agent, new certificates conforming to the instructions of the broker or dealer have not been received by the broker or deal, the broker or dealer has not received a written statement by the issuer or its transfer agent acknowledging the transfer instructions and the possession of the securities or the broker or dealer has not obtained a revalidation of a window ticket from a transfer agent with respect to the certificate delivered for transfer; or

(4) Are in the custody of a foreign depository, foreign clearing agency or foreign custodian bank which the Commission upon application from a broker

or dealer, a registered national securities exchange or a registered national securities association, or upon its own motion shall designate as a satisfactory control location for securities; or

(5) Are in the custody or control of a bank as defined in section 3(a)(6) of the Act, the delivery of which securities to the broker or dealer does not require the payment of money or value and the bank having acknowledged in writing that the securities in its custody or control are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank or any person claiming through the bank; or

(6)(i) Are held in or are in transit between offices of the broker or dealer; or (ii) are held by a corporate subsidiary if the broker or dealer owns and exercises a majority of the voting rights of all of the voting securities of such subsidiary, assumes or guarantees all of the subsidiary's obligations and liabilities, operates the subsidiary as a branch office of the broker or dealer, and assumes full responsibility for compliance by the subsidiary and all of its associated persons with the provisions of the Federal securities laws as well as for all of the other acts of the subsidiary and such associated persons; or

(7) Are held in such other locations as the Commission shall upon application from a broker or dealer find and designate to be adequate for the protection of customer securities.

(d) *Requirement to reduce securities to possession or control.* Not later than the next business day, a broker or dealer, as of the close of the preceding business day, shall determine from its books or records the quantity of fully paid securities and excess margin securities in its possession or control and the quantity of fully paid securities and excess margin securities not in its possession or control. In making this daily determination inactive margin accounts (accounts having no activity by reason of purchase or sale of securities, receipt or delivery of cash or securities or similar type events) may be computed not less than once weekly. If such books or records indicate, as of such close of the business day, that such broker or dealer has not obtained physical possession or control of all fully paid and excess margin securities as required by this section and there are securities of the same issue and class in any of the following noncontrol locations:

(1) Securities subject to a lien securing moneys borrowed by the broker or dealer or securities loaned to another broker or dealer or a clearing corporation, then the broker or dealer shall, not later than the business day following the day on which such determination is made, issue instructions for the release of such securities from the lien or return of such loaned securities and shall obtain physical possession or control of such securities within two business days following the date of issuance of the instructions in the case of securities subject to lien securing borrowed moneys and within five business days following the date of issuance of instructions in the case of securities loaned; or

(2) Securities included on the broker's or dealer's books or records as failed to receive more than 30 calendar days, then the broker or dealer shall, not later than the business day following the day on which such determination is made, take prompt steps to obtain physical possession or control of securities so failed to receive through a buy-in procedure or otherwise; or

(3) Securities receivable by the broker or dealer as a security dividend receivable, stock split or similar distribution for more than 45 calendar days, then the broker or dealer shall, not later than the business day following the day on which such determination is made, take prompt steps to obtain physical possession or control of securities so receivable through a buy-in procedure or otherwise; or

(4) Securities included on the broker's or dealer's books or records that allocate to a short position of the broker or dealer or a short position for another person, excluding positions covered by paragraph (m) of this section, for more than 30 calendar days, then the broker or dealer must, not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities. For the purposes of this paragraph (d)(4), the 30 day time period

will not begin to run with respect to a syndicate short position established in connection with an offering of securities until the completion of the underwriter's participation in the distribution as determined pursuant to §242.100(b) of Regulation M of this chapter (17 CFR 242.100 through 242.105); or

(5) A broker or dealer which is subject to the requirements of §240.15c3–3 with respect to physical possession or control of fully paid and excess margin securities shall prepare and maintain a current and detailed description of the procedures which it utilizes to comply with the possession or control requirements set forth in this section. The records required herein shall be made available upon request to the Commission and to the designated examining authority for such broker or dealer.

(e) *Special reserve bank accounts for the exclusive benefit of customers and PAB accounts.* (1) Every broker or dealer must maintain with a bank or banks at all times when deposits are required or hereinafter specified a ''Special Reserve Bank Account for the Exclusive Benefit of Customers'' (hereinafter referred to as the *Customer Reserve Bank Account*) and a ''Special Reserve Bank Account for Brokers and Dealers'' (hereinafter referred to as the *PAB Reserve Bank Account*), each of which will be separate from the other and from any other bank account of the broker or dealer. Such broker or dealer must at all times maintain in the Customer Reserve Bank Account and the PAB Reserve Bank Account, through deposits made therein, cash and/or qualified securities in amounts computed in accordance with the formula attached as Exhibit A (17 CFR 240.15c3–3a), as applied to customer and PAB accounts respectively.

(2) With respect to each computation required pursuant to paragraph (e)(1) of this section, a broker or dealer must not accept or use any of the amounts under items comprising Total Credits under the formula referred to in paragraph (e)(1) of this section except for the specified purposes indicated under items comprising Total Debits under the formula, and, to the extent Total Credits exceed Total Debits, at least the net amount thereof must be maintained in the Customer Reserve Bank Account and PAB Reserve Bank Account pursuant to paragraph (e)(1) of this section.

(3) *Reserve Bank Account computations.* (i) Computations necessary to determine the amount required to be deposited in the Customer Reserve Bank Account and PAB Reserve Bank Account as specified in paragraph (e)(1) of this section must be made weekly, as of the close of the last business day of the week, and the deposit so computed must be made no later than one hour after the opening of banking business on the second following business day; *provided, however,* a broker or dealer which has aggregate indebtedness not exceeding 800 percent of net capital (as defined in §240.15c3–1) and which carries aggregate customer funds (as defined in paragraph (a)(10) of this section), as computed at the last required computation pursuant to this section, not exceeding $1,000,000, may in the alternative make the Customer Reserve Bank Account computation monthly, as of the close of the last business day of the month, and, in such event, must deposit not less than 105 percent of the amount so computed no later than one hour after the opening of banking business on the second following business day.

(ii) If a broker or dealer, computing on a monthly basis, has, at the time of any required computation, aggregate indebtedness in excess of 800 percent of net capital, such broker or dealer must thereafter compute weekly as aforesaid until four successive weekly Customer Reserve Bank Account computations are made, none of which were made at a time when its aggregate indebtedness exceeded 800 percent of its net capital.

(iii) A broker or dealer that does not carry the accounts of a ''customer'' as defined by this section or conduct a proprietary trading business may make the computation to be performed with respect to PAB accounts under paragraph (e)(1) of this section monthly rather than weekly. If a broker or dealer performing the computation with respect to PAB accounts under paragraph (e)(1) of this section on a monthly basis is, at the time of any required computation, required to deposit additional cash or qualified securities in the PAB

Reserve Bank Account, the broker or dealer must thereafter perform the computation required with respect to PAB accounts under paragraph (e)(1) of this section weekly until four successive weekly computations are made, none of which is made at a time when the broker or dealer was required to deposit additional cash or qualified securities in the PAB Reserve Bank Account.

(iv) Computations in addition to the computations required in this paragraph (e)(3), may be made as of the close of any business day, and the deposits so computed must be made no later than one hour after the opening of banking business on the second following business day.

(v) The broker or dealer must make and maintain a record of each such computation made pursuant to this paragraph (e)(3) or otherwise and preserve each such record in accordance with § 240.17a–4.

(4) If the computation performed under paragraph (e)(3) of this section with respect to PAB accounts results in a deposit requirement, the requirement may be satisfied to the extent of any excess debit in the computation performed under paragraph (e)(3) of this section with respect to customer accounts of the same date. However, a deposit requirement resulting from the computation performed under paragraph (e)(3) of this section with respect to customer accounts cannot be satisfied with excess debits from the computation performed under paragraph (e)(3) of this section with respect to PAB accounts.

(5) In determining whether a broker or dealer maintains the minimum deposits required under this section, the broker or dealer must exclude the total amount of any cash deposited with an affiliated bank. The broker or dealer also must exclude cash deposited with a non-affiliated bank to the extent that the amount of the deposit exceeds 15% of the bank's equity capital as reported by the bank in its most recent Call Report or any successor form the bank is required to file by its appropriate Federal banking agency (as defined by section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)).

(f) *Notification of banks.* A broker or dealer required to maintain a Customer Reserve Bank Account and PAB Reserve Bank Account prescribed by paragraph (e)(1) of this section or who maintains a Special Account referred to in paragraph (k) of this section must obtain and preserve in accordance with § 240.17a–4 a written notification from each bank with which it maintains a Customer Reserve Bank Account, a PAB Reserve Bank Account, or a Special Account that the bank was informed that all cash and/or qualified securities deposited therein are being held by the bank for the exclusive benefit of the customers and account holders of the broker or dealer in accordance with the regulations of the Commission, and are being kept separate from any other accounts maintained by the broker or dealer with the bank, and the broker or dealer must have a written contract with the bank which provides that the cash and/or qualified securities will at no time be used directly or indirectly as security for a loan to the broker or dealer by the bank and will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

(g) *Withdrawals from the reserve bank account.* A broker or dealer may make withdrawals from a Customer Reserve Bank Account and a PAB Reserve Bank Account if and to the extent that at the time of the withdrawal the amount remaining in the Customer Reserve Bank Account and PAB Reserve Bank Account is not less than the amount then required by paragraph (e) of this section. A bank may presume that any request for withdrawal from a reserve bank account is in conformity and compliance with this paragraph (g). On any business day on which a withdrawal is made, the broker or dealer shall make a record of the computation on the basis of which he makes such withdrawal, and he shall preserve such computation in accordance with § 240.17a–4.

(h) *Buy-in of short security differences.* A broker or dealer shall within 45 calendar days after the date of the examination, count, verification and comparison of securities pursuant to

§ 240.17a–13 or otherwise or to the annual report of financial condition in accordance with § 240.17a–5 or 240.17a–12, buy-in all short security differences which are not resolved during the 45-day period.

(i) *Notification in the event of failure to make a required deposit.* If a broker or dealer shall fail to make in its Customer Reserve Bank Account, PAB Reserve Bank Account or special account a deposit, as required by this section, the broker or dealer shall by telegram immediately notify the Commission and the regulatory authority for the broker or dealer, which examines such broker or dealer as to financial responsibility and shall promptly thereafter confirm such notification in writing.

(j) *Treatment of free credit balances.* (1) A broker or dealer must not accept or use any free credit balance carried for the account of any customer of the broker or dealer unless such broker or dealer has established adequate procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent, together with or as part of the customer's statement of account, whenever sent but not less frequently than once every three months, a written statement informing the customer of the amount due to the customer by the broker or dealer on the date of the statement, and that the funds are payable on demand of the customer.

(2) A broker or dealer must not convert, invest, or transfer to another account or institution, credit balances held in a customer's account except as provided in paragraphs (j)(2)(i) and (ii) of this section.

(i) A broker or dealer is permitted to invest or transfer to another account or institution, free credit balances in a customer's account only upon a specific order, authorization, or draft from the customer, and only in the manner, and under the terms and conditions, specified in the order, authorization, or draft.

(ii) A broker or dealer is permitted to transfer free credit balances held in a customer's securities account to a product in its Sweep Program or to transfer a customer's interest in one product in a Sweep Program to another product in a Sweep Program, *provided:*

(A) For an account opened on or after the effective date of this paragraph (j)(2)(ii), the customer gives prior written affirmative consent to having free credit balances in the customer's securities account included in the Sweep Program after being notified:

(*1*) Of the general terms and conditions of the products available through the Sweep Program; and

(*2*) That the broker or dealer may change the products available under the Sweep Program.

(B) For any account:

(*1*) The broker or dealer provides the customer with the disclosures and notices regarding the Sweep Program required by each self-regulatory organization of which the broker or dealer is a member;

(*2*) The broker or dealer provides notice to the customer, as part of the customer's quarterly statement of account, that the balance in the bank deposit account or shares of the money market mutual fund in which the customer has a beneficial interest can be liquidated on the customer's order and the proceeds returned to the securities account or remitted to the customer; and

(*3*)(*i*) The broker or dealer provides the customer with written notice at least 30 calendar days before:

(*A*) Making changes to the terms and conditions of the Sweep Program;

(*B*) Making changes to the terms and conditions of a product currently available through the Sweep Program;

(*C*) Changing, adding or deleting products available through the Sweep Program; or

(*D*) Changing the customer's investment through the Sweep Program from one product to another.

(*ii*) The notice must describe the new terms and conditions of the Sweep Program or product or the new product, and the options available to the customer if the customer does not accept the new terms and conditions or product.

(k) *Exemptions.* (1) The provisions of this section shall not be applicable to a broker or dealer meeting all of the following conditions:

(i) The broker's or dealer's transactions as dealer (as principal for its own account) are limited to the purchase, sale, and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company; except that a broker or dealer transacting business as a sole proprietor may also effect occasional transactions in other securities for its own account with or through another registered broker or dealer;

(ii) The broker's or dealer's transactions as broker (agent) are limited to:

(*a*) The sale and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company;

(*b*) the solicitation of share accounts for savings and loan associations insured by an instrumentality of the United States; and

(*c*) the sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies; and

(iii) The broker or dealer promptly transmits all funds and delivers all securities received in connection with its activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.

(iv) Notwithstanding the foregoing, this section shall not apply to any insurance company which is a registered broker-dealer, and which otherwise meets all of the conditions in paragraphs (k)(1) (i), (ii), and (iii) of this section, solely by reason of its participation in transactions that are a part of the business of insurance, including the purchasing, selling, or holding of securities for or on behalf of such company's general and separate accounts.

(2) The provisions of this section shall not be applicable to a broker or dealer:

(i) Who carries no margin accounts, promptly transmits all customer funds and delivers all securities received in connection with its activities as a broker or dealer, does not otherwise hold funds or securities for, or owe money or securities to, customers and effectuates all financial transactions between the broker or dealer and its customers through one or more bank accounts, each to be designated as ''Special Account for the Exclusive Benefit of Customers of (name of the broker or dealer)''; or

(ii) Who, as an introducing broker or dealer, clears all transactions with and for customers on a fully disclosed basis with a clearing broker or dealer, and who promptly transmits all customer funds and securities to the clearing broker or dealer which carries all of the accounts of such customers and maintains and preserves such books and records pertaining thereto pursuant to the requirements of §§ 240.17a–3 and 240.17a–4 of this chapter, as are customarily made and kept by a clearing broker or dealer.

(3) Upon written application by a broker or dealer, the Commission may exempt such broker or dealer from the provisions of this section, either unconditionally or on specified terms and conditions, if the Commission finds that the broker or dealer has established safeguards for the protection of funds and securities of customers comparable with those provided for by this section and that it is not necessary in the public interest or for the protection of investors to subject the particular broker or dealer to the provisions of this section.

(l) *Delivery of securities.* Nothing stated in this section shall be construed as affecting the absolute right of a customer of a broker or dealer to receive in the course of normal business operations following demand made on the broker or dealer, the physical delivery of certificates for:

(1) Fully-paid securities to which he is entitled, and,

(2) Margin securities upon full payment by such customer to the broker or dealer of the customer's indebtedness to the broker or dealer; and, subject to the right of the broker or dealer under Regulation T (12 CFR 220) to retain collateral for its own protection beyond the requirements of Regulation T, excess margin securities not reasonably required to collateralize such customer's indebtedness to the broker or dealer.

(m) *Completion of sell orders on behalf of customers.* If a broker or dealer executes a sell order of a customer (other than an order to execute a sale of securities which the seller does not own) and if for any reason whatever the broker or dealer has not obtained possession of the securities from the customer within 10 business days after the settlement date, the broker or dealer shall immediately thereafter close the transaction with the customer by purchasing securities of like kind and quantity: *Provided, however,* The term *customer* for the purpose of this paragraph (m) shall not include a broker or dealer who maintains an omnibus credit account with another broker or dealer in compliance with secttion 7(f) of Regulation T (12 CFR 220.7(f)).

NOTE TO PARAGRAPH (m): See 38 FR 12103, May 9, 1973 for an order suspending indefinitely the operation of paragraph (m) as to sell orders for exempted securities (e.g., U.S. Government and municipal obligations).

(n) *Extensions of time.* If a registered national securities exchange or a registered national securities association is satisfied that a broker or dealer is acting in good faith in making the application and that exceptional circumstances warrant such action, such exchange or association, on application of the broker or dealer, may extend any period specified in paragraphs (d) (2) through (4), (h) and (m) of this section, relating to the requirement that such broker or dealer take action within a designated period of time to buy-in a security, for one or more limited periods commensurate with the circumstances. Each such exchange or association shall make and preserve for a period of not less than 3 years a record of each extension granted pursuant to paragraph (n) of this section which shall contain a summary of the justification for the granting of the extension.

(o) *Security futures products*—(1) *Where security futures products shall be held.* A broker or dealer registered with the Commission pursuant to section 15(b)(1) of the Act (15 U.S.C. 78*o*(b)(1)) that is also a futures commission merchant registered with the Commodity Futures Trading Commission pursuant to section 4f(a)(1) of the Commodity Exchange Act (7 U.S.C. 6f(a)(1)):

(i) Shall hold a customer's security futures products in either a securities account or a futures account; and

(ii) Shall establish written policies or procedures for determining whether customer security futures products will be placed in a securities account or a futures account and, if applicable, the process by which a customer may elect the type or types of account in which security futures products will be held (including the procedure to be followed if a customer fails to make an election of account type).

(2) *Disclosure and record requirements.* (i) Except as provided in paragraph (o)(2)(ii), before a broker or dealer registered with the Commission pursuant to section 15(b)(1) of the Act (15 U.S.C. 78o(b)(1)) accepts the first order for a security futures product from or on behalf of a customer, the broker or dealer shall furnish the customer with a disclosure document containing the following information:

(A) A description of the protections provided by the requirements set forth under this section and SIPA applicable to a securities account;

(B) A description of the protections provided by the requirements set forth under section 4d of the Commodity Exchange Act (7 U.S.C. 6d) applicable to a futures account;

(C) A statement indicating whether the customer's security futures products will be held in a securities account or a futures account, or whether the firm permits customers to make or change an election of account type; and

(D) A statement that, with respect to holding the customer's security futures products in a securities account or a futures account, the alternative regulatory scheme is not available to the customer with relation to that account.

(ii) Where a customer account containing an open security futures product position is transferred to a broker or dealer registered with the Commission pursuant to section 15(b)(1) of the Act (15 U.S.C. 78o(b)(1)), that broker or dealer may instead provide the statements described in paragraphs (o)(2)(i)(C) and (o)(2)(i)(D) of this section no later than ten business days after the date the account is received.

(3) *Changes in account type*. A broker or dealer registered with the Commission pursuant to section 15(b)(1) of the Act (15 U.S.C. 78*o*(b)(1)) that is also a futures commission merchant registered pursuant to section 4f(a)(1) of the Commodity Exchange Act (7 U.S.C. 6f(a)(1)) may change the type of account in which a customer's security futures products will be held; *provided* that:

(i) The broker or dealer creates a record of each change in account type, including the name of the customer, the account number, the date the broker or dealer received the customer's request to change the account type, if applicable, and the date the change in account type became effective; and

(ii) The broker or dealer, at least ten days before the customer's account type is changed:

(A) Notifies the customer in writing of the date that the change will become effective; and

(B) Provides the customer with the disclosures described in paragraph (o)(2)(i) of this section.

[37 FR 25226, Nov. 29, 1972; 38 FR 6277, Mar. 8, 1973, as amended at 42 FR 23790, May 10, 1977; 44 FR 1975, Jan. 9, 1979; 45 FR 37688, June 4, 1980; 47 FR 21775, May 20, 1982; 47 FR 23920, June 2, 1982; 50 FR 41340, Oct. 10, 1985; 52 FR 30333, Aug. 14, 1987; 63 FR 59400, Nov. 3, 1998; 67 FR 58299, Sept. 13, 2002; 68 FR 12783, Mar. 17, 2003; 78 FR 51902, Aug. 21, 2013]

§ 240.15c3–3a Exhibit A—Formula for determination of customer and PAB account reserve requirements of brokers and dealers under § 240.15c3–3.

	Credits	Debits
1. Free credit balances and other credit balances in customers' security accounts. (See Note A)	XXX	
2. Monies borrowed collateralized by securities carried for the accounts of customers (See Note B)	XXX	
3. Monies payable against customers' securities loaned (See Note C)	XXX	
4. Customers' securities failed to receive (See Note D)	XXX	
5. Credit balances in firm accounts which are attributable to principal sales to customers.	XXX	
6. Market value of stock dividends, stock splits and similar distributions receivable outstanding over 30 calendar days	XXX	
7. Market value of short security count differences over 30 calendar days old	XXX	
8. Market value of short securities and credits (not to be offset by longs or by debits) in all suspense accounts over 30 calendar days	XXX	
9. Market value of securities which are in transfer in excess of 40 calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer during the 40 days	XXX	
10. Debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection. (See Note E)	....	XXX
11. Securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver	....	XXX
12. Failed to deliver of customers' securities not older than 30 calendar days	....	XXX
13. Margin required and on deposit with the Options Clearing Corporation for all option contracts written or purchased in customer accounts. (See Note F)	....	XXX
14. Margin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q–1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1) related to the following types of positions written, purchased or sold in customer accounts: (1) security futures products and (2) futures contracts (and options thereon) carried in a securities account pursuant to an SRO portfolio margining rule (See Note G)	....	XXX
Total credits	....	
Total debits	....	
15. Excess of total credits (sum of items 1–9) over total debits (sum of items 10–14) required to be on deposit in the "Reserve Bank Account" (§ 240.15c3–3(e)). If the computation is made monthly as permitted by this section, the deposit must be not less than 105% of the excess of total credits over total debits.	....	XXX

NOTES REGARDING THE CUSTOMER RESERVE BANK ACCOUNT COMPUTATION

NOTE A. Item 1 must include all outstanding drafts payable to customers which have been applied against free credit balances or other credit balances and must also include checks drawn in excess of bank balances per the records of the broker or dealer.

NOTE B. Item 2 must include the amount of options-related or security futures product-related Letters of Credit obtained by a member of a registered clearing agency or a derivatives clearing organization which are collateralized by customers' securities, to the extent of the member's margin requirement at the registered clearing agency or derivatives clearing organization. Item 2 must also include the amount of Letters of Credit which are collateralized by customers' securities and related to other futures contracts (and options thereon) carried in a securities account pursuant to an SRO portfolio margining rule.

NOTE C. Item 3 must include in addition to monies payable against customers' securities loaned the amount by which the market value of securities loaned exceeds the collateral value received from the lending of such securities.

NOTE D. Item 4 must include in addition to customers' securities failed to receive the amount by which the market value of securities failed to receive and outstanding more than thirty (30) calendar days exceeds their contract value.

NOTE E. (1) Debit balances in margin accounts must be reduced by the amount by which a specific security (other than an exempted security) which is collateral for margin accounts exceeds in aggregate value 15 percent of the aggregate value of all securities which collateralize all margin accounts receivable; provided, however, the required reduction must not be in excess of the amounts of the debit balance required to be excluded because of this concentration rule. A specified security is deemed to be collateral for a margin account only to the extent it represents in value not more than 140 percent of the customer debit balance in a margin account.

(2) Debit balances in special omnibus accounts, maintained in compliance with the requirements of Section 7(f) of Regulation T (12 CFR 220.7(f)) or similar accounts carried on behalf of another broker or dealer, must be reduced by any deficits in such accounts (or if a credit, such credit must be increased) less any calls for margin, mark to the market, or other required deposits which are outstanding 5 business days or less.

(3) Debit balances in customers' cash and margin accounts included in the formula under Item 10 must be reduced by an amount equal to 1 percent of their aggregate value.

(4) Debit balances in cash and margin accounts of household members and other persons related to principals of a broker or dealer and debit balances in cash and margin accounts of affiliated persons of a broker or dealer must be excluded from the Reserve Formula, unless the broker or dealer can demonstrate that such debit balances are directly related to credit items in the formula.

(5) Debit balances in margin accounts (other than omnibus accounts) must be reduced by the amount by which any single customer's debit balance exceeds 25% (to the extent such amount is greater than $50,000) of the broker-dealer's tentative net capital (*i.e.*, net capital prior to securities haircuts) unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the Reserve Formula. Related accounts (*e.g.*, the separate accounts of an individual, accounts under common control or subject to cross guarantees) will be deemed to be a single customer's accounts for purposes of this provision.

If the registered national securities exchange or the registered national securities association having responsibility for examining the broker or dealer (''designated examining authority'') is satisfied, after taking into account the circumstances of the concentrated account including the quality, diversity, and marketability of the collateral securing the debit balances or margin accounts subject to this provision, that the concentration of debit balances is appropriate, then such designated examining authority may grant a partial or plenary exception from this provision. The debit balance may be included in the reserve formula computation for five business days from the day the request is made.

(6) Debit balances in joint accounts, custodian accounts, participation in hedge funds or limited partnerships or similar type accounts or arrangements that include both assets of a person or

persons who would be excluded from the definition of customer (''noncustomer'') and assets of a person or persons who would be included in the definition of customer must be included in the Reserve Formula in the following manner: If the percentage ownership of the non-customer is less than 5 percent then the entire debit balance shall be included in the formula; if such percentage ownership is between 5 percent and 50 percent then the portion of the debit balance attributable to the non-customer must be excluded from the formula unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the formula; or if such percentage ownership is greater than 50 percent, then the entire debit balance must be excluded from the formula unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the formula.

NOTE F. Item 13 must include the amount of margin required and on deposit with the Options Clearing Corporation to the extent such margin is represented by cash, proprietary qualified securities and letters of credit collateralized by customers' securities.

NOTE G. (a) Item 14 must include the amount of margin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q–1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1) for customer accounts to the extent that the margin is represented by cash, proprietary qualified securities, and letters of credit collateralized by customers' securities.

(b) Item 14 will apply only if the broker or dealer has the margin related to security futures products, or futures (and options thereon) carried in a securities account pursuant to an approved SRO portfolio margining program on deposit with:

(1) A registered clearing agency or derivatives clearing organization that:

(i) Maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least $2 billion, at least $500 million of which must be in the form of security deposits. For the purposes of this Note G, the term ''security deposits'' refers to a general fund, other than margin deposits or their equivalent, that consists of cash or securities held by a registered clearing agency or derivative clearing organization; or

(ii) Maintains at least $3 billion in margin deposits; or

(iii) Does not meet the requirements of paragraphs (b)(1)(i) through (b)(1)(iii) of this Note G, if the Commission has determined, upon a written request for exemption by or for the benefit of the broker or dealer, that the broker or dealer may utilize such a registered clearing agency or derivatives clearing organization. The Commission may, in its sole discretion, grant such an exemption subject to such conditions as are appropriate under the circumstances, if the Commission determines that such conditional or unconditional exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors; and

(2) A registered clearing agency or derivatives clearing organization that, if it holds funds or securities deposited as margin for security futures products or futures in a portfolio margin account in a bank, as defined in section 3(a)(6) of the Act (15 U.S.C. 78c(a)(6)), obtains and preserves written notification from the bank at which it holds such funds and securities or at which such funds and securities are held on its behalf. The written notification will state that all funds and/or securities deposited with the bank as margin (including customer security futures products and futures in a portfolio margin account), or held by the bank and pledged to such registered clearing agency or derivatives clearing agency as margin, are being held by the bank for the exclusive benefit of clearing members of the registered clearing agency or derivatives clearing organization (subject to the interest of such registered clearing agency or derivatives clearing organization therein), and are being kept separate from any other accounts maintained by the registered clearing agency or derivatives clearing organization with the bank.

The written notification also will provide that such funds and/or securities will at no time be used directly or indirectly as security for a loan to the registered clearing agency or derivatives clearing organization by the bank, and will be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank. This provision, however, will not prohibit a registered clearing agency or derivatives clearing organization from pledging customer funds or securities as collateral to a bank for any purpose that the rules of the Commission or the registered clearing agency or derivatives clearing organization otherwise permit; and

(3) A registered clearing agency or derivatives clearing organization establishes, documents, and maintains:

(i) Safeguards in the handling, transfer, and delivery of cash and securities;

(ii) Fidelity bond coverage for its employees and agents who handle customer funds or securities. In the case of agents of a registered clearing agency or derivatives clearing organization, the agent may provide the fidelity bond coverage; and

(iii) Provisions for periodic examination by independent public accountants; and

(iv) A derivatives clearing organization that, if it is not otherwise registered with the Commission, has provided the Commission with a written undertaking, in a form acceptable to the Commission, executed by a duly authorized person at the derivatives clearing organization, to the effect that, with respect to the clearance and settlement of the customer security futures products and futures in a portfolio margin account of the broker or dealer, the derivatives clearing organization will permit the Commission to examine the books and records of the derivatives clearing organization for compliance with the requirements set forth in § 240.15c3–3a, Note G (b)(1) through (3).

(c) Item 14 will apply only if a broker or dealer determines, at least annually, that the registered clearing agency or derivatives clearing organization with which the broker or dealer has on deposit margin related to securities future products or futures in a portfolio margin account meets the conditions of this Note G.

NOTES REGARDING THE PAB RESERVE BANK ACCOUNT COMPUTATION

NOTE 1. Broker-dealers should use the formula in Exhibit A for the purposes of computing the PAB reserve requirement, except that references to ''accounts,'' ''customer accounts, or ''customers'' will be treated as references to PAB accounts.

NOTE 2. Any credit (including a credit applied to reduce a debit) that is included in the computation required by § 240.15c3–3 with respect to customer accounts (the ''customer reserve computation'') may not be included as a credit in the computation required by § 240.15c3–3 with respect to PAB accounts (the ''PAB reserve computation'').

NOTE 3. Note E(1) to § 240.15c3–3a does not apply to the PAB reserve computation.

NOTE 4. Note E(3) to § 240.15c3–3a which reduces debit balances by 1% does not apply to the PAB reserve computation.

NOTE 5. Interest receivable, floor brokerage, and commissions receivable of another broker or dealer from the broker or dealer (excluding clearing deposits) that are otherwise allowable assets under § 240.15c3–1 need not be included in the PAB reserve computation, provided the amounts have been clearly identified as payables on the books of the broker or dealer. Commissions receivable and other receivables of another broker or dealer from the broker or dealer that are otherwise non-allowable assets under § 240.15c3–1 and clearing deposits of another broker or dealer may be included as ''credit balances'' for purposes of the PAB reserve computation, provided the commissions receivable and other receivables are subject to immediate cash payment to the other broker or dealer and the clearing deposit is subject to payment within 30 days.

NOTE 6. Credits included in the PAB reserve computation that result from the use of securities held for a PAB account (''PAB securities'') that are pledged to meet intra-day margin calls in a cross-margin account established between the Options Clearing Corporation and any regulated derivatives clearing organization may be reduced to the extent that the excess margin held by the other clearing corporation in the cross-margin relationship is used the following business day to replace the PAB securities that were previously pledged. In addition, balances resulting from a portfolio margin account that are segregated pursuant to Commodity Futures Trading Commission regulations need not be included in the PAB Reserve Bank Account computation.

NOTE 7. Deposits received prior to a transaction pending settlement which are $5 million or greater for any single transaction or $10 million in aggregate may be excluded as credits from the PAB reserve computation if such balances are placed and maintained in a separate PAB Reserve Bank Account by 12 p.m. Eastern Time on the following business day. Thereafter, the money representing any such deposits may be withdrawn to complete the related transactions without performing a new PAB reserve computation.

NOTE 8. A credit balance resulting from a PAB reserve computation may be reduced by the amount that items representing such credits are swept into money market funds or mutual funds of an investment company registered under the Investment Company Act of 1940 on or prior to 10 a.m. Eastern Time on the deposit date provided that the credits swept into any such fund are not subject to any right, charge, security interest, lien, or claim of any kind in favor of the investment company or the broker or dealer. Any credits that have been swept into money market funds or mutual funds must be maintained in the name of a particular broker or for the benefit of another broker.

NOTE 9. Clearing deposits required to be maintained at registered clearing agencies may be included as debits in the PAB reserve computation to the extent the percentage of the deposit, which is based upon the clearing agency's aggregate deposit requirements (*e.g.*, dollar trading volume), that relates to the proprietary business of other brokers and dealers can be identified.

NOTE 10. A broker or dealer that clears PAB accounts through an affiliate or third party clearing broker must include these PAB account balances and the omnibus PAB account balance in its PAB reserve computation.

[78 FR 51904, Aug. 21, 2013, as amended at 79 FR 1550, Jan. 8, 2014]

§ 240.15c3–4 Internal risk management control systems for OTC derivatives dealers.

(a) An OTC derivatives dealer shall establish, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.

(b) An OTC derivatives dealer shall consider the following when adopting its internal control system guidelines, policies, and procedures:

(1) The ownership and governance structure of the OTC derivatives dealer;

(2) The composition of the governing body of the OTC derivatives dealer;

(3) The management philosophy of the OTC derivatives dealer;

(4) The scope and nature of established risk management guidelines;

(5) The scope and nature of the permissible OTC derivatives activities;

(6) The sophistication and experience of relevant trading, risk management, and internal audit personnel;

(7) The sophistication and functionality of information and reporting systems; and

(8) The scope and frequency of monitoring, reporting, and auditing activities.

(c) An OTC derivatives dealer's internal risk management control system shall include the following elements:

(1) A risk control unit that reports directly to senior management and is independent from business trading units;

(2) Separation of duties between personnel responsible for entering into a transaction and those responsible for recording the transaction in the books and records of the OTC derivatives dealer;

(3) Periodic reviews (which may be performed by internal audit staff) and annual reviews (which must be conducted by independent certified public accountants) of the OTC derivatives dealer's risk management systems;

(4) Definitions of risk, risk monitoring, and risk management; and

(5) Written guidelines, approved by the OTC derivatives dealer's governing body, that include and discuss the following:

(i) The OTC derivatives dealer's consideration of the elements in paragraph (b) of this section;

(ii) The scope, and the procedures for determining the scope, of authorized activities or any nonquantitative limitation on the scope of authorized activities;

(iii) Quantitative guidelines for managing the OTC derivatives dealer's overall risk exposure;

(iv) The type, scope, and frequency of reporting by management on risk exposures;

(v) The procedures for and the timing of the governing body's periodic review of the risk monitoring and risk management written guidelines, systems, and processes;

(vi) The process for monitoring risk independent of the business or trading units whose activities create the risks being monitored;

(vii) The performance of the risk management function by persons independent from or senior to the business or trading units whose activities create the risks;

(viii) The authority and resources of the groups or persons performing the risk monitoring and risk management functions;

(ix) The appropriate response by management when internal risk management guidelines have been exceeded;

(x) The procedures to monitor and address the risk that an OTC derivatives transaction contract will be unenforceable;

(xi) The procedures requiring the documentation of the principal terms of OTC derivatives transactions and other relevant information regarding such transactions;

(xii) The procedures authorizing specified employees to commit the OTC derivatives dealer to particular types of transactions;

(xiii) The procedures to prevent the OTC derivatives dealer from engaging in any securities transaction that is not permitted under § 240.15a–1; and

(xiv) The procedures to prevent the OTC derivatives dealer from improperly relying on the exceptions to § 240.15a–1(c) and § 240.15a–1(d), including the procedures to determine whether a counterparty is acting in the capacity of principal or agent.

(d) Management must periodically review, in accordance with written procedures, the OTC derivatives dealer's business activities for consistency with risk management guidelines including that:

(1) Risks arising from the OTC derivatives dealer's OTC derivatives activities are consistent with prescribed guidelines;

(2) Risk exposure guidelines for each business unit are appropriate for the business unit;

(3) The data necessary to conduct the risk monitoring and risk management function as well as the valuation process over the OTC derivatives dealer's portfolio of products is accessible on a timely basis and information systems are available to capture, monitor, analyze, and report relevant data;

(4) Procedures are in place to enable management to take action when internal risk management guidelines have been exceeded;

(5) Procedures are in place to monitor and address the risk that an OTC derivatives transaction contract will be unenforceable;

(6) Procedures are in place to identify and address any deficiencies in the operating systems and to contain the extent of losses arising from unidentified deficiencies;

(7) Procedures are in place to authorize specified employees to commit the OTC derivatives dealer to particular types of transactions, to specify any quantitative limits on such authority, and to provide for the oversight of their exercise of such authority;

(8) Procedures are in place to prevent the OTC derivatives dealer from engaging in any securities transaction that is not permitted under § 240.15a–1;

(9) Procedures are in place to prevent the OTC derivatives dealer from improperly relying on the exceptions to § 240.15a–1(c) and § 240.15a–1(d), including procedures to determine whether a counterparty is acting in the capacity of principal or agent;

(10) Procedures are in place to provide for adequate documentation of the principal terms of OTC derivatives transactions and other relevant information regarding such transactions;

(11) Personnel resources with appropriate expertise are committed to implementing the risk monitoring and risk management systems and processes; and

(12) Procedures are in place for the periodic internal and external review of the risk monitoring and risk management functions.

[63 FR 59400, Nov. 3, 1998]

§ 240.15c3–5 Risk management controls for brokers or dealers with market access.

(a) For the purpose of this section:

(1) The term *market access* shall mean:

(i) Access to trading in securities on an exchange or alternative trading system as a result of being a member or subscriber of the exchange or alternative trading system, respectively; or

(ii) Access to trading in securities on an alternative trading system provided by a broker-dealer operator of an alternative trading system to a non-broker-dealer.

(2) The term *regulatory requirements* shall mean all federal securities laws, rules and regulations, and rules of self-regulatory organizations, that are applicable in connection with market access.

(b) A broker or dealer with market access, or that provides a customer or any other person with access to an exchange or alternative trading system through use of its market participant identifier or otherwise, shall establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of this business activity. Such broker or dealer shall preserve a copy of its supervisory procedures and a written description of its risk management controls as part of its books and records in a manner consistent with § 240.17a–4(e)(7). A broker-dealer that routes orders on behalf of an exchange or alternative trading system for the purpose of accessing other trading centers with protected quotations in compliance with Rule 611 of Regulation NMS (§ 242.611) for NMS stocks, or in compliance with a national market system plan for listed options, shall not be required to comply with this rule with regard to such routing services, except with regard to paragraph (c)(1)(ii) of this section.

(c) The risk management controls and supervisory procedures required by paragraph (b) of this section shall include the following elements:

(1) *Financial risk management controls and supervisory procedures.* The risk management controls and supervisory procedures shall be reasonably designed to systematically limit the financial exposure of the broker or dealer that could arise as a result of market access, including being reasonably designed to:

(i) Prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker or dealer and, where appropriate, more finely-tuned by sector, security, or otherwise by rejecting orders if such orders would exceed the applicable credit or capital thresholds; and

(ii) Prevent the entry of erroneous orders, by rejecting orders that exceed appropriate price or size parameters, on an order-by-order basis or over a short period of time, or that indicate duplicative orders.

(2) *Regulatory risk management controls and supervisory procedures.* The risk management controls and supervisory procedures shall be reasonably designed to ensure compliance with all regulatory requirements, including being reasonably designed to:

(i) Prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis;

(ii) Prevent the entry of orders for securities for a broker or dealer, customer, or other person if such person is restricted from trading those securities;

(iii) Restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by the broker or dealer; and

(iv) Assure that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access.

(d) The financial and regulatory risk management controls and supervisory procedures described in paragraph (c) of this section shall be under the direct and exclusive control of the broker or dealer that is subject to paragraph (b) of this section.

(1) Notwithstanding the foregoing, a broker or dealer that is subject to paragraph (b) of this section may reasonably allocate, by written contract, after a thorough due diligence review, control over specific regulatory risk management controls and supervisory procedures described in paragraph (c)(2) of this section to a customer that is a registered broker or dealer, provided that such broker or dealer subject to paragraph (b) of this section has a reasonable basis for determining that such customer, based on its position in the transaction and relationship with an ultimate customer, has better access than the broker or dealer to that ultimate customer and its trading information such that it can more effectively implement the specified controls or procedures.

(2) Any allocation of control pursuant to paragraph (d)(1) of this section shall not relieve a broker or dealer that is subject to paragraph (b) of this section from any obligation under this section, including the overall responsibility to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of market access.

(e) A broker or dealer that is subject to paragraph (b) of this section shall establish, document, and maintain a system for regularly reviewing the effectiveness of the risk management controls and supervisory procedures required by paragraphs (b) and (c) of this section and for promptly addressing any issues.

(1) Among other things, the broker or dealer shall review, no less frequently than annually, the business activity of the broker or dealer in connection with market access to assure the overall effectiveness of such risk management controls and supervisory procedures. Such review shall be conducted in accordance with written procedures and shall be documented. The broker or dealer shall preserve a copy of such written procedures, and documentation of each such review, as part of its books and records in a manner consistent with § 240.17a–4(e)(7) and § 240.17a–4(b), respectively.

(2) The Chief Executive Officer (or equivalent officer) of the broker or dealer shall, on an annual basis, certify that such risk management controls and supervisory procedures comply with paragraphs (b) and (c) of this section, and that the broker or dealer conducted such review, and such certifications shall be preserved by the broker or dealer as part of its books and records in a manner consistent with § 240.17a–4(b).

(f) The Commission, by order, may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any broker or dealer, if the Commission determines that such exemption is necessary or appropriate in the public interest consistent with the protection of investors.

[75 FR 69825, Nov. 15, 2010]

§ 240.15c6–1 Settlement cycle.

(a) Except as provided in paragraphs (b), (c), and (d) of this section, a broker or dealer shall not effect or enter into a contract for the purchase or sale of a security (other than an exempted security, government security, municipal security, commercial paper, bankers' acceptances, or commercial bills) that provides for payment of funds and delivery of securities later than the second business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction.

(b) Paragraphs (a) and (c) of this section shall not apply to contracts:

(1) For the purchase or sale of limited partnership interests that are not listed on an exchange or for which

quotations are not disseminated through an automated quotation system of a registered securities association;

(2) For the purchase or sale of securities that the Commission may from time to time, taking into account then existing market practices, exempt by order from the requirements of paragraph (a) of this section, either unconditionally or on specified terms and conditions, if the Commission determines that such exemption is consistent with the public interest and the protection of investors.

(c) Paragraph (a) of this section shall not apply to contracts for the sale for cash of securities that are priced after 4:30 p.m. Eastern time on the date such securities are priced and that are sold by an issuer to an underwriter pursuant to a firm commitment underwritten offering registered under the Securities Act of 1933 or sold to an initial purchaser by a broker-dealer participating in such offering provided that a broker or dealer shall not effect or enter into a contract for the purchase or sale of such securities that provides for payment of funds and delivery of securities later than the fourth business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction.

(d) For purposes of paragraphs (a) and (c) of this section, the parties to a contract shall be deemed to have expressly agreed to an alternate date for payment of funds and delivery of securities at the time of the transaction for a contract for the sale for cash of securities pursuant to a firm commitment offering if the managing underwriter and the issuer have agreed to such date for all securities sold pursuant to such offering and the parties to the contract have not expressly agreed to another date for payment of funds and delivery of securities at the time of the transaction.

[58 FR 52903, Oct. 13, 1993, as amended at 60 FR 26622, May 17, 1995; 82 FR 15601, Mar. 29, 2017]

REGULATION 15D: REPORTS OF REGISTRANTS UNDER THE SECURITIES ACT OF 1933

ANNUAL REPORTS

§ 240.15d–1 Requirement of annual reports.

Every registrant under the Securities Act of 1933 shall file an annual report, on the appropriate form authorized or prescribed therefor, for the fiscal year in which the registration statement under the Securities Act of 1933 became effective and for each fiscal year thereafter, unless the registrant is exempt from such filing by section 15(d) of the Act or rules thereunder. Annual reports shall be filed within the period specified in the appropriate report form.

[47 FR 17052, Apr. 21, 1982, as amended at 61 FR 49960, Sept. 24, 1996]

§ 240.15d–2 Special financial report.

(a) If the registration statement under the Securities Act of 1933 did not contain certified financial statements for the registrant's last full fiscal year (or for the life of the registrant if less than a full fiscal year) preceding the fiscal year in which the registration statement became effective, the registrant shall, within 90 days after the effective date of the registration statement, file a special report furnishing certified financial statements for such last full fiscal year or other period, as the case may be, meeting the requirements of the form appropriate for annual reports of the registrant. If the registrant is a foreign private issuer as defined in § 230.405 of this chapter, then the special financial report shall be filed on the appropriate form for annual reports of the registrant and shall be filed by the later of 90 days after the date on which the registration statement became effective, or four months following the end of the registrant's latest full fiscal year.

(b) The report shall be filed under cover of the facing sheet of the form appropriate for annual reports of the registrant, shall indicate on the facing sheet that it contains only financial statements for the fiscal year in question, and shall be signed in accordance with the requirements of the annual report form.

[13 FR 9326, Dec. 31, 1948, as amended at 36 FR 1891, Feb. 3, 1971; 58 FR 60306, Nov. 15, 1993; 73 FR 58324, Oct. 6, 2008; 83 FR 50222, Oct. 4, 2018]

§ 240.15d–3 Reports for depositary shares registered on Form F–6.

Annual and other reports are not required with respect to Depositary Shares registered on Form F–6 (§ 230.36 of this chapter). The exemption in this section does not apply to any deposited securities registered on any other form under the Securities Act of 1933.

[62 FR 39768, July 24, 1997]

§ 240.15d–4 Reporting by Form 40–F registrants.

A registrant that is eligible to use Forms 40–F and 6–K and files reports in accordance therewith shall be deemed to satisfy the requirements of Regulation 15D (§§ 240.15d–1 through 240.15d–21 of this chapter).

[56 FR 30075, July 1, 1991]

§ 240.15d–5 Reporting by successor issuers.

(a) Where in connection with a succession by merger, consolidation, exchange of securities, acquisition of assets or otherwise, securities of any issuer that is not required to file reports pursuant to section 15(d) (15 U.S.C. 78o(d)) of the Act are issued to the holders of any class of securities of another issuer that is required to file such reports, the duty to file reports pursuant to such section shall be deemed to have been assumed by the issuer of the class of securities so issued. The successor issuer shall, after the consummation of the succession, file reports in accordance with section 15(d) of the Act (15 U.S.C. 78o(d)) and the rules and regulations thereunder, unless that issuer is exempt from filing such reports or the duty to file such reports is suspended under section 15(d) of the Act (15 U.S.C. 78o(d)).

(b) An issuer that is deemed to be a successor issuer according to paragraph (a) of this section shall file reports on the same forms as the predecessor issuer except as follows:

(1) An issuer that is not a foreign issuer shall not be eligible to file on Form 20–F (§ 240.220f of this chapter).

(2) A foreign private issuer shall be eligible to file on Form 20–F.

(c) The provisions of paragraph (a) of this section shall not apply to an issuer of securities in connection with a succession that was registered on Form F–8 (§ 239.38 of this chapter), Form F–10 (§ 239.40 of this chapter) or Form F–80 (§ 239.41 of this chapter).

[36 FR 3805, Feb. 27, 1971, as amended at 48 FR 46740, Oct. 14, 1983; 56 FR 30075, July 1, 1991; 62 FR 39768, July 24, 1997]

§ 240.15d–6 Suspension of duty to file reports.

If the duty of an issuer to file reports pursuant to section 15(d) of the Act as to any fiscal year is suspended as provided in section 15(d) of the Act, such issuer shall, within 30 days after the beginning of the first fiscal year, file a notice on Form 15 informing the Commission of such suspension unless Form 15 has already been filed pursuant to Rule 12h–3. If the suspension resulted from the issuer's merger into, or consolidation with, another issuer or issuers, the notice shall be filed by the successor issuer.

(Secs. 12(g)(4), 12(h), 13(a), 15(d), 23(a), 48 Stat. 892, 894, 895, 901; sec. 203(a), 49 Stat. 704; secs. 3, 8, 49 Stat. 1377, 1379; secs. 3, 4, 6, 78 Stat. 565–568, 569, 570–574; sec. 18, 89 Stat. 155; sec. 204, 91 Stat. 1500; 15 U.S.C. 78*l*(g)(4), 78*l*(h), 78m(a), 78o(d), 78w(a))

[49 FR 12690, Mar. 30, 1984]

OTHER REPORTS

§ 240.15d–10 Transition reports.

(a) Every issuer that changes its fiscal closing date shall file a report covering the resulting transition period between the closing date of its most recent fiscal year and the opening date of its new fiscal year; *Provided, however*, that an issuer shall file an annual report for any fiscal year that ended before the date on which the issuer determined to change its fiscal year end. In no event shall the transition report cover a period of 12 or more months.

(b) The report pursuant to this section shall be filed for the transition period not more than the number of days specified in paragraph (j) of this section after either the close of the transition period or the date of the determination to change the fiscal closing date, whichever is later. The report shall be filed on the form appropriate for annual reports of the issuer, shall cover the period from the close of the last fiscal year end and shall indicate clearly the period covered. The financial statements for the transition period filed therewith shall be audited. Financial statements, which may be unaudited, shall be filed for the comparable period of the prior year, or a footnote, which may be unaudited, shall state for the comparable period of the prior year, revenues, gross profits, income taxes, income or loss from continuing operations and net income or loss. The effects of any discontinued operations as classified under the provisions of generally accepted accounting principles also shall be shown, if applicable. Per share data based upon such income or loss and net income or loss shall be presented in conformity with applicable accounting standards. Where called for by the time span to be covered, the comparable period financial statements or footnote shall be included in subsequent filings.

(c) If the transition period covers a period of less than six months, in lieu of the report required by paragraph (b) of this section, a report may be filed for the transition period on Form 10–Q (§ 249.308 of this chapter) not more than the number of days specified in paragraph (j) of this section after either the close of the transition period or the date of the determination to change the fiscal closing date, whichever is later. The report on Form 10–Q shall cover the period from the close of the last fiscal year end and shall indicate clearly the period covered. The financial statements filed therewith need not be audited but, if they are not audited, the issuer shall file with the first annual report for the newly adopted fiscal year separate audited statements of income and cash flows covering the transition period. The notes to financial statements for the transition period included in such first annual report may be integrated with the notes to financial statements for the full fiscal period. A separate audited balance sheet as of the end of the transition period shall be filed in the annual report only if the audited balance sheet as of the end of the fiscal year before the transition period is not filed. Schedules need not be filed in transition reports on Form 10–Q.

(d) Notwithstanding the foregoing in paragraphs (a), (b), and (c) of this section, if the transition period covers a period of one month or less, the issuer need not file a separate transition report if either:

(1) The first report required to be filed by the issuer for the newly adopted fiscal year after the date of the determination to change the fiscal year end is an annual report, and that report covers the transition period as well as the fiscal year; or

(2)(i) The issuer files with the first annual report for the newly adopted fiscal year separate audited statements of income and cash flows covering the transition period; and

(ii) The first report required to be filed by the issuer for the newly adopted fiscal year after the date of the determination to change the fiscal year end is a quarterly report on Form 10–Q; and

(iii) Information on the transition period is included in the issuer's quarterly report on Form 10–Q for the first quarterly period (except the fourth quarter) of the newly adopted fiscal year that ends after the date of the determination to change the fiscal year. The information covering the transition period required by Part II and Item 2 of Part I may be combined with the information regarding the quarter. However, the financial statements required by Part I, which may be unaudited, shall be furnished separately for the transition period.

(e) Every issuer required to file quarterly reports on Form 10–Q pursuant to § 240.15d–13 that changes its fiscal year end shall:

(1) File a quarterly report on Form 10–Q within the time period specified in General Instruction A.1. to that form for any quarterly period (except the fourth quarter) of the old fiscal year that ends before the date on which the issuer determined to change its fiscal year end, except that the issuer need not file such quarterly report if the

date on which the quarterly period ends also is the date on which the transition period ends;

(2) File a quarterly report on Form 10–Q within the time specified in General Instruction A.1 to that form for each quarterly period of the old fiscal year within the transition period. In lieu of a quarterly report for any quarter of the old fiscal year within the transition period, the issuer may file a quarterly report on Form 10–Q for any period of three months within the transition period that coincides with a quarter of the newly adopted fiscal year if the quarterly report is filed within the number of days specified in paragraph (j) of this section after the end of such three month period, provided the issuer thereafter continues filing quarterly reports on the basis of the quarters of the newly adopted fiscal year;

(3) Commence filing quarterly reports for the quarters of the new fiscal year no later than the quarterly report for the first quarter of the new fiscal year that ends after the date on which the issuer determined to change the fiscal year end; and

(4) Unless such information is or will be included in the transition report, or the first annual report on Form 10–K for the newly adopted fiscal year, include in the initial quarterly report on Form 10–Q for the newly adopted fiscal year information on any period beginning on the first day after the period covered by the issuer's final quarterly report on Form 10–Q or annual report on Form 10–K for the old fiscal year. The information covering such period required by Part II and Item 2 of Part I may be combined with the information regarding the quarter. However, the financial statements required by Part I, which may be unaudited, shall be furnished separately for such period.

NOTE TO PARAGRAPHS (c) AND (e): If it is not practicable or cannot be cost-justified to furnish in a transition report on Form 10–Q or a quarterly report for the newly adopted fiscal year financial statements for corresponding periods of the prior year where required, financial statements may be furnished for the quarters of the preceding fiscal year that most nearly are comparable if the issuer furnishes an adequate discussion of seasonal and other factors that could affect the comparability of information or trends reflected, an assessment of the comparability of the data, and a representation as to the reason recasting has not been undertaken.

(f) Every successor issuer that has a different fiscal year from that of its predecessor(s) shall file a transition report pursuant to this section, containing the required information about each predecessor, for the transition period, if any, between the close of the fiscal year covered by the last annual report of each predecessor and the date of succession. The report shall be filed for the transition period on the form appropriate for annual reports of the issuer not more than the number of days specified in paragraph (j) of this section after the date of the succession, with financial statements in conformity with the requirements set forth in paragraph (b) of this section. If the transition period covers a period of less than six months, in lieu of a transition report on the form appropriate for the issuer's annual reports, the report may be filed for the transition period on Form 10-Q not more than the number of days specified in paragraph (j) of this section after the date of the succession, with financial statements in conformity with the requirements set forth in paragraph (c) of this section. Notwithstanding the foregoing, if the transition period covers a period of one month or less, the successor issuer need not file a separate transition report if the information is reported by the successor issuer in conformity with the requirements set forth in paragraph (d) of this section.

(g)(1) Paragraphs (a) through (f) of this section shall not apply to foreign private issuers.

(2) Every foreign private issuer that changes its fiscal closing date shall file a report covering the resulting transition period between the closing date of its most recent year and the opening date of its new fiscal year. In no event shall a transition report cover a period longer than 12 months.

(3) The report for the transition period shall be filed on Form 20–F (§ 249.220f of this chapter) responding to all items to which such issuer is required to respond when Form 20–F is used as an annual report. The financial statements for the transition period

filed therewith shall be audited. The report shall be filed within four months after either the close of the transition period or the date on which the issuer made the determination to change the fiscal closing date, whichever is later.

(4) If the transition period covers a period of six or fewer months, in lieu of the report required by paragraph (g)(3) of this section, a report for the transition period may be filed on Form 20–F responding to Items 5, 8.A.7., 13, 14, and 17 or 18 within three months after either the close of the transition period or the date on which the issuer made the determination to change the fiscal closing date, whichever is later. The financial statements required by either Item 17 or Item 18 shall be furnished for the transition period. Such financial statements may be unaudited and condensed as permitted in Article 10 of Regulation S-X (§ 210.10–01 of this chapter), but if the financial statements are unaudited and condensed, the issuer shall file with the first annual report for the newly adopted fiscal year separate audited statements of income and cash flows covering the transition period.

(5) Notwithstanding the foregoing in paragraphs (g)(2), (g)(3), and (g)(4) of this section, if the transition period covers a period of one month or less, a foreign private issuer need not file a separate transition report if the first annual report for the newly adopted fiscal year covers the transition period as well as the fiscal year.

(h) The provisions of this rule shall not apply to investment companies required to file reports pursuant to Rule 30a–1 (§ 270.30a–1 of this chapter) under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*).

(i) No filing fee shall be required for a transition report filed pursuant to this section.

(j)(1) For transition reports to be filed on the form appropriate for annual reports of the issuer, the number of days shall be:

(i) 60 days (75 days for fiscal years ending before December 15, 2006) for large accelerated filers (as defined in § 240.12b–2);

(ii) 75 days for accelerated filers (as defined in § 240.12b–2); and

(iii) 90 days for all other issuers; and

(2) For transition reports to be filed on Form 10–Q (§ 249.308 of this chapter), the number of days shall be:

(i) 40 days for large accelerated filers and accelerated filers (as defined in § 240.12b–2); and

(ii) 45 days for all other issuers.

(k)(1) Paragraphs (a) through (g) of this section shall not apply to asset-backed issuers.

(2) Every asset-backed issuer that changes its fiscal closing date shall file a report covering the resulting transition period between the closing date of its most recent fiscal year and the opening date of its new fiscal year. In no event shall a transition report cover a period longer than 12 months.

(3) The report for the transition period shall be filed on Form 10–K (§ 249.310 of this chapter) responding to all items to which such asset-backed issuer is required to respond pursuant to General Instruction J. of Form 10–K. Such report shall be filed within 90 days after the later of either the close of the transition period or the date on which the issuer made the determination to change the fiscal closing date.

(4) Notwithstanding the foregoing in paragraphs (k)(2) and (k)(3) of this section, if the transition period covers a period of one month or less, an asset-backed issuer need not file a separate transition report if the first annual report for the newly adopted fiscal year covers the transition period as well as the fiscal year.

(5) Any obligation of the asset-backed issuer to file distribution reports pursuant to § 240.15d–17 will continue to apply regardless of a change in the asset-backed issuer's fiscal closing date.

NOTE 1: In addition to the report or reports required to be filed pursuant to this section, every issuer, except a foreign private issuer or an investment company required to file reports pursuant to § 270.30b1–1 of this chapter, that changes its fiscal closing date is required to file a Form 8–K (§ 249.308 of this chapter) report that includes the information required by Item 5.03 of Form 8–K within the period specified in General Instruction B.1. to that form.

NOTE 2: The report or reports to be filed pursuant to this section must include the certification required by § 240.15d–14.

[54 FR 10318, Mar. 13, 1989, as amended at 56 FR 30075, July 1, 1991; 64 FR 53912, Oct. 5, 1999; 67 FR 57289, Sept. 9, 2002; 67 FR 58505, Sept. 16, 2002; 69 FR 15618, Mar. 25, 2004; 69 FR 68236, Nov. 23, 2004; 70 FR 1622, Jan. 7, 2005; 70 FR 76642, Dec. 27, 2005; 73 FR 978, Jan. 4, 2008; 73 FR 58324, Oct. 6, 2008; 81 FR 82020, Nov. 18, 2016; 83 FR 50222, Oct. 4, 2018]

§ 240.15d–11 Current reports on Form 8–K (§ 249.308 of this chapter).

(a) Except as provided in paragraph (b) of this section, every registrant subject to § 240.15d–1 shall file a current report on Form 8–K within the period specified in that form unless substantially the same information as that required by Form 8–K has been previously reported by the registrant.

(b) This section shall not apply to foreign governments, foreign private issuers required to make reports on Form 6–K (17 CFR 249.306) pursuant to § 240.15d–16, issuers of American Depositary Receipts for securities of any foreign issuer, or investment companies required to file reports pursuant to § 270.30a–1 of this chapter under the Investment Company Act of 1940, except where such an investment company is required to file:

(1) Notice of a blackout period pursuant to § 245.104 of this chapter;

(2) Disclosure pursuant to Instruction 2 to § 240.14a–11(b)(1) of information concerning outstanding shares and voting; or

(3) Disclosure pursuant to Instruction 2 to § 240.14a–11(b)(10) of the date by which a nominating shareholder or nominating shareholder group must submit the notice required pursuant to § 240.14a–11(b)(10).

(c) No failure to file a report on Form 8–K that is required solely pursuant to Item 1.01, 1.02, 2.03, 2.04, 2.05, 2.06, 4.02(a), 5.02(e) or 6.03 of Form 8-K shall be deemed to be a violation of 15 U.S.C. 78j(b) and § 240.10b–-5.

[42 FR 4429, Jan. 25, 1977, as amended at 50 FR 27939, July 9, 1985; 68 FR 4355, Jan. 28, 2002; 69 FR 15618, Mar. 25, 2004; 70 FR 1622, Jan. 7, 2005; 71 FR 53263, Sept. 8, 2006; 75 FR 56792, Sept. 16, 2010; 81 FR 82020, Nov. 18, 2016]

§ 240.15d–13 Quarterly reports on Form 10–Q (§ 249.308 of this chapter).

(a) Except as provided in paragraphs (b) and (c) of this section, every issuer that has securities registered pursuant to the Securities Act and is required to file annual reports pursuant to section 15(d) of the Act on Form 10–K (§ 249.310 of this chapter) shall file a quarterly report on Form 10–Q (§ 249.308 of this chapter) within the period specified in General Instruction A.1 to that form for each of the first three quarters of each fiscal year of the issuer, commencing with the first fiscal quarter following the most recent fiscal year for which full financial statements were included in the registration statement, or, if the registration statement included financial statements for an interim period after the most recent fiscal year end meeting the requirements of Article 10 of Regulation S–X, or Rule 8–03 of Regulation S–X for smaller reporting companies, for the first fiscal quarter after the quarter reported upon in the registration statement. The first quarterly report of the issuer shall be filed either within 45 days after the effective date of the registration statement or on or before the date on which such report would have been required to be filed if the issuer had been required to file reports on Form 10–Q as of its last fiscal quarter, whichever is later.

(b) The provisions of this rule shall not apply to the following issuers:

(1) Investment companies required to file reports pursuant to § 270.30a–1;

(2) Foreign private issuers required to file reports pursuant to § 240.15d–16; and

(3) Asset-backed issuers required to file reports pursuant to § 240.15d–17.

(c) Part I of the quarterly reports on Form 10-Q need not be filed by:

(1) Mutual life insurance companies; or

(2) Mining companies not in the production stage but engaged primarily in the exploration for the development of mineral deposits other than oil, gas or coal, if all of the following conditions are met:

(i) The registrant has not been in production during the current fiscal year or the two years immediately prior thereto; except that being in production for an aggregate period of not more than eight months over the three-year period shall not be a violation of this condition.

(ii) Receipts from the sale of mineral products or from the operations of mineral producing properties by the registrant and its subsidiaries combined have not exceeded $500,000 in any of the most recent six years and have not aggregated more than $1,500,000 in the most recent six fiscal years.

(d) Notwithstanding the foregoing provisions of this section, the financial information required by Part I of Form 10–Q shall not be deemed to be ''filed'' for the purpose of section 18 of the Act or otherwise subject to the liabilities of that section of the Act, but shall be subject to all other provisions of the Act.

(e) Notwithstanding the foregoing provisions of this section, the financial information required by Part I of Form 10–Q, or financial information submitted in lieu thereof pursuant to paragraph (d) of this section, shall not be deemed to be ''filed'' for the purpose of section 18 of the Act or otherwise subject to the liabilities of that section of the Act, but shall be subject to all other provisions of the Act.

[42 FR 24065, May 12, 1977, as amended at 46 FR 63255, Dec. 31, 1981; 50 FR 27939, July 9, 1985; 54 FR 10319, Mar. 13, 1989, 61 FR 30403, June 14, 1996; 70 FR 1622, Jan. 7, 2005; 73 FR 978, Jan. 4, 2008; 81 FR 82020, Nov. 18, 2016]

§ 240.15d–14 Certification of disclosure in annual and quarterly reports.

(a) Each report, including transition reports, filed on Form 10–Q, Form 10–K, Form 20–F or Form 40–F (§ 249.308a, § 249.310, § 249.220f or § 249.240f of this chapter) under section 15(d) of the Act (15 U.S.C. 78o(d)), other than a report filed by an Asset-Backed Issuer (as defined in § 229.1101 of this chapter) or a report on Form 20–F filed under § 240.15d–19, must include certifications in the form specified in the applicable exhibit filing requirements of such report, and such certifications must be filed as an exhibit to such report. Each principal executive and principal financial officer of the issuer, or persons performing similar functions, at the time of filing of the report must sign a certification. The principal executive and principal financial officers of an issuer may omit the portion of the introductory language in paragraph 4 as well as language in paragraph 4(b) of the certification that refers to the certifying officers' responsibility for designing, establishing and maintaining internal control over financial reporting for the issuer until the issuer becomes subject to the internal control over financial reporting requirements in § 240.13a–15 or § 240.15d–15.

(b) Each periodic report containing financial statements filed by an issuer pursuant to section 15(d) of the Act (15 U.S.C. 78o(d)) must be accompanied by the certifications required by Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) and such certifications must be furnished as an exhibit to such report as specified in the applicable exhibit requirements for such report. Each principal executive and principal financial officer of the issuer (or equivalent thereof) must sign a certification. This requirement may be satisfied by a single certification signed by an issuer's principal executive and principal financial officers.

(c) A person required to provide a certification specified in paragraph (a), (b) or (d) of this section may not have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority.

(d) Each annual report and transition report filed on Form 10–K (§ 249.310 of this chapter) by an asset-backed issuer under section 15(d) of the Act (15 U.S.C. 78o(d)) must include a certification in the form specified in the applicable exhibit filing requirements of such report and such certification must be filed as an exhibit to such report. Terms used in paragraphs (d) and (e) of this section have the same meaning as in Item 1101 of Regulation AB (§ 229.1101 of this chapter).

(e) With respect to asset-backed issuers, the certification required by paragraph (d) of this section must be signed by either:

(1) The senior officer in charge of securitization of the depositor if the depositor is signing the report; or

(2) The senior officer in charge of the servicing function of the servicer if the

servicer is signing the report on behalf of the issuing entity. If multiple servicers are involved in servicing the pool assets, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent function) must sign if a representative of the servicer is to sign the report on behalf of the issuing entity.

(f) The certification requirements of this section do not apply to an Interactive Data File, as defined in § 232.11 of this chapter (Rule 11 of Regulation S–T).

[67 FR 57289, Sept. 9, 2002, as amended at 68 FR 36666, June 18, 2003; 70 FR 1622, Jan. 7, 2005; 70 FR 6572, Feb. 8, 2005; 70 FR 42247, July 21, 2005; 71 FR 76596, Dec. 21, 2006; 73 FR 979, Jan. 4, 2008; 74 FR 6819, Feb. 10, 2009; 83 FR 40878, Aug. 16, 2018]

§ 240.15d–15 Controls and procedures.

(a) Every issuer that files reports under section 15(d) of the Act (15 U.S.C. 78o(d)), other than an Asset Backed Issuer (as defined in § 229.1101 of this chapter), a small business investment company registered on Form N–5 (§§ 239.24 and 274.5 of this chapter), or a unit investment trust as defined in section 4(2) of the Investment Company Act of 1940 (15 U.S.C. 80a–4(2)), must maintain disclosure controls and procedures (as defined in paragraph (e) of this section) and, if the issuer either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year, internal control over financial reporting (as defined in paragraph (f) of this section).

(b) Each such issuer's management must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness of the issuer's disclosure controls and procedures, as of the end of each fiscal quarter, except that management must perform this evaluation:

(1) In the case of a foreign private issuer (as defined in § 240.3b–4) as of the end of each fiscal year; and

(2) In the case of an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8), within the 90-day period prior to the filing date of each report requiring certification under § 270.30a–2 of this chapter.

(c) The management of each such issuer, that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34–55929 will satisfy the evaluation required by this paragraph.

(d) The management of each such issuer that previously either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8), must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, any change in the issuer's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters, or fiscal year in the case of a foreign private issuer, that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

(e) For purposes of this section, the term disclosure controls and procedures means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act (15 U.S.C. 78a *et seq.*) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(f) The term *internal control over financial reporting* is defined as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

[68 FR 36667, June 18, 2003, as amended at 70 FR 1622, Jan. 7, 2005; 71 FR 76596, Dec. 21, 2006; 72 FR 35322, June 27, 2007]

§ 240.15d–16 Reports of foreign private issuers on Form 6–K [17 CFR 249.306].

(a) Every foreign private issuer which is subject to Rule 15d–1 [17 CFR 240.15d–1] shall make reports on Form 6–K, except that this rule shall not apply to:

(1) Investment companies required to file reports pursuant to § 270.30a–1 of this chapter;

(2) Issuers of American depositary receipts for securities of any foreign issuer; and

(3) Asset-backed issuers, as defined in § 229.1101 of this chapter.

(b) Such reports shall be transmitted promptly after the information required by Form 6–K is made public by the issuer, by the country of its domicile or under the laws of which it was incorporated or organized or by a foreign securities exchange with which the issuer has filed the information.

(c) Reports furnished pursuant to this rule shall not be deemed to be ''filed'' for the purpose of section 18 of the Act or otherwise subject to the liabilities of that section.

[32 FR 7849, May 30, 1967, as amended at 44 FR 70137, Dec. 6, 1979; 47 FR 54781, Dec. 6, 1982; 50 FR 27939, July 9, 1985; 56 FR 30075, July 1, 1991; 70 FR 1622, Jan. 7, 2005; 81 FR 82020, Nov. 18, 2016]

§ 240.15d–17 Reports of asset-backed issuers on Form 10–D (§ 249.312 of this chapter).

Every asset-backed issuer subject to § 240.15d–1 shall make reports on Form 10–D (§ 249.312 of this chapter). Such reports shall be filed within the period specified in Form 10–D.

[70 FR 1622, Jan. 7, 2005]

§ 240.15d–18 Compliance with servicing criteria for asset-backed securities.

(a) This section applies to every class of asset-backed securities subject to the reporting requirements of section 15(d) of the Act (15 U.S.C. 78o(d)). Terms used in this section have the same meaning as in Item 1101 of Regulation AB (§ 229.1101 of this chapter).

(b) *Reports on assessments of compliance with servicing criteria for asset-backed securities required.* With regard to a class of asset-backed securities subject to the reporting requirements of section 15(d) of the Act, the annual report on Form 10–K (§ 249.308 of this chapter) for such class must include from each party participating in the servicing function a report regarding its assessment of compliance with the servicing criteria specified in paragraph (d) of Item 1122 of Regulation AB (§ 229.1122(d) of this chapter), as of and for the period ending the end of each fiscal year, with respect to asset-backed securities transactions taken as a whole involving the party participating in the servicing function and that are backed by the same asset type backing the class of asset-backed securities (including the asset-backed securities transaction that is to be the subject of the report on Form 10–K for that fiscal year).

(c) *Attestation reports on assessments of compliance with servicing criteria for asset-backed securities required.* With respect to each report included pursuant to paragraph (b) of this section, the annual report on Form 10–K must also include a report by a registered public accounting firm that attests to, and reports on, the assessment made by the asserting party. The attestation report on assessment of compliance with servicing criteria for asset-backed securities must be made in accordance with standards for attestation engagements issued or adopted by the Public Company Accounting Oversight Board.

NOTE TO § 240.15d–18: If multiple parties are participating in the servicing function, a separate assessment report and attestation report must be included for each party participating in the servicing function. A party participating in the servicing function means any entity (e.g., master servicer, primary servicers, trustees) that is performing activities that address the criteria in paragraph (d) of Item 1122 of Regulation AB (§ 229.1122(d) of this chapter), unless such entity's activities relate only to 5% or less of the pool assets.

[70 FR 1622, Jan. 7, 2005]

§ 240.15d–19 Reports by shell companies on Form 20–F.

Every foreign private issuer that was a shell company, other than a business combination related shell company, immediately before a transaction that causes it to cease to be a shell company shall, within four business days of completion of that transaction, file a report on Form 20–F (§ 249.220f of this chapter) containing the information that would be required if the issuer were filing a form for registration of securities on Form 20–F to register under the Act all classes of the issuer's securities subject to the reporting requirements of section 13 (15 U.S.C. 78m) or section 15(d) (15 U.S.C. 78o(d)) of the Act upon consummation of the transaction, with such information reflecting the registrant and its securities upon consummation of the transaction.

[70 FR 42247, July 21, 2005]

§ 240.15d–20 Plain English presentation of specified information.

(a) Any information included or incorporated by reference in a report filed under section 15(d) of the Act (15 U.S.C. 78o(d)) that is required to be disclosed pursuant to Item 402, 403, 404 or 407 of Regulation S–K (§ 229.402, § 229.403, § 229.404 or § 229.407 of this chapter) must be presented in a clear, concise and understandable manner. You must prepare the disclosure using the following standards:

(1) Present information in clear, concise sections, paragraphs and sentences;

(2) Use short sentences;

(3) Use definite, concrete, everyday words;

(4) Use the active voice;

(5) Avoid multiple negatives;

(6) Use descriptive headings and subheadings;

(7) Use a tabular presentation or bullet lists for complex material, wherever possible;

(8) Avoid legal jargon and highly technical business and other terminology;

(9) Avoid frequent reliance on glossaries or defined terms as the primary means of explaining information. Define terms in a glossary or other section of the document only if the meaning is unclear from the context. Use a

glossary only if it facilitates understanding of the disclosure; and

(10) In designing the presentation of the information you may include pictures, logos, charts, graphs and other design elements so long as the design is not misleading and the required information is clear. You are encouraged to use tables, schedules, charts and graphic illustrations that present relevant data in an understandable manner, so long as such presentations are consistent with applicable disclosure requirements and consistent with other information in the document. You must draw graphs and charts to scale. Any information you provide must not be misleading.

(b) [Reserved]

NOTE TO § 240.15d–20: In drafting the disclosure to comply with this section, you should avoid the following:

1. Legalistic or overly complex presentations that make the substance of the disclosure difficult to understand;

2. Vague ''boilerplate'' explanations that are imprecise and readily subject to different interpretations;

3. Complex information copied directly from legal documents without any clear and concise explanation of the provision(s); and

4. Disclosure repeated in different sections of the document that increases the size of the document but does not enhance the quality of the information.

[71 FR 53263, Sept. 8, 2006, as amended at 73 FR 979, Jan. 4, 2008]

EXEMPTION OF CERTAIN ISSUERS FROM SECTION 15(d) OF THE ACT

§ 240.15d–21 Reports for employee stock purchase, savings and similar plans.

(a) Separate annual and other reports need not be filed pursuant to section 15(d) of the Act with respect to any employee stock purchase, savings or similar plan: *Provided*,

(1) The issuer of the stock or other securities offered to employees through their participation in the plan files annual reports on Form 10–K (§ 249.310 of this chapter); and

(2) Such issuer furnishes, as a part of its annual report on such form or as an amendment thereto, the financial statements required by Form 11–K (§ 249.311 of this chapter) with respect to the plan.

(b) If the procedure permitted by this Rule is followed, the financial statements required by Form 11–K with respect to the plan shall be filed within 120 days after the end of the fiscal year of the plan, either as a part of or as an amendment to the annual report of the issuer for its last fiscal year, *provided that* if the fiscal year of the plan ends within 62 days prior to the end of the fiscal year of the issuer, such information, financial statements and exhibits may be furnished as a part of the issuer's next annual report. If a plan subject to the Employee Retirement Income Security Act of 1974 uses the procedure permitted by this Rule, the financial statements required by Form 11–K shall be filed within 180 days after the plan's fiscal year end.

[27 FR 7871, Aug. 9, 1962, as amended at 55 FR 23929, June 13, 1990; 73 FR 979, Jan. 4, 2008]

§ 240.15d–22 Reporting regarding asset-backed securities under section 15(d) of the Act.

(a) With respect to an offering of asset-backed securities registered pursuant to § 230.415(a)(1)(vii) or § 230.415(a)(1)(xii) of this chapter:

(1) Annual and other reports need not be filed pursuant to section 15(d) of the Act (15 U.S.C. 78o(d)) regarding any class of securities to which such registration statement relates until the first bona fide sale in a takedown of securities under the registration statement; and

(2) The starting and suspension dates for any reporting obligation under section 15(d) of the Act (15 U.S.C. 78o(d)) with respect to a takedown of any class of asset-backed securities are determined separately for each takedown of securities under the registration statement.

(b) The duty to file annual and other reports pursuant to section 15(d) of the Act (15 U.S.C. 78o(d)) regarding any class of asset-backed securities is suspended:

(1) As to any semi-annual fiscal period, if, at the beginning of the semi-annual fiscal period, other than a period in the fiscal year within which the registration statement became effective, or, for offerings conducted pursuant to § 230.415(a)(1)(vii) or § 230.415(a)(1)(xii), the takedown for the

offering occurred, there are no asset-backed securities of such class that were sold in a registered transaction held by non-affiliates of the depositor and a certification on Form 15 (17 CFR 249.323) has been filed; or

(2) When there are no asset-backed securities of such class that were sold in a registered transaction still outstanding, immediately upon filing with the Commission a certification on Form 15 (17 CFR 249.323) if the issuer of such class has filed all reports required by Section 13(a), without regard to Rule 12b–25 (17 CFR 249.322), for the shorter of its most recent three fiscal years and the portion of the current year preceding the date of filing Form 15, or the period since the issuer became subject to such reporting obligation. If the certification on Form 15 is subsequently withdrawn or denied, the issuer shall, within 60 days, file with the Commission all reports which would have been required if such certification had not been filed.

NOTE 1 TO PARAGRAPH (b): Securities held of record by a broker, dealer, bank or nominee for any of them for the accounts of customers shall be considered as held by the separate accounts for which the securities are held.

NOTE 2 TO PARAGRAPH (b): An issuer may not suspend reporting if the issuer and its affiliates acquire and resell securities as part of a plan or scheme to evade the reporting obligations of Section 15(d).

(c) This section does not affect any other reporting obligation applicable with respect to any classes of securities from additional takedowns under the same or different registration statements or any reporting obligation that may be applicable pursuant to section 12 of the Act (15 U.S.C. 78*l*).

[76 FR 52555, Aug. 23, 2011, as amended at 79 FR 57344, Sept. 24, 2014]

§ 240.15d–23 Reporting regarding certain securities underlying asset-backed securities under section 15(d) of the Act.

(a) Regarding a class of asset-backed securities, if the asset pool for the asset-backed securities includes a pool asset representing an interest in or the right to the payments or cash flows of another asset pool, then no separate annual and other reports need be filed pursuant to section 15(d) of the Act (15 U.S.C. 78o(d)) because of the separate registration of the distribution of the pool asset under the Securities Act (15 U.S.C. 77a *et seq.*), if the following conditions are met:

(1) Both the issuing entity for the asset-backed securities and the entity that issued the pool asset were established under the direction of the same sponsor and depositor;

(2) The pool asset was created solely to satisfy legal requirements or otherwise facilitate the structuring of the asset-backed securities transaction;

(3) The pool asset is not part of a scheme to avoid the registration or reporting requirements of the Act;

(4) The pool asset is held by the issuing entity and is a part of the asset pool for the asset-backed securities; and

(5) The offering of the asset-backed securities and the offering of the pool asset were both registered under the Securities Act (15 U.S.C. 77a *et seq.*).

(b) Paragraph (a) of this section does not affect any reporting obligation applicable with respect to the asset-backed securities or any other reporting obligation that may be applicable with respect to the pool asset or any other securities by the issuer of that pool asset pursuant to section 12 or 15(d) of the Act (15 U.S.C. 78*l* or 78o(d)).

(c) This section does not affect any obligation to provide information regarding the pool asset or the asset pool underlying the pool asset in a filing with respect to the asset-backed securities. See Item 1100(d) of Regulation AB (§ 229.1100(d) of this chapter).

(d) Terms used in this section have the same meaning as in Item 1101 of Regulation AB (§ 229.1101 of this chapter).

[70 FR 1623, Jan. 7, 2005]

§ 240.15g–1 Exemptions for certain transactions.

The following transactions shall be exempt from 17 CFR 240.15g–2, 17 CFR 240.15g–3, 17 CFR 240.15g–4, 17 CFR 240.15g–5, and 17 CFR 240.15g–6:

(a) Transactions by a broker or dealer:

(1) Whose commissions, commission equivalents, mark-ups, and mark-downs from transactions in penny

stocks during each of the immediately preceding three months and during eleven or more of the preceding twelve months, or during the immediately preceding six months, did not exceed five percent of its total commissions, commission equivalents, mark-ups, and mark-downs from transactions in securities during those months; and

(2) Who has not been a market maker in the penny stock that is the subject of the transaction in the immediately preceding twelve months.

NOTE: Prior to April 28, 1993, commissions, commission equivalents, mark-ups, and mark-downs from transactions in designated securities, as defined in 17 CFR 240.15c2–6(d)(2) as of April 15, 1992, may be considered to be commissions, commission equivalents, mark-ups, and mark-downs from transactions in penny stocks for purposes of paragraph (a)(1) of this section.

(b) Transactions in which the customer is an institutional accredited investor, as defined in 17 CFR 230.501(a) (1), (2), (3), (7), or (8).

(c) Transactions that meet the requirements of Regulation D (17 CFR 230.500 *et seq*), or transactions with an issuer not involving any public offering pursuant to section 4(2) of the Securities Act of 1933.

(d) Transactions in which the customer is the issuer, or a director, officer, general partner, or direct or indirect beneficial owner of more than five percent of any class of equity security of the issuer, of the penny stock that is the subject of the transaction.

(e) Transactions that are not recommended by the broker or dealer.

(f) Any other transaction or class of transactions or persons or class of persons that, upon prior written request or upon its own motion, the Commission conditionally or unconditionally exempts by order as consistent with the public interest and the protection of investors.

[57 FR 18032, Apr. 28, 1992, as amended at 77 FR 18685, Mar. 28, 2012]

§ 240.15g–2 Penny stock disclosure document relating to the penny stock market.

(a) It shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless, prior to effecting such transaction, the broker or dealer has furnished to the customer a document containing the information set forth in Schedule 15G, § 240.15g–100, and has obtained from the customer a signed and dated acknowledgment of receipt of the document.

(b) Regardless of the form of acknowledgment used to satisfy the requirements of paragraph (a) of this section, it shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer less than two business days after the broker or dealer sends such document.

(c) The broker or dealer shall preserve, as part of its records, a copy of the written acknowledgment required by paragraph (a) of this section for the period specified in 17 CFR 240.17a–4(b) of this chapter.

(d) Upon request of the customer, the broker or dealer shall furnish the customer with a copy of the information set forth on the Commission's Web site at *http://www.sec.gov/investor/pubs/microcapstock.htm.*

[58 FR 37417, July 12, 1993, as amended at 70 FR 40632, July 13, 2005]

§ 240.15g–3 Broker or dealer disclosure of quotations and other information relating to the penny stock market.

(a) *Requirement.* It shall be unlawful for a broker or dealer to effect a transaction in any penny stock with or for the account of a customer unless such broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the following information:

(1) The inside bid quotation and the inside offer quotation for the penny stock.

(2) If paragraph (a)(1) of this section does not apply because of the absence of an inside bid quotation and an inside offer quotation:

(i) With respect to a transaction effected with or for a customer on a principal basis (other than as provided in paragraph (a)(2)(ii) of this section):

(A) The dealer shall disclose its offer price for the security:

(*1*) If during the previous five days the dealer has effected no fewer than three *bona fide* sales to other dealers consistently at its offer price for the security current at the time of those sales, and

(*2*) If the dealer reasonably believes in good faith at the time of the transaction with the customer that its offer price accurately reflects the price at which it is willing to sell one or more round lots to another dealer. For purposes of paragraph (a)(2)(i)(A) of this section, "consistently" shall constitute, at a minimum, seventy-five percent of the dealer's *bona fide* inter-dealer sales during the previous five-day period, and, if the dealer has effected only three *bona fide* inter-dealer sales during such period, all three of such sales.

(B) The dealer shall disclose its bid price for the security:

(*1*) If during the previous five days the dealer has effected no fewer than three *bona fide* purchases from other dealers consistently at its bid price for the security current at the time of those purchases, and

(*2*) If the dealer reasonably believes in good faith at the time of the transaction with the customer that its bid price accurately reflects the price at which it is willing to buy one or more round lots from another dealer. For purposes of paragraph (a)(2)(i)(B) of this section, "consistently" shall constitute, at a minimum, seventy-five percent of the dealer's *bona fide* inter-dealer purchases during the previous five-day period, and, if the dealer has effected only three *bona fide* inter-dealer purchases during such period, all three of such purchases.

(C) If the dealer's bid or offer prices to the customer do not satisfy the criteria of paragraphs (a)(2)(i)(A) or (a)(2)(i)(B) of this section, the dealer shall disclose to the customer:

(*1*) That it has not effected inter-dealer purchases or sales of the penny stock consistently at its bid or offer price, and

(*2*) The price at which it last purchased the penny stock from, or sold the penny stock to, respectively, another dealer in a *bona fide* transaction.

(ii) With respect to transactions effected by a broker or dealer with or for the account of the customer:

(A) On an agency basis or

(B) On a basis other than as a market maker in the security, where, after having received an order from the customer to purchase a penny stock, the dealer effects the purchase from another person to offset a contemporaneous sale of the penny stock to such customer, or, after having received an order from the customer to sell the penny stock, the dealer effects the sale to another person to offset a contemporaneous purchase from such customer, the broker or dealer shall disclose the best independent interdealer bid and offer prices for the penny stock that the broker or dealer obtains through reasonable diligence. A broker-dealer shall be deemed to have exercised reasonable diligence if it obtains quotations from three market makers in the security (or all known market makers if there are fewer than three).

(3) With respect to bid or offer prices and transaction prices disclosed pursuant to paragraph (a) of this section, the broker or dealer shall disclose the number of shares to which the bid and offer prices apply.

(b) *Timing*. (1) The information described in paragraph (a) of this section:

(i) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(ii) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b–10 of this chapter.

(2) A broker or dealer, at the time of making the disclosure pursuant to paragraph (b)(1)(i) of this section, shall make and preserve as part of its records, a record of such disclosure for the period specified in 17 CFR 240.17a–4(b).

(c) *Definitions*. For purposes of this section:

(1) The term *bid price* shall mean the price most recently communicated by the dealer to another broker or dealer at which the dealer is willing to purchase one or more round lots of the penny stock, and shall not include indications of interest.

(2) The term *offer price* shall mean the price most recently communicated by the dealer to another broker or dealer at which the dealer is willing to sell one or more round lots of the penny stock, and shall not include indications of interest.

(3) The term *inside bid quotation* for a security shall mean the highest bid quotation for the security displayed by a market maker in the security on a Qualifying Electronic Quotation System, at any time in which at least two market makers are contemporaneously displaying on such system bid and offer quotations for the security at specified prices.

(4) The term *inside offer quotation* for a security shall mean the lowest offer quotation for the security displayed by a market maker in the security on a Qualifying Electronic Quotation System, at any time in which at least two market makers are contemporaneously displaying on such system bid and offer quotations for the security at specified prices.

(5) The term *Qualifying Electronic Quotation System* shall mean an automated interdealer quotation system that has the characteristics set forth in section 17B(b)(2) of the Act, or such other automated interdealer quotation system designated by the Commission for purposes of this section.

[57 FR 18033, Apr. 28, 1992]

§ 240.15g–4 Disclosure of compensation to brokers or dealers.

PRELIMINARY NOTE: Brokers and dealers may wish to refer to Securities Exchange Act Release No. 30608 (April 20, 1992) for a discussion of the procedures for computing compensation in active and competitive markets, inactive and competitive markets, and dominated and controlled markets.

(a) *Disclosure requirement.* It shall be unlawful for any broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless such broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the aggregate amount of any compensation received by such broker or dealer in connection with such transaction.

(b) *Timing.* (1) The information described in paragraph (a) of this section:

(i) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(ii) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b–10.

(2) A broker or dealer, at the time of making the disclosure pursuant to paragraph (b)(1)(i) of this section, shall make and preserve as part of its records, a record of such disclosure for the period specified in 17 CFR 240.17a–4(b).

(c) *Definition of compensation.* For purposes of this section, *compensation* means, with respect to a transaction in a penny stock:

(1) If a broker is acting as agent for a customer, the amount of any remuneration received or to be received by it from such customer in connection with such transaction;

(2) If, after having received a buy order from a customer, a dealer other than a market maker purchased the penny stock as principal from another person to offset a contemporaneous sale to such customer or, after having received a sell order from a customer, sold the penny stock as principal to another person to offset a contemporaneous purchase from such customer, the difference between the price to the customer and such contemporaneous purchase or sale price; or

(3) If the dealer otherwise is acting as principal for its own account, the difference between the price to the customer and the prevailing market price.

(d) *Active and competitive* market. For purposes of this section only, a market may be deemed to be ''active and competitive'' in determining the prevailing market price with respect to a transaction by a market maker in a penny stock if the aggregate number of transactions effected by such market maker in the penny stock in the five business days preceding such transaction is less than twenty percent of the aggregate number of all transactions in the penny stock reported on a Qualifying Electronic Quotation System (as defined in 17 CFR 240.15g–3(c)(5)) during such five-day period. No presumption shall arise that a market is not ''active and competitive'' solely by reason of a market maker not meeting the conditions specified in this paragraph.

[57 FR 18034, Apr. 28, 1992]

§ 240.15g–5 Disclosure of compensation of associated persons in connection with penny stock transactions.

(a) *General.* It shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless the broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the aggregate amount of cash compensation that any associated person of the broker or dealer who is a natural person and has communicated with the customer concerning the transaction at or prior to receipt of the customer's transaction order, other than any person whose function is solely clerical or ministerial, has received or will receive from any source in connection with the transaction and that is determined at or prior to the time of the transaction, including separate disclosure, if applicable, of the source and amount of such compensation that is not paid by the broker or dealer.

(b) *Timing.* (1) The information described in paragraph (a) of this section:

(i) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(ii) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b–10.

(2) A broker or dealer, at the time of making the disclosure pursuant to paragraph (b)(1)(i) of this section, shall make and preserve as part of its records, a record of such disclosure for the period specified in 17 CFR 240.17a–4(b).

(c) *Contingent compensation arrangements.* Where a portion or all of the cash or other compensation that the associated person may receive in connection with the transaction may be determined and paid following the transaction based on aggregate sales volume levels or other contingencies, the written disclosure required by paragraph (b)(1)(ii) of this section shall state that fact and describe the basis upon which such compensation is determined.

[57 FR 18034, Apr. 28, 1992]

§ 240.15g–6 Account statements for penny stock customers.

(a) *Requirement.* It shall be unlawful for any broker or dealer that has effected the sale to any customer, other than in a transaction that is exempt pursuant to 17 CFR 240.15g–1, of any security that is a penny stock on the last trading day of any calendar month, or any successor of such broker or dealer, to fail to give or send to such customer a written statement containing the information described in paragraphs (c) and (d) of this section with respect to each such month in which such security is held for the customer's account with the broker or dealer, within ten days following the end of such month.

(b) *Exemptions.* A broker or dealer shall be exempted from the requirement of paragraph (a) of this section under either of the following circumstances:

(1) If the broker or dealer does not effect any transactions in penny stocks for or with the account of the customer during a period of six consecutive calendar months, then the broker or dealer shall not be required to provide monthly statements for each quarterly period that is immediately subsequent to such six-month period and in which the broker or dealer does not effect any transaction in penny stocks for or with the account of the customer, *provided* that the broker or dealer gives or sends to the customer written statements containing the information described in paragraphs (d) and (e) of this section on a quarterly basis, within ten days following the end of each such quarterly period.

(2) If, on all but five or fewer trading days of any quarterly period, a security has a price of five dollars or more, the broker or dealer shall not be required to provide a monthly statement covering the security for subsequent quarterly periods, until the end of any such subsequent quarterly period on the last

trading day of which the price of the security is less than five dollars.

(c) *Price determinations.* For purposes of paragraphs (a) and (b) of this section, the price of a security on any trading day shall be determined at the close of business in accordance with the provisions of 17 CFR 240.3a51–1(d)(1).

(d) *Market and price information.* The statement required by paragraph (a) of this section shall contain at least the following information with respect to each penny stock covered by paragraph (a) of this section, as of the last trading day of the period to which the statement relates:

(1) The identity and number of shares or units of each such security held for the customer's account; and

(2) The estimated market value of the security, to the extent that such estimated market value can be determined in accordance with the following provisions:

(i) The highest inside bid quotation for the security on the last trading day of the period to which the statement relates, multiplied by the number of shares or units of the security held for the customer's account; or

(ii) If paragraph (d)(2)(i) of this section is not applicable because of the absence of an inside bid quotation, and if the broker or dealer furnishing the statement has effected at least ten separate Qualifying Purchases in the security during the last five trading days of the period to which the statement relates, the weighted average price per share paid by the broker or dealer in all Qualifying Purchases effected during such five-day period, multiplied by the number of shares or units of the security held for the customer's account; or

(iii) If neither of paragraphs (d)(2)(i) nor (d)(2)(ii) of this section is applicable, a statement that there is ''no estimated market value'' with respect to the security.

(e) *Legend.* In addition to the information required by paragraph (d) of this section, the written statement required by paragraph (a) of this section shall include a conspicuous legend that is identified with the penny stocks described in the statement and that contains the following language:

If this statement contains an estimated value, you should be aware that this value may be based on a limited number of trades or quotes. Therefore, you may not be able to sell these securities at a price equal or near to the value shown. However, the broker-dealer furnishing this statement may not refuse to accept your order to sell these securities. Also, the amount you receive from a sale generally will be reduced by the amount of any commissions or similar charges. If an estimated value is not shown for a security, a value could not be determined because of a lack of information.

(f) *Preservation of records.* Any broker or dealer subject to this section shall preserve, as part of its records, copies of the written statements required by paragraph (a) of this section and keep such records for the periods specified in 17 CFR 240.17a–4(b).

(g) *Definitions.* For purposes of this section:

(1) The term *Quarterly period* shall mean any period of three consecutive full calendar months.

(2) The *inside bid quotation* for a security shall mean the highest bid quotation for the security displayed by a market maker in the security on a Qualifying Electronic Quotation System, at any time in which at least two market makers are contemporaneously displaying on such system bid and offer quotations for the security at specified prices.

(3) The term *Qualifying Electronic Quotation System* shall mean an automated interdealer quotation system that has the characteristics set forth in section 17B(b)(2) of the Act, or such other automated interdealer quotation system designated by the Commission for purposes of this section.

(4) The term *Qualifying Purchases* shall mean *bona fide* purchases by a broker or dealer of a penny stock for its own account, each of which involves at least 100 shares, but excluding any block purchase involving more than one percent of the outstanding shares or units of the security.

[57 FR 18034, Apr. 28, 1992]

§ 240.15g–8 Sales of escrowed securities of blank check companies.

As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any person to sell or offer to sell any security that is deposited and held in an escrow or trust account pursuant to Rule 419 under the Securities Act of 1933 (17 CFR 230.419), or any interest in or related to such security, other than pursuant to a qualified domestic relations order as defined by the Internal Revenue Code of 1986, as amended (26 U.S.C. 1 *et seq.*), or Title I of the Employee Retirement Income Security Act (29 U.S.C. 1001 *et seq.*), or the rules thereunder.

[57 FR 18045, Apr. 28, 1992]

§ 240.15g–9 Sales practice requirements for certain low-priced securities.

(a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for a broker or dealer to sell a penny stock to, or to effect the purchase of a penny stock by, any person unless:

(1) The transaction is exempt under paragraph (c) of this section; or

(2) Prior to the transaction:

(i) The broker or dealer has approved the person's account for transactions in penny stocks in accordance with the procedures set forth in paragraph (b) of this section; and

(ii)(A) The broker or dealer has received from the person an agreement to the transaction setting forth the identity and quantity of the penny stock to be purchased; and

(B) Regardless of the form of agreement used to satisfy the requirements of paragraph (a)(2)(ii)(A) of this section, it shall be unlawful for such broker or dealer to sell a penny stock to, or to effect the purchase of a penny stock by, for or with the account of a customer less than two business days after the broker or dealer sends such agreement.

(b) In order to approve a person's account for transactions in penny stocks, the broker or dealer must:

(1) Obtain from the person information concerning the person's financial situation, investment experience, and investment objectives;

(2) Reasonably determine, based on the information required by paragraph (b)(1) of this section and any other information known by the broker-dealer, that transactions in penny stocks are suitable for the person, and that the person (or the person's independent adviser in these transactions) has sufficient knowledge and experience in financial matters that the person (or the person's independent adviser in these transactions) reasonably may be expected to be capable of evaluating the risks of transactions in penny stocks;

(3) Deliver to the person a written statement:

(i) Setting forth the basis on which the broker or dealer made the determination required by paragraph (b)(2) of this section;

(ii) Stating in a highlighted format that it is unlawful for the broker or dealer to effect a transaction in a penny stock subject to the provisions of paragraph (a)(2) of this section unless the broker or dealer has received, prior to the transaction, a written agreement to the transaction from the person; and

(iii) Stating in a highlighted format immediately preceding the customer signature line that:

(A) The broker or dealer is required by this section to provide the person with the written statement; and

(B) The person should not sign and return the written statement to the broker or dealer if it does not accurately reflect the person's financial situation, investment experience, and investment objectives; and

(4)(i) Obtain from the person a signed and dated copy of the statement required by paragraph (b)(3) of this section; and

(ii) Regardless of the form of statement used to satisfy the requirements of paragraph (b)(4)(i) of this section, it shall be unlawful for such broker or dealer to sell a penny stock to, or to effect the purchase of a penny stock by, for or with the account of a customer less than two business days after the broker or dealer sends such statement.

(c) For purposes of this section, the following transactions shall be exempt:

(1) Transactions that are exempt under 17 CFR 240.15g–1 (a), (b), (d), (e), and (f).

(2) Transactions that meet the requirements of 17 CFR 230.506 (including, where applicable, the requirements of 17 CFR 230.501 through 230.503, and 17

CFR 230.507 through 230.508), or transactions with an issuer not involving any public offering pursuant to section 4(a)(2) of the Securities Act of 1933.

(3) Transactions in which the purchaser is an established customer of the broker or dealer.

(d) For purposes of this section:

(1) The term *penny stock* shall have the same meaning as in 17 CFR 240.3a51–1.

(2) The term *established customer* shall mean any person for whom the broker or dealer, or a clearing broker on behalf of such broker or dealer, carries an account, and who in such account:

(i) Has effected a securities transaction, or made a deposit of funds or securities, more than one year previously; or

(ii) Has made three purchases of penny stocks that occurred on separate days and involved different issuers.

[54 FR 35481, Aug. 28, 1989. Redesignated and amended at 58 FR 37417, July 12, 1993; 70 FR 40632, July 13, 2005; 81 FR 83553, Nov. 21, 2016]

§ 240.15g–100 Schedule 15G—Information to be included in the document distributed pursuant to 17 CFR 240.15g–2.

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

SCHEDULE 15G

Under the Securities Exchange Act of 1934

Instructions to Schedule 15G

A. Schedule 15G (Schedule) may be provided to customers in its entirety either on paper or electronically. It may also be provided to customers electronically through a link to the SEC's Web site.

1. *If the Schedule is sent in paper form*, the format and typeface of the Schedule must be reproduced exactly as presented. For example, words that are capitalized must remain capitalized, and words that are underlined or bold must remain underlined or bold. The typeface must be clear and easy to read. The Schedule may be reproduced either by photocopy or by printing.

2. *If the Schedule is sent electronically*, the e-mail containing the Schedule must have as a subject line ''Important Information on Penny Stocks.'' The Schedule reproduced in the text of the e-mail must be clear, easy-to-read type presented in a manner reasonably calculated to draw the customer's attention to the language in the document, especially words that are capitalized, underlined or in bold.

3. *If the Schedule is sent electronically using a hyperlink to the SEC Web site*, the e-mail containing the hyperlink must have as a subject line: ''Important Information on Penny Stocks.'' Immediately before the hyperlink, the text of the e-mail must reproduce the following statement in clear, easy-to-read type presented in a manner reasonably calculated to draw the customer's attention to the words: ''We are required by the U.S. Securities and Exchange Commission to give you the following disclosure statement: *http://www.sec.gov/investor/schedule15g.htm.* It explains some of the risks of investing in penny stocks. Please read it carefully before you agree to purchase or sell a penny stock.''

B. Regardless of how the Schedule is provided to the customer, the communication must also provide the name, address, telephone number and e-mail address of the broker. E-mail messages may also include any privacy or confidentiality information that the broker routinely includes in e-mail messages sent to customers. No other information may be included in these communications, other than instructions on how to provide a signed and dated acknowledgement of receipt of the Schedule.

C. The document entitled ''Important Information on Penny Stocks'' must be distributed as Schedule 15G and must be no more than two pages in length if provided in paper form.

D. The disclosures made through the Schedule are in addition to any other disclosures that are required under the Federal securities laws.

E. Recipients of the document must not be charged any fee for the document.

F. The content of the Schedule is as follows:

[next page]

Important Information on Penny Stocks

The U.S. Securities and Exchange Commission (SEC) requires your broker to give this statement to you, and to obtain your signature to show that you have received it, before your first trade in a penny stock. This statement contains important information—and you should read it carefully before you sign it, and before you decide to purchase or sell a penny stock.

In addition to obtaining your signature, the SEC requires your broker to wait at least two business days after sending you this statement before executing your first trade to give you time to carefully consider your trade.

Penny Stocks Can Be Very Risky

Penny stocks are low-priced shares of small companies. Penny stocks may trade infrequently—which means that it may be difficult to sell penny stock shares once you have them. Because it may also be difficult to find quotations for penny stocks, they may be impossible to accurately price. Investors in penny stock should be prepared for the possibility that they may lose their whole investment.

While penny stocks generally trade over-the-counter, they may also trade on U.S. securities exchanges, facilities of U.S. exchanges, or foreign exchanges. You should learn about the market in which the penny stock trades to determine how much demand there is for this stock and how difficult it will be to sell. Be especially careful if your broker is offering to sell you newly issued penny stock that has no established trading market.

The securities you are considering have not been approved or disapproved by the SEC. Moreover, the SEC has not passed upon the fairness or the merits of this transaction nor upon the accuracy or adequacy of the information contained in any prospectus or any other information provided by an issuer or a broker or dealer.

Information You Should Get

In addition to this statement, your broker is required to give you a statement of your financial situation and investment goals explaining why his or her firm has determined that penny stocks are a suitable investment for you. In addition, your broker is required to obtain your agreement to the proposed penny stock transaction.

Before you buy penny stock, Federal law requires your salesperson to tell you the ''*offer*'' and the ''*bid*'' on the stock, and the ''*compensation*'' the salesperson and the firm receive for the trade. The firm also must send a confirmation of these prices to you after the trade. You will need this price information to determine what profit or loss, if any, you will have when you sell your stock.

The offer price is the wholesale price at which the dealer is willing to sell stock to other dealers. The bid price is the wholesale price at which the dealer is willing to buy the stock from other dealers. In its trade with you, the dealer may add a retail charge to these wholesale prices as compensation (called a ''markup'' or ''markdown'').

The difference between the bid and the offer price is the dealer's ''*spread.*'' A spread that is large compared with the purchase price can make a resale of a stock very costly. To be profitable when you sell, the bid price of your stock must rise above the amount of this spread and the compensation charged by both your selling and purchasing dealers. *Remember that if the dealer has no bid price, you may not be able to sell the stock after you buy it, and may lose your whole investment.*

After you buy penny stock, your brokerage firm must send you a monthly account statement that gives an estimate of the value of each penny stock in your account, if there is enough information to make an estimate. If the firm has not bought or sold any penny stocks for your account for six months, it can provide these statements every three months.

Additional information about low-priced securities—including penny stocks—is available on the SEC's Web site at *http://www.sec.gov/investor/pubs/microcapstock.htm.* In addition, your broker will send you a copy of this information upon request. The SEC encourages you to learn all you can before making this investment.

Brokers' Duties and Customers' Rights and Remedies

Remember that your salesperson is not an impartial advisor—he or she is being paid to sell you stock. Do not rely only on the salesperson, but seek outside advice before you buy any stock. You can get the disciplinary history of a salesperson or firm from NASD at 1–800–289–9999 or contact NASD via the Internet at *http://www.nasd.com.* You can also get additional information from your state securities official. The North American Securities Administrators Association, Inc. can give you contact information for your state. You can reach NASAA at (202) 737–0900 or via the Internet at *http://www.nasaa.org.*

If you have problems with a salesperson, contact the firm's compliance officer. You can also contact the securities regulators listed above. Finally, if you are a victim of fraud, you may have rights and remedies under state and Federal law. In addition to the regulators listed above, you also may contact the SEC with complaints at (800) SEC–0330 or via the Internet at *help@sec.gov.*

[70 FR 40632, July 13, 2005]

NATIONAL AND AFFILIATED SECURITIES ASSOCIATIONS

§ 240.15Aa–1 Registration of a national or an affiliated securities association.

Any application for registration of an association as a national, or as an affiliated, securities association shall be made in triplicate on Form X–15AA–1 accompanied by three copies of the exhibits prescribed by the Commission to be filed in connection therewith.

(Sec. 15A, 52 Stat. 1070; 15 U.S.C. 78*o*–3)

[13 FR 8209, Dec. 22, 1948. Redesignated at 30 FR 11851, Sept. 16, 1965]

§ 240.15Aj–1 Amendments and supplements to registration statements of securities associations.

Every association applying for registration or registered as a national securities association or as an affiliated securities association shall keep its registration statement up-to-date in the manner prescribed below:

(a) *Amendments.* Promptly after the discovery of any inaccuracy in the registration statement or in any amendment or supplement thereto the association shall file with the Commission an amendment correcting such inaccuracy.

(b) *Current supplements.* Promptly after any change which renders no longer accurate any information contained or incorporated in the registration statement or in any amendment or supplement thereto the association shall file with the Commission a current supplement setting forth such change, except that:

(1) Supplements setting forth changes in the information called for in Exhibit C need not be filed until 10 days after the calendar month in which the changes occur.

(2) No current supplements need be filed with respect to changes in the information called for in Exhibit B.

(3) If changes in the information called for in items (1) and (2) of Exhibit C are reported in any record which is published at least once a month by the association and promptly filed in triplicate with the Commission, no current supplement need be filed with respect thereto.

(c) *Annual supplements.* (1) Promptly after March 1 of each year, the association shall file with the Commission an annual consolidated supplement as of such date on Form X–15AJ–2 (§ 249.803) except that:

(i) If the securities association publishes or cooperates in the publication of the information required in Items 6(a) and 6(b) of Form X–15AJ–2 on an annual or more frequent basis, in lieu of filing such an item the securities association may:

(A) Identify the publication in which such information is available, the name, address, and telephone number of the person from whom such publication may be obtained, and the price thereof; and

(B) Certify to the accuracy of such information as of its date.

(ii) Promptly after March 1, 1995, and every three years thereafter each association shall file complete Exhibit A to Form X–15AJ–2. The information contained in this exhibit shall be up to date as of the latest practicable date within 3 months of the date on which these exhibits are filed. If the association publishes or cooperates in the publication of the information required in this exhibit on an annual or more frequent basis, in lieu of filing such exhibit the association may:

(A) Identify the publication in which such information is available, the name, address, and telephone number of the person from whom such publication may be obtained, and the price thereof; and

(B) Certify to the accuracy of such information as of its date. If a securities association keeps the information required in this exhibit up to date and makes it available to the Commission and the public upon request, in lieu of filing such an exhibit a securities association may certify that the information is kept up to date and is available to the Commission and the public upon request.

(2) Promptly after the close of each fiscal year of the association, it shall file with the Commission a supplement setting forth its balance sheet as of the close of such year and its income and expense statement for such year.

(d) *Filing, dating, etc.* Each amendment or supplement shall be filed in triplicate, at least one of which must be signed and attested, in the same manner as required in the case of the original registration statement, and must conform to the requirements of Form X–15Aj–1, except that the annual consolidated supplement shall be filed on Form X–15Aj–2. All amendments and supplements shall be dated and numbered in order of filing. One amendment or supplement may include any number of changes. In addition to the formal filing of amendments and supplements above described, each association shall send to the Commission three copies of any notices, reports, circulars, loose-leaf insertions, riders, new additions, lists or other records of changes covered by amendments or supplements when, as and if such records are made available to members of the association.

(Sec. 15A, 52 Stat. 1070; 15 U.S.C. 78*o*–3)

[13 FR 8209, Dec. 22, 1948, as amended at 18 FR 6259, Oct. 1, 1953. Redesignated at 30 FR 11851, Sept. 16, 1965; 59 FR 66700, Dec. 28, 1994]

§ 240.15Al2–1 [Reserved]

§ 240.15Ba1–1 Definitions.

As used in the rules and regulations prescribed by the Commission pursuant to section 15B of the Act (15 U.S.C. 78*o*-4) in §§ 240.15Ba1–1 through 240.15Ba1–8 and 240.15Bc4–1:

(a) *Guaranteed investment contract* has the same meaning as in section 15B(e)(2) of the Act (15 U.S.C. 78*o*-4(e)(2)); *provided, however*, that the contract relates to investments of proceeds of municipal securities or municipal escrow investments.

(b) *Investment strategies* has the same meaning as in section 15B(e)(3) of the Act (15 U.S.C. 78*o*-4(e)(3)), and includes plans or programs for the investment of proceeds of municipal securities that are not municipal derivatives or guaranteed investment contracts, and the recommendation of and brokerage of municipal escrow investments.

(c) *Managing agent* means any person, including a trustee, who directs or manages, or who participates in directing or managing, the affairs of any unincorporated organization or association other than a partnership.

(d)(1) *Municipal advisor*.

(i) *In general*. Except as otherwise provided in paragraphs (d)(2) and (d)(3) of this section, the term *municipal advisor* has the same meaning as in section 15B(e)(4) of the Act (15 U.S.C. 78*o*-4(e)(4)). Under section 15B(e)(4)(A) of the Act (15 U.S.C. 78*o*-4(e)(4)(A)), the term *municipal advisor* means a person (who is not a municipal entity or an employee of a municipal entity) that provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; or undertakes a solicitation of a municipal entity or an obligated person. Under section 15B(e)(4)(C) of the Act (15 U.S.C. 78*o*-4(e)(4)(C)) and paragraph (d)(2) of this section, a *municipal advisor* does not include a person that engages in specified excluded activities.

(ii) *Advice standard*. For purposes of the municipal advisor definition under paragraph (d)(1)(i) of this section, advice excludes, among other things, the provision of general information that does not involve a recommendation regarding municipal financial products or the issuance of municipal securities (including with respect to the structure, timing, terms and other similar matters concerning such financial products or issues).

(iii) *Certain types of municipal advisors.* Under section 15B(e)(4)(B) of the Act (15 U.S.C. 78*o*-4(e)(4)(B)), *municipal advisors* include, without limitation, financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders, and swap advisors, to the extent that such persons otherwise meet the requirements of the municipal advisor definition in this paragraph (d)(1).

(2) *Exclusions from municipal advisor definition.* Pursuant to section 15B(e)(4)(C) of the Act (15 U.S.C. 78*o*-4(e)(4)(C)), the term *municipal advisor* excludes the following persons with respect to the specified excluded activities:

(i) *Serving as an underwriter.* A broker, dealer, or municipal securities dealer serving as an underwriter of a particular issuance of municipal securities to the extent that the broker, dealer, or municipal securities dealer engages in activities that are within the scope of an underwriting of such issuance of municipal securities.

(ii) *Registered investment advisers—In general.* Any investment adviser registered under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 *et seq.*) or any person associated with such registered investment adviser to the extent that such registered investment adviser or such person is providing investment advice in such capacity. Solely for purposes of this paragraph (d)(2)(ii), investment advice does not include advice concerning whether and how to issue municipal securities, advice concerning the structure, timing, and terms of an issuance of municipal securities and other similar matters, advice concerning municipal derivatives, or a solicitation of a municipal entity or obligated person.

(iii) *Registered commodity trading advisors.* Any commodity trading advisor registered under the Commodity Exchange Act (7 U.S.C. 1 *et seq.*), or person associated with a registered commodity trading advisor, to the extent that such registered commodity trading advisor or such person is providing advice that is related to swaps (as defined in Section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)) and section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)), and any rules and regulations thereunder).

(iv) *Attorneys.* Any attorney to the extent that the attorney is offering legal advice or providing services that are of a traditional legal nature with respect to the issuance of municipal securities or municipal financial products to a client of such attorney that is a municipal entity, obligated person, or other participant in the transaction. To the extent an attorney represents himself or herself as a financial advisor or financial expert regarding the issuance of municipal securities or municipal financial products, however, the attorney is not excluded with respect to such financial activities under this paragraph (d)(2)(iv).

(v) *Engineers.* Any engineer to the extent that the engineer is providing engineering advice.

(3) *Exemptions from municipal advisor definition.* The Commission exempts the following persons from the definition of municipal advisor to the extent they are engaging in the specified activities:

(i) *Accountants.* Any accountant to the extent that the accountant is providing audit or other attest services, preparing financial statements, or issuing letters for underwriters for, or on behalf of, a municipal entity or obligated person.

(ii) *Public officials and employees.* (A) Any person serving as a member of a governing body, an advisory board, or a committee of, or acting in a similar official capacity with respect to, or as an official of, a municipal entity or obligated person to the extent that such person is acting within the scope of such person's official capacity.

(B) Any employee of a municipal entity or obligated person to the extent that such person is acting within the scope of such person's employment.

(iii) *Banks.* Any bank, as defined in section 3(a)(6) of the Act (15 U.S.C.

78c(a)(6)), to the extent the bank provides advice with respect to the following:

(A) Any investments that are held in a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank;

(B) Any extension of credit by a bank to a municipal entity or obligated person, including the issuance of a letter of credit, the making of a direct loan, or the purchase of a municipal security by the bank for its own account;

(C) Any funds held in a sweep account that meets the requirements of section 3(a)(4)(B)(v) of the Act (15 U.S.C. 78c(a)(4)(B)(v)); or

(D) Any investment made by a bank acting in the capacity of an indenture trustee or similar capacity.

(iv) *Responses to requests for proposals or qualifications.* Any person providing a response in writing or orally to a request for proposals or qualifications from a municipal entity or obligated person for services in connection with a municipal financial product or the issuance of municipal securities; *provided, however,* that such person does not receive separate direct or indirect compensation for advice provided as part of such response.

(v) *Swap dealers.* (A) A swap dealer (as defined in Section 1a(49) of the Commodity Exchange Act (7 U.S.C. 1a(49)) and the rules and regulations thereunder) registered under the Commodity Exchange Act or associated person of the swap dealer recommending a municipal derivative or a trading strategy that involves a municipal derivative, so long as the registered swap dealer or associated person is not *acting as an advisor* to the municipal entity or obligated person with respect to the municipal derivative or trading strategy pursuant to Section 4s(h)(4) of the Commodity Exchange Act and the rules and regulations thereunder.

(B) For purposes of determining whether a swap dealer is *acting as an advisor* in this paragraph (d)(3)(v), the municipal entity or obligated person involved in the transaction will be treated as a *special entity* under Section 4s(h)(2) of the Commodity Exchange Act and the rules and regulations thereunder (even if such municipal entity or obligated person does not satisfy the definition of *special entity* under those provisions).

(vi) *Participation by an independent registered municipal advisor.* Any person engaging in municipal advisory activities in a circumstance in which a municipal entity or obligated person is otherwise represented by an independent registered municipal advisor with respect to the same aspects of a municipal financial product or an issuance of municipal securities, provided that the following requirements are met:

(A) *Independent registered municipal advisor.* An independent registered municipal advisor is providing advice with respect to the same aspects of the municipal financial product or issuance of municipal securities. For purposes of this paragraph (d)(3)(vi), the term *independent registered municipal advisor* means a municipal advisor registered pursuant to section 15B of the Act (15 U.S.C. 78*o*–4) and the rules and regulations thereunder and that is not, and within at least the past two years was not, associated (as defined in section 15B(e)(7) (15 U.S.C. 78*o*–4(e)(7)) of the Act) with the person seeking to rely on this paragraph (d)(3)(vi).

(B) *Required representation.* A person seeking to rely on this paragraph (d)(3)(vi) receives from the municipal entity or obligated person a representation in writing that it is represented by, and will rely on the advice of, an independent registered municipal advisor, provided that the person receiving such representation has a reasonable basis for relying on the representation.

(C) *Required disclosures.* (*1*) With respect to a municipal entity, such person discloses in writing to the municipal entity that, by obtaining such representation from the municipal entity, such person is not a municipal advisor and is not subject to the fiduciary duty set forth in section 15B(c)(1) of the Act (15 U.S.C. 78*o*–4(c)(1)) with respect to the municipal financial product or issuance of municipal securities, and provides a copy of such disclosure to the independent registered municipal advisor.

(*2*) With respect to an obligated person, such person discloses in writing to the obligated person that, by obtaining such representation from the obligated person, such person is not a municipal advisor with respect to the municipal financial product or issuance of municipal securities, and provides a copy of such disclosure to the independent registered municipal advisor.

(*3*) Each such disclosure must be made at a time and in a manner reasonably designed to allow the municipal entity or obligated person to assess the material incentives and conflicts of interest that such person may have in connection with the municipal advisory activities.

(vii) *Persons that provide advice on certain investment strategies.* A person that provides advice with respect to investment strategies that are not plans or programs for the investment of the proceeds of municipal securities or the recommendation of and brokerage of municipal escrow investments.

(viii) *Certain solicitations.* A person that undertakes a solicitation of a municipal entity or obligated person for the purpose of obtaining or retaining an engagement by a municipal entity or by an obligated person of a broker, dealer, municipal securities dealer, or municipal advisor for or in connection with municipal financial products that are investment strategies to the extent that those investment strategies are not plans or programs for the investment of the proceeds of municipal securities or the recommendation of and brokerage of municipal escrow investments.

(4) *Special rule for separately identifiable departments or divisions of banks for municipal advisory purposes.* If a bank engages in municipal advisory activities through a separately identifiable department or division that meets the requirements of this paragraph (d)(4), the determination of whether those municipal advisory activities cause any person to be a municipal advisor may be made separately for such department or division. In such event, that department or division, rather than the bank itself, shall be deemed to be the municipal advisor.

(i) *Separately identifiable department or division.* For purposes of this paragraph (d)(4), a *separately identifiable department or division* of a bank is that unit of the bank which conducts all of the municipal advisory activities of the bank, provided that the following requirements are met:

(A) *Supervision.* Such unit is under the direct supervision of an officer or officers designated by the board of directors of the bank as responsible for the day-to-day conduct of the bank's municipal advisory activities, including the supervision of all bank employees engaged in the performance of such activities.

(B) *Separate records.* All of the records relating to the bank's municipal advisory activities are separately maintained in, or extractable from, such unit's own facilities or the facilities of the bank, and such records are so maintained or otherwise accessible as to permit independent examination thereof and enforcement of applicable provisions of the Act, the rules and regulations thereunder, and the rules of the Municipal Securities Rulemaking Board relating to municipal advisors.

(ii) [Reserved]

(e) *Municipal advisory activities* means the following activities specified in section 15B(e)(4)(A) of the Act (15 U.S.C. 78*o*–4(e)(4)(A)) and paragraph (d)(1) of this section that, absent the availability of an exclusion under paragraph (d)(2) of this section or an exemption under paragraph (d)(3) of this section, would cause a person to be a municipal advisor:

(1) Providing advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; or

(2) Solicitation of a municipal entity or an obligated person.

(f) *Municipal derivatives* means any swap (as defined in Section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)) and section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)), including any rules and regulations thereunder) or security-based swap (as defined in section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)), including any rules and regulations thereunder) to which:

(1) A municipal entity is a counterparty; or

(2) An obligated person, acting in such capacity, is a counterparty.

(g) *Municipal entity* means any State, political subdivision of a State, or municipal corporate instrumentality of a State or of a political subdivision of a State, including:

(1) Any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality;

(2) Any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and

(3) Any other issuer of municipal securities.

(h) *Municipal escrow investments.* (1) *In general.* Except as otherwise provided in paragraph (h)(2) of this section, *municipal escrow investments* means proceeds of municipal securities and any other funds of a municipal entity that are deposited in an escrow account to pay the principal of, premium, if any, and interest on one or more issues of municipal securities.

(2) *Reasonable reliance on representations.* In determining whether or not funds to be invested or reinvested constitute municipal escrow investments for purposes of this section, a person may rely on representations in writing made by a knowledgeable official of the municipal entity or obligated person whose funds are to be invested or reinvested regarding the nature of such investments, provided that the person seeking to rely on such representations has a reasonable basis for such reliance.

(i) *Municipal financial product* has the same meaning as in section 15B(e)(5) of the Act (15 U.S.C. 78*o*–4(e)(5)).

(j) *Non-resident* means:

(1) In the case of an individual, one who resides in or has his principal office and place of business in any place not subject to the jurisdiction of the United States;

(2) In the case of a corporation, one incorporated in or having its principal office and place of business in any place not subject to the jurisdiction of the United States; or

(3) In the case of a partnership or other unincorporated organization or association, one having its principal office and place of business in any place not subject to the jurisdiction of the United States.

(k) *Obligated person* has the same meaning as in section 15B(e)(10) of the Act (15 U.S.C. 78*o*–4(e)(10)); *provided, however,* that the term *obligated person* shall not include:

(1) A person who provides municipal bond insurance, letters of credit, or other liquidity facilities;

(2) A person whose financial information or operating data is not material to a municipal securities offering, without reference to any municipal bond insurance, letter of credit, liquidity facility, or other credit enhancement; or

(3) The federal government.

(l) *Principal office and place of business* means the executive office of the municipal advisor from which the officers, partners, or managers of the municipal advisor direct, control, and coordinate the activities of the municipal advisor.

(m)(1) *Proceeds of municipal securities—In general.* Except as otherwise provided in paragraphs (m)(2) and (m)(3) of this section, *proceeds of municipal securities* means monies derived by a municipal entity from the sale of municipal securities, investment income derived from the investment or reinvestment of such monies, and any monies of a municipal entity or obligated person held in funds under legal documents for the municipal securities that are reasonably expected to be used as security or a source of payment for the payment of the debt service on the municipal securities, including reserves, sinking funds, and pledged funds created for such purpose, and the investment income derived from the investment or reinvestment of monies in such funds. When such monies are spent to carry out the authorized purposes of municipal securities, they cease to be proceeds of municipal securities.

(2) *Exception for Section 529 college savings plans.* Solely for purposes of this paragraph (m), monies derived from a municipal security issued by an education trust established by a State under Section 529(b) of the Internal Revenue Code (26 U.S.C. 529(b)) are not proceeds of municipal securities.

(3) *Reasonable reliance on representations.* In determining whether or not funds to be invested constitute proceeds of municipal securities for purposes of this section, a person may rely on representations in writing made by a knowledgeable official of the municipal entity or obligated person whose funds are to be invested regarding the nature of such funds, provided that the person seeking to rely on such representations has a reasonable basis for such reliance.

(n) *Solicitation of a municipal entity or obligated person* has the same meaning as in section 15B(e)(9) of the Act (15 U.S.C. 78*o*–4(e)(9)); *provided, however,* that a solicitation does not include:

(1) Advertising by a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser; or

(2) Solicitation of an obligated person, if such obligated person is not acting in the capacity of an obligated person or the solicitation of the obligated person is not in connection with the issuance of municipal securities or with respect to municipal financial products.

[78 FR 67633, Nov. 12, 2013]

§ 240.15Ba1–2 Registration of municipal advisors and information regarding certain natural persons.

(a) *Form MA.* A person applying for registration with the Commission as a municipal advisor pursuant to section 15B of the Act (15 U.S.C. 78*o*–4) must complete Form MA (17 CFR 249.1300) in accordance with the instructions in the Form and file the Form electronically with the Commission.

(b) *Form MA–I.* (1) A person applying for registration or registered with the Commission as a municipal advisor pursuant to section 15B of the Act (15 U.S.C. 78*o*–4) must complete Form MA–I (17 CFR 249.1310) with respect to each natural person who is a person associated with the municipal advisor (as defined in section 15B(e)(7) of the Act (15 U.S.C. 78*o*–4(e)(7))) and engaged in municipal advisory activities on its behalf in accordance with the instructions in the Form and file the Form electronically with the Commission.

(2) A natural person applying for registration with the Commission as a municipal advisor pursuant to section 15B of the Act (15 U.S.C. 78*o*–4), in addition to completing and filing Form MA pursuant to paragraph (a) of this section, must complete Form MA–I (17 CFR 249.1310) in accordance with the instructions in the Form and file the Form electronically with the Commission.

(c) *When filed.* Each Form MA (17 CFR 249.1300) shall be considered filed with the Commission upon submission of a completed Form MA, together with all additional required documents, including all required filings of Form MA–I (17 CFR 249.1310), to the Commission's Electronic Data Gathering, Analysis, and Retrieval system.

(d) *Form MA and Form MA–I are reports.* Each Form MA (17 CFR 249.1300) and Form MA–I (17 CFR 249.1310) required to be filed under this section shall constitute a report within the meaning of sections 15B(c), 17(a), 18(a), 32(a) of the Act (15 U.S.C. 78*o*–4(c), 78q(a), 78r(a), 78ff(a)) and other applicable provisions of the Act.

[78 FR 67633, Nov. 12, 2013]

§ 240.15Ba1–3 Exemption of certain natural persons from registration under section 15B(a)(1)(B) of the Act.

A natural person municipal advisor shall be exempt from section 15B(a)(1)(B) of the Act (15 U.S.C. 78*o*–4(a)(1)(B)) if he or she:

(a) Is an associated person of an advisor that is registered with the Commission pursuant to section 15B(a)(2) of the Act (15 U.S.C. 78*o*–4(a)(2)) and the rules and regulations thereunder; and

(b) Engages in municipal advisory activities solely on behalf of a registered municipal advisor.

[78 FR 67633, Nov. 12, 2013]

§ 240.15Ba1–4 Withdrawal from municipal advisor registration.

(a) *Form MA–W.* Notice of withdrawal from registration as a municipal advisor shall be filed on Form MA–W (17 CFR 249.1320) in accordance with the instructions to the Form.

(b) *Electronic filing.* Any notice of withdrawal on Form MA–W (17 CFR 249.1320) must be filed electronically.

(c) *Effective date.* A notice of withdrawal from registration shall become effective for all matters on the 60th day after the filing thereof, within such longer period of time as to which the municipal advisor consents or which the Commission by order may determine as necessary or appropriate in the public interest or for the protection of investors, or within such shorter period of time as the Commission may determine. If a notice of withdrawal from registration is filed at any time subsequent to the date of the issuance of a Commission order instituting proceedings pursuant to section 15B(c) of the Act (15 U.S.C. 78*o*–4(c)) to censure, place limitations on the activities, functions or operations of, or suspend or revoke the registration of, the municipal advisor, or if prior to the effective date of the notice of withdrawal pursuant to this paragraph (c), the Commission institutes such a proceeding or a proceeding to impose terms or conditions upon such withdrawal, the notice of withdrawal shall not become effective pursuant to this paragraph (c) except at such time and upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

(d) *Form MA–W is a report.* Each Form MA–W (17 CFR 249.1320) required to be filed under this section shall constitute a report within the meaning of sections 15B(c), 17(a), 18(a), 32(a) of the Act (15 U.S.C. 78*o*–4(c), 78q(a), 78r(a), 78ff(a)) and other applicable provisions of the Act.

[78 FR 67633, Nov. 12, 2013]

§ 240.15Ba1–5 Amendments to Form MA and Form MA–I.

(a) *When amendment is required—Form MA.* A registered municipal advisor shall promptly amend the information contained in its Form MA (17 CFR 249.1300):

(1) At least annually, within 90 days of the end of a municipal advisor's fiscal year, or of the end of the calendar year for a sole proprietor; and

(2) More frequently, if required by the General Instructions (17 CFR 249.1300), as applicable.

(b) *When amendment is required—Form MA–I.* A registered municipal advisor shall promptly amend the information contained in Form MA–I (17 CFR 249.1310) by filing an amended Form MA–I whenever the information contained in the Form MA–I becomes inaccurate for any reason.

(c) *Electronic filing of amendments.* A registered municipal advisor shall file all amendments to Form MA (17 CFR 249.1300) and Form MA–I (17 CFR 249.1310) electronically.

(d) *Amendments to Form MA and Form MA–I are reports.* Each amendment required to be filed under this section shall constitute a report within the meaning of sections 15B(c), 17(a), 18(a), 32(a) of the Act (15 U.S.C. 78*o*–4(c), 78q(a), 78r(a), 78ff(a)) and other applicable provisions of the Act.

[78 FR 67633, Nov. 12, 2013]

§ 240.15Ba1–6 Consent to service of process to be filed by non-resident municipal advisors; legal opinion to be provided by non-resident municipal advisors.

(a)(1) Each non-resident municipal advisor applying for registration pursuant to section 15B(a) of the Act (15 U.S.C. 78*o*–4(a)) shall, at the time of filing of the municipal advisor's application on Form MA (17 CFR 249.1300), file with the Commission a written irrevocable consent and power of attorney on Form MA–NR (17 CFR 249.1330) to appoint an agent in the United States, other than a Commission member, official, or employee, upon whom may be served any process, pleadings, or other papers in any action brought against the non-resident municipal advisor to enforce this chapter.

(2) Each municipal advisor applying for registration pursuant to or registered under section 15B of the Act (15 U.S.C. 78*o*–4) shall, at the time of filing the relevant Form MA (17 CFR 249.1300) or Form MA–I (17 CFR 249.1310), file with the Commission a written irrevocable consent and power of attorney on Form MA–NR (17 CFR 249.1330) to appoint an agent in the United States, other than a Commission member, official, or employee, upon whom may be served any process, pleadings, or other papers in any action brought against the municipal advisor's non-resident general partner or non-resident managing agent, or non-resident natural persons who are persons associated with the municipal advisor (as defined in section 15B(e)(7) of the Act (15 U.S.C.

78*o*–4(e)(7))) and engaged in municipal advisory activities on its behalf, to enforce this chapter.

(b) The registered municipal advisor shall communicate promptly to the Commission by filing a new Form MA–NR (17 CFR 249.1330) any change to the name or address of the agent for service of process of each such non-resident municipal advisor, general partner, managing agent, or natural persons who are persons associated with the municipal advisor (as defined in section 15B(e)(7) of the Act (15 U.S.C. 78*o*–4(e)(7))) and engaged in municipal advisory activities on its behalf.

(c)(1) Each registered non-resident municipal advisor must promptly appoint a successor agent for service of process and file a new Form MA–NR (17 CFR 249.1330) if the non-resident municipal advisor discharges its identified agent for service of process or if its agent for service of process is unwilling or unable to accept service on behalf of the non-resident municipal advisor.

(2) Each registered municipal advisor must require each of its non-resident general partners or non-resident managing agents, or non-resident natural persons who are persons associated with the municipal advisor (as defined in section 15B(e)(7) of the Act (15 U.S.C. 78*o*–4(e)(7))) and engaged in municipal advisory activities on its behalf, to promptly appoint a successor agent for service of process and the registered municipal advisor must file a new Form MA–NR (17 CFR 249.1330) if such non-resident general partner, managing agent, or associated person discharges the identified agent for service of process or if the agent for service of process is unwilling or unable to accept service on behalf such person.

(d) Each non-resident municipal advisor applying for registration pursuant to section 15B(a) of the Act (15 U.S.C. 78*o*–4(a)) shall provide an opinion of counsel on Form MA (17 CFR 249.1300) that the municipal advisor can, as a matter of law, provide the Commission with access to the books and records of the municipal advisor as required by law and that the municipal advisor can, as a matter of law, submit to inspection and examination by the Commission.

(e) Form MA–NR (17 CFR 249.1330) must be filed electronically.

[78 FR 67633, Nov. 12, 2013]

§ 240.15Ba1–7 Registration of successor to municipal advisor.

(a) In the event that a municipal advisor succeeds to and continues the business of a municipal advisor registered pursuant to section 15B(a) of the Act (15 U.S.C. 78*o*–4(a)), the registration of the predecessor shall be deemed to remain effective as the registration of the successor if the successor, within 30 days after the succession, files an application for registration on Form MA (17 CFR 249.1300), and the predecessor files a notice of withdrawal from registration on Form MA–W (17 CFR 249.1320); *provided, however*, that the registration of the predecessor municipal advisor will cease to be effective as the registration of the successor municipal advisor 45 days after the application for registration on Form MA is filed by the successor.

(b) Notwithstanding paragraph (a) of this section, if a municipal advisor succeeds to and continues the business of a registered predecessor municipal advisor, and the succession is based solely on a change in the predecessor's date or state of incorporation, form of organization, or composition of a partnership, the successor may, within 30 days after the succession, amend the registration of the predecessor municipal advisor on Form MA (17 CFR 249.1300) to reflect these changes. This amendment shall be deemed an application for registration filed by the predecessor and adopted by the successor.

[78 FR 67633, Nov. 12, 2013]

§ 240.15Ba1–8 Books and records to be made and maintained by municipal advisors.

(a) Every person registered or required to be registered under section 15B of the Act (15 U.S.C. 78*o*-4) and the rules and regulations thereunder shall make and keep true, accurate, and current the following books and records relating to its municipal advisory activities:

(1) Originals or copies of all written communications received, and originals or copies of all written communications sent, by such municipal advisor (including inter-office memoranda and communications) relating to municipal advisory activities, regardless of the format of such communications;

(2) All check books, bank statements, general ledgers, cancelled checks and cash reconciliations of the municipal advisor;

(3) A copy of each version of the municipal advisor's policies and procedures, if any, that:

(i) Are in effect; or

(ii) At any time within the last five years were in effect, not including those in effect prior to July 1, 2014;

(4) A copy of any document created by the municipal advisor that was material to making a recommendation to a municipal entity or obligated person or that memorializes the basis for that recommendation;

(5) All written agreements (or copies thereof) entered into by the municipal advisor with any municipal entity, employee of a municipal entity, or an obligated person or otherwise relating to the business of such municipal advisor as such;

(6) A record of the names of persons who are currently, or within the past five years were, associated with the municipal advisor, not including persons associated with the municipal advisor prior to July 1, 2014;

(7) Books and records containing a list or other record of:

(i) The names, titles, and business and residence addresses of all persons associated with the municipal advisor;

(ii) All municipal entities or obligated persons with which the municipal advisor is engaging or has engaged in municipal advisory activities in the past five years, not including those prior to July 1, 2014;

(iii) The name and business address of each person to whom the municipal advisor provides or agrees to provide, directly or indirectly, payment to solicit a municipal entity, an employee of a municipal entity, or an obligated person on its behalf; and

(iv) The name and business address of each person that provides or agrees to provide, directly or indirectly, payment to the municipal advisor to solicit a municipal entity, an employee of a municipal entity, or an obligated person on its behalf; and

(8) Written consents to service of process from each natural person who is a person associated with the municipal advisor and engages in municipal advisory activities solely on behalf of such municipal advisor.

(b)(1) All books and records required to be made under this section shall be maintained and preserved for a period of not less than five years, the first two years in an easily accessible place.

(2) Partnership articles and any amendments thereto, articles of incorporation, charters, minute books, and stock certificate books of the municipal advisor and of any predecessor, excluding those that were only in effect prior to July 1, 2014, shall be maintained in the principal office of the municipal advisor and preserved until at least three years after termination of the business or withdrawal from registration as a municipal advisor.

(c) A municipal advisor subject to paragraph (a) of this section, before ceasing to conduct or discontinuing business as a municipal advisor, shall arrange for and be responsible for the preservation of the books and records required to be maintained and preserved under this section for the remainder of the period specified in this section, and shall notify the Commission in writing, at its principal office in Washington, DC, of the exact address where such books and records will be maintained during such period.

(d) *Electronic storage permitted.* (1) *General.* The records required to be maintained and preserved pursuant to this part may be maintained and preserved for the required time on:

(i) Electronic storage media, including any digital storage medium or system that meets the terms of this section; or

(ii) Paper documents.

(2) *General requirements.* The municipal advisor must:

(i) Arrange and index the records in a way that permits easy location, access, and retrieval of any particular record;

(ii) Provide promptly any of the following that the Commission (by its staff or other representatives) may request:

(A) A legible, true, and complete copy of the record in the medium and format in which it is stored;

(B) A legible, true, and complete printout of the record; and

(C) Means to access, view, and print the records; and

(iii) Separately store, for the time required for preservation of the record, a duplicate copy of the record on any medium allowed by this section.

(3) *Special requirements for electronic storage media*. In the case of records on electronic storage media, the municipal advisor must establish and maintain procedures:

(i) To maintain and preserve the records, so as to reasonably safeguard them from loss, alteration, or destruction;

(ii) To limit access to the records to properly authorized personnel and the Commission (including its staff and other representatives); and

(iii) To reasonably ensure that any reproduction of a non-electronic record on electronic storage media is complete, true, and legible when retrieved.

(e)(1) Any book or other record made, kept, maintained, and preserved in compliance with §§ 240.17a–3 and 240.17a–4, rules of the Municipal Securities Rulemaking Board, or § 275.204–2 under the Investment Advisers Act of 1940 (15 U.S.C. 80b–1 *et seq.*), which is substantially the same as a book or other record required to be made, kept, maintained, and preserved under this section, shall satisfy the requirements of this section.

(2) A record made and kept pursuant to any provision of paragraph (a) of this section that contains all the information required under any other provision of paragraph (a) of this section, need not be maintained in duplicate in order to meet the requirements of the other provisions of paragraph (a) of this section.

(f)(1) Except as provided in paragraph (f)(3) of this section, each non-resident municipal advisor registered or applying for registration pursuant to section 15B of the Act (15 U.S.C. 78*o*-4) and the rules and regulations thereunder shall keep, maintain, and preserve, at a place within the United States designated in a notice from such municipal advisor as provided in paragraph (f)(2) of this section, true, correct, complete, and current copies of books and records that such municipal advisor is required to make, keep current, maintain or preserve pursuant to any provisions of any rule or regulation of the Commission adopted under the Act.

(2) Except as provided in paragraph (f)(3) of this section, each non-resident municipal advisor subject to paragraph (f)(1) of this section shall furnish to the Commission a written notice specifying the address of the place within the United States where the copies of the books and records required to be kept, maintained, and preserved by such municipal advisor pursuant to paragraph (f)(1) of this section are located. Each non-resident municipal advisor registered or applying for registration when this paragraph becomes effective shall file such notice within 30 calendar days after this paragraph becomes effective. Each non-resident municipal advisor that files an application for registration after this paragraph becomes effective shall file such notice with such application for registration.

(3) Notwithstanding the provisions of paragraphs (f)(1) and (2) of this section, a non-resident municipal advisor need not keep, maintain, or preserve within the United States copies of the books and records referred to in paragraphs (f)(1) and (2) of this section, if:

(i) Such non-resident municipal advisor files with the Commission, at the time or within the period provided by paragraph (f)(2) of this section, a written undertaking, in a form acceptable to the Commission and signed by a duly authorized person, to furnish to the Commission, upon demand, at the Commission's principal office in Washington, DC, or at any Regional Office of the Commission designated in such demand, true, correct, complete, and current copies of any or all of the books and records which such municipal advisor is required to make, keep current, maintain, or preserve pursuant to any provision of any rule or regulation of the Commission adopted under the Act, or any part of such books and records that may be specified in such demand.

Such undertaking shall be in substantially the following form:

The undersigned hereby undertakes to furnish at its own expense to the Securities and Exchange Commission at the Commission's principal office in Washington, DC or at any Regional Office of the Commission specified in a demand for copies of books and records made by or on behalf of the Commission, true, correct, complete, and current copies of any or all, or any part, of the books and records that the undersigned is required to make, keep current, maintain, or preserve pursuant to any provision of any rule or regulation of the Securities and Exchange Commission under the Securities Exchange Act of 1934. This undertaking shall be suspended during any period when the undersigned is making, keeping current, maintaining, and preserving copies of all of said books and records at a place within the United States in compliance with 17 CFR 240.15Ba1–7(f)(1) and (2). This undertaking shall be binding upon the undersigned and the heirs, successors and assigns of the undersigned, and the written irrevocable consents and powers of attorney of the undersigned, its general partners, and managing agents filed with the Securities and Exchange Commission shall extend to and cover any action to enforce the same.

and

(ii) Such non-resident municipal advisor furnishes to the Commission, at such municipal advisor's own expense 14 calendar days after written demand therefor forwarded to such municipal advisor by registered mail at such municipal advisor's last address of record filed with the Commission and signed by the Secretary of the Commission or such person as the Commission may authorize to act in its behalf, true, correct, complete, and current copies of any or all books and records which such municipal advisor is required to make, keep current, maintain, or preserve pursuant to any provision of any rule or regulation of the Commission adopted under the Act, or any part of such books and records that may be specified in said written demand. Such copies shall be furnished to the Commission at the Commission's principal office in Washington, DC, or at any Regional Office of the Commission which may be specified in said written demand.

[78 FR 67633, Nov. 12, 2013, as amended at 79 FR 2779, Jan. 16, 2014]

§ 240.15Ba2–1 Application for registration of municipal securities dealers which are banks or separately identifiable departments or divisions of banks.

(a) An application for registration, pursuant to Section 15B(a) of the Act, of a municipal securities dealer which is a bank (as defined in section 3(a)(6) of the Act) or a separately identifiable department or division of a bank (as defined by the Municipal Securities Rulemaking Board), shall be filed with the Commission on Form MSD (§ 249.950 of this chapter), in accordance with the instructions contained therein.

(b) If the information contained in any application for registration pursuant to paragraph (a) of this section, or in any amendment to such application, is or becomes inaccurate for any reason, applicant shall promptly file an amendment on Form MSD (§ 249.950 of this chapter) correcting such information.

(c) Every amendment filed pursuant to this rule shall constitute a ''report'' within the meaning of sections 17 and 32(a) of the Act (15 U.S.C. 78q and 78ff (a)).

[40 FR 49776, Oct. 24, 1975]

§ 240.15Ba2–2 Application for registration of non-bank municipal securities dealers whose business is exclusively intrastate.

(a) An application for registration, pursuant to section 15B(a) of the Act, of a municipal securities dealer who is not subject to the requirements of § 240.15Ba2–1, that is filed on or after January 25, 1993, shall be filed with the Central Registration Depository (operated by the Financial Industry Regulatory Authority, Inc.) on Form BD in accordance with the instructions contained therein.

(b) Every applicant shall file with its application for registration a statement that such applicant is filing for registration as an intrastate dealer in accordance with the requirements of this section. Such statement shall be deemed a part of the application for registration.

(c) If the information contained in any application for registration filed pursuant to paragraph (a) of this section, or in any amendment to such application, is or becomes inaccurate for any reason, the dealer shall promptly file with the Central Registration Depository an amendment on Form BD correcting such information.

(d) Every application or amendment filed with the Central Registration Depository pursuant to this section shall constitute a ''report'' filed with the Commission within the meaning of Sections 15(b), 15B(c), 17(a), 18(a), 32(a) (15 U.S.C. 78o(b), 78o–4(c), 78q(a), 78r(a), 78ff(a)) and other applicable provisions of the Act.

[58 FR 14, Jan. 4, 1993, as amended at 64 FR 25148, May 10, 1999; 64 FR 37594, July 12, 1999; 64 FR 42596, Aug. 5, 1999; 73 FR 4692, Jan. 28, 2008]

§ 240.15Ba2–4 Registration of successor to registered municipal securities dealer.

(a) In the event that a municipal securities dealer succeeds to and continues the business of a registered municipal securities dealer, the registration of the predecessor shall be deemed to remain effective as the registration of the successor if the successor, within 30 days after such succession, files an application for registration on Form MSD, in the case of a municipal securities dealer that is a bank or a separately identifiable department or division of a bank, or Form BD, in the case of any other municipal securities dealer, and the predecessor files a notice of withdrawal from registration on Form MSDW or Form BDW, as the case may be; *Provided, however,* That the registration of the predecessor dealer will cease to be effective as the registration of the successor dealer 45 days after the application for registration on Form MSD or Form BD is filed by such successor.

(b) Notwithstanding paragraph (a) of this section, if a municipal securities dealer succeeds to and continues the business of a registered predecessor municipal securities dealer, and the succession is based solely on a change in the predecessor's date or state of incorporation, form of organization, or composition of a partnership, the successor may, within 30 days after the succession, amend the registration of the predecessor dealer on Form MSD, in the case of a predecessor municipal securities dealer that is a bank or a separately identifiable department or division of a bank, or on Form BD, in the case of any other municipal securities dealer, to reflect these changes. This amendment shall be deemed an application for registration filed by the predecessor and adopted by the successor.

[58 FR 10, Jan. 4, 1993]

§ 240.15Ba2–5 Registration of fiduciaries.

The registration of a municipal securities dealer shall be deemed to be the registration of any executor, administrator, guardian, conservator, assignee for the benefit of creditors, receiver, trustee in insolvency or bankruptcy, or other fiduciary, appointed or qualified by order, judgment, or decree of a court of competent jurisdiction to continue the business of such registered municipal securities dealer, provided that such fiduciary files with the Commission, within 30 days after entering upon the performance of his duties, a statement setting forth as to such fiduciary substantially the information required by Form MSD, if the municipal securities dealer is a bank or a separately identifiable department of a bank, or Form BD, if the municipal securities dealer is other than a bank or a separately identifiable department or division of a bank.

[41 FR 28948, July 14, 1976]

§ 240.15Ba2–6 [Reserved]

§ 240.15Bc3–1 Withdrawal from registration of municipal securities dealers.

(a) Notice of withdrawal from registration as a municipal securities dealer pursuant to Section 15B(c) (15 U.S.C. 78o–4(c)) shall be filed on Form MSDW (17 CFR 249.1110), in the case of a municipal securities dealer which is a bank or a separately identifiable department or division of a bank, or Form BDW (17 CFR 249.501a), in the case of any other municipal securities dealer, in accordance with the instructions contained therein. Prior to filing a notice of withdrawal from registration on Form MSDW (17 CFR 249.1110) or Form BDW (17 CFR 249.501a), a municipal securities dealer shall amend Form MSD (17 CFR 249.1100) in accordance with § 240.15Ba2–1(b) or amend Form BD (17 CFR 249.501) in accordance with § 240.15Ba2–2(c) to update any inaccurate information.

(b) Every notice of withdrawal from registration as a municipal securities dealer that is filed on Form BDW (17 CFR 249.501a) shall be filed with the Central Registration Depository (operated by the Financial Industry Regulatory Authority, Inc.) in accordance with applicable filing requirements. Every notice of withdrawal of Form MSDW (17 CFR 249.1110) shall be filed with the Commission.

(c) A notice of withdrawal from registration filed by a municipal securities dealer pursuant to Section 15B(c) (15 U.S.C. 78o–4(c)) shall become effective for all matters on the 60th day after the filing thereof with the Commission, within such longer period of time as to which such municipal securities dealer consents or which the Commission by order may determine as necessary or appropriate in the public interest or for the protection of investors, or within such shorter period of time as the Commission may determine. If a notice of withdrawal from registration is filed with the Commission at any time subsequent to the date of the issuance of a Commission order instituting proceedings pursuant to Section 15B(c) (15 U.S.C. 78o–4(c)) to censure, place limitations on the activities, functions or operations of, or suspend or revoke the registration of, such municipal securities dealer, or if prior to the effective date of the notice of withdrawal pursuant to this paragraph (c), the Commission institutes such a proceeding or a proceeding to impose terms or conditions upon such withdrawal, the notice of withdrawal shall not become effective pursuant to this paragraph (c) except at such time and upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

(d) Every notice of withdrawal filed with the Central Registration Depository pursuant to this section shall constitute a "report" filed with the Commission within the meaning of Sections 15B(c), 17(a), 18(a), 32(a) (15 U.S.C. 78o–4(c), 78q(a), 78r(a), 78ff(a)) and other applicable provisions of the Act.

(e) The Commission, by order, may exempt any broker or dealer from the filing requirements provided in Form BDW (17 CFR 249.501a) under conditions that differ from the filing instructions contained in Form BDW.

[64 FR 25148, May 10, 1999, as amended at 64 FR 42596, Aug. 5, 1999; 73 FR 4692, Jan. 28, 2008]

§ 240.15Bc4–1 Persons associated with municipal advisors.

A person associated, seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated with a municipal advisor, shall be subject to a Commission order that censures or places limitations on the activities or functions of such person, or suspends for a period not exceeding twelve months or bars such person from being associated with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed any act, or is subject to an order or finding, enumerated in subparagraph (A), (D), (E), (H), or (G) of paragraph (4) of section 15(b) of the Act (15 U.S.C. 78*o*(b)(4)(A), 78*o*(b)(4)(D), 78*o*(b)(4)(E), 78*o*(b)(4)(H), 78*o*(b)(4)(G)), has been convicted of any offense specified in subparagraph (B) of such paragraph (4) (15 U.S.C. 78*o*(b)(4)(B)) within 10 years of the commencement of the proceedings under section 15B(c)(4) (15 U.S.C. 78*o*–4(c)(4)), or is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4) (15 U.S.C. 78*o*(b)(4)(C)). It shall be unlawful for any person as to whom an order entered pursuant to section 15B(c)(4) of the Act (15 U.S.C. 78*o*–4(c)(4)) or section 15B(c)(5) of the Act (15 U.S.C. 78*o*–4(c)(5)) suspending or barring him from being associated with a municipal advisor is in effect willfully to become, or to be, associated with a municipal advisor without the consent of the Commission, and it shall be unlawful for any municipal advisor to permit such a person to become, or remain, a person associated with it without the consent of the Commission, if such municipal advisor knew, or, in the exercise of reasonable care should have known, of such order.

[78 FR 67638, Nov. 12, 2013]

§ 240.15Bc7–1 Availability of examination reports.

(a) Upon written request, copies of any report of an examination of a municipal securities dealer made by the Commission or furnished to it by an appropriate regulatory agency pursuant to section 17(c)(3) of the Act or by a registered securities association pursuant to section 15B(c)(7)(B) of the Act shall be made available to the Municipal Securities Rulemaking Board (the "Board") by the Commission subject to the following limitations:

(1) The Board shall establish by rule and shall maintain adequate procedures for ensuring the confidentiality of any information made available to it by the Commission pursuant to section 15B(c)(7)(B) of the Act;

(2) Information made available to the Board shall not identify any municipal securities broker, municipal securities dealer, or associated person that is the subject of a non-public examination report.

(b) If information to be made available to the Board is furnished to the Commission on a separate form prepared by an appropriate regulatory agency other than the Commission or by a registered securities association, that form, rather than a copy of any report of an examination, will be made available to the Board, provided that the conditions set forth in this paragraph are satisfied. Within sixty days of every six month period ending May 31 and November 30, each appropriate regulatory agency or registered securities association making available information on a separate form shall furnish to the Commission two copies of a form containing the information set forth in paragraphs (b)(1) through (b)(8) of this section. The Commission shall make one copy of the form promptly available to the Board. Copies of any forms furnished pursuant to this paragraph shall not identify any municipal securities broker, municipal securities dealer, or associated person that is the subject of an examination from which information was derived for the form; however, the Commission may obtain for its own use, upon request, the identity of any such examinee or the full examination reports. Furnished forms shall include the following information:

(1) The report period.

(2)(i) With respect to a registered securities association, the number of examinations that formed the basis of the report and, of these examinations, the number that were routine, special, and financial/operational.

(ii) With respect to an appropriate regulatory agency that is a bank agency, the number of examinations that formed the basis of the report and, of these examinations, the number that were routine, special, and financial/operational. The number of examinations that formed the basis of the report of bank dealers and the number of examinations of separately identifiable departments or divisions of banks effecting municipal securities transactions.

(3) Indications of the violations of each Board rule found in examinations that formed the basis for the report.

(4) Copies of public notices issued during the report period of any formal actions and non-public information regarding any actions taken on violations of Board rules.

(5) Any comments concerning any questionable practices relating to municipal securities activities, whether or not covered by provisions of the Act and the rules and regulations thereunder, including the rules of the Board.

(6) Descriptions of any significant or recurring customer complaints relating to municipal securities activities received by the appropriate regulatory agency or registered securities association during the report period or by municipal securities dealers during the 12 month period preceding the examination.

(7) Description of any novel issues or interpretations arising under the Board's rules.

(8) Description of any changes to existing Board rules or additional rules that would improve the regulatory scheme for municipal securities professionals or assist in the enforcement of the Board's rules.

(c) Copies of any report of an examination of a municipal securities broker or municipal securities dealer made by the Commission or furnished to it pursuant to section 15B(c)(7)(B) or 17(c)(3) of the Act, or separate forms made available to the Commission pursuant to paragraph (b) of this section, will be maintained in a non-public file.

[50 FR 48556, Nov. 26, 1985]

REGISTRATION OF GOVERNMENT SECURITIES BROKERS AND GOVERNMENT SECURITIES DEALERS

SOURCE: Sections 240.15.Ca1–1 through 240.15Cc1–1 appear at 52 FR 16839, May 6, 1987, unless otherwise noted.

§ 240.15Ca1–1 Notice of government securities broker-dealer activities.

(a) Every government securities broker or government securities dealer that is a broker or dealer registered pursuant to section 15 or 15B of the Act (other than a financial institution as defined in section 3(a)(46) of the Act) shall file with the Commission written notice on Form BD (§ 249.501 of this chapter) in accordance with the instructions contained therein that it is a government securities broker or government securities dealer. After July 25, 1987, every broker or dealer subject to this paragraph shall file notice that it is a government securities broker or government securities dealer prior to or on the date it begins acting as a government securities broker or government securities dealer.

(b) Every government securities broker or government securities dealer required to file notice under paragraph (a) of this section shall file with the Commission written notice on Form BD in accordance with the instructions contained therein when it ceases to be a government securities broker or government securities dealer. Notice shall be filed within 30 days after the date the broker or dealer has ceased acting as a government securities broker or a government securities dealer.

(c) Any notice required pursuant to this section shall be considered filed with the Commission if it is filed with the Central Registration Depository (operated by the Financial Industry Regulatory Authority, Inc.) in accordance with applicable filing requirements.

[52 FR 16839, May 6, 1987, as amended at 58 FR 14, Jan. 4, 1993; 64 FR 25148, May 10, 1999; 73 FR 4693, Jan. 28, 2008]

§ 240.15Ca2–1 Application for registration as a government securities broker or government securities dealer.

(a) An application for registration pursuant to Section 15C(a)(1)(A) of the Act, of a government securities broker or government securities dealer that is filed on or after January 25, 1993, shall be filed with the Central Registration Depository (operated by the Financial Industry Regulatory Authority, Inc.) on Form BD in accordance with the instructions contained therein.

(b) Every application or amendment filed pursuant to this section shall constitute a "report" filed with the Commission within the meaning of Sections 15, 15C, 17(a), 18, 32(a), and other applicable provisions of the Act.

[58 FR 15, Jan. 4, 1993, as amended at 64 FR 37594, July 12, 1999; 64 FR 42596, Aug. 5, 1999; 73 FR 4693, Jan. 28, 2008]

§ 240.15Ca2–2 [Reserved]

§ 240.15Ca2–3 Registration of successor to registered government securities broker or government securities dealer.

(a) In the event that a government securities broker or government securities dealer succeeds to and continues the business of a government securities broker or government securities dealer registered pursuant to section 15C(a)(1)(A) of the Act, the registration of the predecessor shall be deemed to remain effective as the registration of the successor if the successor, within 30 days after such succession, files an application for registration on Form BD, and the predecessor files a notice of withdrawal from registration on Form BDW; *Provided, however,* That the registration of the predecessor government securities broker or government securities dealer will cease to be effective as the registration of the successor government securities broker or government securities dealer 45 days after the application for registration on Form BD is filed by such successor.

(b) Notwithstanding paragraph (a) of this section, if a government securities broker or government securities dealer succeeds to and continues the business of a predecessor government securities broker or government securities dealer that is registered pursuant to section 15C(a)(1)(A) of the Act, and the succession is based solely on a change in the predecessor's date or state of incorporation, form of organization, or composition of a partnership, the successor may, within 30 days after the succession, amend the registration of the predecessor broker or dealer on Form BD to reflect these changes. This amendment shall be deemed an application for registration filed by the predecessor and adopted by the successor.

[58 FR 11, Jan. 4, 1993]

§ 240.15Ca2–4 Registration of fiduciaries.

The registration of a government securities broker or government securities dealer pursuant to section 15C of the Act shall be deemed to be the registration of any executor, administrator, guardian, conservator, assignee for the benefit of creditors, receiver, trustee in insolvency or bankruptcy, or other fiduciary, appointed or qualified by order, judgment, or decree of a court of competent jurisdiction to continue the business of such registered government securities broker or government securities dealer, provided that such fiduciary files with the Commission, no more than 30 days after entering upon the performance of its duties, a statement setting forth as to such fiduciary substantially the information required by Form BD.

§ 240.15Ca2–5 Consent to service of process to be furnished by non-resident government securities brokers or government securities dealers and by non-resident general partners or managing agents of government securities brokers or government securities dealers.

(a) Each non-resident government securities broker or government securities dealer applying for registration pursuant to section 15C(a)(1)(A) of the Act, each non-resident general partner of a government securities broker or government securities dealer partnership that is applying for such registration, and each non-resident managing agent of any other unincorporated government securities broker or government securities dealer that is applying for registration, shall furnish to the Commission, in a form acceptable to the Commission, a written irrevocable consent and power of attorney that—

(1) Designates the Securities and Exchange Commission as an agent of such government securities broker or government securities dealer upon whom may be served any process, pleadings, or other papers in any civil suit or action brought in any appropriate court in any place subject to the jurisdiction of the United States, with respect to any cause of action,

(i) That accrues during the period beginning when such government securities broker or government securities dealer becomes registered pursuant to section 15C(a)(1)(A) of the Act and ending either when such registration is cancelled or revoked, or when a notice filed by such government securities broker or government securities dealer to withdraw from such registration becomes effective, whichever is earlier,

(ii) That arises out of any activity, in any place subject to the jurisdiction of the United States, occurring in connection with the conduct of the business of such government securities broker or government securities dealer, and

(iii) That is founded, directly or indirectly, upon the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, or any rule or regulation under any of those Acts, and

(2) Stipulates and agrees that any such civil suit or action may be commenced against such government securities broker or government securities dealer by the service of process upon the Commission and the forwarding of a copy thereof as provided in paragraph (c) of this section and that the service as aforesaid of any such process, pleadings, or other papers upon the Commission shall be taken and held in all courts to be as valid and binding as if due process service thereof had been made.

(b) Each government securities broker or government securities dealer registered pursuant to section 15C(a)(1)(A) of the Act that becomes a non-resident government securities broker or government securities dealer, and each general partner or managing agent of an unincorporated government securities broker or government securities dealer registered or applying for registration pursuant to section 15C(a)(1)(A) of the Act who becomes a non-resident after such registration or filing of an application for such registration, shall furnish such consent and power of attorney no more than 30 days thereafter.

(c) Service of any process, pleadings, or other papers on the Commission under this rule shall be made by delivering the requisite number of copies thereof to the Secretary of the Commission or to such other person as the Commission may authorize to act in its behalf. Whenever any process, pleadings, or other papers as aforesaid are served upon the Commission, it shall promptly forward a copy thereof by registered or certified mail to the appropriate defendants at their last address of record filed with the Commission; but any failure by the Commission to forward such a copy shall have no effect on the validity of the service made upon the Commission. The Commission shall be furnished a sufficient number of copies for such purpose, and one copy for its file.

(d) For purposes of this rule the following definitions shall apply:

(1) The term *managing agent* shall mean any person, including a trustee, who directs or manages or who participates in the directing or managing of the affairs of any unincorporated organization or association that is not a partnership.

(2) The term *non-resident government securities broker or government securities dealer* shall mean (i) in the case of an individual, one who is domiciled in or has his principal place of business in any place not subject to the jurisdiction of the United States, (ii) in the case of a corporation, one incorporated in or having its principal place of business in any place not subject to the jurisdiction of the United States; (iii) in the case of a partnership or other unincorporated organization or association, one having its principal place of business in any place not subject to the jurisdiction of the United States.

(3) A general partner or managing agent of a government securities broker or government securities dealer shall be deemed to be a non-resident if he is domiciled in any place not subject to the jurisdiction of the United States.

§ 240.15Cc1–1 Withdrawal from registration of government securities brokers or government securities dealers.

(a) Notice of withdrawal from registration as a government securities broker or government securities dealer pursuant to Section 15C(a)(1)(A) of the Act (15 U.S.C. 78o–5(a)(1)(A)) shall be filed on Form BDW (17 CFR 249.501a) in accordance with the instructions contained therein. Every notice of withdrawal from registration as a government securities broker or dealer shall be filed with the Central Registration Depository (operated by the Financial Industry Regulatory Authority, Inc.) in accordance with applicable filing requirements. Prior to filing a notice of withdrawal from registration on Form BDW (17 CFR 249.501a), a government securities broker or government securities dealer shall amend Form BD (17 CFR 249.501) in accordance with 17 CFR 400.5(a) to update any inaccurate information.

(b) A notice of withdrawal from registration filed by a government securities broker or government securities dealer shall become effective for all matters on the 60th day after the filing thereof with the Commission, within such longer period of time as to which such government securities broker or government securities dealer consents or the Commission by order may determine as necessary or appropriate in the public interest or for the protection of investors, or within such shorter period of time as the Commission may determine. If a notice of withdrawal from registration is filed with the Commission at any time subsequent to the date of the issuance of a Commission order instituting proceedings pursuant to Section 15C(c) (15 U.S.C. 78o–5(c)) to censure, place limitations on the activities, functions or operations of, or suspend or revoke the registration of such government securities broker or government securities dealer, or if prior to the effective date of the notice of withdrawal pursuant to this paragraph (b), the Commission institutes such a proceeding or a proceeding to impose terms or conditions upon such withdrawal, the notice of withdrawal shall not become effective pursuant to this paragraph (b) except at such time and upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

(c) Every notice of withdrawal filed with the Central Registration Depository pursuant to this section shall constitute a ''report'' filed with the Commission within the meaning of Sections 15(b), 15C(c), 17(a), 18(a), 32(a) (15 U.S.C. 78o(b), 78o–5(c), 78q(a), 78r(a), 78ff(a)) and other applicable provisions of the Act.

(d) The Commission, by order, may exempt any broker or dealer from the filing requirements provided in Form BDW (17 CFR 249.501a) under conditions that differ from the filing instructions contained in Form BDW.

[64 FR 25148, May 10, 1999, as amended at 64 FR 42596, Aug. 5, 1999; 73 FR 4693, Jan. 28, 2008]

Registration and Regulation of Security-based Swap Dealers and Major Security-based Swap Participants

Source: Sections 240.15Fb1–1 through 240.15Fb6–2 appear at 80 FR 49013, Aug. 14, 2015, unless otherwise noted.

§ 240.15Fb1–1. Signatures.

(a) Required signatures to, or within, any electronic submission (including, without limitation, signatories within the forms and certifications required by §§ 240.15Fb2–1, 240.15Fb2–4, and 240.15Fb6–2) must be in typed form rather than manual format. Signatures in an HTML, XML or XBRL document that are not required may, but are not required to, be presented in a graphic or image file within the electronic filing. When used in connection with an electronic filing, the term ''signature'' means an electronic entry in the form of a magnetic impulse or other form of computer data compilation of any letters or series of letters or characters comprising a name, executed, adopted or authorized as a signature.

(b) Each signatory to an electronic filing (including, without limitation, each signatory to the forms and certifications required by §§ 240.15Fb2–1, 240.15Fb2–4, and 240.15Fb6–2) shall manually sign a signature page or other document authenticating, acknowledging or otherwise adopting his or her signature that appears in typed form within the electronic filing. Such document shall be executed before or at the time the electronic filing is made. Upon request, the security-based swap dealer or major security-based swap participant shall furnish to the Commission or its staff a copy of any or all documents retained pursuant to this paragraph (b).

(c) A person required to provide a signature on an electronic submission (including, without limitation, each signatory to the forms and certifications required by §§ 240.15Fb2–1, 240.15Fb2–4, and 240.15Fb6–2) may not have the form or certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority.

(d) Each manually signed signature page or other document authenticating, acknowledging or otherwise adopting his or her signature that appears in typed form within the electronic filing—

(1) On Schedule F to Form SBSE (§ 249.1600 of this chapter), SBSE–A (§ 249.1600a of this chapter), or SBSE–BD (§ 249.1600b of this chapter), as appropriate, shall be retained by the filer until at least three years after the

form or certification has been replaced or is no longer effective;

(2) On Form SBSE–C (§ 249.1600c of this chapter) shall be retained by the filer until at least three years after the Form was filed with the Commission.

§ 240.15Fb2–1 Registration of security-based swap dealers and major security-based swap participants.

(a) *Application.* An application for registration of a security-based swap dealer or a major security-based swap participant that is filed pursuant to Section 15F(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(b)) shall be filed on Form SBSE (§ 249.1600 of this chapter) or Form SBSE–A (§ 249.1600a of this chapter) or Form SBSE–BD (§ 249.1600b of this chapter), as appropriate, in accordance with paragraph (c) and the instructions to the forms. Applicants shall also file as part of their application the required certifications on Form SBSE–C (§ 249.1600c of this chapter).

(b) *Senior Officer Certification.* A senior officer shall certify on Form SBSE–C (§ 249.1600c of this chapter) that;

(1) After due inquiry, he or she has reasonably determined that the security-based swap dealer or major security-based swap participant has developed and implemented written policies and procedures reasonably designed to prevent violation of federal securities laws and the rules thereunder, and

(2) He or she has documented the process by which he or she reached such determination.

(c) *Filing*—(1) *Electronic filing.* Every application for registration of a security-based swap dealer or major security-based swap participant and any additional registration documents shall be filed electronically with the Commission through the Commission's EDGAR system.

(2) *Filing date.* An application of a security-based swap dealer or a major security-based swap participant submitted pursuant to paragraph (a) of this section shall be considered filed when an applicant has submitted a complete Form SBSE–C (§ 249.1600c of this chapter) and a complete Form SBSE (§ 249.1600 of this chapter), Form SBSE–A (§ 249.1600a of this chapter), or Form SBSE–BD (§ 249.1600b of this chapter), as appropriate, and all required additional documents electronically with the Commission.

(d) *Conditional registration.* An applicant that has submitted a complete Form SBSE–C (§ 249.1600c of this chapter) and a complete Form SBSE (§ 249.1600 of this chapter) or Form SBSE–A (§ 249.1600a of this chapter) or Form SBSE–BD (§ 249.1600b of this chapter), as applicable, in accordance with paragraph (b) within the time periods set forth in § 240.3a67–8 (if the person is a major security-based swap participant) or § 240.3a71–2(b) (if the person is a security-based swap dealer), and has not withdrawn its registration shall be conditionally registered.

(e) *Commission decision.* The Commission may deny or grant ongoing registration to a security-based swap dealer or major security-based swap participant based on a security-based swap dealer's or major security-based swap participant's application, filed pursuant to paragraph (a) of this section. The Commission will grant ongoing registration if it finds that the requirements of Section 15F(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(b)) are satisfied. The Commission may institute proceedings to determine whether ongoing registration should be denied if it does not or cannot make such finding or if the applicant is subject to a statutory disqualification (as described in Sections 3(a)(39)(A) through (F) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(39)(A)–(F)), or the Commission is aware of inaccurate statements in the application. Such proceedings shall include notice of the grounds for denial under consideration and opportunity for hearing. At the conclusion of such proceedings, the Commission shall grant or deny such registration.

§ 240.15Fb2–3 Amendments to Form SBSE, Form SBSE–A, and Form SBSE–BD.

If a security-based swap dealer or a major security-based swap participant finds that the information contained in its Form SBSE (§ 249.1600 of this chapter), Form SBSE–A (§ 249.1600a of this chapter), or Form SBSE–BD (§ 249.1600b of this chapter), as appropriate, or in any amendment thereto, is or has become inaccurate for any reason, the security-based swap dealer or a major security-based swap participant shall promptly file an amendment electronically with the Commission through the Commission's EDGAR system on the appropriate Form to correct such information.

§ 240.15Fb2–4 Nonresident security-based swap dealers and major security-based swap participants.

(a) *Definition.* For purposes of this section, the terms *nonresident security-based swap dealer* and *nonresident major security-based swap participant* shall mean:

(1) In the case of an individual, one who resides, or has his or her principal place of business, in any place not in the United States;

(2) In the case of a corporation, one incorporated in or having its principal place of business in any place not in the United States; or

(3) In the case of a partnership or other unincorporated organization or association, one having its principal place of business in any place not in the United States.

(b) *Power of attorney.* (1) Each nonresident security-based swap dealer and nonresident major security-based swap participant registered or applying for registration pursuant to Section 15F(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(b)) shall obtain a written irrevocable consent and power of attorney appointing an agent in the United States, other than the Commission or a Commission member, official or employee, upon whom may be served any process, pleadings, or other papers in any action brought against the nonresident security-based swap dealer or nonresident major security-based swap participant to enforce the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*). This consent and power of attorney must be signed by the nonresident security-based swap dealer or nonresident major security-based swap participant and the named agent(s) for service of process.

(2) Each nonresident security-based swap dealer and nonresident major security-based swap participant registered or applying for registration pursuant to section 15F(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(b)) shall, at the time of filing its application on Form SBSE (§ 249.1600 of this chapter), Form SBSE–A (§ 249.1600a of this chapter), or Form SBSE–BD (§ 249.1600b of this chapter), as appropriate, furnish to the Commission the name and address of its United States agent for service of process on Schedule F to the appropriate form.

(3) Any change of a nonresident security-based swap dealer's and nonresident major security-based swap participant's agent for service of process and any change of name or address of a nonresident security-based swap dealer's and nonresident major security-based swap participant's existing agent for service of process shall be communicated promptly to the Commission through amendment of the Schedule F of Form SBSE (§ 249.1600 of this chapter), Form SBSE–A (§ 249.1600a of this chapter), or Form SBSE–BD (§ 249.1600b of this chapter), as appropriate.

(4) Each nonresident security-based swap dealer and nonresident major security-based swap participant must promptly appoint a successor agent for service of process, consistent with the process described in paragraph (b)(1), if the nonresident security-based swap dealer and nonresident major security-based swap participant discharges its identified agent for service of process or if its agent for service of process is unwilling or unable to accept service on behalf of the nonresident security-based swap dealer or nonresident major security-based swap participant.

(5) Each nonresident security-based swap dealer and nonresident major security-based swap participant must maintain, as part of its books and records, the agreement identified in paragraphs (b)(1) and (b)(4) of this section for at least three years after the agreement is terminated.

(c) *Access to books and records*—(1) *Certification and opinion of counsel.* Each nonresident security-based swap dealer and nonresident major security-based swap participant applying for registration pursuant to Section 15F(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(b) shall:

(i) Certify on Schedule F of Form SBSE (§ 249.1600 of this chapter), Form SBSE–A (§ 249.1600a of this chapter), or Form SBSE–BD (§ 249.1600b of this chapter), as appropriate, that the nonresident security-based swap dealer and nonresident major security-based swap participant can, as a matter of law, and will provide the Commission with prompt access to the books and records of such nonresident security-based swap dealer and nonresident major security-based swap participant, and can, as a matter of law, and will submit to onsite inspection and examination by the Commission; and

(ii) Provide an opinion of counsel that the nonresident security-based swap dealer and nonresident major security-based swap participant can, as a matter of law, provide the Commission with prompt access to the books and records of such nonresident security-based swap dealer and nonresident major security-based swap participant, and can, as a matter of law, submit to onsite inspection and examination by the Commission.

(2) *Amendments*. Each nonresident security-based swap dealer and nonresident major security-based swap participant shall re-certify, on Schedule F to Form SBSE (§ 249.1600 of this chapter), Form SBSE–A (§ 249.1600a of this chapter), or Form SBSE–BD (§ 249.1600b of this chapter), as applicable, within 90 days after any changes in the legal or regulatory framework that would impact the nonresident security-based swap dealer's or nonresident major security-based swap participant's ability to provide, or the manner in which it provides the Commission with prompt access to its books and records, or would impact the Commission's ability to inspect and examine the nonresident security-based swap dealer or nonresident major security-based swap participant. The re-certification shall be accompanied by a revised opinion of counsel describing how, as a matter of law, the nonresident security-based swap dealer or nonresident major security-based swap participant will continue to meet its obligations to provide the Commission with prompt access to its books and records and to be subject to Commission inspection and examination under the new regulatory regime.

§ 240.15Fb2–5 Registration of successor to registered security-based swap dealer or a major security-based swap participant.

(a) In the event that a security-based swap dealer or major security-based swap participant succeeds to and continues the business of a security-based swap dealer or major security-based swap participant registered pursuant to Section 15F(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(b)), the registration of the predecessor shall be deemed to remain effective as the registration of the successor if the successor, within 30 days after such succession, files an application for registration in accordance with § 240.15Fb2–1, and the predecessor files a notice of withdrawal from registration on Form SBSE–W (§ 249.1601 of this chapter).

(b) Notwithstanding paragraph (a) of this section, if a security-based swap dealer or major security-based swap participant succeeds to and continues the business of a registered predecessor security-based swap dealer or major security-based swap participant, and the succession is based solely on a change in the predecessor's date or state of incorporation, form of organization, or composition of a partnership, the successor may, within 30 days after the succession, amend the registration of the predecessor security-based swap dealer or major security-based swap participant on Form SBSE (§ 249.1600 of this chapter), Form SBSE–A (§ 249.1600a of this chapter), or Form SBSE–BD (§ 249.1600b of this chapter), as appropriate, to reflect these changes. This amendment shall be deemed an application for registration filed by the predecessor and adopted by the successor.

§ 240.15Fb2–6 Registration of fiduciaries.

The registration of a security-based swap dealer or a major security-based swap participant shall be deemed to be the registration of any executor, administrator, guardian, conservator, assignee for the benefit of creditors, receiver, trustee in insolvency or bankruptcy, or other fiduciary, appointed or qualified by order, judgment, or decree of a court of competent jurisdiction to continue the business of such registered security-based swap dealer or a major security-based swap participant; Provided, that such fiduciary files with the Commission, within 30 days after entering upon the performance of his or her duties, an amended Form SBSE (§ 249.1600 of this chapter), Form SBSE–A (§ 249.1600a of this chapter), or Form SBSE–BD (§ 249.1600b of this chapter), as appropriate, indicating the fiduciary's position with respect to management of the firm and, as an additional document, a copy of the order, judgment, decree, or other document appointing the fiduciary.

§ 240.15Fb3–1 Duration of registration.

(a) *General.* A person registered as a security-based swap dealer or major security-based swap participant in accordance with § 240.15Fb2–1 will continue to be so registered until the effective date of any cancellation, revocation or withdrawal of such registration.

(b) *Conditional registration.* Notwithstanding paragraph (a) of this section, conditional registration shall expire on the date the registrant withdraws from registration or the Commission grants or denies the person's ongoing registration in accordance with § 240.15Fb2–1(e).

§ 240.15Fb3–2 Withdrawal from registration.

(a) Notice of withdrawal from registration as a security-based swap dealer or major security-based swap participant pursuant to Section 15F(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(b)) shall be filed on Form SBSE–W (§ 249.1601 of this chapter) in accordance with the instructions contained therein. Every notice of withdrawal from registration as a security-based swap dealer or major security-based swap participant shall be filed electronically with the Commission through the Commission's EDGAR system. Prior to filing a notice of withdrawal from registration on Form SBSE–W, a security-based swap dealer or major security-based swap participant shall amend its Form SBSE (§ 249.1600 of this chapter), Form SBSE–A (§ 249.1600a of this chapter) or Form SBSE–BD (§ 249.1600b of this chapter), as appropriate, in accordance with § 240.15Fb2–3(a) to update any inaccurate information.

(b) A notice of withdrawal from registration filed by a security-based swap dealer or major security-based swap participant pursuant to Section 15F(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(b)) shall become effective for all matters (except as provided in this paragraph (b)) on the 60th day after the filing thereof with the Commission or its designee, within such longer period of time as to which such security-based swap dealer or major security-based swap participant consents or which the Commission by order may determine as necessary or appropriate in the public interest or for the protection of investors, or within such shorter period of time as the Commission may determine. If a notice of withdrawal from registration is filed with the Commission at any time subsequent to the date of the issuance of a Commission order instituting proceedings to censure, place limitations on the activities, functions or operations of, or suspend or revoke the registration of, such security-based swap dealer or major security-based swap participant, or if prior to the effective date of the notice of withdrawal pursuant to this paragraph (b), the Commission institutes such a proceeding or a proceeding to impose terms or conditions upon such withdrawal, the notice of withdrawal shall not become effective pursuant to this paragraph (b) except at such time and upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

§ 240.15Fb3–3 Cancellation and revocation of registration.

(a) *Cancellation.* If the Commission finds that any person registered pursuant to § 240.15Fb2–1 is no longer in existence or has ceased to do business as a security-based swap dealer or major security-based swap participant, the

Commission shall by order cancel the registration of such person.

(b) *Revocation.* The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, or revoke the registration of any security-based swap dealer or major security-based swap participant that has registered with the Commission if it makes a finding as specified in Section 15F(l)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(l)(2)).

§ 240.15Fb6–1 Associated persons.

Unless otherwise ordered by the Commission, when it files an application to register with the Commission as a security-based swap dealer or major security-based swap participant, a security-based swap dealer or a major security-based swap participant may permit a person that is associated with such security-based swap dealer or major security-based swap participant that is not a natural person and that is subject to statutory disqualification to effect or be involved in effecting security-based swaps on its behalf, provided that the statutory disqualification(s), described in Sections 3(a)(39)(A) through (F) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(39)(A)–(F)), occurred prior to the compliance date of this rule, and provided that it identifies each such associated person on Schedule C of Form SBSE (§ 249.1600 of this chapter), Form SBSE–A (§ 249.1600a of this chapter), or Form SBSE–BD (§ 249.1600b of this chapter), as appropriate.

EFFECTIVE DATE NOTE: At 84 FR 4947, Feb. 19, 2019, § 240.15Fb6–1 was removed, effective Apr. 22, 2019.

§ 240.15Fb6–2 Associated person certification.

(a) *Certification.* No registered security-based swap dealer or major security-based swap participant shall act as a security-based swap dealer or major security-based swap participant unless it has certified electronically on Form SBSE–C (Section 249.1600c of this chapter) that it neither knows, nor in the exercise of reasonable care should have known, that any person associated with such security-based swap dealer or major security-based swap participant who effects or is involved in effecting security-based swaps on behalf of the security-based swap dealer or major security-based swap participant is subject to a statutory disqualification, as described in Sections 3(a)(39)(A) through (F) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(39)(A)–(F)), unless otherwise specifically provided by rule, regulation or order of the Commission.

(b) To support the certification required by paragraph (a) of this section, the security-based swap dealer's or major security-based swap participant's Chief Compliance Officer, or his or her designee, shall review and sign the questionnaire or application for employment, which the security-based swap dealer or major security-based swap participant is required to obtain pursuant to the relevant recordkeeping rule applicable to such security-based swap dealer or major security-based swap participant, executed by each associated person who is a natural person and who effects or is involved in effecting security based swaps on the security-based swap dealer's or major security-based swap participant's behalf. The questionnaire or application shall serve as a basis for a background check of the associated person to verify that the person is not subject to statutory disqualification.

§ 240.15Fh–1 Scope and reliance on representations.

(a) *Scope.* Sections 240.15Fh–1 through 240.15Fh–6, and 240.15Fk–1 are not intended to limit, or restrict, the applicability of other provisions of the federal securities laws, including but not limited to section 17(a) of the Securities Act of 1933 and sections 9 and 10(b) of the Act, and rules and regulations thereunder, or other applicable laws and rules and regulations. Sections 240.15Fh–1 through 240.15Fh–6, and 240.15Fk–1 apply, as relevant, in connection with entering into security-based swaps and continue to apply, as appropriate, over the term of executed security-based swaps. Sections 240.15Fh–3(a) through 240.15Fh–3(f), 240.15Fh–4(b) and 240.15Fh–5 are not applicable to security-based swaps that security-based swap dealers or major security-based swap participants enter into with their majority-owned affiliates. For these purposes the counterparties to a security-based swap are majority-owned affiliates if one counterparty directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the security-based swap, where "majority interest" is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

(b) *Reliance on representations.* A security-based swap dealer or major security-based swap participant may rely on written representations from the counterparty or its representative to satisfy its due diligence requirements under § 240.15Fh, unless it has information that would cause a reasonable person to question the accuracy of the representation.

[81 FR 30144, May 13, 2016]

§ 240.15Fh–2 Definitions.

As used in §§ 240.15Fh–1 through 240.15Fh–6:

(a) *Act as an advisor to a special entity.* A security-based swap dealer *acts as an advisor to a special entity* when it recommends a security-based swap or a trading strategy that involves the use of a security-based swap to the special entity, unless:

(1) With respect to a special entity as defined in § 240.15Fh–2(d)(3):

(i) The special entity represents in writing that it has a fiduciary as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) that is responsible for representing the special entity in connection with the security-based swap;

(ii) The fiduciary represents in writing that it acknowledges that the security-based swap dealer is not acting as an advisor; and

(iii) The special entity represents in writing:

(A) That it will comply in good faith with written policies and procedures reasonably designed to ensure that any recommendation the special entity receives from the security-based swap dealer involving a security-based swap transaction is evaluated by a fiduciary before the transaction is entered into; or

(B) That any recommendation the special entity receives from the security-based swap dealer involving a security-based swap transaction will be evaluated by a fiduciary before the transaction is entered into.

(2) With respect to any special entity:

(i) The special entity represents in writing that:

(A) It acknowledges that the security-based swap dealer is not acting as an advisor; and

(B) The special entity will rely on advice from a qualified independent representative as defined in § 240.15Fh–5(a); and

(ii) The security-based swap dealer discloses to the special entity that it is not undertaking to act in the best interest of the special entity, as otherwise required by section 15F(h)(4) of the Act.

(b) *Eligible contract participant* means any person as defined in section 3(a)(65) of the Act and the rules and regulations thereunder and in section 1a of the Commodity Exchange Act (7 U.S.C. 1a) and the rules and regulations thereunder.

(c) *Security-based swap dealer or major security-based swap participant* includes, where relevant, an associated person of the security-based swap dealer or major security-based swap participant.

(d) *Special entity* means:

(1) A Federal agency;

(2) A State, State agency, city, county, municipality, other political subdivision of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State;

(3) Any employee benefit plan, subject to Title I of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002);

(4) Any employee benefit plan defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) and not otherwise defined as a special entity, unless such employee benefit plan elects not to be a special entity by notifying a security-based swap dealer or major security-

based swap participant of its election prior to entering into a security-based swap with the particular security-based swap dealer or major security-based swap participant;

(5) Any governmental plan, as defined in section 3(32) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(32)); or

(6) Any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986.

(e) A person is *subject to a statutory disqualification* for purposes of §240.15Fh–5 if that person would be subject to a statutory disqualification, as described in section 3(a)(39)(A)–(F) of the Act.

[81 FR 30144, May 13, 2016]

§ 240.15Fh–3 Business conduct requirements.

(a) *Counterparty status*—(1) *Eligible contract participant*. A security-based swap dealer or a major security-based swap participant shall verify that a counterparty meets the eligibility standards for an eligible contract participant before entering into a security-based swap with that counterparty, provided that the requirements of this paragraph (a)(1) shall not apply to a transaction executed on a registered national securities exchange.

(2) *Special entity*. A security-based swap dealer or a major security-based swap participant shall verify whether a counterparty is a special entity before entering into a security-based swap with that counterparty, unless the transaction is executed on a registered or exempt security-based swap execution facility or registered national securities exchange, and the security-based swap dealer or major security-based swap participant does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer or major security-based swap participant to comply with the obligations of paragraph (a) of this section.

(3) *Special entity election*. In verifying the special entity status of a counterparty pursuant to §240.15Fh–3(a)(2), a security-based swap dealer or major security-based swap participant shall verify whether a counterparty is eligible to elect not to be a special entity under §240.15Fh–2(d)(4) and, if so, notify such counterparty of its right to make such an election.

(b) *Disclosure*. At a reasonably sufficient time prior to entering into a security-based swap, a security-based swap dealer or major security-based swap participant shall disclose to a counterparty, other than a security-based swap dealer, major security-based swap participant, swap dealer or major swap participant, material information concerning the security-based swap in a manner reasonably designed to allow the counterparty to assess the material risks and characteristics and material incentives or conflicts of interest, as described below, so long as the identity of the counterparty is known to the security-based swap dealer or major security-based swap participant at a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer or major security-based swap participant to comply with the obligations of paragraph (b) of this section.

(1) *Material risks and characteristics* means the material risks and characteristics of the particular security-based swap, which may include:

(i) Market, credit, liquidity, foreign currency, legal, operational, and any other applicable risks; and

(ii) The material economic terms of the security-based swap, the terms relating to the operation of the security-based swap, and the rights and obligations of the parties during the term of the security-based swap.

(2) *Material incentives or conflicts of interest* means any material incentives or conflicts of interest that the security-based swap dealer or major security-based swap participant may have in connection with the security-based swap, including any compensation or other incentives from any source other than the counterparty in connection with the security-based swap to be entered into with the counterparty.

(3) *Record*. The security-based swap dealer or major security-based swap participant shall make a written record of the non-written disclosures made pursuant to this paragraph (b),

and provide a written version of these disclosures to its counterparties in a timely manner, but in any case no later than the delivery of the trade acknowledgement of the particular transaction pursuant to § 240.15Fi–1.

(c) *Daily mark.* A security-based swap dealer or major security-based swap participant shall disclose the daily mark to the counterparty, other than a security-based swap dealer, major security-based swap participant, swap dealer or major swap participant, which shall be:

(1) For a cleared security-based swap, upon request of the counterparty, the daily mark that the security-based swap dealer or major security-based swap participant receives from the appropriate clearing agency;

(2) For an uncleared security-based swap, the midpoint between the bid and offer, or the calculated equivalent thereof, as of the close of business, unless the parties agree in writing otherwise to a different time, on each business day during the term of the security-based swap. The daily mark may be based on market quotations for comparable security-based swaps, mathematical models or a combination thereof. The security-based swap dealer or major security-based swap participant shall also disclose its data sources and a description of the methodology and assumptions used to prepare the daily mark, and promptly disclose any material changes to such data sources, methodology and assumptions during the term of the security-based swap; and

(3) The security-based swap dealer or major security-based swap participant shall provide the daily mark without charge to the counterparty and without restrictions on the internal use of the daily mark by the counterparty.

(d) *Disclosure regarding clearing rights.* A security-based swap dealer or major security-based swap participant shall disclose the following information to a counterparty, other than a security-based swap dealer, major security-based swap participant, swap dealer or major swap participant, so long as the identity of the counterparty is known to the security-based swap dealer or major security-based swap participant at a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer or major security-based swap participant to comply with the obligations of paragraph (d) of this section:

(1) *For security-based swaps subject to clearing requirement.* Before entering into a security-based swap subject to the clearing requirement under section 3C(a) of the Act, a security-based swap dealer or major security-based swap participant shall:

(i) Disclose to the counterparty the names of the clearing agencies that accept the security-based swap for clearing, and through which of those clearing agencies the security-based swap dealer or major security-based swap participant is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap; and

(ii) Notify the counterparty that it shall have the sole right to select which of the clearing agencies described in paragraph (d)(1)(i) of this section shall be used to clear the security-based swap subject to section 3C(g)(5) of the Act.

(2) *For security-based swaps not subject to clearing requirement.* Before entering into a security-based swap not subject to the clearing requirement under section 3C(a) of the Act, a security-based swap dealer or major security-based swap participant shall:

(i) Determine whether the security-based swap is accepted for clearing by one or more clearing agencies;

(ii) Disclose to the counterparty the names of the clearing agencies that accept the security-based swap for clearing, and whether the security-based swap dealer or major security-based swap participant is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap through such clearing agencies; and

(iii) Notify the counterparty that it may elect to require clearing of the security-based swap and shall have the sole right to select the clearing agency at which the security-based swap will be cleared, provided it is a clearing agency at which the security-based swap dealer or major security-based swap participant is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap.

(3) *Record.* The security-based swap dealer or major security-based swap participant shall make a written record of the non-written disclosures made pursuant to this paragraph (d), and provide a written version of these disclosures to its counterparties in a timely manner, but in any case no later than the delivery of the trade acknowledgement of the particular transaction pursuant to § 240.15Fi–1.

(e) *Know your counterparty.* Each security-based swap dealer shall establish, maintain and enforce written policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each counterparty whose identity is known to the security-based swap dealer that are necessary for conducting business with such counterparty. For purposes of paragraph (e) of this section, the *essential facts concerning a counterparty* are:

(1) Facts required to comply with applicable laws, regulations and rules;

(2) Facts required to implement the security-based swap dealer's credit and operational risk management policies in connection with transactions entered into with such counterparty; and

(3) Information regarding the authority of any person acting for such counterparty.

(f) *Recommendations of security-based swaps or trading strategies.* (1) A security-based swap dealer that recommends a security-based swap or trading strategy involving a security-based swap to a counterparty, other than a security-based swap dealer, major security-based swap participant, swap dealer, or major swap participant, must:

(i) Undertake reasonable diligence to understand the potential risks and rewards associated with the recommended security-based swap or trading strategy involving a security-based swap; and

(ii) Have a reasonable basis to believe that a recommended security-based swap or trading strategy involving a security-based swap is suitable for the counterparty. To establish a reasonable basis for a recommendation, a security-based swap dealer must have or obtain relevant information regarding the counterparty, including the counterparty's investment profile, trading objectives, and its ability to absorb potential losses associated with the recommended security-based swap or trading strategy involving a security-based swap.

(2) A security-based swap dealer may also fulfill its obligations under paragraph (f)(1)(ii) of this section with respect to an institutional counterparty, if:

(i) The security-based swap dealer reasonably determines that the counterparty, or an agent to which the counterparty has delegated decision-making authority, is capable of independently evaluating investment risks with regard to the relevant security-based swap or trading strategy involving a security-based swap;

(ii) The counterparty or its agent affirmatively represents in writing that it is exercising independent judgment in evaluating the recommendations of the security-based swap dealer with regard to the relevant security-based swap or trading strategy involving a security-based swap; and

(iii) The security-based swap dealer discloses that it is acting in its capacity as a counterparty, and is not undertaking to assess the suitability of the security-based swap or trading strategy for the counterparty.

(3) A security-based swap dealer will be deemed to have satisfied its obligations under paragraph (f)(2)(i) of this section if it receives written representations, as provided in § 240.15Fh–1(b), that:

(i) In the case of a counterparty that is not a special entity, the counterparty has complied in good faith with written policies and procedures that are reasonably designed to ensure that the persons responsible for evaluating the recommendation and making trading decisions on behalf of the counterparty are capable of doing so; or

(ii) In the case of a counterparty that is a special entity, satisfy the terms of the safe harbor in § 240.15Fh–5(b).

(4) For purposes of paragraph (f)(2) of this section, an institutional

counterparty is a counterparty that is an eligible contract participant as defined in clauses (A)(i), (ii), (iii), (iv), (viii), (ix) or (x), or clause (B)(ii) (other than a person described in clause (A)(v)) of section 1a(18) of the Commodity Exchange Act (7 U.S.C. 1(a)(18)) and the rules and regulations thereunder, or any person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.

(g) *Fair and balanced communications.* A security-based swap dealer or major security-based swap participant shall communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith. In particular:

(1) Communications must provide a sound basis for evaluating the facts with regard to any particular security-based swap or trading strategy involving a security-based swap;

(2) Communications may not imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast; and

(3) Any statement referring to the potential opportunities or advantages presented by a security-based swap shall be balanced by an equally detailed statement of the corresponding risks.

(h) *Supervision*—(1) *In general.* A security-based swap dealer or major security-based swap participant shall establish and maintain a system to supervise, and shall diligently supervise, its business and the activities of its associated persons. Such a system shall be reasonably designed to prevent violations of the provisions of applicable federal securities laws and the rules and regulations thereunder relating to its business as a security-based swap dealer or major security-based swap participant, respectively.

(2) *Minimum requirements.* The system required by paragraph (h)(1) of this section shall, at a minimum, provide for:

(i) The designation of at least one person with authority to carry out the supervisory responsibilities of the security-based swap dealer or major security-based swap participant for each type of business in which it engages for which registration as a security-based swap dealer or major security-based swap participant is required;

(ii) The use of reasonable efforts to determine that all supervisors are qualified, either by virtue of experience or training, to carry out their assigned responsibilities; and

(iii) Establishment, maintenance and enforcement of written policies and procedures addressing the supervision of the types of security-based swap business in which the security-based swap dealer or major security-based swap participant is engaged and the activities of its associated persons that are reasonably designed to prevent violations of applicable federal securities laws and the rules and regulations thereunder, and that include, at a minimum:

(A) Procedures for the review by a supervisor of transactions for which registration as a security-based swap dealer or major security-based swap participant is required;

(B) Procedures for the review by a supervisor of incoming and outgoing written (including electronic) correspondence with counterparties or potential counterparties and internal written communications relating to the security-based swap dealer's or major security-based swap participant's business involving security-based swaps;

(C) Procedures for a periodic review, at least annually, of the security-based swap business in which the security-based swap dealer or major security-based swap participant engages that is reasonably designed to assist in detecting and preventing violations of applicable federal securities laws and the rules and regulations thereunder;

(D) Procedures to conduct a reasonable investigation regarding the good character, business repute, qualifications, and experience of any person prior to that person's association with the security-based swap dealer or major security-based swap participant;

(E) Procedures to consider whether to permit an associated person to establish or maintain a securities or commodities account or a trading relationship in the name of, or for the benefit of such associated person, at another security-based swap dealer, broker, dealer, investment adviser, or other financial institution; and if permitted, procedures to supervise the trading at the other security-based swap dealer, broker, dealer, investment adviser, or financial institution;

(F) A description of the supervisory system, including the titles, qualifications and locations of supervisory persons and the responsibilities of each supervisory person with respect to the types of business in which the security-based swap dealer or major security-based swap participant is engaged;

(G) Procedures prohibiting an associated person who performs a supervisory function from supervising his or her own activities or reporting to, or having his or her compensation or continued employment determined by, a person or persons he or she is supervising; provided, however, that if the security-based swap dealer or major security-based swap participant determines, with respect to any of its supervisory personnel, that compliance with this requirement is not possible because of the firm's size or a supervisory person's position within the firm, the security-based swap dealer or major security-based swap participant must document the factors used to reach such determination and how the supervisory arrangement with respect to such supervisory personnel otherwise complies with paragraph (h)(1) of this section, and include a summary of such determination in the annual compliance report prepared by the security-based swap dealer's or major security-based swap participant's chief compliance officer pursuant to § 240.15Fk–1(c);

(H) Procedures reasonably designed to prevent the supervisory system required by paragraph (h)(1) of this section from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person, the revenue such person generates for the security-based swap dealer or major security-based swap participant, or any compensation that the associated person conducting the supervision may derive from the associated person being supervised; and

(I) Procedures reasonably designed, taking into consideration the nature of such security-based swap dealer's or major security-based swap participant's business, to comply with the duties set forth in section 15F(j) of the Act.

(3) *Failure to supervise.* A security-based swap dealer or major security-based swap participant or an associated person of a security-based swap dealer or major security-based swap participant shall not be deemed to have failed to diligently supervise any other person, if such other person is not subject to his or her supervision, or if:

(i) The security-based swap dealer or major security-based swap participant has established and maintained written policies and procedures as required in § 240.15Fh–3(h)(2)(iii), and a documented system for applying those policies and procedures, that would reasonably be expected to prevent and detect, insofar as practicable, any violation of the federal securities laws and the rules and regulations thereunder relating to security-based swaps; and

(ii) The security-based swap dealer or major security-based swap participant, or associated person of the security-based swap dealer or major security-based swap participant, has reasonably discharged the duties and obligations required by such written policies and procedures and documented system and did not have a reasonable basis to believe that such written policies and procedures and documented system were not being followed.

(4) *Maintenance of written supervisory procedures.* A security-based swap dealer or major security-based swap participant shall:

(i) Promptly amend its written supervisory procedures as appropriate when material changes occur in applicable securities laws or rules or regulations thereunder, and when material changes occur in its business or supervisory system; and

(ii) Promptly communicate any material amendments to its supervisory procedures to all associated persons to whom such amendments are relevant based on their activities and responsibilities.

[81 FR 30144, May 13, 2016]

§ 240.15Fh–4 Antifraud provisions for security-based swap dealers and major security-based swap participants; special requirements for security-based swap dealers acting as advisors to special entities.

(a) *Antifraud provisions.* It shall be unlawful for a security-based swap dealer or major security-based swap participant:

(1) To employ any device, scheme, or artifice to defraud any special entity or prospective customer who is a special entity;

(2) To engage in any transaction, practice, or course of business that operates as a fraud or deceit on any special entity or prospective customer who is a special entity; or

(3) To engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.

(b) *Special requirements for security-based swap dealers acting as advisors to special entities.* A security-based swap dealer that acts as an advisor to a special entity regarding a security-based swap shall comply with the following requirements:

(1) *Duty.* The security-based swap dealer shall have a duty to make a reasonable determination that any security-based swap or trading strategy involving a security-based swap recommended by the security-based swap dealer is in the best interests of the special entity.

(2) *Reasonable efforts.* The security-based swap dealer shall make reasonable efforts to obtain such information that the security-based swap dealer considers necessary to make a reasonable determination that a security-based swap or trading strategy involving a security-based swap is in the best interests of the special entity. This information shall include, but not be limited to:

(i) The authority of the special entity to enter into a security-based swap;

(ii) The financial status of the special entity, as well as future funding needs;

(iii) The tax status of the special entity;

(iv) The hedging, investment, financing or other objectives of the special entity;

(v) The experience of the special entity with respect to entering into security-based swaps, generally, and security-based swaps of the type and complexity being recommended;

(vi) Whether the special entity has the financial capability to withstand changes in market conditions during the term of the security-based swap; and

(vii) Such other information as is relevant to the particular facts and circumstances of the special entity, market conditions and the type of security-based swap or trading strategy involving a security-based swap being recommended.

(3) *Exception.* The requirements of this paragraph (b) shall not apply with respect to a security-based swap if:

(i) The transaction is executed on a registered or exempt security-based swap execution facility or registered national securities exchange; and

(ii) The security-based swap dealer does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer to comply with the obligations of paragraph (b) of this section.

[81 FR 30144, May 13, 2016]

§ 240.15Fh–5 Special requirements for security-based swap dealers and major security-based swap participants acting as counterparties to special entities.

(a)(1) A security-based swap dealer or major security-based swap participant that offers to enter into or enters into a security-based swap with a special entity, other than a special entity defined in § 240.15Fh–2(d)(3), must have a reasonable basis to believe that the special entity has a qualified independent representative. For these purposes, a qualified independent representative is a representative that:

(i) Has sufficient knowledge to evaluate the transaction and risks;

(ii) Is not subject to a statutory disqualification;

(iii) Undertakes a duty to act in the best interests of the special entity;

(iv) Makes appropriate and timely disclosures to the special entity of material information concerning the security-based swap;

(v) Evaluates, consistent with any guidelines provided by the special entity, the fair pricing and the appropriateness of the security-based swap;

(vi) In the case of a special entity defined in §§ 240.15Fh–2(d)(2) or (5), is a person that is subject to rules of the Commission, the Commodity Futures Trading Commission or a self-regulatory organization subject to the jurisdiction of the Commission or the Commodity Futures Trading Commission prohibiting it from engaging in specified activities if certain political contributions have been made, *provided that* this paragraph (a)(1)(vi) shall not apply if the independent representative is an employee of the special entity; and

(vii) Is independent of the security-based swap dealer or major security-based swap participant.

(A) A representative of a special entity is independent of a security-based swap dealer or major security-based swap participant if the representative does not have a relationship with the security-based swap dealer or major security-based swap participant, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision-making of the representative.

(B) A representative of a special entity will be deemed to be independent of a security-based swap dealer or major security-based swap participant if:

(*1*) The representative is not and, within one year of representing the special entity in connection with the security-based swap, was not an associated person of the security-based swap dealer or major security-based swap participant;

(*2*) The representative provides timely disclosures to the special entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the special entity and complies with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest; and

(*3*) The security-based swap dealer or major security-based swap participant did not refer, recommend, or introduce the representative to the special entity within one year of the representative's representation of the special entity in connection with the security-based swap.

(2) A security-based swap dealer or major security-based swap participant that offers to enter into or enters into a security-based swap with a special entity as defined in § 240.15Fh–2(d)(3) must have a reasonable basis to believe that the special entity has a representative that is a fiduciary as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002).

(b) *Safe harbor*. (1) A security-based swap dealer or major security-based swap participant shall be deemed to have a reasonable basis to believe that the special entity, other than a special entity defined in § 240.15Fh–2(d)(3), has a representative that satisfies the applicable requirements of paragraph (a)(1) of this section, provided that:

(i) The special entity represents in writing to the security-based swap dealer or major security-based swap participant that it has complied in good faith with written policies and procedures reasonably designed to ensure that it has selected a representative that satisfies the applicable requirements of paragraph (a)(1) of this section, and that such policies and procedures provide for ongoing monitoring of the performance of such representative consistent with the requirements of paragraph (a)(1) of this section; and

(ii) The representative represents in writing to the special entity and security-based swap dealer or major security-based swap participant that the representative:

(A) Has policies and procedures reasonably designed to ensure that it satisfies the applicable requirements of paragraph (a)(1) of this section;

(B) Meets the independence test in paragraph (a)(1)(vii) of this section; has the knowledge required under paragraph (a)(1)(i) of this section; is not subject to a statutory disqualification under paragraph (a)(1)(ii) of this section; undertakes a duty to act in the best interests of the special entity as required under paragraph (a)(1)(iii) of this section; and is subject to the requirements regarding political contributions, as applicable, under paragraph (a)(1)(vi) of this section; and

(C) Is legally obligated to comply with the applicable requirements of paragraph (a)(1) of this section by agreement, condition of employment, law, rule, regulation, or other enforceable duty.

(2) A security-based swap dealer or major security-based swap participant shall be deemed to have a reasonable basis to believe that a special entity defined in § 240.15Fh–2(d)(3) of this section has a representative that satisfies the applicable requirements in paragraph (a)(2) of this section, provided that the special entity provides in writing to the security-based swap dealer or major security-based swap participant the representative's name and contact information, and represents in writing that the representative is a fiduciary as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002).

(c) Before initiation of a security-based swap with a special entity, a security-based swap dealer shall disclose to the special entity in writing the capacity in which the security-based swap dealer is acting in connection with the security-based swap and, if the security-based swap dealer engages in business with the counterparty in more than one capacity, the security-based swap dealer shall disclose the material differences between such capacities and any other financial transaction or service involving the counterparty.

(d) The requirements of this section shall not apply with respect to a security-based swap if:

(1) The transaction is executed on a registered or exempt security-based swap execution facility or registered national securities exchange; and

(2) The security-based swap dealer or major security-based swap participant does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer or major security-based swap participant to comply with the obligations of paragraphs (a) through (c) of this section.

[81 FR 30144, May 13, 2016]

§ 240.15Fh–6 Political contributions by certain security-based swap dealers.

(a) *Definitions*. For the purposes of this section:

(1) The term *contribution* means any gift, subscription, loan, advance, or deposit of money or anything of value made:

(i) For the purpose of influencing any election for federal, state or local office;

(ii) For payment of debt incurred in connection with any such election; or

(iii) For transition or inaugural expenses incurred by the successful candidate for state or local office.

(2) The term *covered associate* means:

(i) Any general partner, managing member or executive officer, or other person with a similar status or function;

(ii) Any employee who solicits a municipal entity to enter into a security-based swap with the security-based swap dealer and any person who supervises, directly or indirectly, such employee; and

(iii) A political action committee controlled by the security-based swap dealer or by a person described in paragraphs (a)(2)(i) and (ii) of this section.

(3) The term *executive officer of a security-based swap dealer* means:

(i) The president;

(ii) Any vice president in charge of a principal business unit, division or function (such as sales, administration or finance);

(iii) Any other officer of the security-based swap dealer who performs a policy-making function; or

(iv) Any other person who performs similar policy-making functions for the security-based swap dealer.

(4) The term *municipal entity* is defined in section 15B(e)(8) of the Act.

(5) The term *official of a municipal entity* means any person (including any election committee for such person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a municipal entity, if the office:

(i) Is directly or indirectly responsible for, or can influence the outcome of, the selection of a security-based swap dealer by a municipal entity; or

(ii) Has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the selection of a security-based swap dealer by a municipal entity.

(6) The term *payment* means any gift, subscription, loan, advance, or deposit of money or anything of value.

(7) The term *regulated person* means:

(i) A person that is subject to rules of the Commission, the Commodity Futures Trading Commission or a self-regulatory organization subject to the jurisdiction of the Commission or the Commodity Futures Trading Commission prohibiting it from engaging in specified activities if certain political contributions have been made, or its officers or employees;

(ii) A general partner, managing member or executive officer of such person, or other individual with a similar status or function; or

(iii) An employee of such person who solicits a municipal entity for the security-based swap dealer and any person who supervises, directly or indirectly, such employee.

(8) The term *solicit* means a direct or indirect communication by any person with a municipal entity for the purpose of obtaining or retaining an engagement related to a security-based swap.

(b) *Prohibitions and exceptions.* (1) It shall be unlawful for a security-based swap dealer to offer to enter into, or enter into, a security-based swap, or a trading strategy involving a security-based swap, with a municipal entity within two years after any contribution to an official of such municipal entity was made by the security-based swap dealer, or by any covered associate of the security-based swap dealer.

(2) The prohibition in paragraph (b)(1) of this section does not apply:

(i) If the only contributions made by the security-based swap dealer to an official of such municipal entity were made by a covered associate, if a natural person:

(A) To officials for whom the covered associate was entitled to vote at the time of the contributions, *if* the contributions in the aggregate do not exceed $350 to any one official per election; or

(B) To officials for whom the covered associate was not entitled to vote at the time of the contributions, *if* the contributions in the aggregate do not exceed $150 to any one official, per election;

(ii) To a security-based swap dealer as a result of a contribution made by a natural person more than six months prior to becoming a covered associate of the security-based swap dealer, *however*, this exclusion shall not apply if the natural person, after becoming a covered associate, solicits the municipal entity on behalf of the security-based swap dealer to offer to enter into, or to enter into, security-based swap, or a trading strategy involving a security-based swap; or

(iii) With respect to a security-based swap that is executed on a registered national securities exchange or registered or exempt security-based swap execution facility where the security-based swap dealer does not know the identity of the counterparty to the transaction at a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer to comply with the obligations of paragraph (b)(1) of this section.

(3) No security-based swap dealer or any covered associate of the security-based swap dealer shall:

(i) Provide or agree to provide, directly or indirectly, payment to any person to solicit a municipal entity to offer to enter into, or to enter into, a security-based swap or any trading strategy involving a security-based swap with that security-based swap dealer unless such person is a regulated person; or

(ii) Coordinate, or solicit any person or political action committee to make, any:

(A) Contribution to an official of a municipal entity with which the security-based swap dealer is offering to enter into, or has entered into, a security-based swap or a trading strategy involving a security-based swap; or

(B) Payment to a political party of a state or locality with which the security-based swap dealer is offering to enter into, or has entered into, a security-based swap or a trading strategy involving a security-based swap.

(c) *Circumvention of rule.* No security-based swap dealer shall, directly or indirectly, through or by any other person or means, do any act that would result in a violation of paragraph (a) or (b) of this section.

(d) *Requests for exemption.* The Commission, upon application, may conditionally or unconditionally exempt a security-based swap dealer from the prohibition under paragraph (b)(1) of this section. In determining whether to grant an exemption, the Commission will consider, among other factors:

(1) Whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the Act;

(2) Whether the security-based swap dealer:

(i) Before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of this section;

(ii) Prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution; and

(iii) After learning of the contribution:

(A) Has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to obtain a return of the contribution; and

(B) Has taken such other remedial or preventive measures as may be appropriate under the circumstances;

(3) Whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the security-based swap dealer, or was seeking such employment;

(4) The timing and amount of the contribution which resulted in the prohibition;

(5) The nature of the election (*e.g.*, federal, state or local); and

(6) The contributor's apparent intent or motive in making the contribution that resulted in the prohibition, as evidenced by the facts and circumstances surrounding the contribution.

(e) *Prohibitions inapplicable.* (1) The prohibitions under paragraph (b) of this section shall not apply to a contribution made by a covered associate of the security-based swap dealer if:

(i) The security-based swap dealer discovered the contribution within 120 calendar days of the date of such contribution;

(ii) The contribution did not exceed $350; and

(iii) The covered associate obtained a return of the contribution within 60 calendar days of the date of discovery of the contribution by the security-based swap dealer.

(2) A security-based swap dealer that has more than 50 covered associates may not rely on paragraph (e)(1) of this section more than three times in any 12-month period, while a security-based swap dealer that has 50 or fewer covered associates may not rely on paragraph (e)(1) of this section more than twice in any 12-month period.

(3) A security-based swap dealer may not rely on paragraph (e)(1) of this section more than once for any covered associate, regardless of the time between contributions.

[81 FR 30144, May 13, 2016]

§ 240.15Fi–1 Definitions.

For the purposes of § 240.15Fi–1 and § 240.15Fi–2:

(a) The term *business day* means any day other than a Saturday, Sunday, or legal holiday.

(b) The term *clearing agency* means a clearing agency as defined in section 3(a)(23) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(23)) that is registered pursuant to section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78q–1) and provides central counterparty services for security-based swap transactions.

(c) The term *clearing transaction* means a security-based swap that has a clearing agency as a direct counterparty.

(d) The term *day of execution* means the calendar day of the counterparty to the security-based swap transaction that ends the latest, provided that if a security-based swap transaction is

(1) Entered into after 4:00 p.m. in the place of a counterparty; or

(2) Entered into on a day that is not a business day in the place of a counterparty, then such security-based swap transaction shall be deemed to

have been entered into by that counterparty on the immediately succeeding business day of that counterparty, and the day of execution shall be determined with reference to such business day.

(e) The term *execution* means the point at which the counterparties become irrevocably bound to a transaction under applicable law.

(f) The term *security-based swap execution facility* means a security-based swap execution facility as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) that is registered pursuant to section 3D of the Securities Exchange Act of 1934 (15 U.S.C. 78c–4).

(g) The term *national securities exchange* means an exchange as defined in section 3(a)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(1)) that is registered pursuant to section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f).

(h) The term *trade acknowledgment* means a written or electronic record of a security-based swap transaction sent by one counterparty of the security-based swap transaction to the other.

(i) The term *verification* means the process by which a trade acknowledgment has been manually, electronically, or by some other legally equivalent means, signed by the receiving counterparty.

[81 FR 39844, June 17, 2016]

§ 240.15Fi–2 Acknowledgment and verification of security-based swap transactions.

(a) *Trade acknowledgment requirement.* In any transaction in which a security-based swap dealer or major security-based swap participant purchases from or sells to any counterparty a security-based swap, a trade acknowledgment must be provided by:

(1) The security-based swap dealer, if the transaction is between a security-based swap dealer and a major security-based swap participant;

(2) The security-based swap dealer or major security-based swap participant, if only one counterparty in the transaction is a security-based swap dealer or major security-based swap participant; or

(3) The counterparty that the counterparties have agreed will provide the trade acknowledgment in any transaction other than one described by paragraph (a)(1) or (a)(2) of this section.

(b) *Prescribed time.* Any trade acknowledgment required by paragraph (a) of this section must be provided promptly, but in any event by the end of the first business day following the day of execution.

(c) *Form and content of trade acknowledgment.* Any trade acknowledgment required by paragraph (a) of this section must be provided through electronic means that provide reasonable assurance of delivery and a record of transmittal, and must disclose all the terms of the security-based swap transaction.

(d) *Trade verification.* (1) A security-based swap dealer or major security-based swap participant must establish, maintain, and enforce written policies and procedures that are reasonably designed to obtain prompt verification of the terms of a trade acknowledgment provided pursuant to paragraph (a) of this section.

(2) A security-based swap dealer or major security-based swap participant must promptly verify the accuracy of, or dispute with its counterparty, the terms of a trade acknowledgment it receives pursuant to paragraph (a) of this section.

(e) *Exception for clearing transactions.* A security-based swap dealer or major security-based swap participant is excepted from the requirements of this section with respect to any clearing transaction.

(f) Exception for transactions executed on a security-based swap execution facility or national securities exchange or accepted for clearing by a clearing agency.

(1) A security-based swap dealer or major security-based swap participant is excepted from the requirements of this subsection with respect to any security-based swap transaction executed on a security-based swap execution facility or national securities exchange, provided that the rules, procedures or processes of the security-based swap

execution facility or national securities exchange provide for the acknowledgment and verification of all terms of the security-based swap transaction no later than the time required by paragraphs (b) and (d)(2) of this section.

(2) A security-based swap dealer or major security-based swap participant is excepted from the requirements of this subsection with respect to any security-based swap transaction that is submitted for clearing to a clearing agency, provided that:

(i) The security-based swap transaction is submitted for clearing as soon as technologically practicable, but in any event no later than the time established for providing a trade acknowledgment under paragraph (b) of this section; and

(ii) The rules, procedures or processes of the clearing agency provide for the acknowledgment and verification of all terms of the security-based swap transaction prior to or at the same time that the security-based swap transaction is accepted for clearing.

(3) If a security-based swap dealer or major security-based swap participant receives notice that a security-based swap transaction has not been acknowledged and verified pursuant to the rules, procedures or processes of a security-based swap execution facility or a national securities exchange, or accepted for clearing by a clearing agency, the security-based swap dealer or major security-based swap participant shall comply with the requirements of this section with respect to such security-based swap transaction as if such security-based swap transaction were executed at the time the security-based swap dealer or major security-based swap participant receives such notice.

(g) *Exemption from § 240.10b–10.* A security-based swap dealer or major security-based swap participant that is also a broker or dealer, is purchasing from or selling to any counterparty, and that complies with paragraph (a) or (d)(2) of this section with respect to the security-based swap transaction, is exempt from the requirements of § 240.10b–10 with respect to the security-based swap transaction.

[81 FR 39844, June 17, 2016]

§ 240.15Fk–1 Designation of chief compliance officer for security-based swap dealers and major security-based swap participants.

(a) *In general.* A security-based swap dealer and major security-based swap participant shall designate an individual to serve as a chief compliance officer on its registration form.

(b) *Duties.* The chief compliance officer shall:

(1) Report directly to the board of directors or to the senior officer of the security-based swap dealer or major security-based swap participant; and

(2) Take reasonable steps to ensure that the registrant establishes, maintains and reviews written policies and procedures reasonably designed to achieve compliance with the Act and the rules and regulations thereunder relating to its business as a security-based swap dealer or major security-based swap participant by:

(i) Reviewing the compliance of the security-based swap dealer or major security-based swap participant with respect to the security-based swap dealer and major security-based swap participant requirements described in section 15F of the Act, and the rules and regulations thereunder, where the review shall involve preparing the registrant's annual assessment of its written policies and procedures reasonably designed to achieve compliance with section 15F of the Act, and the rules and regulations thereunder, by the security-based swap dealer or major security-based swap participant;

(ii) Taking reasonable steps to ensure that the registrant establishes, maintains and reviews policies and procedures reasonably designed to remediate non-compliance issues identified by the chief compliance officer through any means, including any:

(A) Compliance office review;

(B) Look-back;

(C) Internal or external audit finding;

(D) Self-reporting to the Commission and other appropriate authorities; or

(E) Complaint that can be validated; and

(iii) Taking reasonable steps to ensure that the registrant establishes and follows procedures reasonably designed for the handling, management response, remediation, retesting, and resolution of non-compliance issues;

(3) In consultation with the board of directors or the senior officer of the security-based swap dealer or major security-based swap participant, take reasonable steps to resolve any material conflicts of interest that may arise; and

(4) Administer each policy and procedure that is required to be established pursuant to section 15F of the Act and the rules and regulations thereunder.

(c) *Annual reports*—(1) *In general.* The chief compliance officer shall annually prepare and sign a compliance report that contains a description of the written policies and procedures of the security-based swap dealer or major security-based swap participant described in paragraph (b) of this section (including the code of ethics and conflict of interest policies).

(2) *Requirements.* (i) Each compliance report shall also contain, at a minimum, a description of:

(A) The security-based swap dealer or major security-based swap participant's assessment of the effectiveness of its policies and procedures relating to its business as a security-based swap dealer or major security-based participant;

(B) Any material changes to the registrant's policies and procedures since the date of the preceding compliance report;

(C) Any areas for improvement, and recommended potential or prospective changes or improvements to its compliance program and resources devoted to compliance;

(D) Any material non-compliance matters identified; and

(E) The financial, managerial, operational, and staffing resources set aside for compliance with the Act and the rules and regulations thereunder relating to its business as a security-based swap dealer or major security-based swap participant, including any material deficiencies in such resources.

(ii) A compliance report under paragraph (c)(1) of this section also shall:

(A) Be submitted to the Commission within 30 days following the deadline for filing the security-based swap dealer's or major security-based swap participant's annual financial report with the Commission pursuant to section 15F of the Act and rules and regulations thereunder;

(B) Be submitted to the board of directors and audit committee (or equivalent bodies) and the senior officer of the security-based swap dealer or major security-based swap participant prior to submission to the Commission;

(C) Be discussed in one or more meetings conducted by the senior officer with the chief compliance officer(s) in the preceding 12 months, the subject of which addresses the obligations in this section; and

(D) Include a certification by the chief compliance officer or senior officer that, to the best of his or her knowledge and reasonable belief and under penalty of law, the information contained in the compliance report is accurate and complete in all material respects.

(iii) *Extensions of time.* A security-based swap dealer or major security-based swap participant may request from the Commission an extension of time to submit its compliance report, provided the registrant's failure to timely submit the report could not be eliminated by the registrant without unreasonable effort or expense. Extensions of the deadline will be granted at the discretion of the Commission.

(iv) *Incorporation by reference.* A security-based swap dealer or major security-based swap participant may incorporate by reference sections of a compliance report that have been submitted within the current or immediately preceding reporting period to the Commission.

(v) *Amendments.* A security-based swap dealer or major security-based swap participant shall promptly submit an amended compliance report if material errors or omissions in the report are identified. An amendment must contain the certification required under paragraph (c)(2)(ii)(D) of this section.

(d) *Compensation and removal.* The compensation and removal of the chief compliance officer shall require the approval of a majority of the board of directors of the security-based swap dealer or major security-based swap participant.

(e) *Definitions*. For purposes of this section, references to:

(1) The *board* or *board of directors* shall include a body performing a function similar to the board of directors.

(2) The *senior officer* shall include the chief executive officer or other equivalent officer.

(3) *Complaint that can be validated* shall include any written complaint by a counterparty involving the security-based swap dealer or major security-based swap participant or associated person of a security-based swap dealer or major security-based swap participant that can be supported upon reasonable investigation.

(4) A *material non-compliance matter* means any non-compliance matter about which the board of directors of the security-based swap dealer or major security-based swap participant would reasonably need to know to oversee the compliance of the security-based swap dealer or major security-based swap participant, and that involves, without limitation:

(i) A violation of the federal securities laws relating to its business as a security-based swap dealer or major security-based swap participant by the firm or its officers, directors, employees or agents;

(ii) A violation of the policies and procedures relating to its business as a security-based swap dealer or major security-based swap participant by the firm or its officers, directors, employees or agents; or

(iii) A weakness in the design or implementation of the policies and procedures relating to its business as a security-based swap dealer or major security-based swap participant.

[81 FR 30144, May 13, 2016]

§ 240.15Ga–1 Repurchases and replacements relating to asset-backed securities.

(a) *General*. With respect to any asset-backed security (as that term is defined in Section 3(a)(79) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(79)) for which the underlying transaction agreements contain a covenant to repurchase or replace an underlying asset for breach of a representation or warranty, a securitizer (as that term is defined in Section 15G(a) of the Securities Exchange Act of 1934) shall disclose fulfilled and unfulfilled repurchase requests across all trusts by providing the information required in paragraph (a)(1) of this section concerning all assets securitized by the securitizer that were the subject of a demand to repurchase or replace for breach of the representations and warranties concerning the pool assets for all asset-backed securities held by non-affiliates of the securitizer during the reporting period.

Name of Issuing Entity	Check if Regis-tered	Name of Originator	Total Assets in ABS by Originator			Assets That Were Subject of Demand			Assets That Were Repurchased or Replaced			Assets Pending Repurchase or Replacement (within cure period)			Demand in Dispute			Demand Withdrawn			Demand Rejected		
			(#)	($)	(% of principal balance)	(#)	($)	(% of principal balance)	(#)	($)	(% of principal balance)	(#)	($)	(% of principal balance)	(#)	($)	(% of principal balance)	(#)	($)	(% of principal balance)	(#)	($)	(% of principal balance)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)	(m)	(n)	(o)	(p)	(q)	(r)	(s)	(t)	(u)	(v)	(w)	(x)
Asset Class X																							
Issuing Entity A CIK #	X	Originator 1																					
		Originator 2																					
Total			#	$		#	$		#	$		#	$		#	$		#	$		#	$	
Asset Class Y																							
Issuing Entity B		Originator 3																					
Total			#	$		#	$		#	$		#	$		#	$		#	$		#	$	
Total			#	$		#	$		#	$		#	$		#	$		#	$		#	$	

(1) The table shall:

(i) Disclose the asset class and group the issuing entities by asset class (column (a)).

(ii) Disclose the name of the issuing entity (as that term is defined in Item 1101(f) of Regulation AB (17 CFR

229.1101(f)) of the asset-backed securities. List the issuing entities in order of the date of formation (column (a)).

INSTRUCTION TO PARAGRAPH (a)(1)(ii): Include all issuing entities with outstanding asset-backed securities during the reporting period.

(iii) For each named issuing entity, indicate by check mark whether the transaction was registered under the Securities Act of 1933 (column (b)) and disclose the CIK number of the issuing entity (column (a)).

(iv) Disclose the name of the originator of the underlying assets (column (c)).

INSTRUCTION TO PARAGRAPH (a)(1)(iv): Include all originators that originated assets in the asset pool for each issuing entity.

(v) Disclose the number, outstanding principal balance and percentage by principal balance of assets at the time of securitization (columns (d) through (f)).

(vi) Disclose the number, outstanding principal balance and percentage by principal balance of assets that were subject of a demand to repurchase or replace for breach of representations and warranties (columns (g) through (i)).

(vii) Disclose the number, outstanding principal balance and percentage by principal balance of assets that were repurchased or replaced for breach of representations and warranties (columns (j) through (l)).

(viii) Disclose the number, outstanding principal balance and percentage by principal balance of assets that are pending repurchase or replacement for breach of representations and warranties due to the expiration of a cure period (columns (m) through (o)).

(ix) Disclose the number, outstanding principal balance and percentage by principal balance of assets that are pending repurchase or replacement for breach of representations and warranties because the demand is currently in dispute (columns (p) through (r)).

(x) Disclose the number, outstanding principal balance and percentage by principal balance of assets that were not repurchased or replaced because the demand was withdrawn (columns (s) through (u)).

(xi) Disclose the number, outstanding principal balance and percentage by principal balance of assets that were not repurchased or replaced because the demand was rejected (columns (v) through (x)).

INSTRUCTION TO PARAGRAPHS (a)(1)(vi) THROUGH (xi): For purposes of these (a)(1)(vi) through (xi) the outstanding principal balance shall be the principal balance as of the reporting period end date and the percentage by principal balance shall be the outstanding principal balance of an asset divided by the outstanding principal balance of the asset pool as of the reporting period end date.

(xii) Provide totals by asset class, issuing entity and for all issuing entities for columns that require number of assets and principal amounts (columns (d), (e), (g), (h), (j), (k), (m), (n) (p), (q), (s), (t), (v) and (w)).

INSTRUCTION 1 TO PARAGRAPH (a)(1): The table should include any activity during the reporting period, including activity related to assets subject to demands made prior to the beginning of the reporting period.

INSTRUCTION 2 TO PARAGRAPH (a)(1): Indicate by footnote and provide narrative disclosure in order to further explain the information presented in the table, as appropriate.

(2) If any of the information required by this paragraph (a) is unknown and not available to the securitizer without unreasonable effort or expense, such information may be omitted, provided the securitizer provides the information it possesses or can acquire without unreasonable effort or expense, and the securitizer includes a statement showing that unreasonable effort or expense would be involved in obtaining the omitted information. Further, if a securitizer requested and was unable to obtain all information with respect to investor demands upon a trustee that occurred prior to July 22, 2010, so state by footnote. In this case, also state that the disclosures do not contain investor demands upon a trustee made prior to July 22, 2010.

(b) In the case of multiple affiliated securitizers for a single asset-backed securities transaction, if one securitizer has filed all the disclosures required in order to meet the obligations under paragraph (a) of this section, other affiliated securitizers shall not be required to separately provide and file the same disclosures related to the same asset-backed security.

(c) The disclosures in paragraph (a) of this section shall be provided by a securitizer:

(1) For the three year period ended December 31, 2011, by any securitizer that issued an asset-backed security during the period, or organized and initiated an asset-backed securities transaction during the period, by securitizing an asset, either directly or indirectly, including through an affiliate, in each case, if the underlying transaction agreements provide a covenant to repurchase or replace an underlying asset for breach of a representation or warranty and the securitizer has asset-backed securities, containing such a covenant, outstanding and held by non-affiliates as of the end of the three year period. If a securitizer has no activity to report, it shall indicate by checking the appropriate box on Form ABS–15G (17 CFR 249.1400). The requirement of this paragraph (c)(1) applies to all issuances of asset-backed securities whether or not publicly registered under the provisions of the Securities Act of 1933. The disclosures required by this paragraph (c)(1) shall be filed no later than February 14, 2012.

INSTRUCTION TO PARAGRAPH (c)(1): For demands made prior to January 1, 2009, the disclosure should include any related activity subsequent to January 1, 2009 associated with such demand.

(2) For each calendar quarter, by any securitizer that issued an asset-backed security during the period, or organized and initiated an asset-backed securities transaction by securitizing an asset, either directly or indirectly, including through an affiliate, or had outstanding asset-backed securities held by non-affiliates during the period, in each case, if the underlying transaction agreements provide a covenant to repurchase or replace an underlying asset for breach of a representation or warranty. The disclosures required by this paragraph (c)(2) shall be filed no later than 45 calendar days after the end of such calendar quarter:

(i) Except that, a securitizer may suspend its duty to provide periodic quarterly disclosures if no activity occurred during the initial filing period in paragraph (c)(1) of this section or during a calendar quarter that is required to be reported under paragraph (a) of this section. A securitizer shall indicate that it has no activity to report by checking the appropriate box on Form ABS–15G (17 CFR 249.1400). Thereafter, a periodic quarterly report required by this paragraph (c)(2) will only be required if a change in the demand, repurchase or replacement activity occurs that is required to be reported under paragraph (a) of this section during a calendar quarter; and

(ii) Except that, annually, any securitizer that has suspended its duty to provide quarterly disclosures pursuant to paragraph (c)(2)(i) of this section must confirm that no activity occurred during the previous calendar year by checking the appropriate box on Form ABS–15G (17 CFR 249.1400). The confirmation required by this paragraph (c)(2)(ii) shall be filed no later than 45 days after each calendar year.

(3) Except that, if a securitizer has no asset-backed securities outstanding held by non-affiliates, the duty under paragraph (c)(2) of this section to file periodically the disclosures required by paragraph (a) of this section shall be terminated immediately upon filing a notice on Form ABS–15G (17 CFR 249.1400).

[76 FR 4511, Jan. 26, 2011, as amended at 76 FR 54375, Sept. 1, 2011; 79 FR 57344, Sept. 24, 2014]

§ 240.16a–1 Definition of terms.

Terms defined in this rule shall apply solely to section 16 of the Act and the rules thereunder. These terms shall not be limited to section 16(a) of the Act but also shall apply to all other subsections under section 16 of the Act.

(a) The term *beneficial owner* shall have the following applications:

(1) Solely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered pursuant to section 12 of the Act, the term ''beneficial owner'' shall mean any person who is deemed a beneficial owner pursuant to section 13(d) of the Act and the rules thereunder; *provided, however*, that the following institutions or persons shall not be deemed the beneficial owner of securities of such class held for the benefit of third parties or in

customer or fiduciary accounts in the ordinary course of business (or in the case of an employee benefit plan specified in paragraph (a)(1)(vi) of this section, of securities of such class allocated to plan participants where participants have voting power) as long as such shares are acquired by such institutions or persons without the purpose or effect of changing or influencing control of the issuer or engaging in any arrangement subject to Rule 13d–3(b) (§ 240.13d–3(b)):

(i) A broker or dealer registered under section 15 of the Act (15 U.S.C. 78o);

(ii) A bank as defined in section 3(a)(6) of the Act (15 U.S.C. 78c);

(iii) An insurance company as defined in section 3(a)(19) of the Act (15 U.S.C. 78c);

(iv) An investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8);

(v) Any person registered as an investment adviser under Section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3) or under the laws of any state;

(vi) An employee benefit plan as defined in Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended, 29 U.S.C. 1001 *et seq.* (''ERISA'') that is subject to the provisions of ERISA, or any such plan that is not subject to ERISA that is maintained primarily for the benefit of the employees of a state or local government or instrumentality, or an endowment fund;

(vii) A parent holding company or control person, provided the aggregate amount held directly by the parent or control person, and directly and indirectly by their subsidiaries or affiliates that are not persons specified in § 240.16a–1 (a)(1)(i) through (x), does not exceed one percent of the securities of the subject class;

(viii) A savings association as defined in Section 3(b) of the Federal Deposit Insurance Act (12 U.S.C. 1813);

(ix) A church plan that is excluded from the definition of an investment company under section 3(c)(14) of the Investment Company Act of 1940 (15 U.S.C. 80a–30;

(x) A non-U.S. institution that is the functional equivalent of any of the institutions listed in paragraphs (a)(1)(i) through (ix) of this section, so long as the non-U.S. institution is subject to a regulatory scheme that is substantially comparable to the regulatory scheme applicable to the equivalent U.S. institution and the non-U.S. institution is eligible to file a Schedule 13G pursuant to § 240.13d–1(b)(1)(ii)(J); and

(xi) A group, provided that all the members are persons specified in § 240.16a–1 (a)(1)(i) through (x).

NOTE TO PARAGRAPH (a): Pursuant to this section, a person deemed a beneficial owner of more than ten percent of any class of equity securities registered under section 12 of the Act would file a Form 3 (§ 249.103), but the securities holdings disclosed on Form 3, and changes in beneficial ownership reported on subsequent Forms 4 (§ 249.104) or 5 (§ 249.105), would be determined by the definition of ''beneficial owner'' in paragraph (a)(2) of this section.

(2) Other than for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered under Section 12 of the Act, the term *beneficial owner* shall mean any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares a direct or indirect pecuniary interest in the equity securities, subject to the following:

(i) The term *pecuniary interest* in any class of equity securities shall mean the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities.

(ii) The term *indirect pecuniary interest* in any class of equity securities shall include, but not be limited to:

(A) Securities held by members of a person's immediate family sharing the same household; provided, however, that the presumption of such beneficial ownership may be rebutted; *see* also § 240.16a–1(a)(4);

(B) A general partner's proportionate interest in the portfolio securities held by a general or limited partnership. The general partner's proportionate interest, as evidenced by the partnership agreement in effect at the time of the transaction and the partnership's most recent financial statements, shall be the greater of:

(*1*) The general partner's share of the partnership's profits, including profits attributed to any limited partnership interests held by the general partner and any other interests in profits that arise from the purchase and sale of the partnership's portfolio securities; or

(*2*) The general partner's share of the partnership capital account, including the share attributable to any limited partnership interest held by the general partner.

(C) A performance-related fee, other than an asset-based fee, received by any broker, dealer, bank, insurance company, investment company, investment adviser, investment manager, trustee or person or entity performing a similar function; *provided, however,* that no pecuniary interest shall be present where:

(*1*) The performance-related fee, regardless of when payable, is calculated based upon net capital gains and/or net capital appreciation generated from the portfolio or from the fiduciary's overall performance over a period of one year or more; and

(*2*) Equity securities of the issuer do not account for more than ten percent of the market value of the portfolio. A right to a nonperformance-related fee alone shall not represent a pecuniary interest in the securities;

(D) A person's right to dividends that is separated or separable from the underlying securities. Otherwise, a right to dividends alone shall not represent a pecuniary interest in the securities;

(E) A person's interest in securities held by a trust, as specified in §240.16a–8(b); and

(F) A person's right to acquire equity securities through the exercise or conversion of any derivative security, whether or not presently exercisable.

(iii) A shareholder shall not be deemed to have a pecuniary interest in the portfolio securities held by a corporation or similar entity in which the person owns securities if the shareholder is not a controlling shareholder of the entity and does not have or share investment control over the entity's portfolio.

(3) Where more than one person subject to section 16 of the Act is deemed to be a beneficial owner of the same equity securities, all such persons must report as beneficial owners of the securities, either separately or jointly, as provided in §240.16a–3(j). In such cases, the amount of short-swing profit recoverable shall not be increased above the amount recoverable if there were only one beneficial owner.

(4) Any person filing a statement pursuant to section 16(a) of the Act may state that the filing shall not be deemed an admission that such person is, for purposes of section 16 of the Act or otherwise, the beneficial owner of any equity securities covered by the statement.

(5) The following interests are deemed not to confer beneficial ownership for purposes of section 16 of the Act:

(i) Interests in portfolio securities held by any investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*); and

(ii) Interests in securities comprising part of a broad-based, publicly traded market basket or index of stocks, approved for trading by the appropriate federal governmental authority.

(b) The term *call equivalent position* shall mean a derivative security position that increases in value as the value of the underlying equity increases, including, but not limited to, a long convertible security, a long call option, and a short put option position.

(c) The term *derivative securities* shall mean any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security, but shall not include:

(1) Rights of a pledgee of securities to sell the pledged securities;

(2) Rights of all holders of a class of securities of an issuer to receive securities pro rata, or obligations to dispose of securities, as a result of a merger, exchange offer, or consolidation involving the issuer of the securities;

(3) Rights or obligations to surrender a security, or have a security withheld, upon the receipt or exercise of a derivative security or the receipt or vesting of equity securities, in order to satisfy

the exercise price or the tax withholding consequences of receipt, exercise or vesting;

(4) Interests in broad-based index options, broad-based index futures, and broad-based publicly traded market baskets of stocks approved for trading by the appropriate federal governmental authority;

(5) Interests or rights to participate in employee benefit plans of the issuer;

(6) Rights with an exercise or conversion privilege at a price that is not fixed; or

(7) Options granted to an underwriter in a registered public offering for the purpose of satisfying over-allotments in such offering.

(d) The term *equity security of such issuer* shall mean any equity security or derivative security relating to an issuer, whether or not issued by that issuer.

(e) The term *immediate family* shall mean any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, and shall include adoptive relationships.

(f) The term ''officer'' shall mean an issuer's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer. Officers of the issuer's parent(s) or subsidiaries shall be deemed officers of the issuer if they perform such policy-making functions for the issuer. In addition, when the issuer is a limited partnership, officers or employees of the general partner(s) who perform policy-making functions for the limited partnership are deemed officers of the limited partnership. When the issuer is a trust, officers or employees of the trustee(s) who perform policy-making functions for the trust are deemed officers of the trust.

NOTE: ''Policy-making function'' is not intended to include policy-making functions that are not significant. If pursuant to Item 401(b) of Regulation S-K (§ 229.401(b)) the issuer identifies a person as an ''executive officer,'' it is presumed that the Board of Directors has made that judgment and that the persons so identified are the officers for purposes of Section 16 of the Act, as are such other persons enumerated in this paragraph (f) but not in Item 401(b).

(g) The term *portfolio securities* shall mean all securities owned by an entity, other than securities issued by the entity.

(h) The term *put equivalent position* shall mean a derivative security position that increases in value as the value of the underlying equity decreases, including, but not limited to, a long put option and a short call option position.

[56 FR 7265, Feb. 21, 1991, as amended at 56 FR 19927, May 1, 1991; 61 FR 30391, June 14, 1996; 63 FR 2868, Jan. 16, 1998; 73 FR 60093, Oct. 9, 2008; 76 FR 71876, Nov. 21, 2011]

§ 240.15Ga–2 Findings and conclusions of third-party due diligence reports.

(a) The issuer or underwriter of an offering of any asset-backed security (as that term is defined in Section 3(a)(79) of the Act (15 U.S.C. 78c(a)(79))) that is to be rated by a nationally recognized statistical rating organization must furnish Form ABS–15G (§ 249.1400 of this chapter) to the Commission containing the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter at least five business days prior to the first sale in the offering.

Instruction to paragraph (a): Disclosure of the findings and conclusions includes, but is not limited to, disclosure of the criteria against which the loans were evaluated, and how the evaluated loans compared to those criteria along with the basis for including any loans not meeting those criteria. This disclosure is only required for an initial rating and does not need to be furnished in connection with any subsequent rating actions. For purposes of this rule, the date of first sale is the date on which the first investor is irrevocably contractually committed to invest, which, depending on the terms and conditions of the contract, could be the date on which the issuer receives the investor's subscription agreement or check.

(b) In the case where the issuer and one or more underwriters have obtained the same third-party due diligence report related to a particular asset-backed securities transaction, if any one such party has furnished all the disclosures required in order to meet the obligations under paragraph (a) of this section, the other party or parties are not required to separately furnish the same disclosures related to such third-party due diligence report.

(c) If the disclosure required by this rule has been made in the prospectus (including an attribution to the third-party that provided the third-party due diligence report), the issuer or underwriter may refer to that section of the prospectus in Form ABS–15G rather than providing the findings and conclusions itself directly in Form ABS–15G.

(d) For purposes of paragraphs (a) and (b) of this section, *issuer* is defined in Rule 17g–10(d)(2) (§ 240.17g–10(d)(2) of this chapter) and *third-party due diligence report* means any report containing findings and conclusions of any *due diligence services* as defined in Rule 17g–10(d)(1) (§ 240.17g–10(d)(1) of this chapter) performed by a third party.

(e) The requirements of this rule would not apply to an offering of an asset-backed security if certain conditions are met, including:

(i) The offering is not required to be, and is not, registered under the Securities Act of 1933;

(ii) The issuer of the rated security is not a U.S. person (as defined under Securities Act Rule 902(k)); and

(iii) the security issued by the issuer will be offered and sold upon issuance, and any underwriter or arranger linked to the security will effect transactions of the security after issuance, only in transactions that occur outside the United States.

(f) The requirements of this rule would not apply to an offering of an asset-backed security if certain conditions are met, including:

(i) The issuer of the rated security is a municipal issuer; and

(ii) The offering is not required to be, and is not, registered under the Securities Act of 1933.

(g) For purposes of paragraph (f) of this section, a municipal issuer is an *issuer* (as that term is defined in Rule 17g–10(d)(2) (§ 240.17g–10(d)(2) of this chapter)) that is any State or Territory of the United States, the District of Columbia, any political subdivision of any State, Territory or the District of Columbia, or any public instrumentality of one or more States, Territories or the District of Columbia.

(h) An offering of an asset-backed security that is exempted from the requirements of this rule pursuant to paragraph (f) of this section remains subject to the requirements of Section 15E(s)(4)(A) of the Act (15 U.S.C. 78o–7(s)(4)(A)), which requires that the issuer or underwriter of any asset-backed security shall make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.

[79 FR 55261, Sept. 15, 2014; 79 FR 61576, Oct. 14, 2014]

§ 240.16a–2 Persons and transactions subject to section 16.

Any person who is the beneficial owner, directly or indirectly, of more than ten percent of any class of equity securities (''ten percent beneficial owner'') registered pursuant to section 12 of the Act (15 U.S.C. 78*l*), any director or officer of the issuer of such securities, and any person specified in section 30(h) of the Investment Company Act of 1940 (15 U.S.C. 80a–29(h)), including any person specified in § 240.16a–8, shall be subject to the provisions of section 16 of the Act (15 U.S.C. 78p). The rules under section 16 of the Act apply to any class of equity securities of an issuer whether or not registered under section 12 of the Act. The rules under section 16 of the Act also apply to non-equity securities as provided by the Investment Company Act of 1940. With respect to transactions by persons subject to section 16 of the Act:

(a) A transaction(s) carried out by a director or officer in the six months prior to the director or officer becoming subject to section 16 of the Act shall be subject to section 16 of the Act and reported on the first required Form 4 only if the transaction(s) occurred within six months of the transaction giving rise to the Form 4 filing obligation and the director or officer became subject to section 16 of the Act solely as a result of the issuer registering a class of equity securities pursuant to section 12 of the Act.

(b) A transaction(s) following the cessation of director or officer status shall be subject to section 16 of the Act only if:

(1) Executed within a period of less than six months of an opposite transaction subject to section 16(b) of the Act that occurred while that person was a director or officer; and

(2) Not otherwise exempted from section 16(b) of the Act pursuant to the provisions of this chapter.

NOTE TO PARAGRAPH (b): For purposes of this paragraph, an acquisition and a disposition each shall be an opposite transaction with respect to the other.

(c) The transaction that results in a person becoming a ten percent beneficial owner is not subject to section 16 of the Act unless the person otherwise is subject to section 16 of the Act. A ten percent beneficial owner not otherwise subject to section 16 of the Act must report only those transactions conducted while the beneficial owner of more than ten percent of a class of equity securities of the issuer registered pursuant to section 12 of the Act.

(d)(1) Transactions by a person or entity shall be exempt from the provisions of section 16 of the Act for the 12 months following appointment and qualification, to the extent such person or entity is acting as:

(i) Executor or administrator of the estate of a decedent;

(ii) Guardian or member of a committee for an incompetent;

(iii) Receiver, trustee in bankruptcy, assignee for the benefit of creditors, conservator, liquidating agent, or other similar person duly authorized by law to administer the estate or assets of another person; or

(iv) Fiduciary in a similar capacity.

(2) Transactions by such person or entity acting in a capacity specified in paragraph (d)(1) of this section after the period specified in that paragraph shall be subject to section 16 of the Act only where the estate, trust or other entity is a beneficial owner of more than ten percent of any class of equity security registered pursuant to section 12 of the Act.

[56 FR 7265, Feb. 21, 1991, as amended at 61 FR 30392, June 14, 1996; 67 FR 43535, June 28, 2002; 76 FR 71877, Nov. 21, 2011]

§ 240.16a–3 Reporting transactions and holdings.

(a) Initial statements of beneficial ownership of equity securities required by section 16(a) of the Act shall be filed on Form 3. Statements of changes in beneficial ownership required by that section shall be filed on Form 4. Annual statements shall be filed on Form 5. At the election of the reporting person, any transaction required to be reported on Form 5 may be reported on an earlier filed Form 4. All such statements shall be prepared and filed in accordance with the requirements of the applicable form.

(b) A person filing statements pursuant to section 16(a) of the Act with respect to any class of equity securities registered pursuant to section 12 of the Act need not file an additional statement on Form 3:

(1) When an additional class of equity securities of the same issuer becomes registered pursuant to section 12 of the Act; or

(2) When such person assumes a different or an additional relationship to the same issuer (for example, when an officer becomes a director).

(c) Any issuer that has equity securities listed on more than one national securities exchange may designate one exchange as the only exchange with which reports pursuant to section 16(a) of the Act need be filed. Such designation shall be made in writing and shall be filed with the Commission and with each national securities exchange on which any equity security of the issuer is listed at the time of such election. The reporting person's obligation to file reports with each national securities exchange on which any equity security of the issuer is listed shall be satisfied by filing with the exchange so designated.

(d) Any person required to file a statement with respect to securities of a single issuer under both section 16(a) of the Act (15 U.S.C. 78p(a)) and section 30(h) of the Investment Company Act of 1940 (15 U.S.C. 80a–29(h)) may file a single statement containing the required information, which will be deemed to be filed under both Acts.

(e) Any person required to file a statement under section 16(a) of the Act shall, not later than the time the statement is transmitted for filing with the Commission, send or deliver a duplicate to the person designated by the issuer to receive such statements, or, in the absence of such a designation, to the issuer's corporate secretary or person performing equivalent functions.

(f)(1) A Form 5 shall be filed by every person who at any time during the issuer's fiscal year was subject to section 16 of the Act with respect to such issuer, except as provided in paragraph (f)(2) of this section. The Form shall be filed within 45 days after the issuer's fiscal year end, and shall disclose the following holdings and transactions not reported previously on Forms 3, 4 or 5:

(i) All transactions during the most recent fiscal year that were exempt from section 16(b) of the Act, except:

(A) Exercises and conversions of derivative securities exempt under either § 240.16b–3 or § 240.16b–6(b), and any transaction exempt under § 240.16b–3(d), § 240.16b–3(e), or § 240.16b–3(f) (these are required to be reported on Form 4);

(B) Transactions exempt from section 16(b) of the Act pursuant to § 240.16b–3(c), which shall be exempt from section 16(a) of the Act; and

(C) Transactions exempt from section 16(a) of the Act pursuant to another rule;

(ii) Transactions that constituted small acquisitions pursuant to § 240.16a–6(a);

(iii) All holdings and transactions that should have been reported during the most recent fiscal year, but were not; and

(iv) With respect to the first Form 5 requirement for a reporting person, all holdings and transactions that should have been reported in each of the issuer's last two fiscal years but were not, based on the reporting person's reasonable belief in good faith in the completeness and accuracy of the information.

(2) Notwithstanding the above, no Form 5 shall be required where all transactions otherwise required to be reported on the Form 5 have been reported before the due date of the Form 5.

Persons no longer subject to section 16 of the Act, but who were subject to the Section at any time during the issuer's fiscal year, must file a Form 5 unless paragraph (f)(2) is satisfied. *See also* § 240.16a–2(b) regarding the reporting obligations of persons ceasing to be officers or directors.

(g)(1) A Form 4 must be filed to report: All transactions not exempt from section 16(b) of the Act; All transactions exempt from section 16(b) of the Act pursuant to § 240.16b–3(d), § 240.16b–3(e), or § 240.16b–3(f); and all exercises and conversions of derivative securities, regardless of whether exempt from section 16(b) of the Act. Form 4 must be filed before the end of the second business day following the day on which the subject transaction has been executed.

(2) Solely for purposes of section 16(a)(2)(C) of the Act and paragraph (g)(1) of this section, the date on which the executing broker, dealer or plan administrator notifies the reporting person of the execution of the transaction is deemed the date of execution for a transaction where the following conditions are satisfied:

(i) the transaction is pursuant to a contract, instruction or written plan for the purchase or sale of equity securities of the issuer (as defined in § 16a–1(d)) that satisfies the affirmative defense conditions of § 240.10b5–1(c) of this chapter; and

(ii) the reporting person does not select the date of execution.

(3) Solely for purposes of section 16(a)(2)(C) of the Act and paragraph (g)(1) of this section, the date on which the plan administrator notifies the reporting person that the transaction has been executed is deemed the date of execution for a discretionary transaction (as defined in § 16b–3(b)(1)) for which the reporting person does not select the date of execution.

(4) In the case of the transactions described in paragraphs (g)(2) and (g)(3) of this section, if the notification date is later than the third business day following the trade date of the transaction, the date of execution is deemed

to be the third business day following the trade date of the transaction.

(5) At the option of the reporting person, transactions that are reportable on Form 5 may be reported on Form 4, so long as the Form 4 is filed no later than the due date of the Form 5 on which the transaction is otherwise required to be reported.

(h) The date of filing with the Commission shall be the date of receipt by the Commission.

(i) *Signatures.* Where Section 16 of the Act, or the rules or forms thereunder, require a document filed with or furnished to the Commission to be signed, such document shall be manually signed, or signed using either typed signatures or duplicated or facsimile versions of manual signatures. Where typed, duplicated or facsimile signatures are used, each signatory to the filing shall manually sign a signature page or other document authenticating, acknowledging or otherwise adopting his or her signature that appears in the filing. Such document shall be executed before or at the time the filing is made and shall be retained by the filer for a period of five years. Upon request, the filer shall furnish to the Commission or its staff a copy of any or all documents retained pursuant to this section.

(j) Where more than one person subject to section 16 of the Act is deemed to be a beneficial owner of the same equity securities, all such persons must report as beneficial owners of the securities, either separately or jointly. Where persons in a group are deemed to be beneficial owners of equity securities pursuant to § 240.16a–1(a)(1) due to the aggregation of holdings, a single Form 3, 4 or 5 may be filed on behalf of all persons in the group. Joint and group filings must include all required information for each beneficial owner, and such filings must be signed by each beneficial owner, or on behalf of such owner by an authorized person.

(k) Any issuer that maintains a corporate Web site shall post on that Web site by the end of the business day after filing any Form 3, 4 or 5 filed under section 16(a) of the Act as to the equity securities of that issuer. Each such form shall remain accessible on such issuer's Web site for at least a 12-month period. In the case of an issuer that is an investment company and that does not maintain its own Web site, if any of the issuer's investment adviser, sponsor, depositor, trustee, administrator, principal underwriter, or any affiliated person of the investment company maintains a Web site that includes the name of the issuer, the issuer shall comply with the posting requirements by posting the forms on one such Web site.

[56 FR 7265, Feb. 21, 1991, as amended at 60 FR 26622, May 17, 1995; 61 FR 30392, 30404, June 14, 1996; 67 FR 43535, June 28, 2002; 67 FR 56467, Sept. 3, 2002; 68 FR 25799, May 13, 2003; 76 FR 71877, Nov. 21, 2011]

§ 240.16a–4 Derivative securities.

(a) For purposes of section 16 of the Act, both derivative securities and the underlying securities to which they relate shall be deemed to be the same class of equity securities, *except that* the acquisition or disposition of any derivative security shall be separately reported.

(b) The exercise or conversion of a call equivalent position shall be reported on Form 4 and treated for reporting purposes as:

(1) A purchase of the underlying security; and

(2) A closing of the derivative security position.

(c) The exercise or conversion of a put equivalent position shall be reported on Form 4 and treated for reporting purposes as:

(1) A sale of the underlying security; and

(2) A closing of the derivative security position.

(d) The disposition or closing of a long derivative security position, as a result of cancellation or expiration, shall be exempt from section 16(a) of the Act if exempt from section 16(b) of the Act pursuant to § 240.16b–6(d).

NOTE TO § 240.16a–4: A purchase or sale resulting from an exercise or conversion of a derivative security may be exempt from section 16(b) of the Act pursuant to § 240.16b–3 or § 240.16b–6(b).

[56 FR 7265, Feb. 21, 1991, as amended at 56 FR 19927, May 1, 1991; 61 FR 30392, June 14, 1996]

§ 240.16a–5 Odd-lot dealers.

Transactions by an odd-lot dealer (a) in odd-lots as reasonably necessary to carry on odd-lot transactions, or (b) in round lots to offset odd-lot transactions previously or simultaneously executed or reasonably anticipated in the usual course of business, shall be exempt from the provisions of section 16(a) of the Act with respect to participation by such odd-lot dealer in such transaction.

§ 240.16a–6 Small acquisitions.

(a) Any acquisition of an equity security or the right to acquire such securities, other than an acquisition from the issuer (including an employee benefit plan sponsored by the issuer), not exceeding $10,000 in market value shall be reported on Form 5, subject to the following conditions:

(1) Such acquisition, when aggregated with other acquisitions of securities of the same class (including securities underlying derivative securities, but excluding acquisitions exempted by rule from section 16(b) or previously reported on Form 4 or Form 5) within the prior six months, does not exceed a total of $10,000 in market value; and

(2) The person making the acquisition does not within six months thereafter make any disposition, other than by a transaction exempt from section 16(b) of the Act.

(b) If an acquisition no longer qualifies for the reporting deferral in paragraph (a) of this section, all such acquisitions that have not yet been reported must be reported on Form 4 before the end of the second business day following the day on which the conditions of paragraph (a) of this section are no longer met.

[56 FR 7265, Feb. 21, 1991, as amended at 61 FR 30392, June 14, 1996; 67 FR 56467, Sept. 3, 2002]

§ 240.16a–7 Transactions effected in connection with a distribution.

(a) Any purchase and sale, or sale and purchase, of a security that is made in connection with the distribution of a substantial block of securities shall be exempt from the provisions of section 16(a) of the Act, to the extent specified in this rule, subject to the following conditions:

(1) The person effecting the transaction is engaged in the business of distributing securities and is participating in good faith, in the ordinary course of such business, in the distribution of such block of securities; and

(2) The security involved in the transaction is:

(i) Part of such block of securities and is acquired by the person effecting the transaction, with a view to distribution thereof, from the issuer or other person on whose behalf such securities are being distributed or from a person who is participating in good faith in the distribution of such block of securities; or

(ii) A security purchased in good faith by or for the account of the person effecting the transaction for the purpose of stabilizing the market price of securities of the class being distributed or to cover an over-allotment or other short position created in connection with such distribution.

(b) Each person participating in the transaction must qualify on an individual basis for an exemption pursuant to this section.

§ 240.16a–8 Trusts.

(a) *Persons subject to section 16*—(1) *Trusts.* A trust shall be subject to section 16 of the Act with respect to securities of the issuer if the trust is a beneficial owner, pursuant to § 240.16a–1(a)(1), of more than ten percent of any class of equity securities of the issuer registered pursuant to section 12 of the Act (''ten percent beneficial owner'').

(2) *Trustees, beneficiaries, and settlors.* In determining whether a trustee, beneficiary, or settlor is a ten percent beneficial owner with respect to the issuer:

(i) Such persons shall be deemed the beneficial owner of the issuer's securities held by the trust, to the extent specified by § 240.16a–1(a)(1); and

(ii) Settlors shall be deemed the beneficial owner of the issuer's securities held by the trust where they have the power to revoke the trust without the consent of another person.

(b) *Trust Holdings and Transactions.* Holdings and transactions in the issuer's securities held by a trust shall be reported by the trustee on behalf of the trust, if the trust is subject to section 16 of the Act, except as provided below. Holdings and transactions in the issuer's securities held by a trust (whether or not subject to section 16 of the Act) may be reportable by other parties as follows:

(1) *Trusts.* The trust need not report holdings and transactions in the issuer's securities held by the trust in an employee benefit plan subject to the Employee Retirement Income Security Act over which no trustee exercises investment control.

(2) *Trustees.* If, as provided by § 240.16a–1(a)(2), a trustee subject to section 16 of the Act has a pecuniary interest in any holding or transaction in the issuer's securities held by the trust, such holding or transaction shall be attributed to the trustee and shall be reported by the trustee in the trustee's individual capacity, as well as on behalf of the trust. With respect to performance fees and holdings of the trustee's immediate family, trustees shall be deemed to have a pecuniary interest in the trust holdings and transactions in the following circumstances:

(i) A performance fee is received that does not meet the proviso of § 240.16a–1(a)(2)(ii)(C); or

(ii) At least one beneficiary of the trust is a member of the trustee's immediate family. The pecuniary interest of the immediate family member(s) shall be attributed to and reported by the trustee.

(3) *Beneficiaries.* A beneficiary subject to section 16 of the Act shall have or share reporting obligations with respect to transactions in the issuer's securities held by the trust, if the beneficiary is a beneficial owner of the securities pursuant to § 240.16a–1(a)(2), as follows:

(i) If a beneficiary shares investment control with the trustee with respect to a trust transaction, the transaction shall be attributed to and reported by both the beneficiary and the trust;

(ii) If a beneficiary has investment control with respect to a trust transaction without consultation with the trustee, the transaction shall be attributed to and reported by the beneficiary only; and

(iii) In making a determination as to whether a beneficiary is the beneficial owner of the securities pursuant to § 240.16a–1(a)(2), beneficiaries shall be deemed to have a pecuniary interest in the issuer's securities held by the trust to the extent of their pro rata interest in the trust where the trustee does not exercise exclusive investment control.

NOTE TO PARAGRAPH (b)(3): Transactions and holdings attributed to a trust beneficiary may be reported by the trustee on behalf of the beneficiary, provided that the report is signed by the beneficiary or other authorized person. Where the transactions and holdings are attributed both to the trustee and trust beneficiary, a joint report may be filed in accordance with § 240.16a–3(j).

(4) *Settlors.* If a settlor subject to section 16 of the Act reserves the right to revoke the trust without the consent of another person, the trust holdings and transactions shall be attributed to and reported by the settlor instead of the trust; *Provided, however,* That if the settlor does not exercise or share investment control over the issuer's securities held by the trust, the trust holdings and transactions shall be attributed to and reported by the trust instead of the settlor.

(c) *Remainder interests.* Remainder interests in a trust are deemed not to confer beneficial ownership for purposes of section 16 of the Act, provided that the persons with the remainder interests have no power, directly or indirectly, to exercise or share investment control over the trust.

(d) A trust, trustee, beneficiary or settlor becoming subject to section 16(a) of the Act pursuant to this rule also shall be subject to sections 16(b) and 16(c) of the Act.

[56 FR 7265, Feb. 21, 1991, as amended at 56 FR 19927, May 1, 1991; 61 FR 30392, June 14, 1996; 67 FR 56467, Sept. 3, 2002]

§ 240.16a–9 Stock splits, stock dividends, and pro rata rights.

The following shall be exempt from section 16 of the Act:

(a) The increase or decrease in the number of securities held as a result of a stock split or stock dividend applying equally to all securities of a class, including a stock dividend in which equity securities of a different issuer are distributed; and

(b) The acquisition of rights, such as shareholder or pre-emptive rights, pursuant to a pro rata grant to all holders of the same class of equity securities registered under section 12 of the Act.

NOTE: The exercise or sale of a pro rata right shall be reported pursuant to § 240.16a–4 and the exercise shall be eligible for exemption from section 16(b) of the Act pursuant to § 240.16b–6(b).

[56 FR 7265, Feb. 21, 1991, as amended at 61 FR 30393, June 14, 1996]

§ 240.16a–10 Exemptions under section 16(a).

Except as provided in § 240.16a–6, any transaction exempted from the requirements of section 16(a) of the Act, insofar as it is otherwise subject to the provisions of section 16(b), shall be likewise exempt from section 16(b) of the Act.

§ 240.16a–11 Dividend or interest reinvestment plans.

Any acquisition of securities resulting from the reinvestment of dividends or interest on securities of the same issuer shall be exempt from section 16 of the Act if the acquisition is made pursuant to a plan providing for the regular reinvestment of dividends or interest and the plan provides for broad-based participation, does not discriminate in favor of employees of the issuer, and operates on substantially the same terms for all plan participants.

[61 FR 30393, June 14, 1996]

§ 240.16a–12 Domestic relations orders.

The acquisition or disposition of equity securities pursuant to a domestic relations order, as defined in the Internal Revenue Code or Title I of the Employee Retirement Income Security Act, or the rules thereunder, shall be exempt from section 16 of the Act.

[61 FR 30393, June 14, 1996]

§ 240.16a–13 Change in form of beneficial ownership.

A transaction, other than the exercise or conversion of a derivative security or deposit into or withdrawal from a voting trust, that effects only a change in the form of beneficial ownership without changing a person's pecuniary interest in the subject equity securities shall be exempt from section 16 of the Act.

[61 FR 30393, June 14, 1996]

EXEMPTION OF CERTAIN TRANSACTIONS FROM SECTION 16(b)

SOURCE: Sections 240.16b–1 through 240.16b–8 appear at 56 FR 7270, Feb. 21, 1991, unless otherwise noted.

§ 240.16b–1 Transactions approved by a regulatory authority.

Any purchase and sale, or sale and purchase, of a security shall be exempt from section 16(b) of the Act, if the transaction is effected by an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) and both the purchase and sale of such security have been exempted from the provisions of section 17(a) (15 U.S.C. 80a–17(a)) of the Investment Company Act of 1940, by rule or order of the Commission.

[56 FR 7270, Feb. 21, 1991, as amended at 61 FR 30404, June 14, 1996; 76 FR 71877, Nov. 21, 2011]

§ 240.16b–2 [Reserved]

§ 240.16b–3 Transactions between an issuer and its officers or directors.

(a) *General.* A transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or director of the issuer that involves issuer equity securities shall be exempt from section 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section.

(b) *Definitions*—(1) A *Discretionary Transaction* shall mean a transaction pursuant to an employee benefit plan that:

(i) Is at the volition of a plan participant;

(ii) Is not made in connection with the participant's death, disability, retirement or termination of employment;

(iii) Is not required to be made available to a plan participant pursuant to a provision of the Internal Revenue Code; and

(iv) Results in either an intra-plan transfer involving an issuer equity securities fund, or a cash distribution funded by a volitional disposition of an issuer equity security.

(2) An *Excess Benefit Plan* shall mean an employee benefit plan that is operated in conjunction with a Qualified Plan, and provides only the benefits or contributions that would be provided under a Qualified Plan but for any benefit or contribution limitations set forth in the Internal Revenue Code of 1986, or any successor provisions thereof.

(3)(i) A *Non-Employee Director* shall mean a director who:

(A) Is not currently an officer (as defined in § 240.16a-1(f)) of the issuer or a parent or subsidiary of the issuer, or otherwise currently employed by the issuer or a parent or subsidiary of the issuer;

(B) Does not receive compensation, either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director, except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to § 229.404(a) of this chapter; and

(C) Does not possess an interest in any other transaction for which disclosure would be required pursuant to § 229.404(a) of this chapter.

(ii) Notwithstanding paragraph (b)(3)(i) of this section, a *Non-Employee Director* of a closed-end investment company shall mean a director who is not an ''interested person'' of the issuer, as that term is defined in Section 2(a)(19) of the Investment Company Act of 1940.

(4) A *Qualified Plan* shall mean an employee benefit plan that satisfies the coverage and participation requirements of sections 410 and 401(a)(26) of the Internal Revenue Code of 1986, or any successor provisions thereof.

(5) A *Stock Purchase Plan* shall mean an employee benefit plan that satisfies the coverage and participation requirements of sections 423(b)(3) and 423(b)(5), or section 410, of the Internal Revenue Code of 1986, or any successor provisions thereof.

(c) *Tax-conditioned plans.* Any transaction (other than a Discretionary Transaction) pursuant to a Qualified Plan, an Excess Benefit Plan, or a Stock Purchase Plan shall be exempt without condition.

(d) *Acquisitions from the issuer.* Any transaction, other than a Discretionary Transaction, involving an acquisition from the issuer (including without limitation a grant or award), whether or not intended for a compensatory or other particular purpose, shall be exempt if:

(1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;

(2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of a majority of the securities of the issuer entitled to vote; *provided that* such ratification occurs no later than the date of the next annual meeting of shareholders; or

(3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, *provided that* this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

(e) *Dispositions to the issuer.* Any transaction, other than a Discretionary Transaction, involving the disposition to the issuer of issuer equity securities, whether or not intended for a compensatory or other particular purpose, shall be exempt, provided that the terms of such disposition are approved in advance in the manner prescribed by either paragraph (d)(1) or paragraph (d)(2) of this section.

(f) *Discretionary Transactions.* A Discretionary Transaction shall be exempt only if effected pursuant to an election made at least six months following the date of the most recent election, with respect to any plan of the issuer, that effected a Discretionary Transaction that was:

(1) An acquisition, if the transaction to be exempted would be a disposition; or

(2) A disposition, if the transaction to be exempted would be an acquisition.

NOTES TO § 240.16b–3

NOTE (1): The exercise or conversion of a derivative security that does not satisfy the conditions of this section is eligible for exemption from section 16(b) of the Act to the extent that the conditions of § 240.16b–6(b) are satisfied.

NOTE (2): Section 16(a) reporting requirements applicable to transactions exempt pursuant to this section are set forth in § 240.16a–3(f) and (g) and § 240.16a–4.

NOTE (3): The approval conditions of paragraphs (d)(1), (d)(2) and (e) of this section require the approval of each specific transaction, and are not satisfied by approval of a plan in its entirety except for the approval of a plan pursuant to which the terms and conditions of each transaction are fixed in advance, such as a formula plan. Where the terms of a subsequent transaction (such as the exercise price of an option, or the provision of an exercise or tax withholding right) are provided for in a transaction as initially approved pursuant to paragraphs (d)(1), (d)(2) or (e), such subsequent transaction shall not require further specific approval.

NOTE (4): For purposes of determining a director's status under those portions of paragraph (b)(3)(i) that reference § 229.404(a) of this chapter, an issuer may rely on the disclosure provided under § 229.404(a) of this chapter for the issuer's most recent fiscal year contained in the most recent filing in which disclosure required under § 229.404(a) is presented. Where a transaction disclosed in that filing was terminated before the director's proposed service as a Non-Employee Director, that transaction will not bar such service. The issuer must believe in good faith that any current or contemplated transaction in which the director participates will not be required to be disclosed under § 229.404(a) of this chapter, based on information readily available to the issuer and the director at the time such director proposes to act as a Non-Employee Director. At such time as the issuer believes in good faith, based on readily available information, that a current or contemplated transaction with a director will be required to be disclosed under § 229.404(a) in a future filing, the director no longer is eligible to serve as a Non-Employee Director; *provided, however*, that this determination does not result in retroactive loss of a Rule 16b-3 exemption for a transaction previously approved by the director while serving as a Non-Employee Director consistent with this note. In making the determinations specified in this Note, the issuer may rely on information it obtains from the director, for example, pursuant to a response to an inquiry.

[61 FR 30393, June 14, 1996, as amended at 70 FR 46089, Aug. 9, 2005; 71 FR 53263, Sept. 8, 2006]

§ 240.16b–4 [Reserved]

§ 240.16b–5 Bona fide gifts and inheritance.

Both the acquisition and the disposition of equity securities shall be exempt from the operation of section 16(b) of the Act if they are: (a) Bona fide gifts; or (b) transfers of securities by will or the laws of descent and distribution.

§ 240.16b–6 Derivative securities.

(a) The establishment of or increase in a call equivalent position or liquidation of or decrease in a put equivalent position shall be deemed a purchase of the underlying security for purposes of section 16(b) of the Act, and the establishment of or increase in a put equivalent position or liquidation of or decrease in a call equivalent position shall be deemed a sale of the underlying securities for purposes of section 16(b) of the Act: *Provided, however*, That if the increase or decrease occurs as a result of the fixing of the exercise price of a right initially issued without a fixed price, where the date the price is fixed is not known in advance and is outside the control of the recipient, the increase or decrease shall be exempt from section 16(b) of the Act with respect to any offsetting transaction within the six months prior to the date the price is fixed.

(b) The closing of a derivative security position as a result of its exercise or conversion shall be exempt from the operation of section 16(b) of the Act, and the acquisition of underlying securities at a fixed exercise price due to the exercise or conversion of a call equivalent position or the disposition of underlying securities at a fixed exercise price due to the exercise of a put equivalent position shall be exempt from the operation of section 16(b) of the Act: *Provided, however*, That the acquisition of underlying securities from the exercise of an out-of-the-money option, warrant, or right shall not be exempt unless the exercise is necessary to comport with the sequential exercise provisions of the Internal Revenue Code (26 U.S.C. 422A).

NOTE TO PARAGRAPH (b): The exercise or conversion of a derivative security that does not satisfy the conditions of this section is eligible for exemption from section 16(b) of the Act to the extent that the conditions of §240.16b–3 are satisfied.

(c) In determining the short-swing profit recoverable pursuant to section 16(b) of the Act from transactions involving the purchase and sale or sale and purchase of derivative and other securities, the following rules apply:

(1) Short-swing profits in transactions involving the purchase and sale or sale and purchase of derivative securities that have identical characteristics (e.g., purchases and sales of call options of the same strike price and expiration date, or purchases and sales of the same series of convertible debentures) shall be measured by the actual prices paid or received in the short-swing transactions.

(2) Short-swing profits in transactions involving the purchase and sale or sale and purchase of derivative securities having different characteristics but related to the same underlying security (e.g., the purchase of a call option and the sale of a convertible debenture) or derivative securities and underlying securities shall not exceed the difference in price of the underlying security on the date of purchase or sale and the date of sale or purchase. Such profits may be measured by calculating the short-swing profits that would have been realized had the subject transactions involved purchases and sales solely of the derivative security that was purchased or solely of the derivative security that was sold, valued as of the time of the matching purchase or sale, and calculated for the lesser of the number of underlying securities actually purchased or sold.

(d) Upon cancellation or expiration of an option within six months of the writing of the option, any profit derived from writing the option shall be recoverable under section 16(b) of the Act. The profit shall not exceed the premium received for writing the option. The disposition or closing of a long derivative security position, as a result of cancellation or expiration, shall be exempt from section 16(b) of the Act where no value is received from the cancellation or expiration.

[56 FR 7270, Feb. 21, 1991, as amended at 61 FR 30394, June 14, 1996]

§ 240.16b–7 Mergers, reclassifications, and consolidations.

(a) The following transactions shall be exempt from the provisions of section 16(b) of the Act:

(1) The acquisition of a security of a company, pursuant to a merger, reclassification or consolidation, in exchange for a security of a company that before the merger, reclassification or consolidation, owned 85 percent or more of either:

(i) The equity securities of all other companies involved in the merger, reclassification or consolidation, or in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies involved in the merger, reclassification or consolidation, computed according to their book values before the merger, reclassification or consolidation as determined by reference to their most recent available financial statements for a 12 month period before the merger, reclassification or consolidation, or such shorter time as the company has been in existence.

(2) The disposition of a security, pursuant to a merger, reclassification or consolidation, of a company that before the merger, reclassification or consolidation, owned 85 percent or more of either:

(i) The equity securities of all other companies involved in the merger, reclassification or consolidation or, in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies undergoing merger, reclassification or consolidation, computed according to their book values before the merger, reclassification or consolidation as determined by reference to their most recent available financial statements for a 12 month period before the merger, reclassification or consolidation.

(b) A merger within the meaning of this section shall include the sale or purchase of substantially all the assets of one company by another in exchange for equity securities which are then distributed to the security holders of the company that sold its assets.

(c) The exemption provided by this section applies to any securities transaction that satisfies the conditions specified in this section and is not conditioned on the transaction satisfying any other conditions.

(d) Notwithstanding the foregoing, if a person subject to section 16 of the Act makes any non-exempt purchase of a security in any company involved in the merger, reclassification or consolidation and any non-exempt sale of a security in any company involved in the merger, reclassification or consolidation within any period of less than six months during which the merger, reclassification or consolidation took place, the exemption provided by this section shall be unavailable to the extent of such purchase and sale.

[70 FR 46089, Aug. 9, 2005]

§ 240.16b–8 Voting trusts.

Any acquisition or disposition of an equity security or certificate representing equity securities involved in the deposit or withdrawal from a voting trust or deposit agreement shall be exempt from section 16(b) of the Act if substantially all of the assets held under the voting trust or deposit agreement immediately after the deposit or immediately prior to the withdrawal consisted of equity securities of the same class as the security deposited or withdrawn: *Provided, however,* That this exemption shall not apply if there is a non-exempt purchase or sale of an equity security of the class deposited within six months (including the date of withdrawal or deposit) of a non-exempt sale or purchase, respectively, of any certificate representing such equity security (other than the actual deposit or withdrawal).

EXEMPTION OF CERTAIN TRANSACTIONS FROM SECTION 16(c)

SOURCE: Sections 240.16c–1 through 240.16c–4 appear at 56 FR 7273, Feb. 21, 1991, unless otherwise noted.

§ 240.16c–1 Brokers.

Any transaction shall be exempt from section 16(c) of the Act to the extent necessary to render lawful the execution by a broker of an order for an account in which the broker has no direct or indirect interest.

§ 240.16c–2 Transactions effected in connection with a distribution.

Any transaction shall be exempt from section 16(c) of the Act to the extent necessary to render lawful any sale made by or on behalf of a dealer in connection with a distribution of a substantial block of securities, where the sale is represented by an over-allotment in which the dealer is participating as a member of an underwriting group, or the dealer or a person acting on the dealer's behalf intends in good faith to offset such sale with a security to be acquired by or on behalf of the dealer as a participant in an underwriting, selling, or soliciting-dealer group of which the dealer is a member at the time of the sale, whether or not the security to be acquired is subject to a prior offering to existing security holders or some other class of persons.

§ 240.16c–3 Exemption of sales of securities to be acquired.

(a) Whenever any person is entitled, incident to ownership of an issued security and without the payment of consideration, to receive another security ''when issued'' or ''when distributed,'' the sale of the security to be acquired shall be exempt from the operation of section 16(c) of the Act: *Provided,* That:

(1) The sale is made subject to the same conditions as those attaching to the right of acquisition;

(2) Such person exercises reasonable diligence to deliver such security to the purchaser promptly after the right of acquisition matures; and

(3) Such person reports the sale on the appropriate form for reporting transactions by persons subject to section 16(a) of the Act.

(b) This section shall not exempt transactions involving both a sale of the issued security and a sale of a security ''when issued'' or ''when distributed'' if the combined transactions result in a sale of more securities than the aggregate of issued securities owned by the seller plus those to be received for the other security "when issued" or "when distributed."

§ 240.16c–4 Derivative securities.

Establishing or increasing a put equivalent position shall be exempt from section 16(c) of the Act, so long as the amount of securities underlying the put equivalent position does not exceed the amount of underlying securities otherwise owned.

ARBITRAGE TRANSACTIONS

§ 240.16e–1 Arbitrage transactions under section 16.

It shall be unlawful for any director or officer of an issuer of an equity security which is registered pursuant to section 12 of the Act to effect any foreign or domestic arbitrage transaction in any equity security of such issuer, whether registered or not, unless he shall include such transaction in the statements required by section 16(a) and shall account to such issuer for the profits arising from such transaction, as provided in section 16(b). The provision of section 16(c) shall not apply to such arbitrage transactions. The provisions of section 16 shall not apply to any bona fide foreign or domestic arbitrage transaction insofar as it is effected by any person other than such director or officer of the issuer of such security.

(Secs. 4, 12, 13, 15, 16, 19, 24, 48 Stat. 77, 892, 894, 895, 896, 85, as amended, 901; 15 U.S.C. 77d, 78*l*, 78m, 78*o*, 78p, 77s, 78x)

[30 FR 2025, Feb. 13, 1965]

PRESERVATION OF RECORDS AND REPORTS OF CERTAIN STABILIZING ACTIVITIES

§ 240.17a–1 Recordkeeping rule for national securities exchanges, national securities associations, registered clearing agencies and the Municipal Securities Rulemaking Board.

(a) Every national securities exchange, national securities association, registered clearing agency and the Municipal Securities Rulemaking Board shall keep and preserve at least one copy of all documents, including all correspondence, memoranda, papers, books, notices, accounts, and other such records as shall be made or received by it in the course of its business as such and in the conduct of its self-regulatory activity.

(b) Every national securities exchange, national securities association, registered clearing agency and the Municipal Securities Rulemaking Board shall keep all such documents for a period of not less than five years, the first two years in an easily accessible place, subject to the destruction and disposition provisions of Rule 17a–6.

(c) Every national securities exchange, registered securities association, registered clearing agency and the Municipal Securities Rulemaking Board shall, upon request of any representative of the Commission, promptly furnish to the possession of such representative copies of any documents required to be kept and preserved by it pursuant to paragraphs (a) and (b) of this section.

[45 FR 79426, Dec. 1, 1980]

§ 240.17a–2 Recordkeeping requirements relating to stabilizing activities.

(a) *Scope of section.* This section shall apply to any person who effects any purchase of a security subject to § 242.104 of this chapter for the purpose of, or who participates in a syndicate or group that engages in, "stabilizing," as defined in § 242.100 of this chapter, the price of any security; or effects a purchase that is a "syndicate covering transaction," as defined in § 242.100 of this chapter; or imposes a "penalty bid," as defined in § 242.100 of this chapter:

(1) With respect to which a registration statement has been, or is to be, filed pursuant to the Securities Act of 1933 (15 U.S.C. 77a *et seq.*); or

(2) Which is being, or is to be, offered pursuant to an exemption from registration under Regulation A (§§ 230.251 through 230.263 of this chapter) adopted under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*); or

(3) Which is being, or is to be, otherwise offered, if the aggregate offering price of the securities being offered exceeds $5,000,000.

(b) *Definitions.* For purposes of this section, the following definitions shall apply:

(1) The term *manager* shall mean the person stabilizing or effecting syndicate covering transactions or imposing a penalty bid for its sole account or for the account of a syndicate or group in which it is a participant, and who, by contract or otherwise, deals with the issuer, organizes the selling effort, receives some benefit from the underwriting that is not shared by other underwriters, or represents any other underwriters in such matters as maintaining the records of the distribution and arranging for allotments of the securities offered.

(2) The term *exempted security* means an exempted security as defined in section 3(a)(12) of the Act, including securities issued, or guaranteed both as to principal and interest, by the International Bank for Reconstruction and Development.

(c) *Records relating to stabilizing, syndicate covering transactions, and penalty bids required to be maintained by manager.* Any person subject to this section who acts as a manager and stabilizes or effects syndicate covering transactions or imposes a penalty bid shall:

(1) Promptly record and maintain the following separately retrievable information, for a period of not less than three years, the first two years in an easily accessible place; *Provided, however,* That if the information is in a record required to be made pursuant to §240.17a–3 or §240.17a–4, or otherwise preserved, such information need not be maintained in a separate file if the person can sort promptly and retrieve the information as if it had been kept in a separate file as a record made pursuant to, and preserves the information in accordance with the time periods specified in, this paragraph (c)(1):

(i) The name and class of any security stabilized or any security in which syndicate covering transactions have been effected or a penalty bid has been imposed;

(ii) The price, date, and time at which each stabilizing purchase or syndicate covering transaction was effected by the manager or by any participant in the syndicate or group, and whether any penalties were assessed;

(iii) The names and the addresses of the members of the syndicate or group;

(iv) Their respective commitments, or, in the case of a standby or contingent underwriting, the percentage participation of each member of the syndicate or group therein; and

(v) The dates when any penalty bid was in effect.

(2) Promptly furnish to each of the members of the syndicate or group the name and class of any security being stabilized, and the date and time at which the first stabilizing purchase was effected by the manager or by any participant in the syndicate or group; and

(3) Promptly notify each of the members of such syndicate or group of the date and time when stabilizing was terminated.

(d) *Notification to manager.* Any person who has a participation in a syndicate account but who is not a manager of such account, and who effects one or more stabilizing purchases or syndicate covering transactions for its sole account or for the account of a syndicate or group, shall within three business days following such purchase notify the manager of the price, date, and time at which such stabilizing purchase or syndicate covering transaction was effected, and shall in addition notify the manager of the date and time when such stabilizing purchase or syndicate covering transaction was terminated. The manager shall maintain such notifications in a separate file, together with the information required by paragraph (c)(1) of this section, for a period of not less than three years, the first two years in an easily accessible place.

(Secs. 9(a)(6), 10(b), 17(a) and 23(a) of the Act, 15 U.S.C. 78i(a)(6), 78j(b), 78q(a) and 78w(a))

[48 FR 41378, Sept. 15, 1983, as amended at 62 FR 544, Jan. 3, 1997]

§240.17a–3 Records to be made by certain exchange members, brokers and dealers.

(a) Every member of a national securities exchange who transacts a business in securities directly with others than members of a national securities exchange, and every broker or dealer who transacts a business in securities through the medium of any such member, and every broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934, as amended, (48 Stat. 895, 49 Stat. 1377, 52 Stat. 1075; 15 U.S.C. 78*o*) shall make and keep current the following books and records relating to its business:

(1) Blotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all other debits and credits. Such records shall show the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered.

(2) Ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts.

(3) Ledger accounts (or other records) itemizing separately as to each cash and margin account of every customer and of such member, broker or dealer and partners thereof, all purchases, sales, receipts and deliveries of securities and commodities for such account and all other debits and credits to such account.

(4) Ledgers (or other records) reflecting the following:

(i) Securities in transfer;

(ii) Dividends and interest received;

(iii) Securities borrowed and securities loaned;

(iv) Moneys borrowed and moneys loaned (together with a record of the collateral therefor and any substitutions in such collateral);

(v) Securities failed to receive and failed to deliver;

(vi) All long and all short securities record differences arising from the examination, count, verification and comparison pursuant to §§ 240.17a–5, 240.17a–12, and 240.17a–13 (by date of examination, count, verification and comparison showing for each security the number of long or short count differences);

(vii) Repurchase and reverse repurchase agreements;

(5) A securities record or ledger reflecting separately for each security as of the clearance dates all ''long'' or ''short'' positions (including securities in safekeeping and securities that are the subjects of repurchase or reverse repurchase agreements) carried by such member, broker or dealer for its account of for the account of its customers or partners or others and showing the location of all securities long and the offsetting position to all securities short, including long security count differences and short security count differences classified by the date of the physical count and verification in which they were discovered, and in all cases the name or designation of the account in which each position is carried.

(6)(i) A memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted. The memorandum shall show the terms and conditions of the order or instructions and of any modification or cancellation thereof; the account for which entered; the time the order was received; the time of entry; the price at which executed; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer or, if a customer entered the order on an electronic system, a notation of that entry; and, to the extent feasible, the time of execution or cancellation. The memorandum need not show the identity of any person, other than the associated person responsible for the account, who may have entered or accepted the order if the order is entered into an electronic system that generates the memorandum and if that system is not capable of receiving an entry of the identity of any person other than the responsible associated person; in that circumstance, the member, broker or dealer shall produce upon request by a representative of a securities regulatory authority a separate record which identifies each other person. An order entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, shall be so designated. The term *instruction* shall include instructions between partners and employees of a member, broker or dealer. The term *time of entry* shall mean the time when the member, broker or dealer transmits the order or instruction for execution.

(ii) This memorandum need not be made as to a purchase, sale or redemption of a security on a subscription way basis directly from or to the issuer, if the member, broker or dealer maintains a copy of the customer's subscription agreement regarding a purchase, or a copy of any other document required by the issuer regarding a sale or redemption.

(7) A memorandum of each purchase and sale for the account of the member, broker, or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where the purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt; the terms and conditions of the order and of any modification thereof; the account for which it was entered; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer or, if a customer entered the order on an electronic system, a notation of that entry. The memorandum need not show the identity of any person other than the associated person responsible for the account who may have entered the order if the order is entered into an electronic system that generates the memorandum and if that system is not capable of receiving an entry of the identity of any person other than the responsible associated person: in that circumstance, the member, broker or dealer shall produce upon request by a representative of a securities regulatory authority a separate record which identifies each other person. An order with a customer other than a member, broker or dealer entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, shall be so designated.

(8) Copies of confirmations of all purchases and sales of securities, including all repurchase and reverse repurchase agreements, and copies of notices of all other debits and credits for securities, cash and other items for the account of customers and partners of such member, broker or dealer.

(9) A record in respect of each cash and margin account with such member, broker or dealer indicating

(i) The name and address of the beneficial owner of such account, and

(ii) Except with respect to exempt employee benefit plan securities as defined in § 240.14a–1(d), but only to the extent such securities are held by employee benefit plans established by the issuer of the securities, whether or not the beneficial owner of securities registered in the name of such members, brokers or dealers, or a registered clearing agency or its nominee objects to disclosure of his or her identity, address and securities positions to issuers, and

(iii) In the case of a margin account, the signature of such owner; *Provided*, That, in the case of a joint account or an account of a corporation, such records are required only in respect of the person or persons authorized to transact business for such account.

(10) A record of all puts, calls, spreads, straddles and other options in which such member, broker or dealer has any direct or indirect interest or which such members, broker or dealer has granted or guaranteed, containing, at least, an identification of the security and the number of units involved. An OTC derivatives dealer shall also keep a record of all eligible OTC derivative instruments as defined in § 240.3b–13 in which the OTC derivatives dealer has any direct or indirect interest or which it has written or guaranteed, containing, at a minimum, an identification of the security or other instrument, the number of units involved, and the identity of the counterparty.

(11) A record of the proof of money balances of all ledger accounts in the form of trial balances, and a record of the computation of aggregate indebtedness and net capital, as of the trial balance date, pursuant to § 240.15c3–1; *Provided, however*, (i) That such computation need not be made by any member,

broker or dealer unconditionally exempt from § 240.15c3–1 by paragraph (b)(1) or (b)(3), thereof; and (ii) that any member of an exchange whose members are exempt from § 240.15c3–1 by paragraph (b)(2) thereof shall make a record of the computation of aggregate indebtedness and net capital as of the trial balance date in accordance with the capital rules of at least one of the exchanges therein listed of which it is a member. Such trial balances and computations shall be prepared currently at least once a month.

(12)(i) A questionnaire or application for employment executed by each "associated person" (as defined in paragraph (h)(4) of this section) of the member, broker or dealer, which questionnaire or application shall be approved in writing by an authorized representative of the member, broker or dealer and shall contain at least the following information with respect to the associated person:

(A) The associated person's name, address, social security number, and the starting date of the associated person's employment or other association with the member, broker or dealer;

(B) The associated person's date of birth;

(C) A complete, consecutive statement of all the associated person's business connections for at least the preceding ten years, including whether the employment was part-time or full-time;

(D) A record of any denial of membership or registration, and of any disciplinary action taken, or sanction imposed, upon the associated person by any federal or state agency, or by any national securities exchange or national securities association, including any finding that the associated person was a cause of any disciplinary action or had violated any law;

(E) A record of any denial, suspension, expulsion or revocation of membership or registration of any member, broker or dealer with which the associated person was associated in any capacity when such action was taken;

(F) A record of any permanent or temporary injunction entered against the associated person or any member, broker or dealer with which the associated person was associated in any capacity at the time such injunction was entered;

(G) A record of any arrest or indictment for any felony, or any misdemeanor pertaining to securities, commodities, banking, insurance or real estate (including, but not limited to, acting or being associated with a broker-dealer, investment company, investment adviser, futures sponsor, bank, or savings and loan association), fraud, false statements or omissions, wrongful taking of property or bribery, forgery, counterfeiting or extortion, and the disposition of the foregoing.

(H) A record of any other name or names by which the associated person has been known or which the associated person has used;

Provided, however, That if such associated person has been registered as a registered representative of such member, broker or dealer with, or the associated person's employment has been approved by, the Financial Industry Regulatory Authority, Inc., the American Stock Exchange LLC, the Boston Stock Exchange, Inc., the Chicago Stock Exchange, Inc., New York Stock Exchange LLC, NYSE Arca, Inc., the Philadelphia Stock Exchange, Inc., the Chicago Board Options Exchange, Incorporated, the National Stock Exchange, Inc. or the International Securities Exchange, LLC, then retention of a full, correct, and complete copy of any and all applications for such registration or approval shall be deemed to satisfy the requirements of this paragraph.

(ii) A record listing every associated person of the member, broker or dealer which shows, for each associated person, every office of the member, broker or dealer where the associated person regularly conducts the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security for the member, broker or dealer, and the Central Registration Depository number, if any, and every internal identification number or code assigned to that person by the member, broker or dealer.

(13) Records required to be maintained pursuant to paragraph (d) of § 240.17f–2.

(14) Copies of all Forms X–17F–1A filed pursuant to § 240.17f–1, all agreements between reporting institutions regarding registration or other aspects of § 240.17f–1, and all confirmations or other information received from the Commission or its designee as a result of inquiry.

(15) Records required to be maintained pursuant to paragraph (e) of § 240.17f–2.

(16)(i) The following records regarding any internal broker-dealer system of which such a broker or dealer is the sponsor:

(A) A record of the broker's or dealer's customers that have access to an internal broker-dealer system sponsored by such broker or dealer (identifying any affiliations between such customers and the broker or dealer);

(B) Daily summaries of trading in the internal broker-dealer system, including:

(*1*) Securities for which transactions have been executed through use of such system; and

(*2*) Transaction volume (separately stated for trading occurring during hours when consolidated trade reporting facilities are and are not in operation):

(*i*) With respect to equity securities, stated in number of trades, number of shares, and total U.S. dollar value;

(*ii*) With respect to debt securities, stated in total settlement value in U.S. dollars; and

(*iii*) With respect to other securities, stated in number of trades, number of units of securities, and in dollar value, or other appropriate commonly used measure of value of such securities; and

(C) Time-sequenced records of each transaction effected through the internal broker-dealer system, including date and time executed, price, size, security traded, counterparty identification information, and method of execution (if internal broker-dealer system allows alternative means or locations for execution, such as routing to another market, matching with limit orders, or executing against the quotations of the broker or dealer sponsoring the system).

(ii) For purposes of paragraph (a) of this section, the term:

(A) *Internal broker-dealer system* shall mean any facility, other than a national securities exchange, an exchange exempt from registration based on limited volume, or an alternative trading system as defined in Regulation ATS, §§ 242.300 through 242.303 of this chapter, that provides a mechanism, automated in full or in part, for collecting, receiving, disseminating, or displaying system orders and facilitating agreement to the basic terms of a purchase or sale of a security between a customer and the sponsor, or between two customers of the sponsor, through use of the internal broker-dealer system or through the broker or dealer sponsor of such system;

(B) *Sponsor* shall mean any broker or dealer that organizes, operates, administers, or otherwise directly controls an internal broker-dealer trading system or, if the operator of the internal broker-dealer system is not a registered broker or dealer, any broker or dealer that, pursuant to contract, affiliation, or other agreement with the system operator, is involved on a regular basis with executing transactions in connection with use of the internal broker-dealer system, other than solely for its own account or as a customer with access to the internal broker-dealer system; and

(C) *System order* means any order or other communication or indication submitted by any customer with access to the internal broker-dealer system for entry into a trading system announcing an interest in purchasing or selling a security. The term ''system order'' does not include inquiries or indications of interest that are not entered into the internal broker-dealer system.

(17) For each account with a natural person as a customer or owner:

(i)(A) An account record including the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a member, broker or dealer), annual income, net worth (excluding value of primary residence), and the account's investment objectives. In the case of a joint account, the account record must include personal information for each joint owner who is a natural person; however, financial information for the individual joint owners may be combined. The account record shall indicate whether it has been signed by the associated person responsible for the account, if any, and approved or accepted by a principal of the member, broker or dealer. For accounts in existence on the effective date of this section, the member, broker or dealer must obtain this information within three years of the effective date of the section.

(B) A record indicating that:

(*1*) The member, broker or dealer has furnished to each customer or owner within three years of the effective date of this section, and to each customer or owner who opened an account after the effective date of this section within thirty days of the opening of the account, and thereafter at intervals no greater than thirty-six months, a copy of the account record or an alternate document with all information required by paragraph (a)(17)(i)(A) of this section. The member, broker or dealer may elect to send this notification with the next statement mailed to the customer or owner after the opening of the account. The member, broker or dealer may choose to exclude any tax identification number and date of birth from the account record or alternative document furnished to the customer or owner. The member, broker or dealer shall include with the account record or alternative document provided to each customer or owner an explanation of any terms regarding investment objectives. The account record or alternate document furnished to the customer or owner shall include or be accompanied by prominent statements that the customer or owner should mark any corrections and return the account record or alternate document to the member, broker or dealer, and that the customer or owner should notify the member, broker or dealer of any future changes to information contained in the account record.

(*2*) For each account record updated to reflect a change in the name or address of the customer or owner, the member, broker or dealer furnished a notification of that change to the customer's old address, or to each joint owner, and the associated person, if any, responsible for that account, on or before the 30th day after the date the member, broker or dealer received notice of the change.

(*3*) For each change in the account's investment objectives the member, broker or dealer has furnished to each customer or owner, and the associated person, if any, responsible for that account a copy of the updated customer account record or alternative document with all information required to be furnished by paragraph (a)(17)(i)(B)(*1*) of this section, on or before the 30th day after the date the member, broker or dealer received notice of any change, or, if the account was updated for some reason other than the firm receiving notice of a change, after the date the account record was updated. The member, broker or dealer may elect to send this notification with the next statement scheduled to be mailed to the customer or owner.

(C) For purposes of this paragraph (a)(17), the neglect, refusal, or inability of a customer or owner to provide or update any account record information required under paragraph (a)(17)(i)(A) of this section shall excuse the member, broker or dealer from obtaining that required information.

(D) The account record requirements in paragraph (a)(17)(i)(A) of this section shall only apply to accounts for which the member, broker or dealer is, or has within the past 36 months been, required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member. Additionally, the furnishing requirement in paragraph (a)(17)(i)(B)(*1*) of this section shall not be applicable to an account for which, within the last 36 months, the member, broker or dealer has not been required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member. This paragraph (a)(17)(i)(D) does not relieve a member, broker or dealer from any obligation arising from the rules of a self-regulatory organization of which it is a member regarding the collection of information from a customer or owner.

(ii) If an account is a discretionary account, a record containing the dated signature of each customer or owner granting the authority and the dated signature of each natural person to whom discretionary authority was granted.

(iii) A record for each account indicating that each customer or owner was furnished with a copy of each written agreement entered into on or after the effective date of this paragraph pertaining to that account and that, if requested by the customer or owner, the customer or owner was furnished with a fully executed copy of each agreement.

(18) A record:

(i) As to each associated person of each written customer complaint received by the member, broker or dealer concerning that associated person. The record shall include the complainant's name, address, and account number; the date the complaint was received; the name of any other associated person identified in the complaint; a description of the nature of the complaint; and the disposition of the complaint. Instead of the record, a member, broker or dealer may maintain a copy of each original complaint in a separate file by the associated person named in the complaint along with a record of the disposition of the complaint.

(ii) Indicating that each customer of the member, broker or dealer has been provided with a notice containing the address and telephone number of the department of the member, broker or dealer to which any complaints as to the account may be directed.

(19) A record:

(i) As to each associated person listing each purchase and sale of a security attributable, for compensation purposes, to that associated person. The record shall include the amount of compensation if monetary and a description of the compensation if nonmonetary. In lieu of making this record, a member, broker or dealer may elect to produce the required information promptly upon request of a representative of a securities regulatory authority.

(ii) Of all agreements pertaining to the relationship between each associated person and the member, broker or dealer including a summary of each associated person's compensation arrangement or plan with the member, broker or dealer, including commission and concession schedules and, to the extent that compensation is based on factors other than remuneration per trade, the method by which the compensation is determined.

(20) A record, which need not be separate from the advertisements, sales literature, or communications, documenting that the member, broker or dealer has complied with, or adopted policies and procedures reasonably designed to establish compliance with, applicable federal requirements and rules of a self-regulatory organization of which the member, broker or dealer is a member which require that advertisements, sales literature, or any other communications with the public by a member, broker or dealer or its associated persons be approved by a principal.

(21) A record for each office listing, by name or title, each person at that office who, without delay, can explain the types of records the firm maintains at that office and the information contained in those records.

(22) A record listing each principal of a member, broker or dealer responsible for establishing policies and procedures that are reasonably designed to ensure compliance with any applicable federal requirements or rules of a self-regulatory organization of which the member, broker or dealer is a member that require acceptance or approval of a record by a principal.

(23) A record documenting the credit, market, and liquidity risk management controls established and maintained by the broker or dealer to assist it in analyzing and managing the risks associated with its business activities, *Provided,* that the records required by this paragraph (a)(23) need only be made if the broker or dealer has more than:

(i) $1,000,000 in aggregate credit items as computed under § 240.15c3–3a; or

(ii) $20,000,000 in capital, which includes debt subordinated in accordance with § 240.15c3–1d.

(b)(1) This section shall not be deemed to require a member of a national securities exchange, a broker, or dealer who transacts a business in securities through the medium of any such member, or a broker or dealer registered pursuant to section 15 of the Act, to make or keep such records of transactions cleared for such member, broker, or dealer as are customarily made and kept by a clearing broker or dealer pursuant to the requirements of §§ 240.17a–3 and 240.17a–4: *Provided,* That the clearing broker or dealer has and maintains net capital of not less than $25,000 and is otherwise in compliance with § 240.15c3–1 or the capital rules of the exchange of which such clearing broker or dealer is a member if the members of such exchange are exempt from § 240.15c3–1 by paragraph (b)(2) thereof.

(2) This section shall not be deemed to require a member of a national securities exchange, a broker, or dealer who transacts a business in securities through the medium of any such member, or a broker or dealer registered pursuant to section 15 of the Act, to make or keep such records of transactions cleared for such member, broker or dealer by a bank as are customarily made and kept by a clearing broker or dealer pursuant to the requirements of §§ 240.17a–3 and 240.17a–4: *Provided,* That such member, broker, or dealer obtains from such bank an agreement in writing to the effect that the records made and kept by such bank are the property of the member, broker, or dealer: *And provided further,* That such bank files with the Commission a written undertaking in form acceptable to the Commission and signed by a duly authorized person, that such books and records are available for examination by representatives of the Commission as specified in section 17(a) of the Act, and that it will furnish to the Commission, upon demand, at its principal office in Washington, DC, or at any regional office of the Commission designated in such demand, true, correct, complete, and current copies of any or all of such records. Such undertaking shall include the following provisions:

The undersigned hereby undertakes to maintain and preserve on behalf of [*BD*] the books and records required to be maintained and preserved by [*BD*] pursuant to Rules 17a–3 and 17a–4 under the Securities Exchange Act of 1934 and to permit examination of such books and records at any time or from time to time during business hours by examiners or other representatives of the Securities and Exchange Commission, and to furnish to said Commission at its principal office in Washington, DC, or at any regional office of said Commission specified in a demand made by or on behalf of said Commission for copies of books and records, true, correct, complete, and current copies of any or all, or any part, of such books and records. This undertaking shall be binding upon the undersigned, and the successors and assigns of the undersigned.

Nothing herein contained shall be deemed to relieve such member, broker, or dealer from the responsibility that such books and records be accurately maintained and preserved as specified in §§ 240.17a–3 and 240.17a–4.

(c) This section shall not be deemed to require a member of a national securities exchange, or a broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934 (48 Stat. 895, 49 Stat. 1377; 15 U.S.C. 78*o*) as amended, to make or keep such records as are required by paragraph (a) reflecting the sale of United States Tax Savings Notes, United States Defense Savings Stamps, or United States Defense Savings Bonds, Series E, F and G.

(d) The records specified in paragraph (a) of this section shall not be required with respect to any cash transaction of $100 or less involving only subscription rights or warrants which by their terms expire within 90 days after the issuance thereof.

(e) For purposes of transactions in municipal securities by municipal securities brokers and municipal securities dealers, compliance with Rule G–8 of the Municipal Securities Rulemaking Board will be deemed to be in compliance with this section.

(f) *Security futures products.* The provisions of this section shall not apply to security futures product transactions and positions in a futures account (as that term is defined in § 240.15c3–3(a)(15)); *provided,* that the

Commodity Futures Trading Commission's recordkeeping rules apply to those transactions and positions.

(g) Every member, broker or dealer shall make and keep current, as to each office, the books and records described in paragraphs (a)(1), (a)(6), (a)(7), (a)(12), (a)(17), (a)(18)(i), (a)(19), (a)(20), (a)(21), and (a)(22) of this section.

(h) When used in this section:

(1) The term *office* means any location where one or more associated persons regularly conduct the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security.

(2) The term *principal* means any individual registered with a registered national securities association as a principal or branch manager of a member, broker or dealer or any other person who has been delegated supervisory responsibility over associated persons by the member, broker or dealer.

(3) The term *securities regulatory authority* means the Commission, any self-regulatory organization, or any securities commission (or any agency or office performing like functions) of the States.

(4) The term *associated person* means an ''associated person of a member'' or ''associated person of a broker or dealer'' as defined in sections 3(a)(21) and 3(a)(18) of the Act (15 U.S.C. 78c(a)(21) and (a)(18)) respectively, but shall not include persons whose functions are solely clerical or ministerial.

CROSS REFERENCE: For interpretative release applicable to § 240.17a–3, see No. 3040 in tabulation, part 241 of this chapter.

[13 FR 8212, Dec. 22, 1948]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 240.17a–3, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.govinfo.gov*.

§ 240.17a–4 Records to be preserved by certain exchange members, brokers and dealers.

(a) Every member, broker and dealer subject to § 240.17a–3 shall preserve for a period of not less than six years, the first two years in an easily accessible place, all records required to be made pursuant to paragraphs § 240.17a–3(a)(1), (a)(2), (a)(3), (a)(5), (a)(21), (a)(22), and analogous records created pursuant to paragraph § 240.17a–3(f).

(b) Every member, broker and dealer subject to § 240.17a–3 shall preserve for a period of not less than three years, the first two years in an easily accessible place:

(1) All records required to be made pursuant to § 240.17a–3(a)(4), (a)(6), (a)(7), (a)(8), (a)(9), (a)(10), (a)(16), (a)(18), (a)(19), (a)(20), and analogous records created pursuant to § 240.17a–3(g).

(2) All check books, bank statements, cancelled checks and cash reconciliations.

(3) All bills receivable or payable (or copies thereof), paid or unpaid, relating to the business of such member, broker or dealer, as such.

(4) Originals of all communications received and copies of all communications sent (and any approvals thereof) by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such, including all communications which are subject to rules of a self-regulatory organization of which the member, broker or dealer is a member regarding communications with the public. As used in this paragraph (b)(4), the term communications includes sales scripts.

(5) All trial balances, computations of aggregate indebtedness and net capital (and working papers in connection therewith), financial statements, branch office reconciliations, and internal audit working papers, relating to the business of such member, broker or dealer, as such.

(6) All guarantees of accounts and all powers of attorney and other evidence of the granting of any discretionary authority given in respect of any account, and copies of resolutions empowering an agent to act on behalf of a corporation.

(7) All written agreements (or copies thereof) entered into by such member, broker or dealer relating to its business as such, including agreements with respect to any account.

(8) Records which contain the following information in support of amounts included in the report prepared as of the audit date on Form X–

17A–5 (§ 249.617 of this chapter) Part II or Part IIA or Part IIB and in annual audited financial statements required by § 240.17a–5(d) and § 240.17a–12(b):

(i) Money balance position, long or short, including description, quantity, price and valuation of each security including contractual commitments in customers' accounts, in cash and fully secured accounts, partly secured accounts, unsecured accounts, and in securities accounts payable to customers;

(ii) Money balance and position, long or short, including description, quantity, price and valuation of each security including contractual commitments in non-customers' accounts, in cash and fully secured accounts, partly secured and unsecured accounts, and in securities accounts payable to non-customers;

(iii) Position, long or short, including description, quantity, price and valuation of each security including contractual commitments included in the Computation of Net Capital as commitments, securities owned, securities owned not readily marketable, and other investments owned not readily marketable;

(iv) Amount of secured demand note, description of collateral securing such secured demand note including quantity, price and valuation of each security and cash balance securing such secured demand note;

(v) Description of futures commodity contracts, contract value on trade date, market value, gain or loss, and liquidating equity or deficit in customers' and non-customers' accounts;

(vi) Description of futures commodity contracts, contract value on trade date, market value, gain or loss and liquidating equity or deficit in trading and investment accounts;

(vii) Description, money balance, quantity, price and valuation of each spot commodity position or commitments in customers' and non-customers' accounts;

(viii) Description, money balance, quantity, price and valuation of each spot commodity position or commitments in trading and investment accounts;

(ix) Number of shares, description of security, exercise price, cost and market value of put and call options including short out of the money options having no market or exercise value, showing listed and unlisted put and call options separately;

(x) Quantity, price, and valuation of each security underlying the haircut for undue concentration made in the Computation for Net Capital;

(xi) Description, quantity, price and valuation of each security and commodity position or contractual commitment, long or short, in each joint account in which the broker or dealer has an interest, including each participant's interest and margin deposit;

(xii) Description, settlement date, contract amount, quantity, market price, and valuation for each aged failed to deliver requiring a charge in the Computation of Net Capital pursuant to § 240.15c3–1;

(xiii) Detail relating to information for possession or control requirements under § 240.15c3–3 and reported on the schedule in Part II or IIA of Form X–17A–5 (§ 249.617 of this chapter);

(xiv) Detail of all items, not otherwise substantiated, which are charged or credited in the Computation of Net Capital pursuant to § 240.15c3–1, such as cash margin deficiencies, deductions related to securities values and undue concentration, aged securities differences and insurance claims receivable; and

(xv) Other schedules which are specifically prescribed by the Commission as necessary to support information reported as required by § 240.17a–5 and § 240.17a–12.

(9) The records required to be made pursuant to § 240.15c3–3(d)(5) and (o).

(10) The records required to be made pursuant to § 240.15c3–4 and the results of the periodic reviews conducted pursuant to § 240.15c3–4(d).

(11) All notices relating to an internal broker-dealer system provided to the customers of the broker or dealer that sponsors such internal broker-dealer system, as defined in paragraph (a)(16)(ii)(A) of § 240.17a–3. Notices, whether written or communicated through the internal broker-dealer trading system or other automated means, shall be preserved under this paragraph (b)(11) if they are provided

to all customers with access to an internal broker-dealer system, or to one or more classes of customers. Examples of notices to be preserved under this paragraph (b)(11) include, but are not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, and instructions pertaining to access to the internal broker-dealer system.

(12) The records required to be made pursuant to § 240.15c3–1e(c)(4)(vi).

(13) The written policies and procedures the broker-dealer establishes, documents, maintains, and enforces to assess creditworthiness for the purpose of § 240.15c3–1(c)(2)(vi)(E), (c)(2)(vi)(F)(*1*), (c)(2)(vi)(F)(*2*), and (c)(2)(vi)(H).

(c) Every member, broker and dealer subject to § 240.17a–3 shall preserve for a period of not less than six years after the closing of any customer's account any account cards or records which relate to the terms and conditions with respect to the opening and maintenance of the account.

(d) Every member, broker and dealer subject to § 240.17a–3 shall preserve during the life of the enterprise and of any successor enterprise all partnership articles or, in the case of a corporation, all articles of incorporation or charter, minute books and stock certificate books (or, in the case of any other form of legal entity, all records such as articles of organization or formation, and minute books used for a purpose similar to those records required for corporations or partnerships), all Forms BD (§ 249.501 of this chapter), all Forms BDW (§ 249.501a of this chapter), all amendments to these forms, all licenses or other documentation showing the registration of the member, broker or dealer with any securities regulatory authority.

(e) Every member, broker and dealer subject to § 240.17a–3 shall maintain and preserve in an easily accessible place:

(1) All records required under paragraph (a)(12) of § 240.17a–3 until at least three years after the associated person's employment and any other connection with the member, broker or dealer has terminated.

(2) All records required under paragraph (a)(13) of § 240.17a–3 until at least three years after the termination of employment or association of those persons required by § 240.17f–2 to be fingerprinted; and

(3) All records required pursuant to paragraph (a)(15) of § 240.17a–3 for the life of the enterprise.

(4) All records required pursuant to paragraph (a)(14) of § 240.17a–3 for three years.

(5) All account record information required pursuant to § 240.17a–3(a)(17) until at least six years after the earlier of the date the account was closed or the date on which the information was replaced or updated.

(6) Each report which a securities regulatory authority has requested or required the member, broker or dealer to make and furnish to it pursuant to an order or settlement, and each securities regulatory authority examination report until three years after the date of the report.

(7) Each compliance, supervisory, and procedures manual, including any updates, modifications, and revisions to the manual, describing the policies and practices of the member, broker or dealer with respect to compliance with applicable laws and rules, and supervision of the activities of each natural person associated with the member, broker or dealer until three years after the termination of the use of the manual.

(8) All reports produced to review for unusual activity in customer accounts until eighteen months after the date the report was generated. In lieu of maintaining the reports, a member, broker or dealer may produce promptly the reports upon request by a representative of a securities regulatory authority. If a report was generated in a computer system that has been changed in the most recent eighteen month period in a manner such that the report cannot be reproduced using historical data in the same format as it was originally generated, the report may be produced by using the historical data in the current system, but must be accompanied by a record explaining each system change which affected the reports. If a report is generated in a computer system that has been changed in the most recent eighteen month period in a manner such

that the report cannot be reproduced in any format using historical data, the member, broker or dealer shall promptly produce upon request a record of the parameters that were used to generate the report at the time specified by a representative of a securities regulatory authority, including a record of the frequency with which the reports were generated.

(9) All records required pursuant to § 240.17a–3(a)(23) until three years after the termination of the use of the risk management controls documented therein.

(f) The records required to be maintained and preserved pursuant to §§ 240.17a–3 and 240.17a–4 may be immediately produced or reproduced on "micrographic media" (as defined in this section) or by means of "electronic storage media" (as defined in this section) that meet the conditions set forth in this paragraph and be maintained and preserved for the required time in that form.

(1) For purposes of this section:

(i) The term *micrographic media* means microfilm or microfiche, or any similar medium; and

(ii) The term *electronic storage media* means any digital storage medium or system and, in the case of both paragraphs (f)(1)(i) and (f)(1)(ii) of this section, that meets the applicable conditions set forth in this paragraph (f).

(2) If electronic storage media is used by a member, broker, or dealer, it shall comply with the following requirements:

(i) The member, broker, or dealer must notify its examining authority designated pursuant to section 17(d) of the Act (15 U.S.C. 78q(d)) prior to employing electronic storage media. If employing any electronic storage media other than optical disk technology (including CD-ROM), the member, broker, or dealer must notify its designated examining authority at least 90 days prior to employing such storage media. In either case, the member, broker, or dealer must provide its own representation or one from the storage medium vendor or other third party with appropriate expertise that the selected storage media meets the conditions set forth in this paragraph (f)(2).

(ii) The electronic storage media must:

(A) Preserve the records exclusively in a non-rewriteable, non-erasable format;

(B) Verify automatically the quality and accuracy of the storage media recording process;

(C) Serialize the original and, if applicable, duplicate units of storage media, and time-date for the required period of retention the information placed on such electronic storage media; and

(D) Have the capacity to readily download indexes and records preserved on the electronic storage media to any medium acceptable under this paragraph (f) as required by the Commission or the self-regulatory organizations of which the member, broker, or dealer is a member.

(3) If a member, broker, or dealer uses micrographic media or electronic storage media, it shall:

(i) At all times have available, for examination by the staffs of the Commission and self-regulatory organizations of which it is a member, facilities for immediate, easily readable projection or production of micrographic media or electronic storage media images and for producing easily readable images.

(ii) Be ready at all times to provide, and immediately provide, any facsimile enlargement which the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer may request.

(iii) Store separately from the original, a duplicate copy of the record stored on any medium acceptable under § 240.17a–4 for the time required.

(iv) Organize and index accurately all information maintained on both original and any duplicate storage media.

(A) At all times, a member, broker, or dealer must be able to have such indexes available for examination by the staffs of the Commission and the self-regulatory organizations of which the broker or dealer is a member.

(B) Each index must be duplicated and the duplicate copies must be stored separately from the original copy of each index.

(C) Original and duplicate indexes must be preserved for the time required for the indexed records.

(v) The member, broker, or dealer must have in place an audit system providing for accountability regarding inputting of records required to be maintained and preserved pursuant to §§ 240.17a–3 and 240.17a–4 to electronic storage media and inputting of any changes made to every original and duplicate record maintained and preserved thereby.

(A) At all times, a member, broker, or dealer must be able to have the results of such audit system available for examination by the staffs of the Commission and the self-regulatory organizations of which the broker or dealer is a member.

(B) The audit results must be preserved for the time required for the audited records.

(vi) The member, broker, or dealer must maintain, keep current, and provide promptly upon request by the staffs of the Commission or the self-regulatory organizations of which the member, broker, or broker-dealer is a member all information necessary to access records and indexes stored on the electronic storage media; or place in escrow and keep current a copy of the physical and logical file format of the electronic storage media, the field format of all different information types written on the electronic storage media and the source code, together with the appropriate documentation and information necessary to access records and indexes.

(vii) For every member, broker, or dealer exclusively using electronic storage media for some or all of its record preservation under this section, at least one third party (''the undersigned''), who has access to and the ability to download information from the member's, broker's, or dealer's electronic storage media to any acceptable medium under this section, shall file with the designated examining authority for the member, broker, or dealer the following undertakings with respect to such records:

The undersigned hereby undertakes to furnish promptly to the U.S. Securities and Exchange Commission (''Commission''), its designees or representatives, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer, upon reasonable request, such information as is deemed necessary by the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer to download information kept on the broker's or dealer's electronic storage media to any medium acceptable under Rule 17a–4.

Furthermore, the undersigned hereby undertakes to take reasonable steps to provide access to information contained on the broker's or dealer's electronic storage media, including, as appropriate, arrangements for the downloading of any record required to be maintained and preserved by the broker or dealer pursuant to Rules 17a–3 and 17a–4 under the Securities Exchange Act of 1934 in a format acceptable to the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer. Such arrangements will provide specifically that in the event of a failure on the part of a broker or dealer to download the record into a readable format and after reasonable notice to the broker or dealer, upon being provided with the appropriate electronic storage medium, the undersigned will undertake to do so, as the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer may request.

(g) If a person who has been subject to § 240.17a–3 ceases to transact a business in securities directly with others than members of a national securities exchange, or ceases to transact a business in securities through the medium of a member of a national securities exchange, or ceases to be registered pursuant to section 15 of the Securities Exchange Act of 1934 as amended (48 Stat. 895, 49 Stat. 1377; 15 U.S.C. 78*o*), such person shall, for the remainder of the periods of time specified in this section, continue to preserve the records which he theretofore preserved pursuant to this section.

(h) For purposes of transactions in municipal securities by municipal securities brokers and municipal securities dealers, compliance with Rule G–9 of the Municipal Securities Rulemaking Board will be deemed to be in compliance with this section.

(i) If the records required to be maintained and preserved pursuant to the provisions of §§ 240.17a–3 and 240.17a–4 are prepared or maintained by an outside service bureau, depository, bank which does not operate pursuant to § 240.17a–3(b)(2), or other recordkeeping service on behalf of the member, broker or dealer required to maintain and preserve such records, such outside entity shall file with the Commission a written undertaking in form acceptable to the Commission, signed by a duly authorized person, to the effect that such records are the property of the member, broker or dealer required to maintain and preserve such records and will be surrendered promptly on request of the member, broker or dealer and including the following provision:

With respect to any books and records maintained or preserved on behalf of [BD], the undersigned hereby undertakes to permit examination of such books and records at any time or from time to time during business hours by representatives or designees of the Securities and Exchange Commission, and to promptly furnish to said Commission or its designee true, correct, complete and current hard copy of any or all or any part of such books and records.

Agreement with an outside entity shall not relieve such member, broker or dealer from the responsibility to prepare and maintain records as specified in this section or in § 240.17a–3.

(j) Every member, broker and dealer subject to this section shall furnish promptly to a representative of the Commission legible, true, complete, and current copies of those records of the member, broker or dealer that are required to be preserved under this section, or any other records of the member, broker or dealer subject to examination under section 17(b) of the Act (15 U.S.C. 78*q*(b)) that are requested by the representative of the Commission.

(k) *Exchanges of futures for physical.* (1) Except as provided in paragraph (k)(2) of this section, upon request of any designee or representative of the Commission or of any self-regulatory organization of which it is a member, every member, broker or dealer subject to this section shall request and obtain from its customers documentation regarding an exchange of security futures products for physical securities, including documentation of underlying cash transactions and exchanges. Upon receipt of such documentation, the member, broker or dealer shall promptly provide that documentation to the requesting designee or representative.

(2) This paragraph (k) does not apply to an underlying cash transaction(s) or exchange(s) that was effected through a member, broker or dealer registered with the Commission and is of a type required to be recorded pursuant to § 240.17a–3.

(l) Records for the most recent two year period required to be made pursuant to § 240.17a–3(g) and paragraphs (b)(4) and (e)(7) of this section which relate to an office shall be maintained at the office to which they relate. If an office is a private residence where only one associated person (or multiple associated persons who reside at that location and are members of the same immediate family) regularly conducts business, and it is not held out to the public as an office nor are funds or securities of any customer of the member, broker or dealer handled there, the member, broker or dealer need not maintain records at that office, but the records must be maintained at another location within the same State as the member, broker or dealer may select. Rather than maintain the records at each office, the member, broker or dealer may choose to produce the records promptly at the request of a representative of a securities regulatory authority at the office to which they relate or at another location agreed to by the representative.

(m) When used in this section:

(1) The term *office* shall have the meaning set forth in § 240.17a–3(h)(1).

(2) The term *principal* shall have the meaning set forth in § 240.17a–3(h)(2).

(3) The term *securities regulatory authority* shall have the meaning set forth in § 240.17a–3(h)(3).

(4) The term *associated person* shall have the meaning set forth in § 240.17a–3(h)(4).

CROSS REFERENCE: For interpretative releases applicable to § 240.17a–4, see No. 3040 and No. 8024 in tabulation, part 241 of this chapter.

[13 FR 8212, Dec. 22, 1948]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 240.17a–4, see the List of CFR Sections Affected, which appears in the

Finding Aids section of the printed volume and at *www.govinfo.gov*.

§ 240.17a–5 Reports to be made by certain brokers and dealers.

(a) *Filing of monthly and quarterly reports.* (1) This paragraph (a) shall apply to every broker or dealer registered pursuant to section 15 of the Act.

(2)(i) Every broker or dealer subject to this paragraph (a) who clears transactions or carries customer accounts must file with the Commission Part I of Form X–17A–5 (§ 249.617 of this chapter) within 10 business days after the end of each month.

(ii) Every broker or dealer subject to this paragraph (a) who clears transactions or carries customer accounts must file with the Commission Part II of Form X–17A–5 (§ 249.617 of this chapter) within 17 business days after the end of the calendar quarter and within 17 business days after the end of the fiscal year of the broker or dealer where that date is not the end of a calendar quarter. Certain of such brokers or dealers shall file Part IIA in lieu thereof if the nature of their business is limited as described in the instructions to Part II of Form X–17A–5 (§ 249.617 of this chapter).

(iii) Every broker or dealer that neither clears transactions nor carries customer accounts must file with the Commission Part IIA of Form X–17A–5 (§ 249.617 of this chapter) within 17 business days after the end of each calendar quarter and within 17 business days after the end of the fiscal year of the broker or dealer where that date is not the end of a calendar quarter.

(iv) Upon receiving written notice from the Commission or the examining authority designated pursuant to section 17(d) (''designated examining authority'') of the Act, a broker or dealer who receives such notice must file with the Commission monthly, or at such times as shall be specified, Part II or Part IIA of Form X–17A–5 (§ 249.617 of this chapter and such other financial or operational information as shall be required by the Commission or the designated examining authority.

(3) The reports provided for in this paragraph (a) that must be filed with the Commission shall be considered filed when received at the Commission's principal office in Washington, DC, and the regional office of the Commission for the region in which the broker or dealer has its principal place of business. All reports filed pursuant to this paragraph (a) shall be deemed to be confidential.

(4) The provisions of paragraphs (a)(2) and (3) of this section shall not apply to a member of a national securities exchange or a registered national securities association if said exchange or association maintains records containing the information required by Part I, Part II or Part IIA of Form X–17A–5 (§ 249.617 of this chapter), as to such member, and transmits to the Commission a copy of the applicable parts of Form X–17A–5 (§ 249.617 of this chapter) as to such member, pursuant to a plan, the procedures and provisions of which have been submitted to and declared effective by the Commission. Any such plan filed by a national securities exchange or a registered national securities association may provide that when a member is also a member of one or more national securities exchanges, or of one or more national securities exchanges and a registered national securities association, the information required to be submitted with respect to any such member may be submitted by only one specified national securities exchange or registered national securities association. For the purposes of this section, a plan filed with the Commission by a national securities exchange or a registered national securities association shall not become effective unless the Commission, having due regard for the fulfillment of the Commission's duties and responsibilities under the provisions of the Act, declares the plan to be effective. Further, the Commission, in declaring any such plan effective, may impose such terms and conditions relating to the provisions of the plan and the period of its effectiveness as may be deemed necessary or appropriate in the public interest, for the protection of investors, or to carry out the Commission's duties and responsibilities under the Act.

(5) Every broker or dealer subject to this paragraph (a) must file Form Custody (§ 249.639 of this chapter) with its designated examining authority within

17 business days after the end of each calendar quarter and within 17 business days after the end of the fiscal year of the broker or dealer where that date is not the end of a calendar quarter. The designated examining authority must maintain the information obtained through the filing of Form Custody and transmit the information to the Commission, at such time as it transmits the applicable part of Form X–17A–5 (§ 249.617 of this chapter) as required in paragraph (a)(4) of this section.

(6) Each broker or dealer that computes certain of its capital charges in accordance with § 240.15c3–1e must file the following additional reports:

(i) Within 17 business days after the end of each month that is not a quarter, as of month-end:

(A) For each product for which the broker or dealer calculates a deduction for market risk other than in accordance with § 240.15c3–1e(b)(1) or (b)(3), the product category and the amount of the deduction for market risk;

(B) A graph reflecting, for each business line, the daily intra-month VaR;

(C) The aggregate value at risk for the broker or dealer;

(D) For each product for which the broker or dealer uses scenario analysis, the product category and the deduction for market risk;

(E) Credit risk information on derivatives exposures, including:

(*1*) Overall current exposure;

(*2*) Current exposure (including commitments) listed by counterparty for the 15 largest exposures;

(*3*) The 10 largest commitments listed by counterparty;

(*4*) The broker or dealer's maximum potential exposure listed by counterparty for the 15 largest exposures;

(*5*) The broker or dealer's aggregate maximum potential exposure;

(*6*) A summary report reflecting the broker or dealer's current and maximum potential exposures by credit rating category; and

(*7*) A summary report reflecting the broker or dealer's current exposure for each of the top ten countries to which the broker or dealer is exposed (by residence of the main operating group of the counterparty); and

(F) Regular risk reports supplied to the broker's or dealer's senior management in the format described in the application; and

(ii) Within 17 business days after the end of each quarter:

(A) Each of the reports required to be filed in paragraph (a)(6)(i) of this section;

(B) A report identifying the number of business days for which the actual daily net trading loss exceeded the corresponding daily VaR; and

(C) The results of backtesting of all internal models used to compute allowable capital, including VaR and credit risk models, indicating the number of backtesting exceptions.

(7) Upon written application by a broker or dealer to its designated examining authority, the designated examining authority may extend the time for filing the information required by this paragraph (a). The designated examining authority for the broker or dealer shall maintain, in the manner prescribed in § 240.17a–1, a record of each extension granted.

(b) *Report filed upon termination of membership interest.* (1) If a broker or dealer holding any membership interest in a national securities exchange or registered national securities association ceases to be a member in good standing of such exchange or association, such broker or dealer shall, within two business days after such event, file with the Commission Part II or Part IIA of Form X–17A–5 (§ 249.617 of this chapter) as determined by the standards set forth in paragraphs (a)(2)(ii) and (iii) of this section as of the date of such event. The report shall be filed at the Commission's principal office in Washington, DC, and with the regional office of the Commission for the region in which the broker or dealer has its principal place of business: *Provided, however,* That such report need not be made or filed if the Commission, upon written request or upon its own motion, exempts such broker or dealer, either unconditionally or on specified terms and conditions, from such requirement: *Provided, further,* That the Commission may, upon request of the broker or dealer, grant extensions of time for filing the report specified herein for good cause shown.

(2) The broker or dealer must attach to the report required by paragraph (b)(1) of this section an oath or affirmation that to the best knowledge and belief of the person making the oath or affirmation the information contained in the report is true and correct. The oath or affirmation must be made before a person duly authorized to administer such oaths or affirmations. If the broker or dealer is a sole proprietorship, the oath or affirmation must be made by the proprietor; if a partnership, by a general partner; if a corporation, by a duly authorized officer; or if a limited liability company or limited liability partnership, by the chief executive officer, chief financial officer, manager, managing member, or those members vested with management authority for the limited liability company or limited liability partnership.

(3) For the purposes of this paragraph (b) ''membership interest'' shall include the following: full membership, allied membership, associated membership, floor privileges, and any other interest that entitles a broker or dealer to the exercise of any privilege on an exchange or with an association.

(4) For the purposes of this paragraph (b), any broker or dealer shall be deemed to have ceased to be a member in good standing of such exchange or association when the broker or dealer has resigned, withdrawn, or been suspended or expelled from a membership interest in such exchange or association, or has directly or through any associated person sold or entered into an agreement for the sale of a membership interest which would on consummation thereof result in the termination of the broker's or dealer's membership interest in such exchange or association.

(5) Whenever any national securities exchange or registered national securities association takes any action which causes any broker or dealer which is a member of such exchange or association to cease to be a member in good standing of such exchange or association or when such exchange or association learns of any action by such member of any other person which causes such broker or dealer to cease to be a member in good standing of such exchange or association, such exchange or association shall report such action promptly to the Commission, furnishing information as to the circumstances surrounding the event, and shall send a copy of such notification to the broker or dealer and notify such broker or dealer of its responsibilities under this paragraph (b).

(c) *Customer Statements*—(1) *Who must furnish the statements.* Every broker or dealer shall file with the Commission at its principal office in Washington, DC, with the regional office of the Commission for the region in which the broker or dealer has its principal place of business, and with each national securities exchange and registered national securities association of which it is a member, and shall send to its customers the statements prescribed by paragraphs (c) (2) and (3) of this section, except as provided in paragraph (c)(5) of this section or if the activities of such broker or dealer are limited to any one or combination of the following and are conducted in the manner prescribed herein:

(i) As introducing broker or dealer, the forwarding of all the transactions of customers of the introducing broker or dealerto a clearing broker or dealer on a fully disclosed basis: *Provided,* That such clearing broker or dealer reflects such transactions on its books and records in accounts it carries in the names of such customers and that the introducing broker or dealer does not hold funds or securities for, or owe funds or securities to, customers other than funds and securities promptly forwarded to the clearing broker or dealer or to customers;

(ii) The prompt forwarding of subscriptions for securities to the issuer, underwriter or other distributor of such securities and of receiving checks, drafts, notes, or other evidences of indebtedness payable solely to the issuer, underwriter or other distributor who delivers the security directly to the subscriber or to a custodian bank, if the broker or dealer does not otherwise hold funds or securities for, or owe money or securities to, customers;

(iii) The sale and redemption of redeemable shares of registered investment companies or the solicitation of share accounts of savings and loan associations and otherwise qualified to maintain net capital of no less than what is required under § 240.15c3–1(a)(2)(iv) or the offering to extend any credit to or participate in arranging a loan for a customer to purchase insurance in connection with the sale of redeemable shares of registered investment companies; or

(iv) Conduct which would exempt the broker or dealer from the provisions of § 240.17a–13 by reason of the provisions of paragraph (a) of that section.

(2) *Audited statements to be furnished.* Audited statements shall be furnished within 105 days after the end of the fiscal year of the broker or dealer. The statements may be furnished 30 days after that time limit has expired if the broker or dealer sends them with the next mailing of the broker's or dealer's quarterly customer statements of account. In that case, the broker or dealer must include a statement in that mailing of the amount of the broker's or dealer's net capital and its required net capital in accordance with § 240.15c3–1, as of a fiscal month end that is within the 75-day period immediately preceding the date the statements are sent to customers. The audited statements shall include the following:

(i) A Statement of Financial Condition with appropriate notes prepared in accordance with U.S. generally accepted accounting principles which shall be audited if the financial statements furnished in accordance with paragraph (d) of this section are required to be certified;

(ii) A footnote containing a statement of the amount of the broker's or dealer's net capital and its required net capital, computed in accordance with § 240.15c3–1. Such statement shall include summary financial statements of subsidiaries consolidated pursuant to Appendix C of § 240.15c3–1, where material, and the effect thereof on the net capital and required net capital of the broker or dealer;

(iii) A statement indicating that the Statement of Financial Condition of the most recent financial report of the broker or dealer under paragraph (d)(1)(i)(A) of this section is available for examination at the principal office of the broker or dealer and at the regional office of the Commission for the region in which the broker or dealer has its principal place of business; and

(iv) If, in connection with the most recent annual reports required under paragraph (d) of this section, the report of the independent public accountant required under paragraph (d)(1)(i)(C) of this section covering the report of the broker or dealer required under paragraph (d)(1)(i)(B)(*1*) of this section identifies one or more *material weaknesses*, a statement by the broker or dealer that one or more *material weaknesses* have been identified and that a copy of the report of the independent public accountant required under paragraph (d)(1)(i)(C) of this section is currently available for the customer's inspection at the principal office of the Commission in Washington, DC, and the regional office of the Commission for the region in which the broker or dealer has its principal place of business.

(3) *Unaudited statements to be furnished.* Unaudited statements dated 6 months from the date of the audited statements required to be furnished by paragraphs (c)(1) and (2) of this section shall be furnished within 65 days after the date of the unaudited statements. The unaudited statements may be furnished 70 days after that time limit has expired if the broker or dealer sends them with the next mailing of the broker's or dealer's quarterly customer statements of account. In that case, the broker or dealer must include a statement in that mailing of the amount of the broker's or dealer's net capital and its required net capital in accordance with § 240.15c3–1, as of a fiscal month end that is within the 75-day period immediately preceding the date the statements are sent to customers. The unaudited statements shall contain the information specified in paragraphs (c)(2)(i) and (ii) of this section.

(4) *Definition of ''customer.''* For purposes of this paragraph (c), the term *customer* includes any person other than:

(i) Another broker or dealer who is exempted by paragraph (c)(1) of this section;

(ii) A general, special or limited partner or director or officer of a broker or dealer; or

(iii) Any person to the extent that such person has a claim for property or funds which by contract, agreement or understanding, or by operation of law, is part of the capital of the broker or dealer or is subordinated to the claims of creditors of the broker or dealer, for or with whom a broker or dealer has effected a securities transaction in a particular month, which month shall be either the month preceding the balance sheet date or the month following the balance sheet date in which the statement is sent.

The term ''customer'' also includes any person for whom the broker or dealer holds securities for safekeeping or as collateral or for whom the broker or dealer carries a free credit balance in the month in which customers are determined for purposes of this paragraph (c).

(5) *Exemption from sending certain financial information to customers.* A broker or dealer is not required to send to its customers the statements prescribed by paragraphs (c)(2) and (c)(3) of this section if the following conditions are met:

(i) The broker or dealer semi-annually sends its customers, at the times it otherwise is required to send its customers the statements prescribed by paragraphs (c)(2) and (c)(3) of this section, a financial disclosure statement that includes:

(A) The amount of the broker's or dealer's net capital and its required net capital in accordance with §240.15c3–1, as of the date of the statements prescribed by paragraphs (c)(2) and (c)(3) of this section;

(B) To the extent required under paragraph (c)(2)(ii) of this section, a description of the effect on the broker's or dealer's net capital and required net capital of the consolidation of the assets and liabilities of subsidiaries or affiliates consolidated pursuant to Appendix C of §240.15c3–1; and

(C) Any statements otherwise required by paragraphs (c)(2)(iii) and (iv) of this section.

(ii) The financial disclosure statement is given prominence in the materials delivered to customers of the broker or dealer and includes an appropriate caption stating that customers may obtain the statements prescribed by paragraphs (c)(2) and (c)(3) of this section, at no cost, by:

(A) Accessing the broker's or dealer's Website at the specified Internet Uniform Resource Locator (URL); or

(B) Calling the broker's or dealer's specified toll-free telephone number.

(iii) Not later than 90 days after the date of the audited statements prescribed by paragraph (c)(2) of this section and not later than 75 days after the date of the unaudited statements prescribed by paragraph (c)(3) of this section, the broker or dealer publishes the statements on its Website, accessible by hyperlinks in either textual or button format, which are separate, prominent links, are clearly visible, and are placed in each of the following locations:

(A) On the broker's or dealer's Website home page; and

(B) On each page at which a customer can enter or log on to the broker's or dealer's Website; and

(C) If the Websites for two or more brokers or dealers can be accessed from the same Home page, on the Home page of the Website of each broker or dealer.

(iv) The broker or dealer maintains a toll-free telephone number that customers can call to request a copy of the statements prescribed by paragraphs (c)(2) and (c)(3) of this section.

(v) If a customer requests a copy of the statements prescribed by paragraphs (c)(2) and (c)(3) of this section, the broker or dealer sends it promptly at no cost to the customer.

(d) *Annual reports.* (1)(i) Except as provided in paragraphs (d)(1)(iii) and (d)(1)(iv) of this section, every broker or dealer registered under section 15 of the Act must file annually:

(A) A financial report as described in paragraph (d)(2) of this section; and

(B)(*1*) If the broker or dealer did not claim it was exempt from §240.15c3–3 throughout the most recent fiscal year, a compliance report as described in paragraph (d)(3) of this section executed by the person who makes the oath or affirmation under paragraph (e)(2) of this section; or

(*2*) If the broker or dealer did claim that it was exempt from §240.15c3–3 throughout the most recent fiscal year, an exemption report as described in paragraph (d)(4) of this section executed by the person who makes the oath or affirmation under paragraph (e)(2) of this section;

(C) Except as provided in paragraph (e)(1)(i) of this section, a report prepared by an independent public accountant, under the engagement provisions in paragraph (g) of this section, covering each report required to be filed under paragraphs (d)(1)(i)(A) and (B) of this section.

(ii) The reports required to be filed under this paragraph (d) must be as of the same fiscal year end each year, unless a change is approved in writing by the designated examining authority for the broker or dealer under paragraph (n) of this section. A copy of the written approval must be sent to the Commission's principal office in Washington, DC, and the regional office of the Commission for the region in which the broker or dealer has its principal place of business.

(iii) A broker or dealer succeeding to and continuing the business of another broker or dealer need not file the reports under this paragraph (d) as of a date in the fiscal year in which the succession occurs if the predecessor broker or dealer has filed reports in compliance with this paragraph (d) as of a date in such fiscal year.

(iv) A broker or dealer that is a member of a national securities exchange, has transacted a business in securities solely with or for other members of a national securities exchange, and has not carried any margin account, credit balance, or security for any person who is defined as a *customer* in paragraph (c)(4) of this section, is not required to file reports under this paragraph (d).

(2) *Financial report.* The financial report must contain:

(i) A Statement of Financial Condition, a Statement of Income, a Statement of Cash Flows, a Statement of Changes in Stockholders' or Partners' or Sole Proprietor's Equity, and a Statement of Changes in Liabilities Subordinated to Claims of General Creditors. The statements must be prepared in accordance with U.S. generally accepted accounting principles and must be in a format that is consistent with the statements contained in Form X–17A–5 (§ 249.617 of this chapter) Part II or Part IIA. If the Statement of Financial Condition filed in accordance with instructions to Form X–17A–5, Part II or Part IIA, is not consolidated, a summary of financial data, including the assets, liabilities, and net worth or stockholders' equity, for subsidiaries not consolidated in the Part II or Part IIA Statement of Financial Condition as filed by the broker or dealer must be included in the notes to the financial statements reported on by the independent public accountant.

NOTE 1 TO PARAGRAPH (d)(2)(i). If there is other comprehensive income in the period(s) presented, the financial report must contain a Statement of Comprehensive Income (as defined in § 210.1–02 of Regulation S–X of this chapter) in place of a Statement of Income.

(ii) Supporting schedules that include, from Part II or Part IIA of Form X–17A–5 (§ 249.617 of this chapter), a Computation of Net Capital Under § 240.15c3–1, a Computation for Determination of the Reserve Requirements under Exhibit A of § 240.15c3–3, and Information Relating to the Possession or Control Requirements Under § 240.15c3–3.

(iii) If either the Computation of Net Capital under § 240.15c3–1 or the Computation for Determination of the Reserve Requirements Under Exhibit A of § 240.15c3–3 in the financial report is materially different from the corresponding computation in the most recent Part II or Part IIA of Form X–17A–5 (§ 249.617 of this chapter) filed by the broker or dealer pursuant to paragraph (a) of this section, a reconciliation, including appropriate explanations, between the computation in the financial report and the computation in the most recent Part II or Part IIA of Form X–17A–5 filed by the broker or dealer. If no material differences exist, a statement so indicating must be included in the financial report.

(3) *Compliance report.* (i) The compliance report must contain:

(A) Statements as to whether:

(*1*) The broker or dealer has established and maintained *Internal Control Over Compliance* as that term is defined in paragraph (d)(3)(ii) of this section;

(*2*) The Internal Control Over Compliance of the broker or dealer was effective during the most recent fiscal year;

(*3*) The Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year;

(*4*) The broker or dealer was in compliance with §§ 240.15c3–1 and 240.15c3–3(e) as of the end of the most recent fiscal year; and

(*5*) The information the broker or dealer used to state whether it was in compliance with §§ 240.15c3–1 and 240.15c3–3(e) was derived from the books and records of the broker or dealer.

(B) If applicable, a description of each material weakness in the Internal Control Over Compliance of the broker or dealer during the most recent fiscal year.

(C) If applicable, a description of any instance of non-compliance with §§ 240.15c3–1 or 240.15c3–3(e) as of the end of the most recent fiscal year.

(ii) The term *Internal Control Over Compliance* means internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with § 240.15c3–1, § 240.15c3–3, § 240.17a–13, or any rule of the designated examining authority of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer (an ''Account Statement Rule'') will be prevented or detected on a timely basis.

(iii) The broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective during the most recent fiscal year if there were one or more material weaknesses in its Internal Control Over Compliance during the most recent fiscal year. The broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective as of the end of the most recent fiscal year if there were one or more material weaknesses in its internal control as of the end of the most recent fiscal year. A *material weakness* is a deficiency, or a combination of deficiencies, in Internal Control Over Compliance such that there is a reasonable possibility that non-compliance with §§ 240.15c3–1 or 240.15c3–3(e) will not be prevented or detected on a timely basis or that non-compliance to a material extent with § 240.15c3–3, except for paragraph (e), § 240.17a–13, or any Account Statement Rule will not be prevented or detected on a timely basis. A *deficiency in Internal Control Over Compliance* exists when the design or operation of a control does not allow the management or employees of the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect on a timely basis non-compliance with § 240.15c3–1, § 240.15c3–3, § 240.17a–13, or any Account Statement Rule.

(4) *Exemption report.* The exemption report must contain the following statements made to the best knowledge and belief of the broker or dealer:

(i) A statement that identifies the provisions in § 240.15c3–3(k) under which the broker or dealer claimed an exemption from § 240.15c3–3;

(ii) A statement that the broker or dealer met the identified exemption provisions in § 240.15c3–3(k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions in § 240.15c3–3(k) throughout the most recent fiscal year except as described under paragraph (d)(4)(iii) of this section; and

(iii) If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions in § 240.15c3–3(k) and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.

(5) The annual reports must be filed not more than sixty (60) calendar days after the end of the fiscal year of the broker or dealer.

(6) The annual reports must be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, the principal office of the designated examining authority for the broker or dealer, and with the Securities Investor Protection Corporation (''SIPC'') if the broker or dealer is a member of SIPC. Copies of the reports must be provided to all self-regulatory organizations of which the broker or dealer is a member, unless the self-regulatory organization by rule waives this requirement.

(e) *Nature and form of reports.* The annual reportsfiled pursuant to paragraph (d) of this section must be prepared and filed in accordance with the following requirements:

(1)(i) The broker or dealer is not required to engage an independent public accountant to provide the reports required under paragraph (d)(1)(i)(C) of this section if, since the date of the registration of the broker or dealer under section 15 of the Act (15 U.S.C. 78o) or of the previous annual reports filed under paragraph (d) of this section:

(A) The securities business of the broker or dealer has been limited to acting as broker (agent) for the issuer in soliciting subscriptions for securities of the issuer, the broker has promptly transmitted to the issuer all funds and promptly delivered to the subscriber all securities received in connection with the transaction, and the broker has not otherwise held funds or securities for or owed money or securities to customers; or

(B) The securities business of the broker or dealer has been limited to buying and selling evidences of indebtedness secured by mortgage, deed of trust, or other lien upon real estate or leasehold interests, and the broker or dealer has not carried any margin account, credit balance, or security for any securities customer.

(ii) A broker or dealer that files annual reports under paragraph (d) of this section that are not covered by reports prepared by an independent public accountant must include in the oath or affirmation required by paragraph (e)(2) of this section a statement of the facts and circumstances relied upon as a basis for exemption from the requirement that the annual reports filed under paragraph (d) of this section be covered by reports prepared by an independent public accountant.

(2) The broker or dealer must attach to the financial report an oath or affirmation that, to the best knowledge and belief of the person making the oath or affirmation,

(i) The financial report is true and correct; and

(ii) Neither the broker or dealer, nor any partner, officer, director, or equivalent person, as the case may be, has any proprietary interest in any account classified solely as that of a customer.

The oath or affirmation must be made before a person duly authorized to administer such oaths or affirmations. If the broker or dealer is a sole proprietorship, the oath or affirmation must be made by the proprietor; if a partnership, by a general partner; if a corporation, by a duly authorized officer; or if a limited liability company or limited liability partnership, by the chief executive officer, chief financial officer, manager, managing member, or those members vested with management authority for the limited liability company or limited liability partnership.

(3) The annual reports filed under paragraph (d) of this section are not confidential, except that, if the Statement of Financial Condition in a format that is consistent with Form X–17A–5 (§ 249.617 of this chapter), Part II, or Part IIA, is bound separately from the balance of the annual reports filed under paragraph (d) of this section, and each page of the balance of the annual reports is stamped ''confidential,'' then the balance of the annual reports shall be deemed confidential to the extent permitted by law. However, the annual reports, including the confidential portions, will be available for official use by any official or employee of the U.S. or any State, by national securities exchanges and registered national securities associations of which the broker or dealer filing such a report is a member, by the Public Company Accounting Oversight Board, and by any other person if the Commission authorizes disclosure of the annual reports to that person as being in the public interest. Nothing contained in this paragraph may be construed to be in derogation of the rules of any registered national securities association or national securities exchange that give to customers of a member broker or dealer the right, upon request to the member broker or dealer, to obtain information relative to its financial condition.

(4)(i) The broker or dealer must file with SIPC a report on the SIPC annual general assessment reconciliation or exclusion from membership forms that contains such information and is in such format as determined by SIPC by rule and approved by the Commission.

(ii) Until the earlier of two years after the date paragraph (e)(4)(i) of this section is effective or SIPC adopts a rule under paragraph (e)(4)(i) of this section and the rule is approved by the Commission, the broker or dealer must file with SIPC a supplemental report on the status of the membership of the broker or dealer in SIPC if, under paragraph (d)(1)(i)(C) of this section, the broker or dealer is required to file reports prepared by an independent public accountant. The supplemental report must include the independent public accountant's report on applying agreed-upon procedures based on the performance of the procedures enumerated in paragraph (e)(4)(ii)(C) of this section. The supplemental report must cover the SIPC annual general assessment reconciliation or exclusion from membership forms not previously reported on under this paragraph (e)(4) that were required to be filed on or prior to the date of the annual reports required by paragraph (d) of this section: Provided, that the broker or dealer is not required to file the supplemental report on the SIPC annual general assessment reconciliation or exclusion from membership form for any period during which the SIPC assessment is a specified dollar value as provided for in section 4(d)(1)(c) of the Securities Investor Protection Act of 1970, as amended. The supplemental report must be filed with the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, the principal office of the designated examining authority for the broker or dealer, and the principal office of SIPC. The supplemental report must include the following:

(A) A schedule of assessment payments showing any overpayments applied and overpayments carried forward including: payment dates, amounts, and name of SIPC collection agent to whom mailed; or

(B) If exclusion from membership was claimed, a statement that the broker or dealer qualified for exclusion from membership under the Securities Investor Protection Act of 1970, as amended; and

(C) *An independent public accountant's report.* The independent public accountant must be engaged to perform the following procedures:

(*1*) Comparison of listed assessment payments with respective cash disbursements record entries;

(*2*) For all or any portion of a fiscal year, comparison of amounts reflected in the annual reports required by paragraph (d) of this section with amounts reported in the Annual General Assessment Reconciliation (Form SIPC–7);

(*3*) Comparison of adjustments reported in Form SIPC–7 with supporting schedules and working papers supporting the adjustments;

(*4*) Proof of the arithmetical accuracy of the calculations reflected in Form SIPC–7 and in the schedules and working papers supporting any adjustments; and

(*5*) Comparison of the amount of any overpayment applied with the Form SIPC–7 on which it was computed; or

(*6*) If exclusion from membership is claimed, a comparison of the income or loss reported in the financial report required by paragraph (d)(2) of this section with the Certification of Exclusion from Membership (Form SIPC–3).

(f)(1) *Qualifications of independent public accountant.* The independent public accountant must be qualified and independent in accordance with § 210.2–01 of this chapter and the independent public accountant must be registered with the Public Company Accounting Oversight Board if required by the Sarbanes-Oxley Act of 2002.

(2) *Statement regarding independent public accountant.* (i) Every broker or dealer that is required to file annual reports under paragraph (d) of this section must file no later than December 10 of each year (or 30 calendar days after the effective date of its registration as a broker or dealer, if earlier) a statement as prescribed in paragraph (f)(2)(ii) of this section with the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which its principal place of business is located, and the principal office of the designated examining authority for the broker or dealer. The statement must

be dated no later than December 1 (or 20 calendar days after the effective date of its registration as a broker or dealer, if earlier). If the engagement of an independent public accountant is of a continuing nature, providing for successive engagements, no further filing is required. If the engagement is for a single year, or if the most recent engagement has been terminated or amended, a new statement must be filed by the required date.

(ii) The statement must be headed ''Statement regarding independent public accountant under Rule 17a–5(f)(2)'' and must contain the following information and representations:

(A) Name, address, telephone number, and registration number of the broker or dealer.

(B) Name, address, and telephone number of the independent public accountant.

(C) The date of the fiscal year of the annual reports of the broker or dealer covered by the engagement.

(D) Whether the engagement is for a single year or is of a continuing nature.

(E) A representation that the independent public accountant has undertaken the items enumerated in paragraphs (g)(1) and (2) of this section.

(F) Except as provided in paragraph (f)(2)(iii) of this section, a representation that the broker or dealer agrees to allow representatives of the Commission or its designated examining authority, if requested in writing for purposes of an examination of the broker or dealer, to review the audit documentation associated with the reports of the independent public accountant filed under paragraph (d)(1)(i)(C) of this section. For purposes of this paragraph, ''audit documentation'' has the meaning provided in standards of the Public Company Accounting Oversight Board. The Commission anticipates that, if requested, it will accord confidential treatment to all documents it may obtain from an independent public accountant under this paragraph to the extent permitted by law.

(G) Except as provided in paragraph (f)(2)(iii) of this section, a representation that the broker or dealer agrees to allow the independent public accountant to discuss with representatives of the Commission and its designated examining authority, if requested in writing for purposes of an examination of the broker or dealer, the findings associated with the reports of the independent public accountant filed under paragraph (d)(1)(i)(C) of this section.

(iii) If a broker or dealer neither clears transactions nor carries customer accounts, the broker or dealer is not required to include the representations in paragraphs (f)(2)(ii)(F) and (G) of this section.

(iv) Any broker or dealer that is not required to file reports prepared by an independent public accountant under paragraph (d)(1)(i)(C) of this section must file a statement required under paragraph (f)(2)(i) of this section indicating the date as of which the unaudited reports will be prepared.

(3) *Replacement of accountant.* A broker or dealer must file a notice that must be received by the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which its principal place of business is located, and the principal office of the designated examining authority for the broker or dealer not more than 15 business days after:

(i) The broker or dealer has notified the independent public accountant that provided the reports the broker or dealer filed under paragraph (d)(1)(i)(C) of this section for the most recent fiscal year that the independent public accountant's services will not be used in future engagements; or

(ii) The broker or dealer has notified an independent public accountant that was engaged to provide the reports required under paragraph (d)(1)(i)(C) of this section that the engagement has been terminated; or

(iii) An independent public accountant has notified the broker or dealer that the independent public accountant would not continue under an engagement to provide the reports required under paragraph (d)(1)(i)(C) of this section; or

(iv) A new independent public accountant has been engaged to provide the reports required under paragraph (d)(1)(i)(C) of this section without any notice of termination having been given to or by the previously engaged independent public accountant.

(v) The notice must include:

(A) The date of notification of the termination of the engagement or of the engagement of the new independent public accountant, as applicable; and

(B) The details of any issues arising during the 24 months (or the period of the engagement, if less than 24 months) preceding the termination or new engagement relating to any matter of accounting principles or practices, financial statement disclosure, auditing scope or procedure, or compliance with applicable rules of the Commission, which issues, if not resolved to the satisfaction of the former independent public accountant, would have caused the independent public accountant to make reference to them in the report of the independent public accountant. The issues required to be reported include both those resolved to the former independent public accountant's satisfaction and those not resolved to the former accountant's satisfaction. Issues contemplated by this section are those that occur at the decision-making level—that is, between principal financial officers of the broker or dealer and personnel of the accounting firm responsible for rendering its report. The notice must also state whether the accountant's report filed under paragraph (d)(1)(i)(C) of this section for any of the past two fiscal years contained an adverse opinion or a disclaimer of opinion or was qualified as to uncertainties, audit scope, or accounting principles, and must describe the nature of each such adverse opinion, disclaimer of opinion, or qualification. The broker or dealer must also request the former independent public accountant to furnish the broker or dealer with a letter addressed to the Commission stating whether the independent public accountant agrees with the statements contained in the notice of the broker or dealer and, if not, stating the respects in which independent public accountant does not agree. The broker or dealer must file three copies of the notice and the accountant's letter, one copy of which must be manually signed by the sole proprietor, a general partner, or a duly authorized corporate, limited liability company, or limited liability partnership officer or member, as appropriate, and by the independent public accountant, respectively.

(g) *Engagement of independent public accountant.* The independent public accountant engaged by the broker or dealer to provide the reports required under paragraph (d)(1)(i)(C) of this section must, as part of the engagement, undertake the following, as applicable:

(1) To prepare an independent public accountant's report based on an examination of the financial report required to be filed by the broker or dealer under paragraph (d)(1)(i)(A) of this section in accordance with standards of the Public Company Accounting Oversight Board; and

(2)(i) To prepare an independent public accountant's report based on an examination of the statements required under paragraphs (d)(3)(i)(A)(*2*) through (*5*) of this section in the compliance report required to be filed by the broker or dealer under paragraph (d)(1)(i)(B)(*1*) of this section in accordance with standards of the Public Company Accounting Oversight Board; or

(ii) To prepare an independent public accountant's report based on a review of the statements required under paragraphs (d)(4)(i) through (iii) of this section in the exemption report required to be filed by the broker or dealer under paragraph (d)(1)(i)(B)(*2*) of this section in accordance with standards of the Public Company Accounting Oversight Board.

(h) *Notification of non-compliance or material weakness.* If, during the course of preparing the independent public accountant's reports required under paragraph (d)(1)(i)(C) of this section, the independent public accountant determines that the broker or dealer is not in compliance with § 240.15c3–1, § 240.15c3–3, or § 240.17a–13 or any rule of the designated examining authority of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer, as applicable, or the independent public accountant determines that any material weaknesses (as defined in paragraph (d)(3)(iii) of this section) exist, the independent public accountant must immediately notify the chief financial officer of the broker or dealer of the nature of the non-compliance or material weakness. If the notice from the accountant concerns an instance of non-compliance that would require a broker or dealer to provide a notification under § 240.15c3–1, § 240.15c3–3, or § 240.17a–11, or if the notice concerns a material weakness, the broker or dealer must provide a notification in accordance with § 240.15c3–1, § 240.15c3–3, or § 240.17a–11, as applicable, and provide a copy of the notification to the independent public accountant. If the independent public accountant does not receive the notification within one business day, or if the independent public accountant does not agree with the statements in the notification, then the independent public accountant must notify the Commission and the designated examining authority within one business day. The report from the accountant must, if the broker or dealer failed to file a notification, describe any instances of non-compliance that required a notification under § 240.15c3–1, § 240.15c3–3, or § 240.17a–11, or any material weaknesses. If the broker or dealer filed a notification, the report from the accountant must detail the aspects of the notification of the broker or dealer with which the accountant does not agree.

Note to paragraph (h): The attention of the broker or dealer and the independent public accountant is called to the fact that under § 240.17a–11(b)(1), among other things, a broker or dealer whose net capital declines below the minimum required pursuant to § 240.15c3–1 shall give notice of such deficiency that same day in accordance with § 240.17a–11(g) and the notice shall specify the broker or dealer's net capital requirement and its current amount of net capital. The attention of the broker or dealer and accountant also is called to the fact that under § 240.15c3–3(i), if a broker or dealer shall fail to make a reserve bank account or special account deposit, as required by § 240.15c3–3, the broker or dealer shall by telegram immediately notify the Commission and the regulatory authority for the broker or dealer, which examines such broker or dealer as to financial responsibility and shall promptly thereafter confirm such notification in writing.

(i) *Reports of the independent public accountant required under paragraph (d)(1)(i)(C) of this section*—(1) *Technical requirements.* The independent public accountant's reports must:

(i) Be dated;

(ii) Be signed manually;

(iii) Indicate the city and state where issued; and

(iv) Identify without detailed enumeration the items covered by the reports.

(2) *Representations.* The independent public accountant's reports must:

(i) State whether the examinations or review, as applicable, were made in accordance with standards of the Public Company Accounting Oversight Board;

(ii) Identify any examination and, if applicable, review procedures deemed necessary by the independent public accountant under the circumstances of the particular case that have been omitted and the reason for their omission.

(iii) Nothing in this section may be construed to imply authority for the omission of any procedure that independent public accountants would ordinarily employ in the course of an examination or review made for the purpose of expressing the opinions or conclusions required under this section.

(3) *Opinion or conclusion to be expressed.* The independent public accountant's reports must state clearly:

(i) The opinion of the independent public accountant with respect to the financial report required under paragraph (d)(1)(i)(A) of this section and the accounting principles and practices reflected in that report;

(ii) The opinion of the independent public accountant with respect to the financial report required under paragraph (d)(1)(i)(A) of this section, as to the consistency of the application of the accounting principles, or as to any changes in those principles, that have a material effect on the financial statements; and

(iii)(A) The opinion of the independent public accountant with respect to the statements required under paragraphs (d)(3)(i)(A)(*2*) through (*5*) of this section in the compliance report required under paragraph (d)(1)(i)(B)(*1*) of this section; or

(B) The conclusion of the independent public accountant with respect to the statements required under paragraphs (d)(4)(i) through (iii) of this section in the exemption report required under paragraph (d)(1)(i)(B)(*2*) of this section.

(4) *Exceptions.* Any matters to which the independent public accountant takes exception must be clearly identified, the exceptions must be specifically and clearly stated, and, to the extent practicable, the effect of each such exception on any related items contained in the annual reports required under paragraph (d) of this section must be given.

(j) [Reserved]

(k) *Supplemental reports.* Each broker or dealer that computes certain of its capital charges in accordance with §240.15c3–1e shall file concurrently with the annual audit report a supplemental report on management controls, which shall be prepared by a registered public accounting firm (as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq.*)). The supplemental report shall indicate the results of the accountant's review of the internal risk management control system established and documented by the broker or dealer in accordance with §240.15c3–4. This review shall be conducted in accordance with procedures agreed upon by the broker or dealer and the registered public accounting firm conducting the review. The agreed upon procedures are to be performed and the report is to be prepared in accordance with the rules promulgated by the Public Company Accounting Oversight Board. The purpose of the review is to confirm that the broker or dealer has established, documented, and is in compliance with the internal risk management controls established in accordance with §240.15c3–4. Before commencement of the review and no later than December 10 of each year, the broker or dealer shall file a statement with the Division of Market Regulation, Office of Financial Responsibility, at the Commission's principal office in Washington, DC that includes:

(1) A description of the agreed-upon procedures agreed to by the broker or dealer and the registered public accounting firm; and

(2) A notice describing changes in those agreed-upon procedures, if any. If there are no changes, the broker or dealer should so indicate.

(l) *Use of certain statements filed with the Securities and Exchange Commission.* At the request of any broker or dealer who is (1) an investment company registered under the Investment Company Act of 1940, or (2) a sponsor or depositor of such a registered investment company who effects transactions in securities only with, or on behalf of, such registered investment company, the Commission will accept the financial statements filed pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 or section 30 of the Investment Company Act of 1940 and the rules and regulations promulgated thereunder as a filing pursuant to paragraph (d) of this section. Such a filing shall be deemed to satisfy the requirements of this section for any calendar year in which such financial statements are filed, provided that the statements so filed meet the requirements of the other rules under which they are filed with respect to time of filing and content.

(m) *Extentions and exemptions.* (1) A broker's or dealer's designated examining authority may extend the period under paragraph (d) of this section for filing annual reports. The designated examining authority for the broker or dealer shall maintain, in the manner prescribed in §240.17a–1, a record of each extension granted.

(2) Any ''bank'' as defined in section 3(a)(6) of the Act (48 Stat. 882; 15 U.S.C. 78c) and any ''insurance company'' as defined in section 3(a)(19) of the Act (78 Stat. 565; 15 U.S.C. 78c) registered as a broker or dealer to sell variable contracts but exempt from §240.15c3–1 shall be exempt from the provisions of this section.

(3) On written request of any national securities exchange, registered national securities association, broker or dealer, or on its own motion, the Commission may grant an extension of time or an exemption from any of the requirements of this section either unconditionally or on specified terms and conditions.

(4) The provisions of § 240.17a–5 shall not apply to a broker or dealer registered pursuant to section 15(b)(11)(A) of the Act (15 U.S.C. 78*o*(b)(11)(A)) that is not a member of either a national securities exchange pursuant to section 6(a) of the Act (15 U.S.C. 78f(a)) or a national securities association registered pursuant to section 15A(a) of the Act (15 U.S.C. 78*o*–3(a)).

(n) *Notification of change of fiscal year.* (1) In the event any broker or dealer finds it necessary to change its fiscal year, it must file, with the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which the broker or dealer has its principal place of business and the principal office of the designated examining authority for such broker or dealer, a notice of such change.

(2) Such notice shall contain a detailed explanation of the reasons for the change. Any change in the filing period for the annual report must be approved in writing by the designated examining authority of the broker or dealer

(o) *Filing requirements.* For purposes of filing requirements as described in § 240.17a–5, such filing shall be deemed to have been accomplished upon receipt at the Commission's principal office in Washington, DC, with duplicate originals simultaneously filed at the locations prescribed in the particular paragraph of § 240.17a–5 which is applicable.

(p) *Compliance with § 240.17a–12.* An OTC derivatives dealer may comply with § 240.17a–5 by complying with the provisions of § 240.17a–12.

CROSS REFERENCE: For interpretative release applicable to § 240.17a–5, see No. 51 in tabulation, part 211 of this chapter.

[40 FR 59713, Dec. 30, 1975]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 240.17a–5, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.govinfo.gov.*

§ 240.17a–6 Right of national securities exchange, national securities association, registered clearing agency or the Municipal Securities Rulemaking Board to destroy or dispose of documents.

(a) Any document kept by or on file with a national securities exchange, national securities association, registered clearing agency or the Municipal Securities Rulemaking Board pursuant to the Act or any rule or regulation thereunder may be destroyed or otherwise disposed of by such exchange, association, clearing agency or the Municipal Securities Rulemaking Board at the end of five years or at such earlier date as is specified in a plan for the destruction or disposition of any such documents if such plan has been filed with the Commission by such exchange, association, clearing agency or the Municipal Securities Rulemaking Board and has been declared effective by the Commission.

(b) Such plan may provide that any such document may be transferred to microfilm or other recording medium after such time as specified in the plan and thereafter be maintained and preserved in that form. If a national securities exchange, association, clearing agency or the Municipal Securities Rulemaking Board uses microfilm or other recording medium it shall:

(1) Be ready at all times to provide, and immediately provide, easily readable projection of the microfilm or other recording medium and easily readable hard copy thereof;

(2) Provide indexes permitting the immediate location of any such document on the microfilm or other recording medium; and

(3) In the case of microfilm, store a duplicate copy of the microfilm separately from the original microfilm for the time required.

(c) For the purposes of this rule a plan filed with the Commission by a national securities exchange, association, clearing agency or the Municipal Securities Rulemaking Board shall not become effective unless the Commission, having due regard for the public interest and for the protection of investors, declares the plan to be effective. The Commission in its declaration may limit the applications, reports, and documents as to which it shall apply, and may impose any other terms and conditions to the plan and to the period of its effectiveness which it deems necessary or appropriate in the public interest or for the protection of investors.

[45 FR 79426, Dec. 1, 1980]

§ 240.17a–7 Records of non-resident brokers and dealers.

(a)(1) Except as provided in paragraphs (b) and (c) of this section, each non-resident broker or dealer registered or applying for registration pursuant to section 15 of the Securities Exchange Act of 1934, as amended, shall keep, maintain, and preserve, at a place within the United States designated in a notice from him as provided in paragraph (a)(2) of this section, true, correct, complete and current copies of the books and records which he is required to make, keep current, maintain or preserve pursuant to any provision of any rule or regulation of the Commission adopted under the act.

(2) Except as provided in paragraph (b) of this section, each non-resident broker or dealer subject to this section shall furnish to the Commission a written notice specifying the address of the place within the United States where the copies of the books and records required to be kept and preserved by him pursuant to paragraph (a)(1) of this section are located. Each non-resident broker or dealer registered or applying for registration when this section becomes effective shall file such notice within 30 days after such rule becomes effective. Each non-resident broker or dealer who files an application for registration after this section becomes effective shall file such notice with such application for registration.

(b) Notwithstanding the provisions of paragraph (a) of this section, a non-resident broker or dealer subject to this section need not keep or preserve within the United States copies of the books and records referred to in said paragraph (a) of this section, if:

(1) Such broker or dealer files with the Commission, at the time or within the period provided by paragraph (a)(2) of this section, a written undertaking in form acceptable to the Commission and signed by a person thereunto duly authorized, to furnish to the Commission, upon demand, at its principal office in Washington, DC, or at any Regional Office of the Commission designated in such demand, true, correct, complete and current copies of any or all of the books and records which he is required to make, keep current, maintain, or preserve pursuant to any provision of any rule or regulation of the Commission adopted under the act, or any part of such books and records which may be specified in such demand. Such undertaking shall be in substantially the following form:

The undersigned hereby undertakes to furnish at his own expense to the Securities and Exchange Commission at its principal office in Washington, DC, or at any Regional Office of said Commission specified in a demand for copies of books and records made by or on behalf of said Commission, true, correct, complete, and current copies of any or all, or any part, of the books and records which the undersigned is required to make, keep current or preserve pursuant to any provision of any rule or regulation of the Securities and Exchange Commission under the Securities Exchange Act of 1934. This undertaking shall be suspended during any period when the undersigned is making, keeping current, and preserving copies of all of said books and records at a place within the United States in compliance with § 240.17a–7 (Rule X–17A–7) under the Securities Exchange Act of 1934. This undertaking shall be binding upon the undersigned and the heirs, successors and assigns of the undersigned, and the written irrevocable consents and powers of attorney of the undersigned, its general partners and managing agents filed with the Securities and Exchange Commission shall extend to and cover any action to enforce same.

and

(2) Such broker or dealer furnishes to the Commission at his own expense within 14 days after written demand therefor forwarded to him by registered mail at his last address of record filed with the Commission and signed by the Secretary of the Commission or such other person as the Commission may authorize to act in its behalf, true, correct, complete and current copies of any or all books and records which such broker or dealer is required to make, keep current or preserve pursuant to any provision of any rule or regulation of the Commission adopted under the act, or any part of such

books and records which may be specified in said written demand. Such copies shall be furnished to the Commission at its principal office in Washington, DC, or at any Regional Office of the Commission which may be specified in said written demand.

(c) The provisions of this section shall not apply to a broker or dealer registered pursuant to section 15(b)(11)(A) of the Act (15 U.S.C. 78*o*(b)(11)(A)) that is not a member of either a national securities exchange pursuant to section 6(a) of the Act (15 U.S.C. 78f(a)) or a national securities association registered pursuant to section 15A(a) of the Act (15 U.S.C. 78*o*–3(a)).

(d) For purposes of this section the following definitions shall apply:

(1) The term *broker* shall have the meaning set out in section 3(a)(4) of the Securities Exchange Act of 1934;

(2) The term *dealer* shall have the meaning set out in section 3(a)(5) of the Securities Exchange Act of 1934;

(3) The term *non-resident broker or dealer* shall mean (i) in the case of an individual, one who resides in or has his principal place of business in any place not subject to the jurisdiction of the United States; (ii) in the case of a corporation, one incorporated in or having its principal place of business in any place not subject to the jurisdiction of the United States; (iii) in the case of a partnership of other unincorporated organization or association, one having its principal place of business in any place not subject to the jurisdiction of the United States.

[21 FR 5524, July 24, 1956, as amended at 59 FR 5945, Feb. 9, 1994; 67 FR 58300, Sept. 13, 2002; 73 FR 32228, June 5, 2008]

§ 240.17a–8 Financial recordkeeping and reporting of currency and foreign transactions.

Every registered broker or dealer who is subject to the requirements of the Currency and Foreign Transactions Reporting Act of 1970 shall comply with the reporting, recordkeeping and record retention requirements of chapter X of title 31 of the Code of Federal Regulations. Where chapter X of title 31 of the Code of Federal Regulations and § 240.17a–4 of this chapter require the same records or reports to be preserved for different periods of time, such records or reports shall be preserved for the longer period of time.

[46 FR 61455, Dec. 17, 1981, as amended at 76 FR 11328, Mar. 2, 2011]

§ 240.17a–9T Records to be made and retained by certain exchange members, brokers and dealers.

This section applies to every member, broker or dealer registered pursuant to Section 15 of the Act, (15 U.S.C. 78*o*), that is required to maintain, as of December 29, December 30 and December 31, 1999, minimum net capital of $250,000 pursuant to § 240.15c3–1(a)(2)(i).

(a) You must make before January 1, 2000, for each of December 29, December 30 and December 31, 1999, separate copies of the blotters pursuant to § 240.17a–3(a)(1).

(b) You must make before January 1, 2000, as of the close of business for each of December 29, December 30 and December 31, 1999, a separate copy of the securities record or ledger pursuant to § 240.17a–3(a)(5).

(c) You must preserve these records for a period of not less than one year.

(d) The provisions of § 240.17a–4(i) shall apply as if part of this § 240.17a–9T.

(e) You may preserve these records in any format that is acceptable and in compliance with the conditions described in § 240.17a–4(f).

(f) You must furnish promptly to a representative of the Commission such legible, true and complete copies of those records, as may be requested.

(g) This temporary section will expire on July 1, 2001.

[64 FR 42029, Aug. 3, 1999]

§ 240.17a–10 Report on revenue and expenses.

(a)(1) Every broker or dealer exempted from the filing requirements of paragraph (a) of § 240.17a–5 shall, not later than 17 business days after the close of each calendar year, file the Facing Page, a Statement of Income (Loss) and balance sheet from Part IIA of Form X–17A–5 (§ 249.617 of this chapter) and Schedule I of Form X–17A–5 (§ 249.617 of this chapter) for such calendar year.

(2) Every broker or dealer subject to the filing requirements of paragraph

(a) of § 240.17a–5 shall submit Schedule I of Form X–17A–5 (§ 249.617 of this chapter) with its Form X–17A–5 (§ 249.617 of this chapter) for the calendar quarter ending December 31 of each year.

(b) The provisions of paragraph (a) of this section shall not apply to a member of a national securities exchange or a registered national securities association which maintains records containing the information required by Form X–17A–5 (§ 249.617 of this chapter) as to each of its members, and which transmits to the Commission a copy of the record as to each such member, pursuant to a plan the procedures and provisions of which have been submitted to and declared effective by the Commission. Any such plan filed by a national securities exchange or a registered national securities association may provide that when a member is also a member of one or more national securities exchanges, or of one or more national securities exchanges and a registered national securities association, the information required to be submitted with respect to any such member may be transmitted by only one specified national securities exchange or registered national securities association. For the purpose of this section, a plan filed with the Commission by a national securities exchange or a registered national securities association shall not become effective unless the Commission, having due regard for the public interest, for the protection of investors, and for the fulfillment of the Commission's functions under the provisions of the Act, declares the plan to be effective. Further, the Commission, in declaring any such plan effective, may impose such terms and conditions relating to the provisions of the plan and the period of its effectiveness as may be deemed necessary or appropriate in the public interest, for the protection of investors, or to carry out the Commission's duties under the Act.

(c) Individual reports filed by, or on behalf of, brokers, dealers, or members of national securities exchanges pursuant to this section are to be considered nonpublic information, except in cases where the Commission determines that it is in the public interest to direct otherwise.

(d) In the event any broker or dealer finds that it cannot file the annual report required by paragraph (a) of this section within the time specified without undue hardship, it may file with the Commission's principal office in Washington, DC, prior to the date upon which the report is due, an application for an extension of time to a specified date which shall not be later than 60 days after the close of the calendar year for which the report is to be made. The application shall state the reasons for the requested extension and shall contain an agreement to file the report on or before the specified date.

(Sec. 17, 48 Stat. 897; 15 U.S.C. 78q)

[33 FR 10390, July 20, 1968, as amended at 35 FR 3804, Feb. 27, 1970; 35 FR 7644, May 16, 1970; 37 FR 13615, July 12, 1972; 40 FR 59717, Dec. 30, 1975; 42 FR 23789, May 10, 1977; 46 FR 60193, Dec. 9, 1981]

§ 240.17a–11 Notification provisions for brokers and dealers.

(a) This section shall apply to every broker or dealer registered with the Commission pursuant to section 15 of the Act.

(b)(1) Every broker or dealer whose net capital declines below the minimum amount required pursuant to § 240.15c3–1, or is insolvent as that term is defined in § 240.15c3–1(c)(16), must give notice of such deficiency that same day in accordance with paragraph (g) of this section.The notice shall specify the broker or dealer's net capital requirement and its current amount of net capital. If a broker or dealer is informed by its designated examining authority or the Commission that it is, or has been, in violation of § 240.15c3–1 and the broker or dealer has not given notice of the capital deficiency under this § 240.17a–11, the broker or dealer, even if it does not agree that it is, or has been, in violation of § 240.15c3–1, shall give notice of the claimed deficiency, which notice may specify the broker's or dealer's reasons for its disagreement.

(2) In addition to the requirements of paragraph (b)(1) of this section, an OTC derivatives dealer or broker or dealer permitted to compute net capital pursuant to the alternative method of § 240.15c3–1e shall also provide notice if its tentative net capital falls below the

minimum amount required pursuant to § 240.15c3–1. The notice shall specify the tentative net capital requirements, and current amount of net capital and tentative net capital, of the OTC derivatives dealer or the broker or dealer permitted to compute net capital pursuant to the alternative method of § 240.15c3–1e.

(c) Every broker or dealer shall send notice promptly (but within 24 hours) after the occurrence of the events specified in paragraphs (c)(1), (c)(2), (c)(3), (c)(4) or (c)(5) of this section in accordance with paragraph (g) of this section:

(1) If a computation made by a broker or dealer subject to the aggregate indebtedness standard of § 240.15c3–1 shows that its aggregate indebtedness is in excess of 1,200 percent of its net capital; or

(2) If a computation made by a broker or dealer, which has elected the alternative standard of § 240.15c3–1, shows that its net capital is less than 5 percent of aggregate debit items computed in accordance with § 240.15c3–3a Exhibit A: Formula for Determination Reserve Requirement of Brokers and Dealers under § 240.15c3–3; or

(3) If a computation made by a broker or dealer pursuant to § 240.15c3–1 shows that its total net capital is less than 120 percent of the broker's or dealer's required minimum net capital, or if a computation made by an OTC derivatives dealer pursuant to § 240.15c3–1 shows that its total tentative net capital is less than 120 percent of the dealer's required minimum tentative net capital.

(4) The occurrence of the fourth and each subsequent backtesting exception under § 240.15c3–1f(e)(1)(iv) during any 250 business day measurement period.

(5) If a computation made by a broker or dealer pursuant to § 240.15c3–1 shows that the total amount of money payable against all securities loaned or subject to a repurchase agreement or the total contract value of all securities borrowed or subject to a reverse repurchase agreement is in excess of 2500 percent of its tentative net capital; *provided*, however, that for purposes of this leverage test transactions involving government securities, as defined in section 3(a)(42) of the Act (15 U.S.C. 78c(a)(42)), must be excluded from the calculation; *provided* further, however, that a broker or dealer will not be required to send the notice required by this paragraph (c)(5) if it reports monthly its securities lending and borrowing and repurchase and reverse repurchase activity (including the total amount of money payable against securities loaned or subject to a repurchase agreement and the total contract value of securities borrowed or subject to a reverse repurchase agreement) to its designated examining authority in a form acceptable to its designated examining authority.

(d) Every broker or dealer who fails to make and keep current the books and records required by § 240.17a–3, shall give notice of this fact that same day in accordance with paragraph (g) of this section, specifying the books and records which have not been made or which are not current. The broker or dealer shall also transmit a report in accordance with paragraph (g) of this section within 48 hours of the notice stating what the broker or dealer has done or is doing to correct the situation.

(e) Whenever any broker or dealer discovers, or is notified by an independent public accountant under § 240.17a–12(i)(2), of the existence of any material inadequacy as defined in § 240.17a–12(h)(2), or whenever any broker or dealer discovers, or is notified by an independent public accountant under § 240.17a–5(h), of the existence of any material weakness as defined in § 240.17a–5(d)(3)(iii), the broker or dealer must:

(1) Give notice, in accordance with paragraph (g) of this section, of the material inadequacy or material weakness within 24 hours of the discovery or notification of the material inadequacy or the material weakness; and

(2) Transmit a report, in accordance with paragraph (g) of this section, within 48 hours of the notice stating what the broker or dealer has done or is doing to correct the situation.

(f) Every national securities exchange or national securities association that learns that a member broker or dealer has failed to send notice or transmit a report as required by paragraphs (b), (c), (d), or (e) of this section, even after being advised by the securities exchange or the national securities association to send notice or transmit a report, shall immediately give notice of such failure in accordance with paragraph (g) of this section.

(g) Every notice or report required to be given or transmitted by this section shall be given or transmitted to the principal office of the Commission in Washington, D.C., the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the designated examining authority of which such broker or dealer is a member, and the Commodity Futures Trading Commission if the broker or dealer is registered as a futures commission merchant with such Commission. For the purposes of this section, ''notice'' shall be given or transmitted by telegraphic notice or facsimile transmission. The report required by paragraphs (d) or (e)(2) of this section may be transmitted by overnight delivery.

(h) Other notice provisions relating to the Commission's financial responsibility or reporting rules are contained in § 240.15c3–1(a)(6)(iv)(B), § 240.15c3–1(a)(6)(v), § 240.15c3–1(a)(7)(ii), § 240.15c3–1(a)(7)(iii), § 240.15c3–1(c)(2)(x)(B)(*1*), § 240.15c3–1(c)(2)(x)(F)(*3*), § 240.15c3–1(e), § 240.15c3–1d(c)(2), § 240.15c3–3(i), § 240.17a–5(h) and § 240.17a–12(i)(2).

(i) The provisions of this section shall not apply to a broker or dealer registered pursuant to section 15(b)(11)(A) of the Act (15 U.S.C. 78*o*(b)(11)(A)) that is not a member of either a national securities exchange pursuant to section 6(a) of the Act (15 U.S.C. 78f(a)) or a national securities association registered pursuant to section 15A(a) of the Act (15 U.S.C. 78*o*–3(a)).

[58 FR 37657, July 13, 1993, as amended at 59 FR 5945, Feb. 9, 1994; 63 FR 59401, Nov. 3, 1998; 67 FR 58300, Sept. 13, 2002; 69 FR 34472, June 21, 2004; 73 FR 32228, June 5, 2008; 78 FR 51907, Aug. 21, 2013; 78 FR 51933, Aug. 21, 2013]

§ 240.17a–12 Reports to be made by certain OTC derivatives dealers.

(a) *Filing of quarterly reports.* (1) This paragraph (a) shall apply to every OTC derivatives dealer registered pursuant to Section 15 of the Act (15 U.S.C. 78o).

(i) Every OTC derivatives dealer shall file Part IIB of Form X–17A–5 (§ 249.617 of this chapter) within 17 business days after the end of each calendar quarter and within 17 business days after the date selected for the annual audit of financial statements where said date is other than the end of the calendar quarter.

(ii) Upon receiving from the Commission written notice that additional reporting is required, an OTC derivatives dealer shall file monthly, or at such times as shall be specified, Part IIB of Form X–17A–5 (§ 249.617 of this chapter) and such other financial or operational information as shall be required by the Commission.

(2) The reports provided for in this paragraph (a) shall be considered filed when received at the Commission's principal office in Washington, DC. All reports filed pursuant to this paragraph (a) shall be deemed to be confidential.

(3) Upon written application by an OTC derivatives dealer to the Commission, the Commission may extend the time for filing the information required by this paragraph (a). The written application shall be filed with the Commission at its principal office in Washington DC.

(b) *Annual filing of audited financial statements.* (1)(i) Every OTC derivatives dealer registered pursuant to Section 15 of the Act (15 U.S.C. 78o) shall file annually, on a calendar or fiscal year basis, a report which shall be audited by a certified public accountant. Reports filed pursuant to this paragraph (b) shall be as of the same fixed or determinable date each year, unless a change is approved in writing by the Commission.

(ii) An OTC derivatives dealer succeeding to and continuing the business of another OTC derivatives dealer need not file a report under this paragraph (b) as of a date in the fiscal or calendar year in which the succession occurs if the predecessor OTC derivatives dealer has filed a report in compliance with this paragraph (b) as of a date in such fiscal or calendar year.

(2) The annual audit report shall contain a Statement of Financial Condition (in a format and on a basis which is consistent with the total reported on

the Statement of Financial Condition contained in Form X–17A–5 (§ 249.617 of this chapter), Part IIB, a Statement of Income, a Statement of Cash Flows, a Statement of Changes in Stockholders' or Partners' or Sole Proprietor's Equity, and a Statement of Changes in Liabilities Subordinated to Claims of General Creditors. Such statements shall be in a format which is consistent with such statements as contained in Form X–17A–5 (§ 249.617 of this chapter), Part IIB. If the Statement of Financial Condition filed in accordance with instructions to Form X–17A–5 (§ 249.617 of this chapter), Part IIB, is not consolidated, a summary of financial data for subsidiaries not consolidated in the Part IIB Statement of Financial Condition as filed by the OTC derivatives dealer shall be included in the notes to the consolidated statement of financial condition reported on by the certified public accountant. The summary financial data shall include the assets, liabilities, and net worth or stockholders' equity of the unconsolidated subsidiaries.

NOTE 1 TO PARAGRAPH (b)(2). If there is other comprehensive income in the period(s) presented, the financial report must contain a Statement of Comprehensive Income (as defined in § 210.1–02 of Regulation S–X of this chapter) in place of a Statement of Income.

(3) Supporting schedules shall include, from Part IIB of Form X–17A–5 (§ 249.617 of this chapter), a Computation of Net Capital under § 240.15c3–1.

(4) A reconciliation, including appropriate explanations, of the Computation of Net Capital under § 240.15c3–1 contained in the audit report with the broker's or dealer's corresponding unaudited most recent Part IIB filing shall be filed with the report when material differences exist. If no material differences exist, a statement so indicating shall be filed.

(5) The annual audit report shall be filed not more than sixty days after the date of the financial statements.

(6) Two copies of the annual audit report shall be filed at the Commission's principal office in Washington, DC.

(c) *Nature and form of reports.* The financial statements filed pursuant to paragraph (b) of this section shall be prepared and filed in accordance with the following requirements:

(1) An audit shall be conducted by a certified public accountant who shall be in fact independent as defined in paragraph (f) of this section, and it shall give an opinion covering the statements filed pursuant to paragraph (b) of this section.

(2) Attached to the report shall be an oath or affirmation that, to the best knowledge and belief of the person making such oath or affirmation, the financial statements and schedules are true and correct and neither the OTC derivatives dealer, nor any partner, officer, or director, as the case may be, has any significant interest in any counterparty or in any account classified solely as that of a counterparty. The oath or affirmation shall be made before a person duly authorized to administer such oaths or affirmations. If the OTC derivatives dealer is a sole proprietorship, the oath or affirmation shall be made by the proprietor; if a partnership, by a general partner; or if a corporation, by a duly authorized officer.

(3) All of the statements filed pursuant to paragraph (b) of this section shall be confidential except that they shall be available for use by any official or employee of the United States or by any other person to whom the Commission authorizes disclosure of such information as being in the public interest.

(d) *Qualification of accountants.* The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the State of his principal office.

(e) *Designation of accountant.* (1) Every OTC derivatives dealer shall file no later than December 10 of each year with the Commission's principal office in Washington, DC a statement indicating the existence of an agreement, dated no later than December 1 of that year, with a certified public accountant covering a contractual commitment to conduct the OTC derivatives dealer's annual audit during the following calendar year.

(2) If the agreement is of a continuing nature, providing for successive yearly audits, no further filing is

required. If the agreement is for a single audit, or if the continuing agreement previously filed has been terminated or amended, a new statement must be filed by the required date.

(3) The statement shall be headed ''Notice pursuant to § 240.17a–12(e)'' and shall contain the following information:

(i) Name, address, telephone number, and registration number of the OTC derivatives dealer;

(ii) Name, address, and telephone number of the certified public accounting firm; and

(iii) The audit date of the OTC derivatives dealer for the year covered by the agreement.

(4) Notwithstanding the date of filing specified in paragraph (e)(1) of this section, every OTC derivatives dealer shall file the notice provided for in paragraph (e) of this section within 30 days following the effective date of registration as an OTC derivatives dealer.

(f) *Independence of accountant.* A certified public accountant shall be independent in accordance with the provisions of § 210.2–01(b) and (c) of this chapter.

(g) *Replacement of accountant.* (1) An OTC derivatives dealer shall file a notice that must be received by the Commission's principal office in Washington, DC not more than 15 business days after:

(i) The OTC derivatives dealer has notified the certified public accountant whose opinion covered the most recent financial statements filed under paragraph (b) of this section that the certified public accountant's services will not be utilized in future engagements; or

(ii) The OTC derivatives dealer has notified a certified public accountant who was engaged to give an opinion covering the financial statements to be filed under paragraph (b) of this section that the engagement has been terminated; or

(iii) A certified public accountant has notified the OTC derivatives dealer that it will not continue under an engagement or give an opinion covering the financial statements to be filed under paragraph (b) of this section; or

(iv) A new certified public accountant has been engaged to give an opinion covering the financial statements to be filed under paragraph (b) of this section without any notice of termination having been given to or by the previously engaged certified public accountant.

(2) Such notice shall state the date of notification of the termination of the engagement of the former certified public accountant or the engagement of the new certified public accountant, as applicable, and the details of any disagreements existing during the 24 months (or the period of the engagement, if less) preceding such termination or new engagement relating to any matter of accounting principles or practices, financial statement disclosure, auditing scope or procedure, or compliance with applicable rules of the Commission, which disagreements, if not resolved to the satisfaction of the former certified public accountant, would have caused the former certified public accountant to make reference to them in connection with the report on the subject matter of the disagreements. The disagreements required to be reported in response to the preceding sentence include both those resolved to the former certified public accountant's satisfaction and those not resolved to the former certified public accountant's satisfaction. Disagreements contemplated by this section are those that occur at the decision-making level (i.e., between principal financial officers of the OTC derivatives dealer and personnel of the certified public accounting firm responsible for rendering its report). The notice shall also state whether the certified public accountant's report on the financial statements for any of the past two years contained an adverse opinion or a disclaimer of opinion or was qualified as to uncertainties, audit scope, or accounting principles, and describe the nature of each such adverse opinion, disclaimer of opinion, or qualification. The OTC derivatives dealer shall also request the former certified public accountant to furnish the OTC derivatives dealer with a letter addressed to the Commission stating whether the former certified public accountant agrees with the statements contained in the notice of the OTC derivatives dealer and, if not, stating the respects

in which the former certified public accountant does not agree. The OTC derivatives dealer shall file three copies of the notice and the certified public accountant's letter, one copy of which shall be manually signed by the sole proprietor, or a general partner or a duly authorized corporate officer, as appropriate, and by the certified public accountant.

(h) *Audit objectives.* (1) The audit shall be made in accordance with U.S. Generally Accepted Auditing Standards and shall include a review of the accounting system, the internal accounting controls, and procedures for safeguarding securities including appropriate tests thereof for the period since the date of the prior audited financial statements. The audit shall include all procedures necessary under the circumstances to enable the certified public accountant to express an opinion on the statement of financial condition, results of operations, cash flows, and the Computation of Net Capital under §240.15c3–1. The scope of the audit and review of the accounting system, the internal accounting controls, and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in the following are disclosed:

(i) The accounting system;

(ii) The internal accounting controls; and

(iii) The procedures for safeguarding securities.

(2) A material inadequacy in the accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures referred to in paragraph (h) (1) of this section that must be reported under these audit objectives includes any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to:

(i) Inhibit an OTC derivatives dealer from promptly completing securities transactions or promptly discharging its responsibilities to counterparties, other brokers and dealers, or creditors;

(ii) Result in material financial loss;

(iii) Result in material misstatements of the OTC derivatives dealer's financial statements; or

(iv) Result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in paragraphs (h)(2)(i), (ii), or (iii) of this section.

(i) *Extent and timing of audit procedures.* (1) The extent and timing of audit procedures are matters for the certified public accountant to determine on the basis of its review and evaluation of existing internal controls and other audit procedures performed in accordance with U.S. Generally Accepted Auditing Standards and the audit objectives set forth in paragraph (h) of this section.

(2) If, during the course of the audit or interim work, the certified public accountant determines that any material inadequacies exist in the accounting system, internal accounting controls, procedures for safeguarding securities, or as otherwise defined in paragraph (h)(2) of this section, then the certified public accountant shall call it to the attention of the chief financial officer of the OTC derivatives dealer, who shall inform the Commission by telegraphic or facsimile notice within 24 hours thereafter as set forth in §240.17a–11(e) and (g). The OTC derivatives dealer shall also furnish the certified public accountant with a copy of said notice to the Commission by telegram or facsimile within the same 24 hour period. If the certified public accountant fails to receive such notice from the OTC derivatives dealer within that 24 hour period, or if the certified public accountant disagrees with the statements contained in the notice of the OTC derivatives dealer, the certified public accountant shall inform the Commission by report of material inadequacy within 24 hours thereafter as set forth in §240.17a–11(g). Such report from the certified public accountant shall, if the OTC derivatives dealer failed to file a notice, describe any material inadequacies found to exist. If the OTC derivatives dealer filed a notice, the certified public accountant shall file a report detailing the aspects, if any, of the OTC derivatives dealer's

notice with which the certified public accountant does not agree.

(j) *Accountant's report, general provisions*—(1) *Technical requirements.* The certified public accountant's report shall be dated; be signed manually; indicate the city and state where issued; and identify without detailed enumeration the financial statements and schedules covered by the report.

(2) *Representations as to the audit.* The certified public accountant's report shall state that the audit was made in accordance with U.S. Generally Accepted Auditing Standards; state whether the certified public accountant reviewed the procedures followed for safeguarding securities; and designate any auditing procedures deemed necessary by the certified public accountant under the circumstances of the particular case that have been omitted, and the reason for their omission. Nothing in this section shall be construed to imply authority for the omission of any procedure which certified public accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required under this section.

(3) *Opinion to be expressed.* The certified public accountant's report shall state clearly the opinion of the certified public accountant:

(i) In respect of the financial statements and schedules covered by the report and the accounting principles and practices reflected therein; and

(ii) As to the consistency of the application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

(4) *Exceptions.* Any matters to which the certified public accountant takes exception shall be clearly identified, explained, and, to the extent practicable, the effect of each such exception on the related financial statements shall be provided.

(5) *Definitions.* For the purpose of this section, the terms *audit* (or *examination*), *accountant's report,* and *certified* shall have the meanings given in §210.1–02 of this chapter.

(k) *Accountant's report on material inadequacies and reportable conditions.* The OTC derivatives dealer shall file concurrently with the annual audit report a supplemental report by the certified public accountant describing any material inadequacies or any matter that would be deemed to be a reportable condition under U.S. Generally Accepted Auditing Standards that are unresolved as of the date of the certified public accountant's report. The report shall also describe any material inadequacies found to have existed since the date of the previous audit. The supplemental report shall indicate any corrective action taken or proposed by the OTC derivatives dealer with regard to any identified material inadequacies or reportable conditions. If the audit did not disclose any material inadequacies or reportable conditions, the supplemental report shall so state.

(l) *Accountant's report on management controls.* (1) The OTC derivatives dealer shall file concurrently with the annual audit report a supplemental report by the certified public accountant indicating the results of the certified public accountant's review of the OTC derivatives dealer's internal risk management control system with respect to the requirements of §240.15c3–4. This review shall be conducted in accordance with procedures agreed to by the OTC derivatives dealer and the certified public accountant conducting the review. The purpose of the review is to confirm that the OTC derivatives dealer has established, documented, and maintained an internal risk management control system in accordance with §240.15c3–4, and is in compliance with that internal risk management control system.

(2) The agreed-upon procedures are to be performed, and the report is to be prepared, in accordance with U.S. Generally Accepted Attestation Standards.

(3) Prior to the commencement of the initial review, every OTC derivatives dealer shall file the procedures to be performed pursuant to paragraph (l)(1) of this section with the Commission's principal office in Washington, DC. Prior to the commencement of any subsequent review, every OTC derivatives dealer shall file with the Commission's principal office in Washington, DC a notice of changes to the agreed-upon procedures.

(m) *Accountant's report on inventory pricing and modeling.* (1) The OTC derivatives dealer shall file concurrently with the annual audit report a supplemental report by the certified public accountant indicating the results of the certified public accountant's review of the broker's or dealer's inventory pricing and modeling procedures. This review shall be conducted in accordance with procedures agreed to by the OTC derivatives dealer and by the certified public accountant conducting the review. The purpose of the review is to confirm that the pricing and modeling procedures relied upon by the OTC derivatives dealer conform to the procedures submitted to the Commission as part of its OTC derivatives dealer application, and that the procedures comply with the qualitative and quantitative standards set forth in §240.15c3–1f.

(2) The agreed-upon procedures are to be performed and the report is to be prepared in accordance with U.S. Generally Accepted Attestation Standards.

(3) Every OTC derivatives dealer shall file prior to the commencement of the initial review, the procedures to be performed pursuant to paragraph (m)(1) of this section with the Commission's principal office in Washington, DC. Prior to the commencement of each subsequent review, every OTC derivatives dealer shall file with the Commission's principal office in Washington, DC notice of changes in the agreed-upon procedures.

(n) *Extensions and exemptions.* Upon the written request of the OTC derivatives dealer, or on its own motion, the Commission may grant an extension of time or an exemption from any of the requirements of this section either unconditionally or on specified terms and conditions.

(o) *Notification of change of fiscal year.* (1) In the event any OTC derivatives dealer finds it necessary to change its fiscal year, it must file a notice of such change with the Commission's principal office in Washington, DC.

(2) Such notice shall contain a detailed explanation of the reasons for the change. Any change in the filing period for the audit report must be approved by the Commission.

(p) *Filing requirements.* For purposes of filing requirements as described in §240.17a–12, these filings shall be deemed to have been accomplished upon receipt at the Commission's principal office in Washington, DC.

[63 FR 59401, Nov. 3, 1998, as amended at 69 FR 34494, June 21, 2004; 83 FR 50223, Oct. 4, 2018]

§ 240.17a–13 Quarterly security counts to be made by certain exchange members, brokers, and dealers.

(a) This section shall apply to every member of a national securities exchange who transacts a business in securities directly with or for others than members of a national securities exchange, every broker or dealer (other than a member) who transacts a business in securities through the medium of any member of a national securities exchange, and every broker or dealer registered pursuant to section 15 of the Act; except that a broker or dealer meeting all of the following conditions shall be exempt from the provisions of this section:

(1) His dealer transactions (as principal for his own account) are limited to the purchase, sale, and redemption of redeemable shares of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company; except that a broker or dealer transacting business as a sole proprietor may also effect occasional transactions in other securities for his own account with or through another registered broker-dealer;

(2) His transactions as broker (agent) are limited to:

(i) The sale and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company;

(ii) The solicitation of share accounts for savings and loan associations insured by an instrumentality of the United States; and

(iii) The sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies; and

(3) He promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.

Notwithstanding the foregoing, this rule shall not apply to any insurance company which is a registered broker-dealer, and which otherwise meets all of the conditions in paragraphs (a)(1), (2), and (3) of this section, solely by reason of its participation in transactions that are a part of the business of insurance, including the purchasing, selling, or holding of securities for or on behalf of such company's general and separate accounts.

(b) Any member, broker, or dealer who is subject to the provisions of this rule shall at least once in each calendar quarter-year:

(1) Physically examine and count all securities held including securities that are the subjects of repurchase or reverse repurchase agreements;

(2) Account for all securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive, failed to deliver, subject to repurchase or reverse repurchase agreements or otherwise subject to his control or direction but not in his physical possession by examination and comparison of the supporting detail records with the appropriate ledger control accounts;

(3) Verify all securities in transfer, in transit, pledge, loaned, borrowed, deposited, failed to receive, failed to deliver, subject to repurchase or reverse repurchase agreements or otherwise subject to his control or direction but not in his physical possession, where such securities have been in said status for longer than thirty days;

(4) Compare the results of the count and verification with his records; and

(5) Record on the books and records of the member, broker, or dealer all unresolved differences setting forth the security involved and date of comparison in a security count difference account no later than 7 business days after the date of each required quarterly security examination, count, and verification in accordance with the requirements provided in paragraph (c) of this section. *Provided, however,* That no examination, count, verification, and comparison for the purpose of this section shall be within 2 months of or more than 4 months following a prior examination, count, verification, and comparison made hereunder.

(c) The examination, count, verification, and comparison may be made either as of a date certain or on a cyclical basis covering the entire list of securities. In either case the recordation shall be effected within 7 business days subsequent to the examination, count, verification, and comparison of a particular security. In the event that an examination, count, verification, and comparison is made on a cyclical basis, it shall not extend over more than 1 calendar quarter-year, and no security shall be examined, counted, verified, or compared for the purpose of this rule less than 2 months or more than 4 months after a prior examination, count, verification, and comparison.

(d) The examination, count, verification, and comparison shall be made or supervised by persons whose regular duties do not require them to have direct responsibility for the proper care and protection of the securities or the making or preservation of the subject records.

(e) The provisions of this section shall not apply to a broker or dealer registered pursuant to section 15(b)(11)(A) of the Act (15 U.S.C. 78*o*(b)(11)(A)) that is not a member of either a national securities exchange pursuant to section 6(a) of the Act (15 U.S.C. 78f(a)) or a national securities association registered pursuant to section 15A(a) of the Act (15 U.S.C. 78*o*–3(a)).

(f) The Commission may, upon written request, exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any member, broker, or dealer who satisfies the Commission that it is not necessary in the public interest and for the protection of investors to subject the particular member, broker, or dealer to certain or all of the provisions of this section, because of the special nature of his business, the safeguards he has established for the protection of customers' funds and securities, or such other reason as the Commission deems appropriate.

[36 FR 21179, Nov. 4, 1971, as amended at 42 FR 23790, May 10, 1977; 52 FR 22299, June 11, 1987; 67 FR 58300, Sept. 13, 2002]

§ 240.17a–18 [Reserved]

§ 240.17a–19 Form X–17A–19 Report by national securities exchanges and registered national securities associations of changes in the membership status of any of their members.

Every national securities exchange and every registered national securities association shall file with the Commission at its principal office in Washington, DC, and with the Securities Investor Protection Corporation such information as is required by § 249.635 of this chapter on Form X–17A–19 within 5 business days of the occurrence of the initiation of the membership of any person or the suspension or termination of the membership of any member. Nothing in this section shall be deemed to relieve a national securities exchange or a registered national securities association of its responsibilities under § 240.17a–5(b)(5) except that, to the extent a national securities exchange or a registered national securities association promptly files a report on Form X–17A–19 including therewith, inter alia, information sufficient to satisfy the requirements of § 240.17a–5(b)(5), it shall not be required to file a report pursuant to § 240.17a–5(b). Upon the occurrence of the events described in this paragraph, every national securities exchange and every registered national securities association shall notify in writing such member of its responsibilities under § 240.17a–5(b).

[45 FR 39841, June 12, 1980]

§ 240.17a–21 Reports of the Municipal Securities Rulemaking Board.

(a) *Annual Report of the Municipal Securities Rulemaking Board.* The Municipal Securities Rulemaking Board shall file annual reports with the Commission as follows:

(1) Prior to October 1, 1976, the Municipal Securities Rulemaking Board shall file with the Commission an annual report for the period from its formation until June 30, 1976 and shall include whatever information, data and recommendations it considers advisable with regard to matters within its jurisdiction.

(2) Prior to December 1, 1977, the Municipal Securities Rulemaking Board shall file with the Commission an annual report for the period from July 1, 1976 until September 30, 1977 and shall include whatever information, data and recommendations it considers advisable with regard to matters within its jurisdiction.

(3) Prior to December 1 of each year beginning in 1978, the Municipal Securities Rulemaking Board shall file with the Commission an annual report for the twelve months immediately preceding October 1 of that year and shall include whatever information, data and recommendations it considers advisable with regard to matters within its jurisdiction.

(4) The Municipal Securities Rulemaking Board shall include in its annual report a statement and an analysis of its expenses and operations including:

(i) A balance sheet as of the end of the period covered by the report and a statement of revenues and expenses for the Board for that period;

(ii) The rules of the Board including any written interpretations of the rules or staff interpretive letters, except that this information may be included in the annual report once every three years and shall be up to date as of the latest practicable date within 3 months of the date on which this information is filed. If the Board publishes or cooperates in the publication of this information on an annual or more frequent basis, in lieu of including such information in the annual report the Board may:

(A) Identify the publication in which such information is available, the name, address, and telephone number of the person from whom such publication may be obtained, and the price thereof; and

(B) Certify to the accuracy of such information as of its date. If the Board keeps this information up to date and makes it available to the Commission and the public upon request, in lieu of filing such information the Board may certify that the information is kept up to date and is available to the Commission and the public upon request;

(iii) The following information concerning members of the Board:

(A) Name;

(B) Dates of commencement and termination of present term of office;

(C) Length of time each member has held such office;

(D) Name of principal organization with which connected;

(E) Title; and

(F) City wherein the principal office of such organization is located;

(iv) Address of the Board, the name and address of each person authorized to receive notices on behalf of the Board from the Commission, and the name and address of counsel to the Board, if any; and

(v) A list, including addresses, as of the latest practicable date, alphabetically arranged, of all municipal securities brokers and municipal securities dealers which have paid to the Board fees and charges to defray the costs and expenses of operating the Board.

(5) Within 10 days after the discovery of any material inaccuracy in its annual report or in any amendment thereto the Municipal Securities Rulemaking Board shall file with the Commission an amendment correcting such inaccuracy.

(b) *Supplemental reports of the Municipal Securities Rulemaking Board.* The Municipal Securities Rulemaking Board shall file supplemental reports to the Commission as follows:

(1) Within 10 days after issuing or making generally available to municipal securities brokers and municipal securities dealers any materials (including notices, circulars, bulletins, lists, periodicals, etc.), the Municipal Securities Rulemaking Board shall file with the Commission three copies of such material (unless such material is filed with the Commission pursuant to Rule 19b–4).

(2) Within 10 days after any action is taken which renders no longer accurate any of the information required by paragraphs (a)(3) (iii), (iv), (v), and (vi) of this section to be contained in the annual report of the Municipal Securities Rulemaking Board (except action reported to the Commission pursuant to Rule 19b–4), the Board shall file with the Commission written notification in triplicate setting forth the nature of such action and the effective date thereof. Such notice may be filed either in the form of a letter or in the form of a notice made generally available to municipal securities brokers and municipal securities dealers.

[41 FR 36200, Aug. 27, 1976, as amended at 59 FR 66701, Dec. 28, 1994]

§ 240.17a–22 Supplemental material of registered clearing agencies.

Within ten days after issuing, or making generally available, to its participants or to other entities with whom it has a significant relationship, such as pledgees, transfer agents, or self-regulatory organizations, any material (including, for example, manuals, notices, circulars, bulletins, lists, or periodicals), a registered clearing agency shall file three copies of such material with the Commission. A registered clearing agency for which the Commission is not the appropriate regulatory agency shall at the same time file one copy of such material with its appropriate regulatory agency.

[45 FR 73914, Nov. 7, 1980]

§ 240.17a–25 Electronic submission of securities transaction information by exchange members, brokers, and dealers.

(a) Every member, broker, or dealer subject to § 240.17a–3 shall, upon request, electronically submit to the Commission the securities transaction information as required in this section:

(1) If the transaction was a proprietary transaction effected or caused to be effected by the member, broker, or dealer for any account in which such member, broker, or dealer, or person associated with the member, broker, or dealer, is directly or indirectly interested, such member, broker or dealer shall submit the following information:

(i) Clearing house number, or alpha symbol of the member, broker, or dealer submitting the information;

(ii) Clearing house number(s), or alpha symbol(s) of the member(s), broker(s) or dealer(s) on the opposite side of the transaction;

(iii) Identifying symbol assigned to the security;

(iv) Date transaction was executed;

(v) Number of shares, or quantity of bonds or options contracts, for each specific transaction; whether each transaction was a purchase, sale, or short sale; and, if an options contract, whether open long or short or close long or short;

(vi) Transaction price;

(vii) Account number; and

(viii) The identity of the exchange or other market where the transaction was executed.

(2) If the transaction was effected or caused to be effected by the member, broker, or dealer for any customer account, such member, broker, or dealer shall submit the following information:

(i) Information contained in paragraphs (a)(1)(i) through (a)(1)(viii) of this section;

(ii) Customer name, address(es), branch office number, registered representative number, whether the order was solicited or unsolicited, date account opened, and the customer's tax identification number(s); and

(iii) If the transaction was effected for a customer of another member, broker, or dealer, whether the other member, broker, or dealer was acting as principal or agent on the transaction.

(b) In addition to the information in paragraph (a) of this section, a member, broker, or dealer shall, upon request, electronically submit to the Commission the following securities transaction information for transactions involving entities that trade using multiple accounts:

(1)(i) If part or all of an account's transactions at the reporting member, broker, or dealer have been transferred or otherwise forwarded to one or more accounts at another member, broker, or dealer, an identifier for this type of transaction; and

(ii) If part or all of an account's transactions at the reporting member, broker, or dealer have been transferred or otherwise received from one or more other members, brokers, or dealers, an identifier for this type of transaction.

(2)(i) If part or all of an account's transactions at the reporting member, broker, or dealer have been transferred or otherwise received from another account at the reporting member, broker, or dealer, an identifier for this type of transaction; and

(ii) If part or all of an account's transactions at the reporting member, broker, or dealer have been transferred or otherwise forwarded to one or more other accounts at the reporting member, broker, or dealer, an identifier for this type of transaction.

(3) If an account's transaction was processed by a depository institution, the identifier assigned to the account by the depository institution.

(c) Every member, broker, or dealer shall, upon request, submit to the Commission and, keep current, information containing the full name, title, address, telephone number(s), facsimile number(s), and electronic-mail address(es) for each person designated by the member, broker, or dealer as responsible for processing securities transaction information requests from the Commission.

(d) The member, broker, or dealer should comply with the format for the electronic submission of the securities transaction information described in paragraphs (a) and (b) of this section as specified by the member, broker, or dealer's designated self-regulatory organization under § 240.17d–1, unless otherwise specified by Commission rule.

[66 FR 35843, July 9, 2001]

§ 240.17d–1 Examination for compliance with applicable financial responsibility rules.

(a) Where a member of SIPC is a member of more than one self-regulatory organization, the Commission shall designate by written notice to one of such organizations responsibility for examining such member for compliance with applicable financial responsibility rules. In making such designations the Commission shall take into consideration the regulatory capabilities and procedures of the self-regulatory organizations, availability of staff, convenience of location, unnecessary regulatory duplication, and such other factors as the Commission may consider germane to the protection of investors, the cooperation and coordination among self-regulatory organizations, and the development of a national market system and a national system for the clearance and settlement of securities transactions.

(b) Upon designation of responsibility pursuant to paragraph (a) of this section, all other self-regulatory organizations of which such person is a member shall be relieved of such responsibility to the extent specified.

(c) After the Commission has acted pursuant to paragraphs (a) and (b) of this section, any self-regulatory organization relieved of responsibility with respect to a member may notify customers of, and persons doing business with, such member of the limited nature of its responsibility for such member's compliance with applicable financial responsibility rules.

[41 FR 18809, May 7, 1976]

§ 240.17d–2 Program for allocation of regulatory responsibility.

(a) Any two or more self-regulatory organizations may file with the Commission within ninety (90) days of the effective date of this rule, and thereafter as changes in designation are necessary or appropriate, a plan for allocating among the self-regulatory organizations the responsibility to receive regulatory reports from persons who are members or participants of more than one of such self-regulatory organizations to examine such persons for compliance, or to enforce compliance by such persons, with specified provisions of the Securities Exchange Act of 1934, the rules and regulations thereunder, and the rules of such self-regulatory organizations, or to carry out other specified regulatory functions with respect to such persons.

(b) Any plan filed hereunder may contain provisions for the allocation among the parties of expenses reasonably incurred by the self-regulatory organization having regulatory responsibilities under the plan.

(c) After appropriate notice and opportunity for comment, the Commission may, by written notice, declare such a plan, or any part of the plan, effective if it finds the plan, or any part thereof, necessary or appropriate in the public interest and for the protection of investors, to foster cooperation and coordination among self-regulatory organizations, or to remove impediments to and foster the development of the national market system and a national system for the clearance and settlement of securities transactions and in conformity with the factors set forth in section 17(d) of the Securities Exchange Act of 1934.

(d) Upon the effectiveness of such a plan or part thereof, any self-regulatory organization which is a party to the plan shall be relieved of responsibility as to any person for whom such responsibility is allocated under the plan to another self-regulatory organization to the extent of such allocation.

(e) Nothing herein shall preclude any self-regulatory organization from entering into more than one plan filed hereunder.

(f) After the Commission has declared a plan or part thereof effective pursuant to paragraph (c) of this section or acted pursuant to paragraph (g) of this section, a self-regulatory organization relieved of responsibility may notify customers of, and persons doing business with, such member or participant of the limited nature of its responsibility for such member's or participant's acts, practices, and course of business.

(g) In the event that plans declared effective pursuant to paragraph (c) of this section do not provide for all members or participants or do not allocate all regulatory responsibilities, the Commission may, after due consideration of the factors enumerated in section 17(d)(1) and notice and opportunity for comment, designate one or more of the self-regulatory organizations responsible for specified regulatory responsibilities with respect to such members or participants.

[41 FR 49093, Nov. 8, 1976]

§ 240.17f–1 Requirements for reporting and inquiry with respect to missing, lost, counterfeit or stolen securities.

(a) *Definitions.* For purposes of this section:

(1) The term *reporting institution* shall include every national securities exchange, member thereof, registered securities association, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, registered transfer

agent, registered clearing agency, participant therein, member of the Federal Reserve System and bank whose deposits are insured by the Federal Deposit Insurance Corporation;

(2) The term *uncertificated security* shall mean a security not represented by an instrument and the transfer of which is registered upon books maintained for that purpose by or on behalf of the issuer;

(3) The term *global certificate securities issue* shall mean a securities issue for which a single master certificate representing the entire issue is registered in the nominee name of a registered clearing agency and for which beneficial owners cannot receive negotiable securities certificates;

(4) The term *customer* shall mean any person with whom the reporting institution has entered into at least one prior securities-related transaction; and

(5) The term *securities-related transaction* shall mean a purpose, sale or pledge of investment securities, or a custodial arrangement for investment securities.

(6) The term *securities certificate* means any physical instrument that represents or purports to represent ownership in a security that was printed by or on behalf of the issuer thereof and shall include any such instrument that is or was:

(i) Printed but not issued;

(ii) Issued and outstanding, including treasury securities;

(iii) Cancelled, which for this purpose means either or both of the procedures set forth in § 240.17Ad–19(a)(1); or

(iv) Counterfeit or reasonably believed to be counterfeit.

(7) The term *issuer* shall include an issuer's:

(i) Transfer agent(s), paying agent(s), tender agent(s), and person(s) providing similar services; and

(ii) Corporate predecessor(s) and successor(s).

(8) The term *missing* shall include any securities certificate that:

(i) Cannot be located or accounted for, but is not believed to be lost or stolen; or

(ii) A transfer agent claims or believes was destroyed in any manner other than by the transfer agent's own certificate destruction procedures as provided in § 240.17Ad–19.

(b) Every reporting institution shall register with the Commission or its designee in accordance with instructions issued by the Commission except:

(1) A member of a national securities exchange who effects securities transactions through the trading facilities of the exchange and has not received or held customer securities within the last six months;

(2) A reporting institution that, within the last six months, limited its securities activities exclusively to uncertificated securities, global securities issues or any securities issue for which neither record nor beneficial owners can obtain a negotiable securities certificate; or

(3) A reporting institution whose business activities, within the last six months, did not involve the handling of securities certificates.

(c) *Reporting requirements*—(1) *Stolen securities*. (i) Every reporting institution shall report to the Commission or its designee, and to a registered transfer agent for the issue, the discovery of the theft or loss of any securities certificates where there is substantial basis for believing that criminal activity was involved. Such report shall be made within one business day of the discovery and, if the certificate numbers of the securities cannot be ascertained at that time, they shall be reported as soon thereafter as possible.

(ii) Every reporting institution shall promptly report to the Federal Bureau of Investigation upon the discovery of the theft or loss of any securities certificate where there is substantial basis for believing that criminal activity was involved.

(2) *Missing or lost securities*. Every reporting institution shall report to the Commission or its designee, and to a registered transfer agent for the issue, the discovery of the loss of any securities certificate where criminal actions are not suspected when the securities certificate has been missing or lost for a period of two business days. Such report shall be made within one business day of the end of such period except that:

(i) Securities certificates lost, missing, or stolen while in transit to customers, transfer agents, banks, brokers or dealers shall be reported by the delivering institution by the later of two business days after notice of non-receipt or as soon after such notice as the certificate numbers of the securities can be ascertained.

(ii) Where a shipment of retired securities certificates is in transit between any transfer agents, banks, brokers, dealers, or other reporting institutions, with no affiliation existing between such entities, and the delivering institution fails to receive notice of receipt or non-receipt of the certificates, the delivering institution shall act to determine the facts. In the event of non-delivery where the certificates are not recovered by the delivering institution, the delivering institution shall report the certificates as lost, stolen, or missing to the Commission or its designee within a reasonable time under the circumstances but in any event within twenty business days from the date of shipment.

(iii) Securities certificates considered lost or missing as a result of securities counts or verifications required by rule, regulation or otherwise (e.g., dividend record date verification made as a result of firm policy or internal audit function report) shall be reported by the later of ten business days after completion of such securities count or verification or as soon after such count or verification as the certificate numbers of the securities can be ascertained.

(iv) Securities certificates not received during the completion of delivery, deposit or withdrawal shall be reported in the following manner:

(A) Where delivery of the securities certificates is through a clearing agency, the delivering institution shall supply to the receiving institution the certificate number of the security within two business days from the date of request from the receiving institution. The receiving institution shall report within one business day of notification of the certificate number;

(B) Where the delivery of securities certificates is in person and where the delivering institution has a receipt, the delivering institution shall supply the receiving institution the certificate numbers of the securities within two business days from the date of request from the receiving institution. The receiving institution shall report within one business day of notification of the certificate number;

(C) Where the delivery of securities certificates is in person and where the delivering institution has no receipt, the delivering institution shall report within two business days of notification of non-receipt by the receiving institution; or

(D) Where delivery of securities certificates is made by mail or via draft, if payment is not received within ten business days, the delivering institution shall confirm with the receiving institution the failure to receive such delivery; if confirmation shows non-receipt, the delivering institution shall report within two business days of such confirmation.

(3) *Counterfeit securities.* Every reporting institution shall report the discovery of any counterfeit securities certificate to the Commission or its designee, to a registered transfer agent for the issue, and to the Federal Bureau of Investigation within one business day of such discovery.

(4) *Transfer agent reporting obligations.* Every transfer agent shall make the reports required above only if it receives notification of the loss, theft or counterfeiting from a non-reporting institution or if it receives notification other than on a Form X–17F–1A or if the certificate was in its possession at the time of the loss.

(5) *Recovery.* Every reporting institution that originally reported a lost, missing or stolen securities certificate pursuant to this Section shall report recovery of that securities certificate to the Commission or its designee and to a registered transfer agent for the issue within one business day of such recovery or finding. Every reporting institution that originally made a report in which criminality was indicated also shall notify the Federal Bureau of Investigation that the securities certificate has been recovered.

(6) *Information to be reported.* All reports made pursuant to this Section shall include, if applicable or available,

the following information with respect to each securities certificate:

(i) Issuer;

(ii) Type of security and series;

(iii) Date of issue;

(iv) Maturity date;

(v) Denomination;

(vi) Interest rate;

(vii) Certificate number, including alphabetical prefix or suffix;

(viii) Name in which registered;

(ix) Distinguishing characteristics, if counterfeit;

(x) Date of discovery of loss or recovery;

(xi) CUSIP number;

(xii) Financial Industry Numbering System (''FINS'') Number; and

(xiii) Type of loss.

(7) *Forms.* Reporting institutions shall make all reports to the Commission or its designee and to a registered transfer agent for the issue pursuant to this section on Form X–17F–1A. Reporting institutions shall make reports to the Federal Bureau of Investigation pursuant to this Section on Form X–17F–1A, unless the reporting institution is a member of the Federal Reserve System or a bank whose deposits are insured by the Federal Deposit Insurance Corporation, in which case reports may be made on the form required by the institution's appropriate regulatory agency for reports to the Federal Bureau of Investigation.

(d) *Required inquiries.* (1) Every reporting institution (except a reporting institution that, acting in its capacity as transfer agent, paying agent, exchange agent or tender agent for an equity issue, or registrar for a bond or other debt issue, compares all transactions against a shareholder or bondholder list and a current list of stop transfers) shall inquire of the Commission or its designee with respect to every securities certificate which comes into its possession or keeping, whether by pledge, transfer or otherwise, to ascertain whether such securities certificate has been reported as missing, lost, counterfeit or stolen, unless:

(i) The securities certificate is received directly from the issuer or issuing agent at issuance;

(ii) The securities certificate is received from another reporting institution or from a Federal Reserve Bank or Branch;

(iii) The securities certificate is received from a customer of the reporting institution; and

(A) Is registered in the name of such customer or its nominee; or

(B) Was previously sold to such customer, as verified by the internal records of the reporting institution;

(iv) The securities certificate is received as part of a transaction which has an aggregate face value of $10,000 or less in the case of bonds, or market value of $10,000 or less in the case of stocks; or

(v) The securities certificate is received directly from a drop which is affiliated with a reporting institution for the purposes of receiving or delivering certificates on behalf of the reporting institution.

(2) *Form of inquiry.* Inquiries shall be made in such manner as prescribed by the Commission or its designee.

(3) A reporting institution shall make required inquiries by the end of the fifth business day after a securities certificate comes into its possession or keeping, provided that such inquiries shall be made before the certificate is sold, used as collateral, or sent to another reporting institution.

(e) *Permissive reports and inquiries.* Every reporting insitution may report to or inquire of the Commission or its designee with respect to any securities certificate not otherwise required by this section to be the subject of a report or inquiry. The Commission on written request or upon its own motion may permit reports to and inquiries of the system by any other person or entity upon such terms and conditions as it deems appropriate and necessary in the public interest and for the protection of investors.

(f) *Exemptions.* The following types of securities are not subject to paragraphs (c) and (d) of this section:

(1) Security issues not assigned CUSIP numbers;

(2) Bond coupons;

(3) Uncertificated securities;

(4) Global securities issues; and

(5) Any securities issue for which neither record nor beneficial owners can obtain a negotiable securities certificates.

(g) *Recordkeeping.* Every reporting institution shall maintain and preserve in an easily accessible place for three years copies of all Forms X–17F–1A filed pursuant to this section, all agreements between reporting institutions regarding registration or other aspects of this section, and all confirmations or other information received from the Commission or its designee as a result of inquiry.

(Secs. 2, 17, and 23, 15 U.S.C. 78b, 78q, 78w)

[44 FR 31503, May 31, 1979; 45 FR 14022, Mar. 3, 1980, as amended at 53 FR 37289, Sept. 26, 1988; 53 FR 40721, Oct. 18, 1988; 68 FR 74400, Dec. 23, 2003]

§ 240.17f–2 Fingerprinting of securities industry personnel.

(a) *Exemptions for the fingerprinting requirement.* Except as otherwise provided in paragraph (a)(1) or (2) of this section, every member of a national securities exchange, broker, dealer, registered transfer agent and registered clearing agency shall require that each of its partners, directors, officers and employees be fingerprinted and shall submit, or cause to be submitted, the fingerprints of such persons to the Attorney General of the United States or its designee for identification and appropriate processing.

(1) *Permissive exemptions.* Every member of a national securities exchange, broker, dealer, registered transfer agent and registered clearing agency may claim one or more of the exemptions in paragraph (a)(1) (i), (ii), (iii) or (iv) of this section; *Provided,* That all the requirements of paragraph (e) of this section are also satisfied.

(i) *Member of a national securities exchange, broker, dealer or registered clearing agency.* Every person who is a partner, director, officer or employee of a member of a national securities exchange, broker, dealer, or registered clearing agency shall be exempt if that person:

(A) Is not engaged in the sale of securities;

(B) Does not regularly have access to the keeping, handling or processing of (*1*) securities, (*2*) monies, or (*3*) the original books and records relating to the securities or the monies; and

(C) Does not have direct supervisory responsibility over persons engaged in the activities referred to in paragraphs (a)(1)(i) (A) and (B) of this section.

(ii) *Registered transfer agents.* Every person who is a partner, director, officer or employee of a registered transfer agent shall be exempt if that person:

(A) Is not engaged in transfer agent functions (as defined in section 3(a)(25) of the Securities Exchange Act of 1934) or activities incidental thereto; or

(B) Meets the conditions in paragraphs (a)(1)(i) (B) and (C) of this section.

(iii) *Registered broker-dealers engaged in sales of certain securities.* Every partner, director, officer and employee of a registered broker or dealer who satisfies paragraph (a)(1)(i)(B) of this section shall be exempt if that broker or dealer:

(A) Is engaged exclusively in the sale of shares of registered open-end management investment companies, variable contracts, or interests in limited partnerships, unit investment trusts or real estate investment trusts; *Provided,* That those securities ordinarily are not evidenced by certificates;

(B) Is current in its continuing obligation under §§ 240.15b1–1 and 15b3–1(b) to update Item 10 of Form BD to disclose the existence of any statutory disqualification set forth in sections 3(a)(39), 15(b)(4) and 15(b)(6) of the Securities Exchange Act of 1934;

(C) Has insurance or bonding indemnifying it for losses to customers caused by the fraudulent or criminal acts of any of its partners, directors, officers or employees for whom an exemption is being claimed under paragraph (a)(1)(iii) of this section; and

(D) Is subject to the jurisdiction of a state insurance department with respect to its sale of variable contracts.

(iv) *Illegible fingerprint cards.* Every person who is a partner, director, officer or employee shall be exempt if that member of a national securities exchange, broker, dealer, registered transfer agent or registered clearing agency, on at least three occasions:

(A) Attempts in good faith to obtain from such person a complete set of fingerprints acceptable to the Attorney General or its designee for identification and appropriate processing by requiring that person to be fingerprinted, by having that person's fingerprints rolled by a person competent to do so and by submitting the fingerprint cards for that person to the Attorney General of the United States or its designee in accordance with proper procedures;

(B) Has that person's fingerprint cards returned to it by the Attorney General of the United States or its designee without that person's fingerprints having been identified because the fingerprints were illegible; and

(C) Retains the returned fingerprint cards and any other required records in accordance with paragraph (d) of this section and §§ 240.17a–3(a)(13), 17a–4(e)(2) and 240.17Ad–7(e)(1) under the Securities Exchange Act of 1934.

(2) *Other exemptions by application to the Commission.* The Commission, upon specified terms, conditions and periods, may grant exemptions to any class of partners, directors, officers or employees of any member of a national securities exchange, broker, dealer, registered transfer agent or registered clearing agency, if the Commission finds that such action is not inconsistent with the public interest or the protection of investors.

(b) *Fingerprinting pursuant to other law.* Every member of a national securities exchange, broker, dealer, registered transfer agent and registered clearing agency may satisfy the fingerprinting requirement of section 17(f)(2) of the Securities Exchange Act of 1934 as to any partner, director, officer or employee, if:

(1) The person, in connection with his or her present employment with such organization, has been fingerprinted pursuant to any other law, statute, rule or regulation of any state or federal government or agency thereof;

(2) The fingerprint cards for that person are submitted, or are caused to be submitted, to the Attorney General of the United States or its designee for identification and appropriate processing, and the Attorney General or its designee has processed those fingerprint cards; and

(3) The processed fingerprint cards or any substitute records, together with any information received from the Attorney General or its designee, are maintained in accordance with paragraph (d) of this section.

(c) *Fingerprinting plans of self-regulatory organizations.* The fingerprinting requirement of section 17(f)(2) of the Securities Exchange Act of 1934 may be satisfied by submitting appropriate and complete fingerprint cards to a registered national securities exchange or to a registered national securities association which, pursuant to a plan filed with, and declared effective by, the Commission, forwards such fingerprint cards to the Attorney General of the United States or its designee for identification and appropriate processing. Any plan filed by a registered national securities exchange or a registered national securities association shall not become effective, unless declared effective by the Commission as not inconsistent with the public interest or the protection of investors; and, in declaring any such plan effective, the Commission may impose any terms and conditions relating to the provisions of the plan and the period of its effectiveness as it may deem necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Securities Exchange Act of 1934.

(d) *Record maintenance*—(1) *Maintenance of processed fingerprint cards and other related information.* Every member of a national securities exchange, broker, dealer, registered transfer agent and registered clearing agency shall maintain the processed fingerprint card or any substitute record when such card is not returned after processing, together with any information received from the Attorney General or its designee, for every person required to be fingerprinted under section 17(f)(2) of the Securities Exchange Act of 1934 and for persons who have complied with this section pursuant to paragraph (b) or (c) of this section. Every substitute record shall state the name of the person whose fingerprint card was submitted to the Attorney General of the United States, the name of the member of a national securities exchange, broker, dealer, registered transfer agent or registered clearing agency that submitted the fingerprint card, the name of the person or organization that rolled the fingerprints, the date on which the fingerprints were rolled, and the date the fingerprint card was submitted to the Attorney General of the United States. The processed fingerprint card and every other substitute record containing the information required by this paragraph, together with any information received from the Attorney General of the United States, shall be kept in an easily accessible place at the organization's principal office and shall be made available upon request to the Commission, the appropriate regulatory agency (if not the Commission) or other designated examining authority. The organization's principal office must provide to the regional, branch or satellite office actually employing the person written evidence that the person's fingerprints have been processed by the FBI, and must provide to that office a copy of any criminal history record information received from the FBI. All fingerprint cards, records and information required to be maintained under this paragraph shall be retained for a period of not less than three years after termination of that person's employment or relationship with the organization.

(2) *Record maintenance by designated examining authorities.* The records required to be maintained and preserved by a member of a national securities exchange, broker, or dealer pursuant to the requirements of paragraph (d)(1) of this section may be maintained and preserved on behalf of that member, broker, or dealer by a self-regulatory organization that is also the designated examining authority for that member, broker or dealer, *Provided* That the self-regulatory organization has filed in accordance with § 240.17f–2(c) a fingerprinting plan or amendments to an existing plan concerning the storage and maintenance of records and that plan, as amended, has been declared effective by the Commission, and *Provided Further* That:

(i) Such records are subject at any time, or from time to time, to reasonable periodic, special or other examinations by representatives of the Commission; and

(ii) The self-regulatory organization furnishes to the Commission, upon demand, at either the principal office or at the regional office complete, correct and current hard copies of any and all such records.

(3) *Reproduction of records on microfilm.* The records required to be maintained pursuant to paragraph (d)(1) of this section may be produced or reproduced on microfilm and preserved in that form. If such microfilm substitution for hard copy is made by a member of a national securities exchange, broker, dealer, registered transfer agent or registered clearing agency, or by a self-regulatory organization maintaining and storing records pursuant to paragraph (d)(2) of this section, it shall at all times:

(i) Have available for examination by the Commission, the appropriate regulatory agency (if not the Commission) or other designated examining authority, facilities for the immediate, easily readable projection of the microfilm and for the production of easily readable and legible facsimile enlargements;

(ii) File and index the films in such a manner as to permit the immediate location and retrieval of any particular record;

(iii) Be ready to provide, and immediately provide, any facsimile enlargement which the Commission, the appropriate regulatory agency (if not the Commission) or other designated examining authority by their examiners or other representatives may request; and

(iv) For the period for which the microfilm records are required to be maintained, store separately from the original microfilm records a copy of the microfilm records.

(e) *Notice requirement.* Every member of a national securities exchange, broker, dealer, registered transfer agent and registered clearing agency that claims one or more of the exemptions in paragraph (a)(1) of this section shall make and keep current a statement entitled ''Notice Pursuant to Rule 17f–2'' containing the information specified in paragraph (e)(1) of this section.

(1) *Contents of statement.* The Notice required by paragraph (e) of this section shall:

(i) State the name of the organization and state whether it is a member of a national securities exchange, broker, dealer, registered transfer agent, or registered clearing agency;

(ii) Identify by division, department, class, or name and position within the organization all persons who are claimed to have satisfied the fingerprinting requirement of section 17(f)(2) of the Securities Exchange Act of 1934 pursuant to paragraph (b) of this section;

(iii) Identify by division, department, class, title or position within the organization all persons claimed to be exempt under paragraphs (a)(1)(i) through (iii) of this section, and identify by name all persons claimed to be exempt under paragraph (a)(1)(iv). Persons identified under this paragraph (e)(1)(iii) shall be exempt from the requirement of section 17(f)(2) of the Securities Exchange Act of 1934 unless notified to the contrary by the Commission;

(iv) Describe, in generic terms, the nature of the duties of the person or classes of persons, and the nature of the functions and operations of the divisions and departments, identified as exempt in paragraph (e)(1)(iii) of this section; and

(v) Describe the security measures utilized to ensure that only those persons who have been fingerprinted in accordance with the fingerprinting requirement of section 17(f)(2) of the Securities Exchange Act of 1934 or who are exempt under paragraph (a)(1)(iv) of this section have access to the keeping, handling or processing of securities or monies or the original books and records relating thereto.

(2) *Record maintenance.* A copy of the Notice required to be made and kept current under paragraph (e) of this section shall be kept in an easily accessible place at the organization's principal office and at the office employing the persons for whom exemptions are claimed and shall be made available upon request for inspection by the Commission, appropriate regulatory agency (if not the Commission) or other designated examining authority.

(3) *Exemption from the notice requirement.* A registered transfer agent that performs transfer agent functions only on behalf of itself as an issuer and that receives fewer than 500 items for transfer and fewer than 500 items for processing during any six consecutive months shall be exempt from the notice requirement of paragraph (c) of this section.

[47 FR 54060, Dec. 1, 1982]

NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

SOURCE: 72 FR 33620, June 18, 2007, unless otherwise noted.

§ 240.17g–1 Application for registration as a nationally recognized statistical rating organization.

(a) *Initial application.* A credit rating agency applying to the Commission to be registered under section 15E of the Act (15 U.S.C. 78o–7) as a nationally recognized statistical rating organization must file with the Commission two paper copies of an initial application on Form NRSRO (§ 249b.300 of this chapter) that follows all applicable instructions for the Form.

(b) *Application to register for an additional class of credit ratings.* A nationally recognized statistical rating organization applying to register for an additional class of the credit ratings described in section 3(a)(62)(B) of the Act (15 U.S.C. 78c(a)(62)(B)) must file with the Commission two paper copies of an application to add a class of credit ratings on Form NRSRO that follows all applicable instructions for the Form. The application will be subject to the requirements of section 15E(a)(2) of the Act (15 U.S.C. 78o–7(a)(2)).

(c) *Supplementing an application prior to final action by the Commission.* An applicant must promptly file with the Commission two paper copies of a written notice if information submitted to the Commission in an initial application to be registered as a nationally recognized statistical rating organization or in an application to register for an additional class of credit ratings is found to be or becomes materially inaccurate prior to the date of a Commission order granting or denying the application. The notice must identify the information that was found to be materially inaccurate. The applicant also must promptly file with the Commission two paper copies of an application supplement on Form NRSRO that follows all applicable instructions for the Form.

(d) *Withdrawing an application.* An applicant may withdraw an initial application to be registered as a nationally recognized statistical rating organization or an application to register for an additional class of credit ratings prior to the date of a Commission order granting or denying the application. To withdraw the application, the applicant must furnish the Commission with two paper copies of a written notice of withdrawal executed by a duly authorized person.

(e) *Update of registration.* A nationally recognized statistical rating organization amending materially inaccurate information in its application for registration pursuant to section 15E(b)(1) of the Act (15 U.S.C. 78o–7(b)(1)) must promptly file with the Commission an update of its registration on Form NRSRO that follows all applicable instructions for the Form. A Form NRSRO and the information and documents in Exhibits 2 through 9 to Form NRSRO, as applicable, filed under this paragraph must be filed electronically with the Commission on EDGAR as a PDF document in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S–T (§ 232.11 of this chapter).

(f) *Annual certification.* A nationally recognized statistical rating organization amending its application for registration pursuant to section 15E(b)(2) of the Act (15 U.S.C. 78o–7(b)(2)) must file with the Commission an annual certification on Form NRSRO that follows all applicable instructions for the Form not later than 90 days after the end of each calendar year. A Form NRSRO and the information and documents in Exhibits 1 through 9 to Form NRSRO filed under this paragraph must be filed electronically with the Commission on EDGAR as a PDF document in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S–T.

(g) *Withdrawal from registration.* A nationally recognized statistical rating organization withdrawing from registration pursuant to section 15E(e)(1) of the Act (15 U.S.C. 78o–7(e)(1)) must furnish the Commission with a notice of withdrawal from registration on Form NRSRO that follows all applicable instructions for the Form. The withdrawal from registration will become effective 45 calendar days after the notice is furnished to the Commission upon such terms and conditions as the Commission may establish as necessary in the public interest or for the protection of investors. A Form NRSRO furnished under this paragraph must be furnished electronically with the Commission on EDGAR as a PDF document in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S–T.

(h) *Filing or furnishing Form NRSRO.* A Form NRSRO filed or furnished, as applicable, under any paragraph of this section will be considered filed with or furnished to the Commission on the date the Commission receives a complete and properly executed Form NRSRO that follows all applicable instructions for the Form. Information filed or furnished, as applicable, on a confidential basis and for which confidential treatment has been requested pursuant to applicable Commission rules will be accorded confidential treatment to the extent permitted by law.

(i) *Public availability of Form NRSRO.* A nationally recognized statistical rating organization must make its current Form NRSRO and information and documents in Exhibits 1 through 9 to Form NRSRO publicly and freely available on an easily accessible portion of its corporate Internet Web site within 10 business days after the date of the Commission order granting an initial application for registration as a nationally recognized statistical rating organization or an application to register for an additional class of credit ratings and within 10 business days after filing with or furnishing to, as applicable, the Commission a Form NRSRO under paragraph (e), (f), or (g) of this section. In addition, a nationally recognized statistical rating organization must make its most recently filed Exhibit 1 to Form NRSRO freely available in writing to any individual who requests a copy of the Exhibit.

[13 FR 8178, Dec. 22, 1948, as amended at 79 FR 55262, Sept. 15, 2014]

§ 240.17g–2 Records to be made and retained by nationally recognized statistical rating organizations.

(a) *Records required to be made and retained.* A nationally recognized statistical rating organization must make and retain the following books and records, which must be complete and current:

(1) Records of original entry into the accounting system of the nationally recognized statistical rating organization and records reflecting entries to and balances in all general ledger accounts of the nationally recognized statistical rating organization for each fiscal year.

(2) Records with respect to each current credit rating of the nationally recognized statistical rating organization indicating (as applicable):

(i) The identity of any credit analyst(s) that participated in determining the credit rating;

(ii) The identity of the person(s) that approved the credit rating before it was issued;

(iii) If a quantitative model was a substantial component in the process of determining the credit rating of a security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction, a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued; and

(iv) Whether the credit rating was solicited or unsolicited.

(3) An account record for each person (for example, an obligor, issuer, underwriter, or other user) that has paid the nationally recognized statistical rating organization for the issuance or maintenance of a credit rating indicating:

(i) The identity and address of the person; and

(ii) The credit rating(s) determined or maintained for the person.

(4) An account record for each subscriber to the credit ratings and/or credit analysis reports of the nationally recognized statistical rating organization indicating the identity and address of the subscriber.

(5) A record listing the general types of services and products offered by the nationally recognized statistical rating organization.

(6) A record documenting the established procedures and methodologies used by the nationally recognized statistical rating organization to determine credit ratings.

(7) A record that lists each security and money market instrument and its corresponding credit rating issued by an asset pool or as part of any asset-backed securities transaction where the nationally recognized statistical rating organization, in determining the credit rating for the security or money market instrument, treats assets within such pool or as a part of such transaction that are not subject to a credit rating of the nationally recognized statistical rating organization by any or a combination of the following methods:

(i) Determining credit ratings for the unrated assets;

(ii) Performing credit assessments or determining private credit ratings for the unrated assets;

(iii) Determining credit ratings or private credit ratings, or performing credit assessments for the unrated assets by taking into consideration the internal credit analysis of another person; or

(iv) Determining credit ratings or private credit ratings, or performing credit assessments for the unrated assets by taking into consideration (but not necessarily adopting) the credit ratings of another nationally recognized statistical rating organization.

(8) For each outstanding credit rating, a record showing all rating actions and the date of such actions from the initial credit rating to the current credit rating identified by the name of the rated security or obligor and, if applicable, the CUSIP of the rated security or the Central Index Key (CIK) number of the rated obligor.

(9) A record documenting the policies and procedures the nationally recognized statistical rating organization is required to establish, maintain, and enforce pursuant to section 15E(h)(4)(A) of the Act (15 U.S.C. 78o–7(h)(4)(A)) and § 240.17g–8(c).

(b) *Records required to be retained.* A nationally recognized statistical rating organization must retain the following books and records (excluding drafts of documents) that relate to its business as a credit rating agency:

(1) Significant records (for example, bank statements, invoices, and trial balances) underlying the information included in the annual financial reports the nationally recognized statistical rating organization filed with or furnished to, as applicable, the Commission pursuant to § 240.17g–3.

(2) Internal records, including nonpublic information and work papers, used to form the basis of a credit rating issued by the nationally recognized statistical rating organization.

(3) Credit analysis reports, credit assessment reports, and private credit rating reports of the nationally recognized statistical rating organization and internal records, including nonpublic information and work papers, used to form the basis for the opinions expressed in these reports.

(4) Compliance reports and compliance exception reports.

(5) Internal audit plans, internal audit reports, documents relating to internal audit follow-up measures, and all records identified by the internal auditors of the nationally recognized statistical rating organization as necessary to perform the audit of an activity that relates to its business as a credit rating agency.

(6) Marketing materials of the nationally recognized statistical rating organization that are published or otherwise made available to persons that are not associated with the nationally recognized statistical rating organization.

(7) External and internal communications, including electronic communications, received and sent by the nationally recognized statistical rating organization and its employees that relate to initiating, determining, maintaining, monitoring, changing,, or withdrawing a credit rating.

(8) Any written communications received from persons not associated with the nationally recognized statistical rating organization that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating.

(9) Internal documents that contain information, analysis, or statistics that were used to develop a procedure or methodology to treat the credit ratings of another nationally recognized statistical rating organization for the purpose of determining a credit rating for a security or money market instrument issued by an asset pool or part of any asset-backed securities transaction.

(10) For each security or money market instrument identified in the record required to be made and retained under paragraph (a)(7) of this section, any document that contains a description of how assets within such pool or as a part of such transaction not rated by the nationally recognized statistical rating organization but rated by another nationally recognized statistical rating organization were treated for the purpose of determining the credit rating of the security or money market instrument.

(11) Forms NRSRO (including Exhibits and accompanying information and documents) the nationally recognized statistical rating organization filed with or furnished to, as applicable, the Commission.

(12) The internal control structure the nationally recognized statistical rating organization is required to establish, maintain, enforce, and document pursuant to section 15E(c)(3)(A) of the Act (15 U.S.C. 78o–7(c)(3)(A)).

(13) The policies and procedures the nationally recognized statistical rating organization is required to establish, maintain, enforce, and document pursuant to § 240.17g–8(a).

(14) The policies and procedures the nationally recognized statistical rating organization is required to establish, maintain, enforce, and document pursuant to § 240.17g–8(b).

(15) The standards of training, experience, and competence for credit analysts the nationally recognized statistical rating organization is required to establish, maintain, enforce, and document pursuant to § 240.17g–9.

(c) *Record retention periods.* The records required to be retained pursuant to paragraphs (a) and (b) of this section must be retained for three years after the date the record is made or received, except that a record identified in paragraph (a)(9), (b)(12), (b)(13), (b)(14), or (b)(15) of this section must be retained until three years after the date the record is replaced with an updated record.

(d) *Manner of retention.* An original, or a true and complete copy of the original, of each record required to be retained pursuant to paragraphs (a) and (b) of this section must be maintained in a manner that, for the applicable retention period specified in paragraph (c) of this section, makes the original record or copy easily accessible to the principal office of the nationally recognized statistical rating organization and to any other office that conducted activities causing the record to be made or received.

(e) *Third-party record custodian.* The records required to be retained pursuant to paragraphs (a) and (b) of this section may be made or retained by a third-party record custodian, provided the nationally recognized statistical rating organization furnishes the Commission at its principal office in Washington, DC with a written undertaking of the custodian executed by a duly authorized person. The undertaking must be in substantially the following form:

The undersigned acknowledges that books and records it has made or is retaining for [the nationally recognized statistical rating organization] are the exclusive property of [the nationally recognized statistical rating organization]. The undersigned undertakes that upon the request of [the nationally recognized statistical rating organization] it will promptly provide the books and records to [the nationally recognized statistical rating organization] or the U.S. Securities and Exchange Commission (''Commission'') or its representatives and that upon the request of the Commission it will promptly permit examination by the Commission or its representatives of the records at any time or from time to time during business hours and promptly furnish to the Commission or its representatives a true and complete copy of any or all or any part of such books and records.

A nationally recognized statistical rating organization that engages a third-party record custodian remains responsible for complying with every provision of this section.

(f) A nationally recognized statistical rating organization must promptly furnish the Commission or its representatives with legible, complete, and current copies, and, if specifically requested, English translations of those records of the nationally recognized statistical rating organization required to be retained pursuant to paragraphs (a) and (b) this section, or any other records of the nationally recognized statistical rating organization subject to examination under section 17(b) of the Act (15 U.S.C. 78q(b)) that are requested by the Commission or its representatives.

[72 FR 33620, June 18, 2007, as amended at 74 FR 6482, Feb. 9, 2009; 74 FR 63863, Dec. 4, 2009; 79 FR 55263, Nov. 14, 2014]

§ 240.17g–3 Annual financial and other reports to be filed or furnished by nationally recognized statistical rating organizations.

(a) A nationally recognized statistical rating organization must annually, not more than 90 calendar days after the end of its fiscal year (as indicated on its current Form NRSRO):

(1) File with the Commission a financial report, as of the end of the fiscal year, containing audited financial statements of the nationally recognized statistical rating organization or audited consolidated financial statements of its parent if the nationally recognized statistical rating organization is a separately identifiable division or department of the parent. The audited financial statements must:

(i) Include a balance sheet, an income statement (or a statement of comprehensive income, as defined in § 210.1–02 of Regulation S–X of this chapter, if required by the applicable generally accepted accounting principles noted in paragraph (a)(1)(ii) of this section) and statement of cash flows, and a statement of changes in ownership equity;

(ii) Be prepared in accordance with generally accepted accounting principles in the jurisdiction in which the nationally recognized statistical rating organization or its parent is incorporated, organized, or has its principal office; and

(iii) Be certified by an accountant who is qualified and independent in accordance with paragraphs (a), (b), and (c)(1), (2), (3), (4), (5) and (8) of § 210.2–01 of this chapter. The accountant must give an opinion on the financial statements in accordance with paragraphs

(a) through (d) of § 210.2–02 of this chapter.

(2) File with the Commission a financial report, as of the end of the fiscal year, containing, if applicable, unaudited consolidating financial statements of the parent of the nationally recognized statistical rating organization that include the nationally recognized statistical rating organization.

NOTE TO PARAGRAPH (a)(2): This financial report must be filed only if the audited financial statements provided pursuant to paragraph (a)(1) of this section are consolidated financial statements of the parent of the nationally recognized statistical rating organization.

(3) File with the Commission an unaudited financial report, as of the end of the fiscal year, providing information concerning the revenue of the nationally recognized statistical rating organization in each of the following categories (as applicable) for the fiscal year:

(i) Revenue from determining and maintaining credit ratings;

(ii) Revenue from subscribers;

(iii) Revenue from granting licenses or rights to publish credit ratings; and

(iv) Revenue from all other services and products (include descriptions of any major sources of revenue).

(4) File with the Commission an unaudited financial report, as of the end of the fiscal year, providing the total aggregate and median annual compensation of the credit analysts of the nationally recognized statistical rating organization for the fiscal year.

NOTE TO PARAGRAPH (a)(4): In calculating total and median annual compensation, the nationally recognized statistical rating organization may exclude deferred compensation, provided such exclusion is noted in the report.

(5) File with the Commission an unaudited financial report, as of the end of the fiscal year, listing the 20 largest issuers and subscribers that used credit rating services provided by the nationally recognized statistical rating organization by amount of net revenue attributable to the issuer or subscriber during the fiscal year. Additionally, include on the list any obligor or underwriter that used the credit rating services provided by the nationally recognized statistical rating organization if the net revenue attributable to the obligor or underwriter during the fiscal year equaled or exceeded the net revenue attributable to the 20th largest issuer or subscriber. Include the net revenue amount for each person on the list.

NOTE TO PARAGRAPH (a)(5): A person is deemed to have ''used the credit rating services'' of the nationally recognized statistical rating organization if the person is any of the following: an obligor that is rated by the nationally recognized statistical rating organization (regardless of whether the obligor paid for the credit rating); an issuer that has securities or money market instruments subject to a credit rating of the nationally recognized statistical rating organization (regardless of whether the issuer paid for the credit rating); any other person that has paid the nationally recognized statistical rating organization to determine a credit rating with respect to a specific obligor, security, or money market instrument; or a subscriber to the credit ratings, credit ratings data, or credit analysis of the nationally recognized statistical rating organization. In calculating net revenue attributable to a person, the nationally recognized statistical rating organization should include all revenue earned by the nationally recognized statistical rating organization for any type of service or product, regardless of whether related to credit rating services, and net of any rebates and allowances paid or owed to the person by the nationally recognized statistical rating organization.

(6) Furnish the Commission with an unaudited report, as of the end of the fiscal year, of the number of credit ratings actions (upgrades, downgrades, placements on credit watch, and withdrawals) taken during the fiscal year in each class of credit ratings identified in section 3(a)(62)(B) of the Act (15 U.S.C. 78c(a)(62)(B)) for which the nationally recognized statistical rating organization is registered with the Commission.

NOTE TO PARAGRAPH (a)(6): A nationally recognized statistical rating organization registered in the class of credit ratings described in section 3(a)(62)(B)(iv) of the Act (15 U.S.C. 78c(a)(62)(B)(iv)) must include credit ratings actions taken on credit ratings of any security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction for purposes of reporting the number of credit ratings actions in this class.

(7)(i) File with the Commission an unaudited report containing an assessment by management of the effectiveness during the fiscal year of the internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings the nationally recognized statistical rating organization is required to establish, maintain, enforce, and document pursuant to section 15E(c)(3)(A) of the Act (15 U.S.C. 78o–7(c)(3)(A)) that includes:

(A) A description of the responsibility of management in establishing and maintaining an effective internal control structure;

(B) A description of each material weakness in the internal control structure identified during the fiscal year, if any, and a description, if applicable, of how each identified material weakness was addressed; and

(C) A statement as to whether the internal control structure was effective as of the end of the fiscal year.

(ii) Management is not permitted to conclude that the internal control structure of the nationally recognized statistical rating organization was effective as of the end of the fiscal year if there were one or more material weaknesses in the internal control structure as of the end of the fiscal year.

(iii) For purposes of this paragraph (a)(7), a deficiency in the internal control structure exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect a failure of the nationally recognized statistical rating organization to:

(A) Implement a policy, procedure, or methodology for determining credit ratings in accordance with the policies and procedures of the nationally recognized statistical rating organization; or

(B) Adhere to an implemented policy, procedure, or methodology for determining credit ratings.

(iv) For purposes of this paragraph (a)(7), a material weakness exists if a deficiency, or a combination of deficiencies, in the design or operation of the internal control structure creates a reasonable possibility that a failure identified in paragraph (a)(7)(iii) of this section that is material will not be prevented or detected on a timely basis.

(8) File with the Commission an unaudited annual report on the compliance of the nationally recognized statistical rating organization with the securities laws and the policies and procedures of the nationally recognized statistical rating organization pursuant to section 15E(j)(5)(B) of the Act (15 U.S.C. 78o–7(j)(5)(B)).

(b)(1) The nationally recognized statistical rating organization must attach to the reports filed or furnished, as applicable, pursuant to paragraphs (a)(1) through (6) of this section a signed statement by a duly authorized person associated with the nationally recognized statistical rating organization stating that the person has responsibility for the reports and, to the best knowledge of the person, the reports fairly present, in all material respects, the financial condition, results of operations, cash flows, revenues, analyst compensation, and credit rating actions of the nationally recognized statistical rating organization for the period presented; and

(2) The nationally recognized statistical rating organization must attach to the report filed pursuant to paragraph (a)(7) of this section a signed statement by the chief executive officer of the nationally recognized statistical rating organization or, if the nationally recognized statistical rating organization does not have a chief executive officer, an individual performing similar functions, stating that the chief executive officer or equivalent individual has responsibility for the report and, to the best knowledge of the chief executive officer or equivalent individual, the report fairly presents, in all material respects: an assessment by management of the effectiveness of the internal control structure during the fiscal year that includes a description of the responsibility of management in establishing and maintaining an effective internal control structure; a description of each material weakness in the internal control structure identified during the fiscal year, if any, and a description, if applicable, of how each identified material weakness was addressed; and an

assessment by management of the effectiveness of the internal control structure as of the end of the fiscal year.

(c) The Commission may grant an extension of time or an exemption with respect to any requirements in this section either unconditionally or on specified terms and conditions on the written request of a nationally recognized statistical rating organization if the Commission finds that such extension or exemption is necessary or appropriate in the public interest and consistent with the protection of investors.

(d) *Electronic filing*. The reports must be filed with or furnished to, as applicable, the Commission electronically on EDGAR as PDF documents in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S–T.

(e) *Confidential treatment*. Information in a report filed or furnished, as applicable, on a confidential basis and for which confidential treatment has been requested pursuant to applicable Commission rules will be accorded confidential treatment to the extent permitted by law. Confidential treatment may be requested by marking each page ''Confidential Treatment Requested'' and by complying with Commission rules governing confidential treatment.

[72 FR 33620, June 18, 2007, as amended at 74 FR 6482, Feb. 9, 2009; 79 FR 55263, Sept. 15, 2014; 79 FR 61576, Nov. 14, 2014; 83 FR 50223, Oct. 4, 2018]

§ 240.17g–4 Prevention of misuse of material nonpublic information.

(a) The written policies and procedures a nationally recognized statistical rating organization establishes, maintains, and enforces to prevent the misuse of material, nonpublic information pursuant to section 15E(g)(1) of the Act (15 U.S.C. 78o–7(g)(1)) must include policies and procedures reasonably designed to prevent:

(1) The inappropriate dissemination within and outside the nationally recognized statistical rating organization of material nonpublic information obtained in connection with the performance of credit rating services;

(2) A person within the nationally recognized statistical rating organization from purchasing, selling, or otherwise benefiting from any transaction in securities or money market instruments when the person is aware of material nonpublic information obtained in connection with the performance of credit rating services that affects the securities or money market instruments; and

(3) The inappropriate dissemination within and outside the nationally recognized statistical rating organization of a pending credit rating action before issuing the credit rating on the Internet or through another readily accessible means.

(b) For the purposes of this section, the term *person within a nationally recognized statistical rating organization* means a nationally recognized statistical rating organization, its credit rating affiliates identified on Form NRSRO, and any partner, officer, director, branch manager, and employee of the nationally recognized statistical rating organization or its credit rating affiliates (or any person occupying a similar status or performing similar functions).

§ 240.17g–5 Conflicts of interest.

(a) A person within a nationally recognized statistical rating organization is prohibited from having a conflict of interest relating to the issuance or maintenance of a credit rating identified in paragraph (b) of this section, unless:

(1) The nationally recognized statistical rating organization has disclosed the type of conflict of interest in Exhibit 6 to Form NRSRO in accordance with section 15E(a)(1)(B)(vi) of the Act (15 U.S.C. 78o–7(a)(1)(B)(vi)) and § 240.17g–1;

(2) The nationally recognized statistical rating organization has established and is maintaining and enforcing written policies and procedures to address and manage conflicts of interest in accordance with section 15E(h) of the Act (15 U.S.C. 78o–7(h)); and

(3) In the case of the conflict of interest identified in paragraph (b)(9) of this section relating to issuing or maintaining a credit rating for a security or money market instrument issued by an

asset pool or as part of any asset-backed securities transaction, the nationally recognized statistical rating organization:

(i) Maintains on a password-protected Internet Web site a list of each such security or money market instrument for which it is currently in the process of determining an initial credit rating in chronological order and identifying the type of security or money market instrument, the name of the issuer, the date the rating process was initiated, and the Internet Web site address where the issuer, sponsor, or underwriter of the security or money market instrument represents that the information described in paragraphs (a)(3)(iii)(C) through (E) of this section can be accessed;

(ii) Provides free and unlimited access to such password-protected Internet Web site during the applicable calendar year to any nationally recognized statistical rating organization that provides it with a copy of the certification described in paragraph (e) of this section that covers that calendar year, provided that such certification indicates that the nationally recognized statistical rating organization providing the certification either:

(A) Determined and maintained credit ratings for at least 10% of the issued securities and money market instruments for which it accessed information pursuant to 17 CFR 240.17g–5(a)(3)(iii) in the calendar year prior to the year covered by the certification, if it accessed such information for 10 or more issued securities or money market instruments; or

(B) Has not accessed information pursuant to 17 CFR 240.17g–5(a)(3) 10 or more times during the most recently ended calendar year; and

(iii) Obtains from the issuer, sponsor, or underwriter of each such security or money market instrument a written representation that can reasonably be relied upon that the issuer, sponsor, or underwriter will:

(A) Maintain the information described in paragraphs (a)(3)(iii)(C) through (E) of this section available at an identified password-protected Internet Web site that presents the information in a manner indicating which information currently should be relied on to determine or monitor the credit rating;

(B) Provide access to such password-protected Internet Web site during the applicable calendar year to any nationally recognized statistical rating organization that provides it with a copy of the certification described in paragraph (e) of this section that covers that calendar year, provided that such certification indicates that the nationally recognized statistical rating organization providing the certification either:

(*1*) Determined and maintained credit ratings for at least 10% of the issued securities and money market instruments for which it accessed information pursuant to 17 CFR 240.17g–5(a)(3)(iii) in the calendar year prior to the year covered by the certification, if it accessed such information for 10 or more issued securities or money market instruments; or

(*2*) Has not accessed information pursuant to 17 CFR 240.17g–5(a)(3) 10 or more times during the most recently ended calendar year.

(C) Post on such password-protected Internet Web site all information the issuer, sponsor, or underwriter provides to the nationally recognized statistical rating organization, or contracts with a third party to provide to the nationally recognized statistical rating organization, for the purpose of determining the initial credit rating for the security or money market instrument, including information about the characteristics of the assets underlying or referenced by the security or money market instrument, and the legal structure of the security or money market instrument, at the same time such information is provided to the nationally recognized statistical rating organization; and

(D) Post on such password-protected Internet Web site all information the issuer, sponsor, or underwriter provides to the nationally recognized statistical rating organization, or contracts with a third party to provide to the nationally recognized statistical rating organization, for the purpose of undertaking credit rating surveillance on the security or money market instrument, including information about the characteristics and performance of the assets underlying or referenced by the security or money market instrument at the same time such information is provided to the nationally recognized statistical rating organization.

(E) Post on such password-protected Internet Web site, promptly after receipt, any executed Form ABS Due Diligence–15E (§ 249b.500 of this chapter) containing information about the security or money market instrument delivered by a person employed to provide third-party due diligence services with respect to the security or money market instrument.

(b) *Conflicts of interest*. For purposes of this section, each of the following is a conflict of interest:

(1) Being paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite.

(2) Being paid by obligors to determine credit ratings with respect to the obligors.

(3) Being paid for services in addition to determining credit ratings by issuers, underwriters, or obligors that have paid the nationally recognized statistical rating organization to determine a credit rating.

(4) Being paid by persons for subscriptions to receive or access the credit ratings of the nationally recognized statistical rating organization and/or for other services offered by the nationally recognized statistical rating organization where such persons may use the credit ratings of the nationally recognized statistical rating organization to comply with, and obtain benefits or relief under, statutes and regulations using the term *nationally recognized statistical rating organization*.

(5) Being paid by persons for subscriptions to receive or access the credit ratings of the nationally recognized statistical rating organization and/or for other services offered by the nationally recognized statistical rating organization where such persons also may own investments or have entered into transactions that could be favorably or adversely impacted by a credit rating issued by the nationally recognized statistical rating organization.

(6) Allowing persons within the nationally recognized statistical rating organization to directly own securities or money market instruments of, or having other direct ownership interests in, issuers or obligors subject to a credit rating determined by the nationally recognized statistical rating organization.

(7) Allowing persons within the nationally recognized statistical rating organization to have a business relationship that is more than an arms length ordinary course of business relationship with issuers or obligors subject to a credit rating determined by the nationally recognized statistical rating organization.

(8) Having a person associated with the nationally recognized statistical rating organization that is a broker or dealer engaged in the business of underwriting securities or money market instruments.

(9) Issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument;

(10) Any other type of conflict of interest relating to the issuance of credit ratings by the nationally recognized statistical rating organization that is material to the nationally recognized statistical rating organization and that is identified by the nationally recognized statistical rating organization in Exhibit 6 to Form NRSRO in accordance with section 15E(a)(1)(B)(vi) of the Act (15 U.S.C. 78o–7(a)(1)(B)(vi)) and § 240.17g–1.

(c) *Prohibited conflicts*. A nationally recognized statistical rating organization is prohibited from having the following conflicts of interest relating to the issuance or maintenance of a credit rating as a credit rating agency:

(1) The nationally recognized statistical rating organization issues or maintains a credit rating solicited by a person that, in the most recently ended fiscal year, provided the nationally recognized statistical rating organization with net revenue (as reported under § 240.17g–3) equaling or exceeding 10% of the total net revenue of the nationally recognized statistical rating organization for the fiscal year;

(2) The nationally recognized statistical rating organization issues or maintains a credit rating with respect to a person (excluding a sovereign nation or an agency of a sovereign nation) where the nationally recognized statistical rating organization, a credit analyst that participated in determining the credit rating, or a person responsible for approving the credit rating, directly owns securities of, or has any other direct ownership interest in, the person that is subject to the credit rating;

(3) The nationally recognized statistical rating organization issues or maintains a credit rating with respect to a person associated with the nationally recognized statistical rating organization;

(4) The nationally recognized statistical rating organization issues or maintains a credit rating where a credit analyst who participated in determining the credit rating, or a person responsible for approving the credit rating, is an officer or director of the person that is subject to the credit rating;

(5) The nationally recognized statistical rating organization issues or maintains a credit rating with respect to an obligor or security where the nationally recognized statistical rating organization or a person associated with the nationally recognized statistical rating organization made recommendations to the obligor or the issuer, underwriter, or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security;

(6) The nationally recognized statistical rating organization issues or maintains a credit rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the nationally recognized statistical rating organization who has responsibility for participating in determining credit ratings or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models;

(7) The nationally recognized statistical rating organization issues or maintains a credit rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating received gifts, including entertainment, from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than $25; or

(8) The nationally recognized statistical rating organization issues or maintains a credit rating where a person within the nationally recognized statistical rating organization who participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative and quantitative models, also:

(i) Participates in sales or marketing of a product or service of the nationally recognized statistical rating organization or a product or service of an affiliate of the nationally recognized statistical rating organization; or

(ii) Is influenced by sales or marketing considerations.

(d) For the purposes of this section, the term *person within a nationally recognized statistical rating organization* means a nationally recognized statistical rating organization, its credit rating affiliates identified on Form NRSRO, and any partner, officer, director, branch manager, and employee of the nationally recognized statistical rating organization or its credit rating affiliates (or any person occupying a similar status or performing similar functions).

(e) *Certification.* In order to access a password-protected Internet Web site described in paragraph (a)(3) of this section, a nationally recognized statistical rating organization must furnish to the Commission, for each calendar year for which it is requesting a password, the following certification, signed by a person duly authorized by the certifying entity:

The undersigned hereby certifies that it will access the Internet Web sites described in 17 CFR 240.17g–5(a)(3) solely for the purpose of determining or monitoring credit ratings. Further, the undersigned certifies that it will keep the information it accesses pursuant to 17 CFR 240.17g–5(a)(3) confidential and treat it as material nonpublic information subject to its written policies and procedures established, maintained, and enforced pursuant to section 15E(g)(1) of the Act (15 U.S.C. 78o–7(g)(1)) and 17 CFR 240.17g–4. Further, the undersigned certifies that it will determine and maintain credit ratings for at least 10% of the issued securities and money market instruments for which it accesses information pursuant to 17 CFR 240.17g–5(a)(3)(iii), if it accesses such information for 10 or more issued securities or money market instruments in the calendar year covered by the certification. Further, the undersigned certifies one of the following as applicable: (1) In the most recent calendar year during which it accessed information pursuant to 17 CFR 240.17g–5(a)(3), the undersigned accessed information for [Insert Number] issued securities and money market instruments through Internet Web sites described in 17 CFR 240.17g–5(a)(3) and determined and maintained credit ratings for [Insert Number] of such securities and money market instruments; or (2) The undersigned previously has not accessed information pursuant to 17 CFR 240.17g–5(a)(3) 10 or more times during the most recently ended calendar year.

(f) Upon written application by a nationally recognized statistical rating organization, the Commission may exempt, either unconditionally or on specified terms and conditions, such nationally recognized statistical rating organization from the provisions of paragraph (c)(8) of this section if the Commission finds that due to the small size of the nationally recognized statistical rating organization it is not appropriate to require the separation within the nationally recognized statistical rating organization of the production of credit ratings from sales and marketing activities and such exemption is in the public interest.

(g) In a proceeding pursuant to section 15E(d)(1) of the Act (15 U.S.C. 78o–7(d)(1)), the Commission shall suspend or revoke the registration of a nationally recognized statistical rating organization if the Commission finds, in lieu of a finding specified under sections 15E(d)(1)(A), (B), (C), (D), (E), or (F) of the Act (15 U.S.C. 78o–7(d)(1)(A) through (F)), that the nationally recognized statistical rating organization has violated a rule issued under section 15E(h) of the Act (15 U.S.C. 78o–7(h)) and that the violation affected a credit rating.

[72 FR 33620, June 18, 2007, as amended at 74 FR 6482, Feb. 9, 2009; 74 FR 63864, Dec. 4, 2009; 79 FR 55264, Sept. 15, 2014; 79 FR 61576, Oct. 14, 2014]

§ 240.17g–6 Prohibited acts and practices.

(a) *Prohibitions.* A nationally recognized statistical rating organization is prohibited from engaging in any of the following unfair, coercive, or abusive practices:

(1) Conditioning or threatening to condition the issuance of a credit rating on the purchase by an obligor or issuer, or an affiliate of the obligor or issuer, of any other services or products, including pre-credit rating assessment products, of the nationally recognized statistical rating organization or any person associated with the nationally recognized statistical rating organization.

(2) Issuing, or offering or threatening to issue, a credit rating that is not determined in accordance with the nationally recognized statistical rating organization's established procedures and methodologies for determining credit ratings, based on whether the rated person, or an affiliate of the rated person, purchases or will purchase the credit rating or any other service or product of the nationally recognized statistical rating organization or any person associated with the nationally recognized statistical rating organization.

(3) Modifying, or offering or threatening to modify, a credit rating in a manner that is contrary to the nationally recognized statistical rating organization's established procedures and methodologies for modifying credit ratings based on whether the rated person, or an affiliate of the rated person, purchases or will purchase the credit rating or any other service or product of the nationally recognized statistical rating organization or any person associated with the nationally recognized statistical rating organization.

(4) Issuing or threatening to issue a lower credit rating, lowering or threatening to lower an existing credit rating, refusing to issue a credit rating, or

withdrawing or threatening to withdraw a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed securities transaction, unless all or a portion of the assets within such pool or part of such transaction also are rated by the nationally recognized statistical rating organization, where such practice is engaged in by the nationally recognized statistical rating organization for an anticompetitive purpose.

[13 FR 8178, Dec. 22, 1948, as amended at 79 FR 55264, Sept. 15, 2014]

§ 240.17g–7 Disclosure requirements.

(a) *Disclosures to be made when taking a rating action.* Except as provided in paragraph (a)(3) of this section, a nationally recognized statistical rating organization must publish the items described in paragraphs (a)(1) and (2) of this section, as applicable, when taking a rating action with respect to a credit rating assigned to an obligor, security, or money market instrument in a class of credit ratings for which the nationally recognized statistical rating organization is registered. For purposes of this section, the term *rating action* means any of the following: the publication of an expected or preliminary credit rating assigned to an obligor, security, or money market instrument before the publication of an initial credit rating; an initial credit rating; an upgrade or downgrade of an existing credit rating (including a downgrade to, or assignment of, default); and an affirmation or withdrawal of an existing credit rating if the affirmation or withdrawal is the result of a review of the credit rating assigned to the obligor, security, or money market instrument by the nationally recognized statistical rating organization using applicable procedures and methodologies for determining credit ratings. The items described in paragraphs (a)(1) and (2) of this section must be published in the same manner as the credit rating that is the result or subject of the rating action and made available to the same persons who can receive or access the credit rating that is the result or subject of the rating action.

(1) *Information disclosure form.* A form generated by the nationally recognized statistical rating organization that meets the requirements of paragraphs (a)(1)(i) through (iii) of this section.

(i) *Format.* The form generated by the nationally recognized statistical rating organization must be in a format that:

(A) Organizes the information into numbered items that are identified by the type of information being disclosed and a reference to the paragraph in this section that specifies the disclosure of the information, and are in the order that the paragraphs specifying the information to be disclosed are codified in this section;

Note to paragraph (a)(1)(i)(A): A given item in the form should be identified by a title that identifies the type of information and references paragraph (a)(1)(ii)(A), (B), (C), (D), (E), (F), (G), (H), (I), (J), (K), (L), (M), (N), or (a)(2) of this section based on the information being disclosed in the item. For example, the information specified in paragraph (a)(1)(ii)(C) of this section should be identified with the caption ''Main Assumptions and Principles Used to Construct the Rating Methodology used to Determine the Credit Rating as required by Paragraph (a)(1)(ii)(C) of Rule 17g–7''). The form must organize the items of information in the following order: items 1 through 14 must contain the information specified in paragraphs (a)(1)(ii)(A) through (N) of this section, respectively, and item 15 must contain the certifications specified in paragraph (a)(2) of this section (the information specified in each paragraph comprising a separate item). For example, item 3 must contain the information specified in paragraph (a)(1)(ii)(C) of this section.

(B) Is easy to use and helpful for users of credit ratings to understand the information contained in the form; and

(C) Provides the content described in paragraphs (a)(1)(ii)(K) through (M) of this section in a manner that is directly comparable across types of obligors, securities, and money market instruments.

(ii) *Content.* The form generated by the nationally recognized statistical rating organization must contain the following information about the credit rating:

(A) The symbol, number, or score in the rating scale used by the nationally recognized statistical rating organization to denote credit rating categories and notches within categories assigned to the obligor, security, or money market instrument that is the subject of the credit rating and, as applicable, the identity of the obligor or the identity and a description of the security or money market instrument;

(B) The version of the procedure or methodology used to determine the credit rating;

(C) The main assumptions and principles used in constructing the procedures and methodologies used to determine the credit rating, including qualitative methodologies and quantitative inputs, and, if the credit rating is for a structured finance product, assumptions about the correlation of defaults across the underlying assets;

(D) The potential limitations of the credit rating, including the types of risks excluded from the credit rating that the nationally recognized statistical rating organization does not comment on, including, as applicable, liquidity, market, and other risks;

(E) Information on the uncertainty of the credit rating including:

(*1*) Information on the reliability, accuracy, and quality of the data relied on in determining the credit rating; and

(*2*) A statement relating to the extent to which data essential to the determination of the credit rating were reliable or limited, including:

(*i*) Any limits on the scope of historical data; and

(*ii*) Any limits on accessibility to certain documents or other types of information that would have better informed the credit rating;

(F) Whether and to what extent the nationally recognized statistical rating organization used due diligence services of a third party in taking the rating action, and, if the nationally recognized statistical rating organization used such services, either:

(*1*) A description of the information that the third party reviewed in conducting the due diligence services and a summary of the findings and conclusions of the third party; or

(*2*) A cross-reference to a Form ABS Due Diligence–15E executed by the third party that is published with the form, provided the cross-referenced Form ABS Due Diligence–15E (§ 249b.500 of this chapter) contains a description of the information that the third party reviewed in conducting the due diligence services and a summary of the findings and conclusions of the third party;

(G) If applicable, how servicer or remittance reports were used, and with what frequency, to conduct surveillance of the credit rating;

(H) A description of the types of data about any obligor, issuer, security, or money market instrument that were relied upon for the purpose of determining the credit rating;

(I) A statement containing an overall assessment of the quality of information available and considered in determining the credit rating for the obligor, security, or money market instrument, in relation to the quality of information available to the nationally recognized statistical rating organization in rating similar obligors, securities, or money market instruments;

(J) Information relating to conflicts of interest of the nationally recognized statistical rating organization, which must include:

(*1*) As applicable, a statement that the nationally recognized statistical rating organization was:

(*i*) Paid to determine the credit rating by the obligor being rated or the issuer, underwriter, depositor, or sponsor of the security or money market instrument being rated;

(*ii*) Paid to determine the credit rating by a person other than the obligor being rated or the issuer, underwriter, depositor, or sponsor of the security or money market instrument being rated; or

(*iii*) Not paid to determine the credit rating;

(*2*) If applicable, in a statement required under paragraph (a)(1)(ii)(J)(*1*)(*i*) or (*ii*) of this section, a statement that the nationally recognized statistical rating organization also was paid for services other than determining credit ratings during the most recently ended fiscal year by the person that paid the nationally recognized statistical rating organization to determine the credit rating; and

(*3*) If the rating action results from a review conducted pursuant to section 15E(h)(4)(A) of the Act (15 U.S.C. 78o–7(h)(4)(A)) and § 240.17g–8(c), the following information (as applicable):

(*i*) If the rating action is a revision of a credit rating pursuant to § 240.17g–8(c)(2)(i)(A), an explanation that the reason for the action is the discovery that a credit rating assigned to the obligor, security, or money market instrument in one or more prior rating actions was influenced by a conflict of interest, including a description of the nature of the conflict, the date and associated credit rating of each prior rating action that the nationally recognized statistical rating organization has determined was influenced by the conflict, and a description of the impact the conflict had on the prior rating action or actions; or

(*ii*) If the rating action is an affirmation of a credit rating pursuant to § 240.17g–8(c)(2)(i)(B), an explanation that the reason for the action is the discovery that a credit rating assigned to the obligor, security, or money market instrument in one or more prior rating actions was influenced by a conflict of interest, including a description of the nature of the conflict, an explanation of why no rating action was taken to revise the credit rating notwithstanding the presence of the conflict, the date and associated credit rating of each prior rating action the nationally recognized statistical rating organization has determined was influenced by the conflict, and a description of the impact the conflict had on the prior rating action or actions.

(K) An explanation or measure of the potential volatility of the credit rating, including:

(*1*) Any factors that are reasonably likely to lead to a change in the credit rating; and

(*2*) The magnitude of the change that could occur under different market conditions determined by the nationally recognized statistical rating organization to be relevant to the rating;

(L) Information on the content of the credit rating, including:

(*1*) If applicable, the historical performance of the credit rating; and

(*2*) The expected probability of default and the expected loss in the event of default;

(M) Information on the sensitivity of the credit rating to assumptions made by the nationally recognized statistical rating organization, including:

(*1*) Five assumptions made in the ratings process that, without accounting for any other factor, would have the greatest impact on the credit rating if the assumptions were proven false or inaccurate; provided that, if the nationally recognized statistical rating organization has made fewer than five such assumptions, it need only disclose information on the assumptions that would have an impact on the credit rating; and

(*2*) An analysis, using specific examples, of how each of the assumptions identified in paragraph (a)(1)(ii)(M)(*1*) of this section impacts the credit rating;

(N)(*1*) If the credit rating is assigned to an asset-backed security as defined in section 3(a)(79) of the Act (15 U.S.C. 78c(a)(79)), information on:

(*i*) The representations, warranties, and enforcement mechanisms available to investors which were disclosed in the prospectus, private placement memorandum or other offering documents for the asset-backed security and that relate to the asset pool underlying the asset-backed security; and

(*ii*) How they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities;

(*2*) A nationally recognized statistical rating organization must include the information required under paragraph (a)(1)(ii)(N)(*1*) of this section only if the rating action is a preliminary credit rating, an initial credit rating, or, in the case of a rating action other than a preliminary credit rating or initial credit rating, the rating action is the first rating action taken after a material change in the representations, warranties, or enforcement mechanisms described in paragraph (a)(1)(ii)(N)(*1*) of this section and the rating action involves an asset-backed security that was initially rated by the nationally recognized statistical rating organization on or after September 26, 2011.

(iii) *Attestation*. The nationally recognized statistical rating organization must attach to the form a signed statement by a person within the nationally recognized statistical rating organization stating that the person has responsibility for the rating action and, to the best knowledge of the person:

(A) No part of the credit rating was influenced by any other business activities;

(B) The credit rating was based solely upon the merits of the obligor, security, or money market instrument being rated; and

(C) The credit rating was an independent evaluation of the credit risk of the obligor, security, or money market instrument.

(2) *Third-party due diligence certification*. Any executed Form ABS Due Diligence–15E (§ 249b.500 of this chapter) containing information about the security or money market instrument subject to the rating action that is received by the nationally recognized statistical rating organization or obtained by the nationally recognized statistical rating organization through an Internet Web site maintained by the issuer, sponsor, or underwriter of the security or money market instrument pursuant to § 240.17g–5(a)(3).

(3) *Exemption*. The provisions of paragraphs (a)(1) and (a)(2) do not apply to a rating action if:

(i) The rated obligor or issuer of the rated security or money market instrument is not a U.S. person (as defined in § 230.902(k) of this chapter); and

(ii) The nationally recognized statistical rating organization has a reasonable basis to conclude that a security or money market instrument issued by the rated obligor or the issuer will be offered and sold upon issuance, and that any underwriter or arranger linked to the security or money market instrument will effect transactions in the security or money market instrument after issuance, only in transactions that occur outside the United States.

(b) *Disclosure of credit rating histories*—(1) *Credit ratings subject to the disclosure requirement*. A nationally recognized statistical rating organization must publicly disclose for free on an easily accessible portion of its corporate Internet Web site:

(i) For a class of credit rating in which the nationally recognized statistical rating organization is registered with the Commission as of the effective date of paragraph (b) of this section, the credit rating assigned to each obligor, security, and money market instrument in the class that was outstanding as of, or initially determined on or after, the date three years prior to the effective date of this rule, and any subsequent upgrade or downgrade of the credit rating (including a downgrade to, or assignment of, default), and a withdrawal of the credit rating; and

(ii) For a class of credit rating in which the nationally recognized statistical rating organization is registered with the Commission after the effective date of paragraph (b) of this section, the credit rating assigned to each obligor, security, and money market instrument in the class that was outstanding as of, or initially determined on or after, the date three years prior to the date the nationally recognized statistical rating organization is registered in the class, and any subsequent upgrade or downgrade of the credit rating (including a downgrade to, or assignment of, default), and a withdrawal of the credit rating.

(2) *Information*. A nationally recognized statistical rating organization must include, at a minimum, the following information with each credit rating disclosed pursuant to paragraph (b)(1) of this section:

(i) The identity of the nationally recognized statistical rating organization disclosing the rating action;

(ii) The date of the rating action;

(iii) If the rating action is taken with respect to a credit rating of an obligor as an entity, the following identifying information about the obligor, as applicable:

(A) The Legal Entity Identifier issued by a utility endorsed or otherwise governed by the Global LEI Regulatory Oversight Committee or the Global LEI Foundation (LEI) of the obligor, if available, or, if an LEI is not available, the Central Index Key (CIK) number of the obligor, if available; and

(B) The name of the obligor.

(iv) If the rating action is taken with respect to a credit rating of a security or money market instrument, as applicable:

(A) The LEI of the issuer of the security or money market instrument, if available, or, if an LEI is not available, the CIK number of the issuer of the security or money market instrument, if available;

(B) The name of the issuer of the security or money market instrument; and

(C) The CUSIP of the security or money market instrument;

(v) A classification of the rating action as either:

(A) An addition to the rating history disclosure because the credit rating was outstanding as of the date three years prior to the effective date of the requirements in paragraph (b) of this section or because the credit rating was outstanding as of the date three years prior to the nationally recognized statistical rating organization becoming registered in the class of credit ratings;

(B) An initial credit rating;

(C) An upgrade of an existing credit rating;

(D) A downgrade of an existing credit rating, which would include classifying the obligor, security, or money market instrument as in default, if applicable; or

(E) A withdrawal of an existing credit rating and, if the classification is withdrawal, the nationally recognized statistical rating organization also must classify the reason for the withdrawal as either:

(*1*) The obligor defaulted, or the security or money market instrument went into default;

(*2*) The obligation subject to the credit rating was extinguished by payment in full of all outstanding principal and interest due on the obligation according to the terms of the obligation; or

(*3*) The credit rating was withdrawn for reasons other than those set forth in paragraph (b)(2)(v)(E)(*1*) or (*2*) of this section; and

(vi) The classification of the class or subclass that applies to the credit rating as either:

(A) Financial institutions, brokers, or dealers;

(B) Insurance companies;

(C) Corporate issuers; or

(D) Issuers of structured finance products in one of the following subclasses:

(*1*) Residential mortgage backed securities (''RMBS'') (for purposes of this subclass, RMBS means a securitization primarily of residential mortgages);

(*2*) Commercial mortgage backed securities (''CMBS'') (for purposes of this subclass, CMBS means a securitization primarily of commercial mortgages);

(*3*) Collateralized loan obligations (''CLOs'') (for purposes of this subclass, a CLO means a securitization primarily of commercial loans);

(*4*) Collateralized debt obligations (''CDOs'') (for purposes of this subclass, a CDO means a securitization primarily of other debt instruments such as RMBS, CMBS, CLOs, CDOs, other asset backed securities, and corporate bonds);

(*5*) Asset-backed commercial paper conduits (''ABCP'') (for purposes of this subclass, ABCP means short term notes issued by a structure that securitizes a variety of financial assets, such as trade receivables or credit card receivables, which secure the notes);

(*6*) Other asset-backed securities (''other ABS'') (for purposes of this subclass, other ABS means a securitization primarily of auto loans, auto leases, floor plans, credit card receivables, student loans, consumer loans, or equipment leases); or

(*7*) Other structured finance products (''other SFPs'') (for purposes of this subclass, other SFPs means any structured finance product not identified in paragraphs (b)(2)(iv)(D)(*1*) through (*6*)) of this section; or

(E) Issuers of government securities, municipal securities, or securities issued by a foreign government in one of the following subclasses:

(*1*) Sovereign issuers;

(*2*) U.S. public finance; or

(*3*) International public finance; and

(vii) The credit rating symbol, number, or score in the applicable rating scale of the nationally recognized statistical rating organization assigned to the obligor, security, or money market instrument as a result of the rating action or, if the credit rating remained unchanged as a result of the action, the credit rating symbol, number, or score in the applicable rating scale of the nationally recognized statistical rating organization assigned to the obligor, security, or money market instrument as of the date of the rating action (in either case, include a credit rating in a default category, if applicable).

(3) *Format and frequency of updating.* The information identified in paragraph (b)(2) of this section must be disclosed in an interactive data file that uses an XBRL (eXtensible Business Reporting Language) format and the List of XBRL Tags for nationally recognized statistical rating organizations as published on the Internet Web site of the Commission, and must be updated no less frequently than monthly.

(4) *Timing.* The nationally recognized statistical rating organization must disclose the information required in paragraph (b)(2) of this section:

(i) Within twelve months from the date the rating action is taken, if the credit rating subject to the action was paid for by the obligor being rated or by the issuer, underwriter, depositor, or sponsor of the security being rated; or

(ii) Within twenty-four months from the date the rating action is taken, if the credit rating subject to the action is not a credit rating described in paragraph (b)(4)(i) of this section.

(5) *Removal of a credit rating history.* The nationally recognized statistical rating organization may cease disclosing a rating history of an obligor, security, or money market instrument if at least 15 years have elapsed since a rating action classified as a withdrawal of a credit rating pursuant to paragraph (b)(2)(v)(E) of this section was disclosed in the rating history of the obligor, security, or money market instrument.

[79 FR 55264, Sept. 15, 2014]

§ 240.17g–8 Policies, procedures, and internal controls.

(a) *Policies and procedures with respect to the procedures and methodologies used to determine credit ratings.* A nationally recognized statistical rating organization must establish, maintain, enforce, and document policies and procedures reasonably designed to ensure:

(1) That the procedures and methodologies, including qualitative and quantitative data and models, the nationally recognized statistical rating organization uses to determine credit ratings are approved by its board of directors or a body performing a function similar to that of a board of directors.

(2) That the procedures and methodologies, including qualitative and quantitative data and models, the nationally recognized statistical rating organization uses to determine credit ratings are developed and modified in accordance with the policies and procedures of the nationally recognized statistical rating organization.

(3) That material changes to the procedures and methodologies, including changes to qualitative and quantitative data and models, the nationally recognized statistical rating organization uses to determine credit ratings are:

(i) Applied consistently to all current and future credit ratings to which the changed procedures or methodologies apply; and

(ii) To the extent that the changes are to surveillance or monitoring procedures and methodologies, applied to current credit ratings to which the changed procedures or methodologies apply within a reasonable period of time, taking into consideration the number of credit ratings impacted, the complexity of the procedures and methodologies used to determine the credit ratings, and the type of obligor, security, or money market instrument being rated.

(4) That the nationally recognized statistical rating organization promptly publishes on an easily accessible portion of its corporate Internet Web site:

(i) Material changes to the procedures and methodologies, including to qualitative models or quantitative inputs, the nationally recognized statistical rating organization uses to determine credit ratings, the reason for the changes, and the likelihood the changes will result in changes to any current credit ratings; and

(ii) Notice of the existence of a significant error identified in a procedure or methodology, including a qualitative or quantitative model, the nationally recognized statistical rating organization uses to determine credit ratings that may result in a change to current credit ratings.

(5) That the nationally recognized statistical rating organization discloses the version of a credit rating procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating.

(b) *Policies and procedures with respect to credit rating symbols, numbers, or scores.* A nationally recognized statistical rating organization must establish, maintain, enforce, and document policies and procedures that are reasonably designed to:

(1) Assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument.

(2) Clearly define each symbol, number, or score in the rating scale used by the nationally recognized statistical rating organization to denote a credit rating category and notches within a category for each class of credit ratings for which the nationally recognized statistical rating organization is registered (including subclasses within each class) and to include such definitions in Exhibit 1 to Form NRSRO (§ 249b.300 of this chapter).

(3) Apply any symbol, number, or score defined pursuant to paragraph (b)(2) of this section in a manner that is consistent for all types of obligors, securities, and money market instruments for which the symbol, number, or score is used.

(c) *Policies and procedures with respect to look-back reviews.* The policies and procedures a nationally recognized statistical rating organization is required to establish, maintain, and enforce pursuant to section 15E(h)(4)(A) of the Act (15 U.S.C. 78o–7(h)(4)(A)) must address instances in which a review conducted pursuant to those policies and procedures determines that a conflict of interest influenced a credit rating assigned to an obligor, security, or money market instrument by including, at a minimum, procedures that are reasonably designed to ensure that the nationally recognized statistical rating organization will:

(1) Promptly determine whether the current credit rating assigned to the obligor, security, or money market instrument must be revised so that it no longer is influenced by a conflict of interest and is solely a product of the documented procedures and methodologies the nationally recognized statistical rating organization uses to determine credit ratings; and

(2)(i) Promptly publish, based on the determination of whether a current credit rating referred to in paragraph (c)(1) of this section must be revised (as applicable):

(A) A revised credit rating, if appropriate, and include with the publication of the revised credit rating the information required by § 240.17g–7(a)(1)(ii)(J)(*3*)(*i*); or

(B) An affirmation of the credit rating, if appropriate, and include with the publication of the affirmation the information required by § 240.17g–7(a)(1)(ii)(J)(*3*)(*ii*).

(ii) If the credit rating is not revised or affirmed pursuant to paragraph (c)(2)(i) of this section within fifteen calendar days of the date of the discovery that the credit rating was influenced by a conflict of interest, publish a rating action placing the credit rating on watch or review and include with the publication an explanation that the reason for the action is the discovery that the credit rating was influenced by a conflict of interest.

(d) *Internal control structures.* A nationally recognized statistical rating organization must take into consideration the factors identified in paragraphs (d)(1) through (4) of this section when establishing, maintaining, enforcing, and documenting an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings pursuant to section 15E(c)(3)(A) of the Act.

(1) With respect to establishing the internal control structure, the nationally recognized statistical rating organization must take into consideration:

(i) Controls reasonably designed to ensure that a newly developed methodology or proposed update to an in-use methodology for determining credit ratings is subject to an appropriate review process (for example, by persons who are independent from the persons that developed the methodology or methodology update) and to management approval prior to the new or updated methodology being employed by the nationally recognized statistical rating organization to determine credit ratings;

(ii) Controls reasonably designed to ensure that a newly developed methodology or update to an in-use methodology for determining credit ratings is disclosed to the public for consultation prior to the new or updated methodology being employed by the nationally recognized statistical rating organization to determine credit ratings, that the nationally recognized statistical rating organization makes comments received as part of the consultation publicly available, and that the nationally recognized statistical rating organization considers the comments before implementing the methodology;

(iii) Controls reasonably designed to ensure that in-use methodologies for determining credit ratings are periodically reviewed (for example, by persons who are independent from the persons who developed and/or use the methodology) in order to analyze whether the methodology should be updated;

(iv) Controls reasonably designed to ensure that market participants have an opportunity to provide comment on whether in-use methodologies for determining credit ratings should be updated, that the nationally recognized statistical rating organization makes any such comments received publicly available, and that the nationally recognized statistical rating organization considers the comments;

(v) Controls reasonably designed to ensure that newly developed or updated quantitative models proposed to be incorporated into a credit rating methodology are evaluated and validated prior to being put into use;

(vi) Controls reasonably designed to ensure that quantitative models incorporated into in-use credit rating methodologies are periodically reviewed and back-tested;

(vii) Controls reasonably designed to ensure that a nationally recognized statistical rating organization engages in analysis before commencing the rating of a class of obligors, securities, or money market instruments the nationally recognized statistical rating organization has not previously rated to determine whether the nationally recognized statistical rating organization has sufficient competency, access to necessary information, and resources to rate the type of obligor, security, or money market instrument;

(viii) Controls reasonably designed to ensure that a nationally recognized statistical rating organization engages in analysis before commencing the rating of an ''exotic'' or ''bespoke'' type of obligor, security, or money market instrument to review the feasibility of determining a credit rating;

(ix) Controls reasonably designed to ensure that measures (for example, statistics) are used to evaluate the performance of credit ratings as part of the review of in-use methodologies for determining credit ratings to analyze whether the methodologies should be updated or the work of the analysts employing the methodologies should be reviewed;

(x) Controls reasonably designed to ensure that, with respect to determining credit ratings, the work and conclusions of the lead credit analyst developing an initial credit rating or conducting surveillance on an existing credit rating is reviewed by other analysts, supervisors, or senior managers before a rating action is formally taken (for example, having the work reviewed through a rating committee process);

(xi) Controls reasonably designed to ensure that a credit analyst documents the steps taken in developing an initial credit rating or conducting surveillance on an existing credit rating with sufficient detail to permit an after-the-fact review or internal audit of the rating file to analyze whether the analyst adhered to the nationally recognized statistical rating organization's procedures and methodologies for determining credit ratings;

(xii) Controls reasonably designed to ensure that the nationally recognized statistical rating organization conducts periodic reviews or internal audits of rating files to analyze whether analysts adhere to the nationally recognized statistical rating organization's procedures and methodologies for determining credit ratings; and

(xiii) Any other controls necessary to establish an effective internal control structure taking into consideration the nature of the business of the nationally recognized statistical rating organization, including its size, activities, organizational structure, and business model.

(2) With respect to maintaining the internal control structure, the nationally recognized statistical rating organization must take into consideration:

(i) Controls reasonably designed to ensure that the nationally recognized statistical rating organization conducts periodic reviews of whether it has devoted sufficient resources to implement and operate the documented internal control structure as designed;

(ii) Controls reasonably designed to ensure that the nationally recognized statistical rating organization conducts periodic reviews or ongoing monitoring to evaluate the effectiveness of the internal control structure and whether it should be updated;

(iii) Controls reasonably designed to ensure that any identified deficiencies in the internal control structure are assessed and addressed on a timely basis;

(iv) Any other controls necessary to maintain an effective internal control structure taking into consideration the nature of the business of the nationally recognized statistical rating organization, including its size, activities, organizational structure, and business model.

(3) With respect to enforcing the internal control structure, the nationally recognized statistical rating organization must take into consideration:

(i) Controls designed to ensure that additional training is provided or discipline taken with respect to employees who fail to adhere to requirements imposed by the internal control structure;

(ii) Controls designed to ensure that a process is in place for employees to report failures to adhere to the internal control structure; and

(iii) Any other controls necessary to enforce an effective internal control structure taking into consideration the nature of the business of the nationally recognized statistical rating organization, including its size, activities, organizational structure, and business model.

(4) With respect to documenting the internal control structure, the nationally recognized statistical rating organization must take into consideration any controls necessary to document an effective internal control structure taking into consideration the nature of the business of the nationally recognized statistical rating organization, including its size, activities, organizational structure, and business model.

[79 FR 55267, Sept. 15, 2014]

§ 240.17g–9 Standards of training, experience, and competence for credit analysts.

(a) A nationally recognized statistical rating organization must establish, maintain, enforce, and document standards of training, experience, and competence for the individuals it employs to participate in the determination of credit ratings that are reasonably designed to achieve the objective that the nationally recognized statistical rating organization produces accurate credit ratings in the classes of credit ratings for which the nationally recognized statistical rating organization is registered.

(b) The nationally recognized statistical rating organization must consider the following when establishing the standards required under paragraph (a) of this section:

(1) If the credit rating procedures and methodologies used by the individual involve qualitative analysis, the knowledge necessary to effectively evaluate and process the data relevant to the creditworthiness of the obligor being rated or the issuer of the securities or money market instruments being rated;

(2) If the credit rating procedures and methodologies used by the individual

involve quantitative analysis, the technical expertise necessary to understand any models and model inputs that are a part of the procedures and methodologies;

(3) The classes and subclasses of credit ratings for which the individual participates in determining credit ratings and the factors relevant to such classes and subclasses, including the geographic location, sector, industry, regulatory and legal framework, and underlying assets, applicable to the obligors or issuers in the classes and subclasses; and

(4) The complexity of the obligors, securities, or money market instruments for which the individual participates in determining credit ratings.

(c) The nationally recognized statistical rating organization must include the following in the standards required under paragraph (a) of this section:

(1) A requirement for periodic testing of the individuals employed by the nationally recognized statistical rating organization to participate in the determination of credit ratings on their knowledge of the procedures and methodologies used by the nationally recognized statistical rating organization to determine credit ratings in the classes and subclasses of credit ratings for which the individual participates in determining credit ratings; and

(2) A requirement that at least one individual with an appropriate level of experience in performing credit analysis, but not less than three years, participates in the determination of a credit rating.

[79 FR 55269, Sept. 15, 2014]

§ 240.17g–10 Certification of providers of third-party due diligence services in connection with asset-backed securities.

(a) The written certification that a person employed to provide third-party due diligence services is required to provide to a nationally recognized statistical rating organization pursuant to section 15E(s)(4)(B) of the Act (15 U.S.C. 78o–7(s)(4)(B)) must be on Form ABS Due Diligence–15E (§ 249b.500 of this chapter).

(b) The written certification must be signed by an individual who is duly authorized by the person providing the third-party due diligence services to make such a certification.

(c) A person employed to provide third-party due diligence services will be deemed to have satisfied its obligations under section 15E(s)(4)(B) of the Act (15 U.S.C. 78o–7(s)(4)(B)) if the person promptly delivers an executed Form ABS Due Diligence–15E (§ 249b.500 of this chapter) after completion of the due diligence services to:

(1) A nationally recognized statistical rating organization that provided a written request for the Form prior to the completion of the due diligence services stating that the services relate to a credit rating the nationally recognized statistical rating organization is producing;

(2) A nationally recognized statistical rating organization that provides a written request for the Form after the completion of the due diligence services stating that the services relate to a credit rating the nationally recognized statistical rating organization is producing; and

(3) The issuer or underwriter of the asset-backed security for which the due diligence services relate that maintains the Internet Web site with respect to the asset-backed security pursuant to § 240.17g–5(a)(3).

(d) For purposes of section 15E(s)(4)(B) of the Act (15 U.S.C. 78o–7(s)(4)(B)) and this section:

(1) The term *due diligence services* means a review of the assets underlying an asset-backed security, as defined in section 3(a)(79) of the Act (15 U.S.C. 78c(a)(79)) for the purpose of making findings with respect to:

(i) The accuracy of the information or data about the assets provided, directly or indirectly, by the securitizer or originator of the assets;

(ii) Whether the origination of the assets conformed to, or deviated from, stated underwriting or credit extension guidelines, standards, criteria, or other requirements;

(iii) The value of collateral securing the assets;

(iv) Whether the originator of the assets complied with federal, state, or local laws or regulations; or

(v) Any other factor or characteristic of the assets that would be material to the likelihood that the issuer of the asset-backed security will pay interest and principal in accordance with applicable terms and conditions.

(2) The term *issuer* includes a sponsor, as defined in § 229.1101 of this chapter, or depositor, as defined in § 229.1101 of this chapter, that participates in the issuance of an asset-backed security, as defined in section 3(a)(79) of the Act (15 U.S.C. 78c(a)(79)).

(3) The term *originator* has the same meaning as in section 15G(a)(4) of the Act (15 U.S.C. 78o–9(a)(4)).

(4) The term *securitizer* has the same meaning as in section 15G(a)(3) of the Act (15 U.S.C. 78o–9(a)(3)).

[79 FR 55270, Sept. 15, 2014]

§ 240.17h–1T Risk assessment recordkeeping requirements for associated persons of brokers and dealers.

(a) *Requirement to maintain and preserve information*. (1) Every broker or dealer registered with the Commission pursuant to section 15 of the Act, and every municipal securities dealer registered pursuant to Section 15B of the Act for which the Commission is the appropriate regulatory agency, unless exempt pursuant to paragraph (d) of this section, shall maintain and preserve the following information:

(i) An organizational chart which includes the broker or dealer and all its associated persons. Included in the organizational chart shall be a designation of which associated persons are Material Associated Persons as that term is used in paragraph (a)(2) of this section;

(ii) Written policies, procedures, or systems concerning the broker or dealer's:

(A) Method(s) for monitoring and controlling financial and operational risks to it resulting from the activities of any of its associated persons, other than a natural person;

(B) Financing and capital adequacy, including information regarding sources of funding, together with a narrative discussion by management of the liquidity of the material assets, the structure of debt capital, and sources of alternative funding; and

(C) Trading positions and risks, such as records regarding reporting responsibilities for trading activities, policies relating to restrictions or limitations on trading securities and financial instruments or products, and a description of the types of reviews conducted to monitor existing positions, and limitations or restrictions on trading activities.

(iii) A description of all material pending legal or arbitration proceedings involving a Material Associated Person or the broker or dealer that are required to be disclosed by the ultimate holding company under generally accepted accounting principles on a consolidated basis;

(iv) Consolidated and consolidating balance sheets, prepared in accordance with generally accepted accounting principles, which may be unaudited and which shall include the notes to the financial statements, as of quarter end for the broker or dealer and its ultimate holding company;

(v) Quarterly consolidated and consolidating income statements and consolidated cash flow statements, prepared in accordance with generally accepted accounting principles, which may be unaudited and which shall include the notes to the financial statements, for the broker or dealer and its ultimate holding company;

NOTE 1 TO PARAGRAPH (a)(1)(v). Statements of comprehensive income (as defined in § 210.1–02 of Regulation S–X of this chapter) must be included in place of income statements, if required by the applicable generally accepted accounting principles.

(vi) The amount as of quarter end, and at month end if greater than quarter end, of the aggregate long and short securities and commodities positions held by each Material Associated Person, including a separate listing of each single unhedged securities or commodities position, other than U.S. government or agency securities, that exceeds the Materiality Threshold at any month end;

(vii) The notional or contractual amounts, and in the case of options, the value of the underlying instruments, as of quarter end, of financial instruments with off-balance sheet risk and financial instruments with concentrations of credit risk where the Material Associated Person operates a trading book, with a separate entry of each commitment where the credit risk (defined as the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract) with respect to a counterparty exceeds the Materiality Threshold at quarter end;

(viii) The aggregate amount as of quarter end, and the amount at month end if greater than quarter end, of all bridge loans and those other material unsecured extensions of credit (not including intra-group receivables) with an initial or remaining maturity of less than one year by each Material Associated Person, together with the allowance for losses for such transactions, including a specific description of any extensions of credit to a single borrower exceeding the Materiality Threshold at any month end;

(ix) The aggregate amount as of quarter end, and the amount at month end if greater than quarter end, of commercial paper, secured and other unsecured borrowing, bank loans, lines of credit, or any other borrowings, and the principal installments of long-term or medium-term debt, scheduled to mature within twelve months from the most recent fiscal quarter for the broker or dealer and each Material Associated Person; and

(x) Data relating to real estate activities, including mortgage loans and investments in real estate, but not including trading positions in whole loans, conducted by each Material Associated Person, including:

(A) Real estate loans and investments by type of property, such as construction and development, residential, commercial and industrial or farmland;

(B) The geographic distribution, as of quarter end, by type of loan or investment where the amount exceeds the Materiality Threshold at quarter end;

(C) The aggregate carrying value of loans which each Material Associated Person deems to be not current as to interest or principal, together with the Material Associated Person's criteria for the determination of which loans are not current, or which are in the process of foreclosure or that have been restructured;

(D) The allowance for losses on loans and on investment real estate by type of loan or investment, and the activity in the allowance for losses account; and

(E) Information about risk concentration in the real estate investment and loan portfolio, including information about risk concentration to a single borrower or location of property if the risk concentration exceeds the Materiality Threshold at quarter end.

(2) The determination of whether an associated person of a broker or dealer is a Material Associated Person shall involve consideration of all aspects of the activities of, and the relationship between, both entities, including without limitation, the following factors:

(i) The legal relationship between the broker or dealer and the associated person;

(ii) The overall financing requirements of the broker or dealer and the associated person, and the degree, if any, to which the broker or dealer and the associated person are financially dependent on each other;

(iii) The degree, if any, to which the broker or dealer or its customers rely on the associated person for operational support or services in connection with the broker's or dealer's business;

(iv) The level of risk present in the activities of the broker's or dealer's associated persons; and

(v) The extent to which the associated person has the authority or the ability to cause a withdrawal of capital from the broker or dealer.

(3) The information, reports and records required by the provisions of this section shall be maintained and preserved in accordance with the provisions of § 240.17a–4 and shall be kept for a period of not less than three years in an easily accessible place.

(4) For the purposes of this section and § 240.17h–2T, the term ''Materiality Threshold'' shall mean the greater of:

(i) $100 million; or

(ii) 10 percent of the broker or dealer's tentative net capital based on the most recently filed Form X–17A–5 or 10 percent of the Material Associated Person's tangible net worth, whichever is greater.

(b) *Special provisions with respect to material associated persons subject to the supervision of certain domestic regulators.*

A broker or dealer shall be deemed to be in compliance with the recordkeeping requirements of paragraph (a) of this section with respect to a Material Associated Person if:

(1) Such Material Associated Person is subject to examination by, or the reporting requirements of, a Federal banking agency and the broker or dealer maintains in accordance with the provisions of this section copies of all reports submitted by such Material Associated Person with the Federal banking agency pursuant to section 5211 of the Revised Statutes, section 9 of the Federal Reserve Act, section 7(a) of the Federal Deposit Insurance Act, section 10(b) of the Home Owners' Loan Act, or section 5 of the Bank Holding Company Act of 1956 other than the Form FR 2068; or

(2) If such Material Associated Person is subject to the supervision of an insurance commissioner or other similar official or agency of a state, and the broker or dealer maintains in accordance with the provisions of this section copies of the Annual and Quarterly Statements with Schedules and Exhibits prepared by the insurance company on forms prescribed by the National Association of Insurance Commissioners; or

(3) In the event an insurance company is not required to prepare Quarterly Statements on forms prescribed by the National Association of Insurance Commissioners, the broker or dealer must maintain and preserve the records required by paragraph (a) of this section on a quarterly basis; or

(4) In the case of a Material Associated Person that is subject to the supervision of the Commodity Futures Trading Commission, the broker or dealer maintains in accordance with the provisions of this section copies of the reports filed on Forms 1 FR-FCM or 1 FR-IB by such Material Associated Person with the Commodity Futures Trading Commission.

(c) *Special provisions with respect to material associated persons subject to the supervision of a foreign financial regulatory authority*. A broker or dealer shall be deemed to be in compliance with the recordkeeping requirements of paragraph (a) of this section with respect to a Material Associated Person if such broker or dealer maintains in accordance with the provisions of this section copies of the reports filed by such Material Associated Persons with a Foreign Financial Regulatory Authority. The broker or dealer shall maintain a copy of the original report and a copy translated into the English language. For the purposes of this section, the term Foreign Financial Regulatory Authority shall have the meaning set forth in section 3(a)(51) of the Act.

(d) *Exemptions*. (1) The provisions of this section shall not apply to any broker or dealer which is exempt from the provisions of § 240.15c3–3:

(i) Pursuant to paragraph (k)(1) of § 240.15c3–3; or

(ii) Pursuant to paragraph (k)(2) of § 240.15c3–3; or

(iii) If the broker or dealer does not qualify for an exemption from the provisions of § 240.15c3–3 and such broker or dealer does not hold funds or securities for, or owe money or securities to, customers and does not carry the accounts of or for customers; unless

(iv) In the case of paragraphs (d)(1)(ii) or (d)(1)(iii) of this section, the broker or dealer maintains capital including debt subordinated in accordance with appendix D of § 240.15c3–1 equal to or greater than $20,000,000.

(2) The provisions of this section shall not apply to any broker or dealer which maintains capital including debt subordinated in accordance with appendix D of section 240.15c3–1 of less than $250,000, even if the broker or dealer hold funds or securities for, or owes money or securities to, customers or carries the accounts of or for customers.

(3) In calculating capital for the purposes of this paragraph, a broker or dealer shall include the equity capital and subordinated debt of any other registered brokers or dealers that are associated with the broker or dealer and are not otherwise exempt from the provisions pursuant to paragraph (d)(1)(i) of this section.

(4) The provisions of this section shall not apply to a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3–1e if that broker or dealer is affiliated with an ultimate holding company that

is not an ultimate holding company that has a principal regulator, as defined in § 240.15c3–1(c)(13).

(5) The Commission may, upon written application by a Reporting Broker or Dealer, exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any brokers or dealers associated with such Reporting Broker or Dealer. The term "Reporting Broker or Dealer" shall mean, in the case of a broker or dealer that is associated with other registered brokers or dealers, the broker or dealer which maintains the greatest amount of net capital as reported on its most recently fixed Form X–17A–5. In granting exemptions under this section, the Commission shall consider, among other factors, whether the records and other information required to be maintained pursuant to this section concerning the Material Associated Persons of the broker or dealer associated with the Reporting Broker or Dealer will be available to the Commission pursuant to § 240.17h–2T.

(e) *Location of records.* A broker or dealer required to maintain records concerning a Material Associated Person pursuant to this section may maintain those records either at the Material Associated Person or at a records storage facility provided that the records are located within the boundaries of the United States and the records are kept in an easily accessible place, as that term is used in § 240.17a–4. In order to operate pursuant to the provisions of this paragraph, the Material Associated Person or other entity maintaining the records shall file with the Commission a written undertaking in form acceptable to the Commission, signed by a duly authorized person, to the effect that the records will be treated as if the broker or dealer was maintaining the records pursuant to this section and that the entity maintaining the records undertakes to permit examination of such records at any time or from time to time during business hours by representatives or designees of the Commission and to promptly furnish the Commission or its designee true, correct, complete and current hard copy of any or all or any part of such records. The election to operate pursuant to the provisions of this paragraph shall not relieve the broker or dealer required to maintain and preserve such records from any of its responsibilities under this section or section 240.17h–2T.

(f) *Confidentiality.* All information obtained by the Commission pursuant to the provisions of this section from a broker or dealer concerning a Material Associated Person shall be deemed confidential information for the purposes of section 24(b) of the Act.

(g) *Temporary implementation schedule.* Every broker or dealer subject to the requirements of this section shall maintain and preserve the information required by paragraphs (a)(1)(i), (ii), and (iii) of this section commencing September 30, 1992. Commencing December 31, 1992, the provisions of this section shall apply in their entirety.

[57 FR 32168, July 21, 1992, as amended at 58 FR 25774, Apr. 28, 1993; 69 FR 34472, June 21, 2004; 69 FR 34494, June 21, 2004; 76 FR 50122, Aug. 12, 2011; 78 FR 42865, July 18, 2013; 83 FR 50223, Oct. 4, 2018]

§ 240.17h–2T Risk assessment reporting requirements for brokers and dealers.

(a) *Reporting requirements of risk assessment information required to be maintained by section 240.17h–1T.* (1) Every broker or dealer registered with the Commission pursuant to section 15 of the Act, and every municipal securities dealer registered pursuant to section 15B of the Act for which the Commission is the appropriate regulatory agency, unless exempt pursuant to paragraph (b) of this section, shall file a Form 17–H within 60 calendar days after the end of each fiscal quarter. The Form 17–H for the fourth fiscal quarter shall be filed within 60 calendar days of the end of the fiscal year. The cumulative year-end financial statements required by section 240.17h–1T may be filed separately within 105 calendar days of the end of the fiscal year.

(2) The reports required to be filed pursuant to paragraph (a)(1) of this section shall be considered filed when received at the Commission's principal office in Washington, DC.

(3) For the purposes of this section, the term Material Associated Person

shall have the meaning used in §240.17h–1T.

(b) *Exemptions.* (1) The provisions of this section shall not apply to any broker or dealer which is exempt from the provisions of section 240.15c3–3:

(i) Pursuant to paragraph (k)(1) of §240.15c3–3; or

(ii) Pursuant to paragraph (k)(2) of §240.15c3–3; or

(iii) If the broker or dealer does not qualify for an exemption from the provisions of §240.15c3–3 and such broker or dealer does not hold funds or securities for, or owe money or securities to, customers and does not carry the accounts of or for customers; unless

(iv) In the case of paragraphs (b)(1)(ii) or (b)(1)(iii) of this section, the broker or dealer maintains capital including debt subordinated in accordance with appendix D of §240.15c3–1 equal to or greater than $20,000,000.

(2) The provisions of this section shall not apply to any broker or dealer which maintains capital including debt subordinated in accordance with appendix D of §240.15c3–1 of less than $250,000, even if the broker or dealer hold funds or securities for, or owes money or securities to, customers or carries the accounts of or for customers.

(3) In calculating capital and subordinated debt for the purposes of this section, a broker or dealer shall include the equity capital and subordinated debt of any other registered brokers or dealers that are associated with the broker or dealer and are not otherwise exempt from the provisions pursuant to paragraph (b)(1)(i) of this section.

(4) The provisions of this section shall not apply to a broker or dealer that computes certain of its capital charges in accordance with §240.15c3–1e if that broker or dealer is affiliated with an ultimate holding company that is not an ultimate holding company that has a principal regulator, as defined in §240.15c3–1(c)(13).

(5) The Commission may, upon written application by a Reporting Broker or Dealer, exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any brokers or dealers associated with the Reporting Broker or Dealer. The term "Reporting Broker or Dealer" shall mean, in the case of a broker or dealer that is associated with other registered brokers or dealers, the broker or dealer which maintains the greatest amount of net capital as reported on its most recently filed Form X–17A–5. In granting exemptions under this section, the Commission shall consider, among other factors, whether the records and other information required to be maintained pursuant to §240.17h–1T concerning the Material Associated Persons of the broker or dealer associated with the Reporting Broker or Dealer will be available to the Commission pursuant to the provisions of this section.

(c) *Special provisions with respect to material associated persons subject to the supervision of certain domestic regulators.* A broker or dealer shall be deemed to be in compliance with the reporting requirements of paragraph (a) of this section with respect to a Material Associated Person if:

(1) Such Material Associated Person is subject to examination by or the reporting requirements of a Federal banking agency and the broker or dealer or such Material Associated Person furnishes in accordance with paragraph (a) of this section copies of reports filed on Form FR Y–9C, Form FR Y–6, Form FR Y–7, and Form FR 2068 by the Material Associated Person with the Federal banking agency pursuant to section 5211 of the Revised Statutes, section 9 of the Federal Reserve Act, section 7(a) of the Federal Deposit Insurance Act, section 10(b) of the Home Owners' Loan Act, or section 5 of the Bank Holding Company Act of 1956; or

(2) If the Material Associated Person is subject to the supervision of an insurance commissioner or other similar official agency of a state; and

(i) In the case of a Material Associated Person organized as a public stock company, the broker or dealer furnishes in accordance with the provisions of this section copies of the filings made by the insurance company pursuant to sections 13 or 15 of the Act and the Investment Company Act of 1940; or

(ii) In the case of Material Associated Person organized as a mutual insurance company or a non-public stock company, the broker or dealer furnishes in accordance with the provisions of this section copies of the Annual and Quarterly Statements prepared by the insurance company on forms prescribed by the National Association of Insurance Commissioners. The Annual Statement furnished to the Commission pursuant to this section shall include: The classification (distribution by state) section from the schedule of real estate; distribution by state, the interest overdue (more than three months), in process of foreclosure, and foreclosed properties transferred to real estate during the year sections from the schedule of mortgages; and the quality and maturity distribution of all bonds at statement values and by major types of issues section from the schedule of bonds and stocks. All other Schedules and Exhibits to such Annual and Quarterly Statements shall be maintained at the broker-dealer pursuant to the provisions of § 240.17h–1T but not furnished to the Commission.

(iii) In the event an insurance company organized as a stock or mutual company is not required to prepare Quarterly Statements, the broker or dealer must file with the Commission a Form 17–H in accordance with the provisions of this section on a quarterly basis.

(3) In the case of a Material Associated Person that is subject to the supervision of the Commodity Futures Trading Commission, the broker or dealer furnishes in accordance with the provisions of this section copies of the reports filed by the Material Associated Person with the Commodity Futures Trading Commission on Forms 1 FR-FCM or 1 FR-IB.

(4) No broker or dealer shall be required to furnish to the Commission any examination report of any Federal banking agency or any supervisory recommendations or analyses contained therein with respect to a Material Associated Person that is subject to the regulation of a Federal banking agency. All information received by the Commission pursuant to this section concerning a Material Associated Person that is subject to examination by or the reporting requirements of a Federal banking agency shall be deemed confidential for the purposes of section 24(b) of the Act.

(5) The furnishing of any information or documents by a broker or dealer pursuant to this section shall not constitute an admission for any purpose that a Material Associated Person is otherwise subject to the Act. Any documents or information furnished to the Commission by a broker or dealer pursuant to this rule shall not be deemed to be ''filed'' for the purposes of the liabilities set forth in section 18 of the Act.

(d) *Special provisions with respect to material associated persons subject to the supervision of a foreign financial regulatory authority.* A broker or dealer shall be deemed to be in compliance with the reporting requirements of this section with respect to a Material Associated Person if such broker or dealer furnishes in accordance with the provisions of this section copies of the reports filed by such Material Associated Person with a Foreign Financial Regulatory Authority. The broker or dealer shall file a copy of the original report and a copy translated into the English language. For the purposes of this section, the term Foreign Financial Regulatory Authority shall have the meaning set forth in section 3(a)(51) of the Act.

(e) *Confidentiality.* All information obtained by the Commission pursuant to the provisions of this section from a broker or dealer concerning a Material Associated Person shall be deemed confidential information for the purposes of section 24(b) of the Act.

(f) *Temporary implementation schedule.* Every broker or dealer subject to the requirements of this section shall file the information required by Items 1, 2 and 3 of Form 17–H by October 31, 1992. Commencing December 31, 1992, the provisions of this section shall apply in their entirety.

[57 FR 32170, July 21, 1992, as amended at 69 FR 34472, June 21, 2004; 69 FR 34494, June 21, 2004; 78 FR 42865, July 18, 2013]

§ 240.17Ab2–1 Registration of clearing agencies.

(a) An application for registration or for exemption from registration as a clearing agency, as defined in section 3(a)(23) of the Act, or an amendment to any such application shall be filed with the Commission on Form CA–1, in accordance with the instructions thereto.

(b) Any applicant for registration or for exemption from registration as a clearing agency whose application is filed with the Commission on or before November 24, 1975, on and in accordance with the instructions to Form CA–1, with respect to the clearing agency activities described in the application shall, during the period from December 1, 1975 until the Commission grants registration, denies registration or grants an exemption from registration, be exempt from the registration provisions of section 17A(b) of the Act and the rules and regulations thereunder and, unless the Commission shall otherwise provide by rule or by order, the provisions of the Act and the rules and regulations thereunder which would be applicable to clearing agencies as a result of registration under the Act.

(c)(1) The Commission, upon the request of a clearing agency, may grant registration of the clearing agency in accordance with sections 17A(b) and 19(a)(1) of the Act but exempt the registrant from one or more of the requirements as to which the Commission is directed to make a determination pursuant to paragraphs (A) through (I) of section 17A(b)(3) of the Act, provided that any such registration shall be effective only for eighteen months from the date the registration is made effective (or such longer period as the Commission may provide by order).

(2) In the case of any clearing agency registered in accordance with paragraph (c)(1) of this section, not later than nine months from the date such registration is made effective the Commission either will grant registration in accordance with sections 17A(b) and 19(a)(1) of the Act, without exempting the registrant from one or more of the requirements as to which the Commission is directed to make a determination pursuant to subparagraphs (A) through (I) of section 17A(b)(3) of the Act, or will institute proceedings in accordance with section 19(a)(1)(B) of the Act to determine whether registration should be denied at the expiration of the registration granted in accordance with paragraph (c)(1) of this section.

(d) The filing of an amendment to an application for registration or for exemption from registration as a clearing agency, which registration or exemption has not been granted, or the filing of additional information or documents prior to the granting of registration or an exemption from registration shall extend to ninety days from the date such filing is made (or to such longer period as to which the applicant consents) the period within which the Commission shall grant registration, institute proceedings to determine whether such registration shall be denied, or conditionally or unconditionally exempt registrant from the registration and other provisions of section 17A of the Act or the rules or regulations thereunder.

(e) If any information reported at items 1–3 of Form CA–1 is or becomes inaccurate, misleading or incomplete for any reason, whether before or after registration or an exemption from registration has been granted, the registrant shall file promptly an amendment on Form CA–1 correcting the inaccurate, misleading or incomplete information.

(f) Every application for registration or for exemption from registration as a clearing agency or amendment to, or additional information or document filed in connection with, any such application shall constitute a ''report'' or ''application'' within the meaning of sections 17, 17A, 19 and 32(a) of the Act.

[40 FR 52358, Nov. 10, 1975]

§ 240.17Ab2–2 Determinations affecting covered clearing agencies.

(a) The Commission may, if it deems appropriate, upon application by any clearing agency or member of a clearing agency, or on its own initiative, determine whether a covered clearing agency is systemically important in multiple jurisdictions. In determining whether a covered clearing agency is systemically important in multiple jurisdictions, the Commission may consider:

(1) Whether the covered clearing agency is a designated clearing agency; and

(2) Whether the clearing agency has been determined to be systemically important by one or more jurisdictions other than the United States through a process that includes consideration of whether the foreseeable effects of a failure or disruption of the designated clearing agency could threaten the stability of each relevant jurisdiction's financial system.

(b) The Commission may, if it deems appropriate, determine whether any of the activities of a clearing agency providing central counterparty services, in addition to clearing agencies registered with the Commission for the purpose of clearing security-based swaps, have a more complex risk profile. In determining whether a clearing agency's activity has a more complex risk profile, the Commission may consider whether the clearing agency clears financial instruments that are characterized by discrete jump-to-default price changes or that are highly correlated with potential participant defaults.

(c) The Commission may, if it deems appropriate, upon application by any clearing agency or member of a clearing agency, or on its own initiative, determine whether to rescind any determination made pursuant to paragraph (a) or (b) of this section. In determining whether to rescind any such determination, the Commission may consider a change in circumstances such that the covered clearing agency no longer meets the criteria supporting the determination in effect.

(d) The Commission shall publish notice of its intention to consider making a determination under paragraph (a), (b), or (c) of this section, together with a brief statement of the grounds under consideration therefor, and provide at least a 30-day public comment period prior to any such determination, giving all interested persons an opportunity to submit written data, views, and arguments concerning such proposed determination. The Commission may provide the clearing agency subject to the proposed determination opportunity for hearing regarding the proposed determination.

(e) Notice of determinations under paragraph (a), (b), or (c) of this section shall be given by prompt publication thereof, together with a statement of written reasons therefor.

(f) For purposes of this rule, the terms *covered clearing agency*, *designated clearing agency*, and *systemically important in multiple jurisdictions* shall have the meanings set forth in § 240.17Ad–22(a).

[81 FR 70901, Oct. 13, 2016]

§ 240.17Ac2–1 Application for registration of transfer agents.

(a) An application for registration, pursuant to section 17A(c) of the Act, of a transfer agent for which the Commission is the appropriate regulatory agency, as defined in section 3(a)(34)(B) of the Act, shall be filed with the Commission on Form TA–1, in accordance with the instructions contained therein and shall become effective on the thirtieth day following the date on which the application is filed, unless the Commission takes affirmative action to accelerate, deny or postpone such registration in accord- ance with the provisions of section 17A(c) of the Act.

(b) The filing of any amendment to an application for registration as a transfer agent pursuant to paragraph (a) of this section, which registration has not become effective, shall postpone the effective date of the registration until the thirtieth day following the date on which the amendment is filed, unless the Commission takes affirmative action to accelerate, deny or postpone the registration in accordance with the provisions of section 17A(c) of the Act.

(c) If any of the information reported on Form TA–1 (§ 249b.100 of this chapter) becomes inaccurate, misleading, or incomplete, the registrant shall correct the information by filing an amendment within sixty days following the date on which the information becomes inaccurate, misleading, or incomplete.

(d) Every registration and amendment filed pursuant to this section shall be filed with the Commission electronically in the Commission's EDGAR system. Transfer agents should refer to Form TA–1 and the instructions to the form (§ 249b.100 of this chapter) and to the EDGAR Filer Manual (§ 232.301 of this chapter) for the technical requirements and instructions for electronic filing. Transfer agents that have previously filed a Form TA–1 with the Commission must refile the information on their Form TA–1, as amended, in electronic format in EDGAR as an amended Form TA–1.

(e) Every registration and amendment filed pursuant to this section shall constitute a ''report'' or ''application'' within the meaning of sections 17, 17A(c), and 32(a) of the Act.

[40 FR 51184, Nov. 4, 1975, as amended at 51 FR 12127, Apr. 9, 1986; 71 FR 74708, Dec. 12, 2006]

§ 240.17Ac2–2 Annual reporting requirement for registered transfer agents.

(a) Every transfer agent registered on December 31 must file a report covering the reporting period on Form TA–2 (§ 249b.102 of this chapter) by March 31 following the end of the reporting period. Form TA–2 must be completed in accordance with the instructions contained in the Form. A transfer agent may file an amendment to Form TA–2 pursuant to the instructions on the form to correct information that has become inaccurate, incomplete, or misleading. A transfer agent may file an amendment at any time; however, in order to be timely filed, all required portions of the form must be completed and filed in accordance with this section and the instructions to the form by the date the form is required to be filed with the Commission.

(1) A registered transfer agent that received fewer than 1,000 items for transfer in the reporting period and that did not maintain master securityholder files for more than 1,000 individual securityholder accounts as of December 31 of the reporting period must complete Questions 1 through 5, 11, and the signature section of Form TA–2.

(2) A named transfer agent that engaged a service company to perform all of its transfer agent functions during the reporting period must complete Questions 1 through 3 and the signature section of Form TA–2.

(3) A named transfer agent that engaged a service company to perform some but not all of its transfer agent functions during the reporting period must complete all of Form TA–2 but should enter zero (0) for those questions that relate to transfer agent functions performed by the service company on behalf of the named transfer agent.

(b) For purposes of this section, the term *reporting period* shall mean the calendar year ending December 31 for which Form TA–2 is being filed. The term *named transfer agent* shall have the same meaning as defined in § 240.17Ad–9(j). The term *service company* shall have the same meaning as defined in § 240.17Ad–9(k).

(c) Every annual report and amendment filed pursuant to this section shall be filed with the Commission electronically in the Commission's EDGAR system. Transfer agents should refer to Form TA–2 and the instructions to the form (§ 249b.102 of this chapter) and the EDGAR Filer Manual (§ 232.301 of this chapter) for further information regarding electronic filing. Every registered transfer agent must file an electronic Form TA–1 with the Commission, or an electronic amendment to its Form TA–1 if the transfer agent previously filed a paper Form TA–1 with the Commission, before it may file an electronic Form TA–2 or Form TA–W with the Commission.

[65 FR 36610, June 9, 2000, as amended at 71 FR 74708, Dec. 12, 2006]

§ 240.17Ac3–1 Withdrawal from registration with the Commission.

(a) Notice of withdrawal from registration as a transfer agent with the Commission pursuant to section 17A(c)(4) of the Act shall be filed on Form TA-W in accordance with the instructions contained thereon.

(b) Except as hereinafter provided, a notice to withdraw from registration filed by a transfer agent pursuant to section 17A(c)(4) of the Act shall become effective on the sixtieth day after the filing thereof with the Commission or within such shorter period of time as the Commission may determine. If a notice to withdraw from registration is filed with the Commission at any time subsequent to the date of issuance of a Commission order instituting proceedings pursuant to section 17A(c)(3) of the Act, or if prior to the effective date of the notice of withdrawal the

Commission institutes such a proceeding or a proceeding to impose terms and conditions upon such withdrawal, the notice of withdrawal shall not become effective except at such time and upon such terms and conditions as the Commission deems necessary or appropriate in the public interest, for the protection of investors, or in furtherance of the purposes of section 17A.

(c) Every withdrawal from registration filed pursuant to this section shall be filed with the Commission electronically in the Commission's EDGAR system. Transfer agents should refer to Form TA–W and the instructions to the form (§ 249b.101 of this chapter) and the EDGAR Filer Manual (§ 232.301 of this chapter) for further information regarding electronic filing.

(d) Every notice of withdrawal filed pursuant to this rule shall constitute a ''report'' within the meaning of sections 17 and 32(a) of the Act.

[42 FR 44984, Sept. 8, 1977, as amended at 71 FR 74709, Dec. 12, 2006]

§ 240.17Ad–1 Definitions.

As used in this section and §§ 240.17Ad–2, 240.17Ad–3, 240.17Ad–4, 240.17Ad–5, 240.17Ad–6, and 240.17Ad–7:

(a)(1) The term *item* means:

(i) A certificate or certificates of the same issue of securities covered by one ticket (or, if there is no ticket, presented by one presentor) presented for transfer, or an instruction to a transfer agent which holds securities registered in the name of the presentor to transfer or to make available all or a portion of those securities;

(ii) Each line on a ''deposit shipment control list'' or a ''withdrawal shipment control list'' submitted by a registered clearing agency; or

(iii) In the case of an outside registrar, each certificate to be countersigned.

(2) If a ''deposit shipment control list'' or ''withdrawal shipment control list'' contains both routine and non-routine transfer instructions, a registered transfer agent shall at its option:

(i) Retain all transfer instructions listed on the shipment control list and treat each line on the shipment control list as a routine item; or

(ii) Return promptly to the registered clearing agency a shipment control list line containing non-routine transfer instructions (together with a copy of the shipment control list, an explanation for the return instructions and all routine transfer instructions reflected on the same line) and treat each line on the shipment control list that reflects retained transfer instructions as a routine item.

(3) A *deposit shipment control list* means a list of transfer instructions that accompanies certificates to be cancelled and reissued in the nominee name of a registered clearing agency.

(4) A *withdrawal shipment control list* means a list of instructions (either in paper or electronic medium) that:

(i) Directs issuance of certificates in the names of persons or entities other than the registered clearing agency; and

(ii) Accompanies certificates to be cancelled which are registered in the nominee name of a registered clearing agency, or directs the transfer agent to reduce certificate or position balances maintained by the transfer agent on behalf of a registered clearing agency under that clearing agency's transfer agent custody program

(b) The term *outside registrar* with respect to a transfer item means a transfer agent which performs only the registrar function for the certificate or certificates presented for transfer and includes the persons performing similar functions with respect to debt issues.

(c) An item is *made available* when

(1) In the case of an item for which the services of an outside registrar are not required, or which has been received from an outside registrar after processing, the transfer agent dispatches or mails the item to, or the item is awaiting pick-up by, the presentor or a person designated by the presentor, or

(2) In the case of an item for which the services of an outside registrar are required, the transfer agent dispatches or mails the item to, or the item is awaiting pick-up by, the outside registrar, or

(3) In the case of an item for which an outside registrar has completed

processing, the outside registrar dispatches or mails the item to, or the item is awaiting pick-up by, the presenting transfer agent.

(d) The *transfer* of an item is accomplished when, in accordance with the presentor's instructions, all acts necessary to cancel the certificate or certificates presented for transfer and to issue a new certificate or certificates, including the performance of the registrar function, are completed and the item is made available to the presentor by the transfer agent, or when, in accordance with the presentor's instructions, a transfer agent which holds securities registered in the name of the presentor completes all acts necessary to issue a new certificate or certificates representing all or a portion of those securities and makes available the new certificate or certificates to the presentor or a person designated by the presentor or, with respect to those transfers of record ownership to be accomplished without the physical issuance of certificates, completes registration of change in ownership of all or a portion of those securities.

(e) The *turnaround* of an item is completed when transfer is accomplished or, when an outside registrar is involved, the transfer agent in accordance with the presentor's instructions completes all acts necessary to cancel the certificate or certificates presented for transfer and to issue a new certificate or certificates, and the item is made available to an outside registrar.

(f) The term *process* means the accomplishing by an outside registrar of all acts necessary to perform the registrar function and to make available to the presenting transfer agent the completed certificate or certificates or to advise the presenting transfer agent, orally or in writing, why performance of the registrar function is delayed or may not be completed.

(g) The *receipt* of an item or a written inquiry or request occurs when the item or written inquiry or request arrives at the premises at which the transfer agent performs transfer agent functions, as defined in section 3(a)(25) of the Act.

(h) A *business day* is any day during which the transfer agent is normally open for business and excludes Saturdays, Sundays, and legal holidays, or other holidays normally observed by the transfer agent.

(i) An item is *routine* if it does not (1) require requisitioning certificates of an issue for which the transfer agent, under the terms of its agency, does not maintain a supply of certificates; (2) include a certificate as to which the transfer agent has received notice of a stop order, adverse claim, or any other restriction on transfer; (3) require any additional certificates, documentation, instructions, assignments, guarantees, endorsements, explanations, or opinions of counsel before transfer may be effected; (4) require review of supporting documentation other than assignments, endorsements or stock powers, certified corporate resolutions, signature, or other common and ordinary guarantees, or appropriate tax, or tax waivers; (5) involve a transfer in connection with a reorganization, tender offer, exchange, redemption, or liquidation; (6) include a warrant, right, or convertible security presented for transfer of record ownership within five business days before any day upon which exercise or conversion privileges lapse or change; (7) include a warrant, right, or convertible security presented for exercise or conversion; or (8) include a security of an issue which within the previous 15 business days was offered to the public, pursuant to a registration statement effective under the Securities Act of 1933, in an offering not of a continuing nature.

(j) The term *depository-eligible securities issue* means an issue of securities that is eligible for deposit at any securities depository that is registered with the Commission under the Securities Exchange Act of 1934 as a clearing agency.

(Secs. 2, 17, 17A and 23(a) (15 U.S.C. 78b, 78q, 78q–1 and 78w(a)); secs. 3, 17A and 23(a), 15 U.S.C. 78c, 78q–1 and 78w(a))

[42 FR 32411, June 24, 1977, as amended at 49 FR 40575, Oct. 17, 1984; 51 FR 36551, Oct. 14, 1986]

§ 240.17Ad–2 Turnaround, processing, and forwarding of items.

(a) Every registered transfer agent (except when acting as an outside registrar) shall turnaround within three business days of receipt at least 90 percent of all routine items received for transfer during a month. For the purposes of this paragraph, items received at or before noon on a business day shall be deemed to have been received at noon on that day, and items received after noon on a business day or received on a day not a business day shall be deemed to have been received at noon on the next business day.

(b) Every registered transfer agent acting as an outside registrar shall process at least 90 percent of all items received during a month (1) by the opening of business on the next business day, in the case of items received at or before noon on a business day, and (2) by noon of the next business day, in the case of items received after noon on a business day. For the purposes of paragraphs (b) and (d) of this section, ''items received'' shall not include any item enumerated in §240.17Ad–1(i) (5), (6), (7), or (8) or any item which is not accompanied by a debit or cancelled certificate. For the purposes of this paragraph, items received on a day not a business day shall be deemed to have been received before noon on the next business day.

(c) Any registered transfer agent which fails to comply with paragraph (a) of this section with respect to any month shall, within ten business days following the end of such month, file with the Commission and the transfer agent's appropriate regulatory agency, if it is not the Commission, a written notice in accordance with paragraph (h) of this section. Such notice shall state the number of routine items and the number of non-routine items received for transfer during the month, the number of routine items which the registered transfer agent failed to turnaround in accordance with the requirements of paragraph (a) of this section, the percentage that such routine items represent of all routine items received during the month, the reasons for such failure, the steps which have been taken, are being taken or will be taken to prevent a future failure and the number of routine items, aged in increments of one business day, which as of the close of business on the last business day of the month have been in its possession for more than four business days and have not been turned around.

(d) Any registered transfer agent which fails to comply with paragraph (b) of this section with respect to any month shall, within ten business days following the end of such month, file with the Commission and the transfer agent's appropriate regulatory agency, if it is not the Commission, a written notice in accordance with paragraph (h) of this section. Such notice shall state the number of items received for processing during the month, the number of items which the registered transfer agent failed to process in accordance with the requirements of paragraph (b) of this section, the percentage that such items represent of all items received during the month, the reasons for such failure and the steps which have been taken, are being taken or will be taken to prevent a future failure and the number of items which as of the close of business on the last business day of the month have been in the transfer agent's possession for more than the time allowed for processing and have not been processed.

(e)(1) Except as provided in paragraph (e)(2) of this section, all routine items not turned around within three business days of receipt as required by paragraph (a) of this section and all items not processed within the periods required by paragraph (b) of this section shall be turned around promptly, and all nonroutine items shall receive diligent and continuous attention and shall be turned around as soon as possible.

(2) A transfer agent that is exempt under §240.17Ad–4(b) and that has received 30 days notice of depository-eligibility of an issue for which it performs transfer agent functions shall turnaround ninety percent of all routine items received during a month within five business days of receipt. Such transfer agent shall devote diligent and continuous attention to the remaining ten percent of routine items and shall turnaround these items as soon as possible.

(f) A registered transfer agent which receives items at locations other than the premises at which it performs transfer agent functions shall have appropriate procedures to assure, and shall assure, that items are forwarded to such premises promptly.

(g) A registered transfer agent which receives processed items from an outside registrar shall have appropriate procedures to assure, and shall assure, that such items are made available promptly to the presentor.

(h) Any notice required by this section or § 240.17Ad–4 shall be filed as follows:

(1) Any notice required to be filed with the Commission shall be filed in triplicate with the principal office of the Commission in Washington, DC 20549 and, in the case of a registered transfer agent for which the Commission is the appropriate regulatory agency, an additional copy shall be filed with the regional office of the Commission for the region in which the registered transfer agent has its principal office for transfer agent activities.

(2) Any notice required to be filed with the Comptroller of the Currency shall be filed with the Office of the Comptroller of the Currency, Administrator of National Banks, Washington, DC 20219.

(3) Any notice required to be filed with the Board of Governors of the Federal Reserve System shall be filed with the Board of Governors of the Federal Reserve System, Washington, DC 20251 and with the Federal Reserve Bank of the district in which the registered transfer agent's principal banking operations are conducted.

(4) Any notice required to be filed with the Federal Deposit Insurance Corporation shall be filed with the Federal Deposit Insurance Corporation, Washington, DC 20429.

[42 FR 32412, June 24, 1977, as amended at 49 FR 40575, Oct. 17, 1984; 59 FR 5946, Feb. 9, 1994; 73 FR 32228, June 5, 2008]

§ 240.17Ad–3 Limitations on expansion.

(a) Any registered transfer agent which is required to file any notice pursuant to § 240.17Ad–2 (c) or (d) for each of three consecutive months shall not from the fifth business day after the end of the third such month until the end of the next following period of three successive months during which no such notices have been required:

(1) Initiate the performance of any transfer agent function or activity for an issue for which the transfer agent does not perform, or is not under agreement to perform, transfer agent functions prior to such fifth business day; and

(2) With respect to an issue for which transfer agent functions are being performed on such fifth business day, initiate for that issue the performance of an additional transfer agent function or activity which the transfer agent does not perform, or is not under agreement to perform, prior to such fifth business day.

(b) Any registered transfer agent which for each of two consecutive months fails to turn around at least 75% of all routine items in accordance with the requirements of § 240.17Ad–2(a) or to process at least 75% of all items in accordance with the requirements of § 240.17Ad–2(b) shall be subject to the limitations imposed by paragraph (a) of this section and further shall, within twenty business days after the close of the second such month, send to the chief executive officer of each issuer for which such registered transfer agent acts a copy of the written notice filed pursuant to § 240.17Ad–2 (c) or (d) with respect to the second such month.

(Secs. 2, 17, 17A and 23(a) (15 U.S.C. 78b, 78q, 78q–1 and 78w(a)))

[42 FR 32412, June 24, 1977]

§ 240.17Ad–4 Applicability of §§ 240.17Ad–2, 240.17Ad–3 and 240.17Ad–6(a) (1) through (7) and (11).

(a) Sections 240.17Ad–2, 240.17Ad–3 and 240.17Ad–6(a) (1) through (7) and (11) shall not apply to interests in limited partnerships, to redeemable securities of investment companies registered under section 8 of the Investment Company Act of 1940, or to interests in dividend reinvestment programs.

(b)(1) For purposes of this section, *exempt transfer agent* means a transfer agent that during any six consecutive months shall have received fewer than 500 items for transfer and fewer than 500 items for processing.

(2) Except as provided in paragraph (c) of this section, an exempt transfer agent that satisfies the requirements

of paragraph (b)(3) shall be exempt from the provisions of §§ 240.17Ad–2 (a), (b), (c), (d) and (h), 240.17Ad–3 and 240.17Ad–6(a) (2) through (7) and (11).

(3) Within ten business days following the close of the sixth consecutive month described in paragraph (b)(1) of this section, an exempt transfer agent shall:

(i) If its appropriate regulatory agency is either the Commission or the Office of the Comptroller of the Currency, prepare and maintain in its possession a document certifying that the transfer agent qualifies as exempt under paragraph (b)(1) of this section; or

(ii) If its appropriate regulatory agency is either the Board of Governors of the Federal Reserve System or the Federal Deposit Insurance Corporation, file with the appropriate regulatory agency a notice certifying that it qualifies as exempt under paragraph (b)(1) of this section.

(c) Within five business days following the close of each month, every exempt transfer agent shall calculate the number of items which it received during the preceding six months. Whenever any exempt transfer agent no longer qualifies as such under paragraph (b)(1), within ten business days after the end of such month: (1) It shall prepare and maintain in its possession a document so stating, if subject to paragraph (b)(3)(i) of this section; or (2) it shall file with its appropriate regulatory agency a notice to that effect, if subject to paragraph (b)(3)(ii) of this section. Thereafter, beginning with the first month following the month in which such document is required to be prepared or such notice is required to be filed, the registered transfer agent no longer shall be exempt under paragraph (b) of this section. Any registered transfer agent which has ceased to be an exempt transfer agent under this paragraph shall not qualify again for exemption until it has conducted its transfer agent operations pursuant to the foregoing sections for six consecutive months following the month in which it was required to prepare the document or prepare and file the notice specified in this paragraph.

(Secs. 2, 17, 17A and 23(a) (15 U.S.C. 78b, 78q, 78q–1 and 78w(a)))

[42 FR 32413, June 24, 1977, as amended at 48 FR 28246, June 21, 1983]

§ 240.17Ad–5 Written inquiries and requests.

(a) When any person makes a written inquiry to a registered transfer agent concerning the status of an item presented for transfer during the preceding six months by such person or anyone acting on his behalf, which inquiry identifies the issue, the number of shares (or principal amount of debt securities or number of units if relating to any other kind of security) presented, the approximate date of presentment and the name in which it is registered, the registered transfer agent shall, within five business days following receipt of the inquiry, respond, stating whether the item has been received; if received, whether it has been transferred; if received and not transferred, the reason for the delay and what additional matter, if any, is necessary before transfer may be effected; and, if received and transferred, the date and manner in which the completed item was made available, the addressee and address to which it was made available and the number of any new certificate which was registered and the name in which it was registered. If a new certificate is dispatched or mailed to the presentor within five business days following receipt of an inquiry pertaining to that certificate, no further response to the inquiry shall be required pursuant to this paragraph.

(b) When any broker-dealer requests in writing that a registered transfer agent acknowledge the transfer instructions and the possession of a security presented for transfer by such broker-dealer or revalidate a window ticket with respect to such security and the request identifies the issue, the number of shares (or principal amount of debt securities or number of units if relating to any other kind of security), the approximate date of presentment, the certificate number and the name in which it is registered, every registered transfer agent shall, within five business days following receipt of the request, in writing, confirm or deny possession of the security, and, if the registered transfer agent has possession, (1) acknowledge the transfer instructions or (2) revalidate the window ticket. If a new certificate is dispatched or mailed to the presentor within five business days following receipt of a request pertaining to that certificate, no further response to the inquiry shall be required pursuant to this paragraph.

(c) When any person, or anyone acting under his authority, requests in writing that a transfer agent confirm possession as of a given date of a certificate presented by such person during the 30 days before the date the inquiry is received and the request identifies the issue, the number of shares (or principal amount of debt securities or number of units if relating to any other kind of security), the approximate date of presentment, the certificate number and the name in which the certificate was registered, every registered transfer agent shall, within ten business days following receipt of the request and upon assurance of payment of a reasonable fee if required by such transfer agent, make available a written response to such person, or anyone acting under his authority, confirming or denying possession of such security as of such given date.

(d) When any person requests in writing a transcript of such person's account with respect to a particular issue, either as the account appears currently or as it appeared on a specific date not more than six months prior to the date the registered transfer agent receives the request, every registered transfer agent shall, within twenty business days following receipt of the request and upon assurance of payment of a reasonable fee if required by such transfer agent, make available to such person a transcript, ledger or statement of account in sufficient detail to permit reconstruction of such account as of the date for which the transcript was requested.

(e)(1) *Response to written inquiries concerning dividend and interest payments.* A registered transfer agent shall respond, within ten business days of receipt, to current claims that contain sufficient detail. A registered transfer agent shall respond, within twenty business days of receipt, to aged claims that contain sufficient detail. The response shall indicate in writing that the inquiry has been received, whether the claim requires further research and, if so, a reasonable estimate of how long that research may take. If no further research is required, the response shall indicate whether that claim is being or will be paid and, if not, the reason for not paying the claim. A registered transfer agent shall devote diligent attention to unresolved inquiries and shall resolve all inquiries as soon as possible.

(2) *Misdirected written inquiries concerning dividend and interest payments.* In the event that a transfer agent is not the dividend disbursing or interest paying agent for an issue that is the subject of a claim under this section, but performed those or any transfer agent services for that issue within the preceding three years, the transfer agent shall provide in writing to the inquirer, within ten business days of receipt of the inquiry, the name and address of the current dividend disbursing or interest paying agent. If the transfer agent did not perform those or other transfer agent services for the issue within the preceding three years, the transfer agent must respond to the inquiry and may respond by returning the inquiry with a statement that the transfer agent is not the current dividend disbursing or interest paying agent and that it does not know the name and address of the current dividend disbursing or interest paying agent.

(3) As used in this paragraph:

(i) A *current claim* means a written inquiry concerning non-payment or incorrect payment of dividends or interest, the payment date for which occurred within the preceding six months.

(ii) An *aged claim* means a written inquiry concerning non-payment or incorrect payment of dividends or interest, the payment date for which occurred more than six months before the inquiry.

(iii) *Sufficient detail* means a written inquiry or request that identifies: The issue; the name(s) in which the securities are registered; the number of shares (or principal amount of debt securities or number of units for any other kind of security) involved; the approximate record date(s) or payment date(s) relating to the claim; and, with respect to registered broker-dealers, registered clearing agencies, or banks, certificate numbers.

(f) *Telephone response.* (1) A transfer agent may satisfy the written response requirements of this section by a telephone response to the inquirer if:

(i) The telephone response resolves that inquiry; and

(ii) The inquirer does not request a written response.

(2) When any person makes a written inquiry or request that would qualify under paragraph (e) of this section except that it fails to provide sufficient detail as specified in paragraph (e)(3)(iii) of this section, a registered transfer agent may telephone the inquirer to obtain the necessary additional detail within the time periods specified in paragraph (e)(1) of this section. If the transfer agent does not receive the additional detail within ten business days, the transfer agent immediately shall make a written request for the additional information.

(g)(1) When any person makes a written inquiry or request which would qualify under paragraph (a), (b), (c), or (d) of this section except that it fails to provide all of the information specified in those paragraphs, or requests information which refers to a time earlier than the time periods specified in those paragraphs, a registered transfer agent shall confirm promptly receipt of the inquiry or request and respond to it as soon as possible.

(2) When any person makes a written inquiry or request which would qualify under paragraph (e) of this section except that it fails to provide sufficient detail as specified in paragraph (e)(3)(iii) of this section, a registered transfer agent must respond to the inquiry within the time periods specified in paragraph (e)(1) of this section. A registered transfer agent may respond to such an inquiry in accordance with paragraph (e)(1) of this section as though sufficient detail had been provided, or may return it to the inquirer, requesting the additional necessary details.

(Secs. 2, 17, 17A and 23(a) (15 U.S.C. 78b, 78q, 78q–1 and 78w(a)))

[42 FR 32413, June 24, 1977, as amended at 51 FR 5707, Feb. 18, 1986]

§ 240.17Ad–6 Recordkeeping.

(a) Every registered transfer agent shall make and keep current the following:

(1) A receipt, ticket, schedule, log or other record showing the business day each routine item and each non-routine item is (i) received from the presentor and, if applicable, from the outside registrar and (ii) made available to the presentor and, if applicable, to the outside registrar;

(2) A log, tally, journal, schedule or other record showing for each month:

(i) The number of routine items received;

(ii) The number of routine items received during the month that were turned around within three business days of receipt;

(iii) The number of routine items received during the month that were not turned around within three business days of receipt;

(iv) The number of non-routine items received during the month;

(v) The number of non-routine items received during the month that were turned around;

(vi) The number of routine items that, as of the close of business on the last business day of each month, have been in such registered transfer agent's possession for more than four business days, aged in increments of one business day (beginning on the fifth business day); and

(vii) The number of non-routine items in such registered transfer agent's possession as of the close of business on the last business day of each month;

(3) With respect to items for which the registered transfer agent acts as an outside registrar:

(i) A receipt, ticket, schedule, log or other record showing the date and time:

(A) Each item is (*1*) received from the presenting transfer agent and (*2*) made available to the presenting transfer agent;

(B) Each written or oral notice of refusal to perform the registrar function is made available to the presenting transfer agent (and the substance of the notice); and

(ii) A log, tally, journal, schedule or other record showing for each month:

(A) The number of items received;

(B) The number of items processed within the time required by § 240.17Ad–2(b); and

(C) The number of items not processed within the time required by § 240.17Ad–2(b);

(4) A record of calculations demonstrating the registered transfer agent's monitoring of its performance under § 240.17Ad–2 (a) and (b);

(5) A copy of any written notice filed pursuant to § 240.17Ad–2;

(6) Any written inquiry or request, including those not subject to the requirements of § 240.17Ad–5, concerning an item, showing the date received; a copy of any written response to an inquiry or request, showing the date dispatched or mailed to the presentor; if no response to an inquiry or request was made, the date the certificate involved was made available to the presentor; or, in the case of an inquiry or request under § 240.17Ad–5(a) responded to by telephone, a telephone log or memorandum showing the date and substance of any telephone response to the inquiry;

(7) A log, journal, schedule or other record showing the number of inquiries subject to § 240.17Ad–5 (a), (b), (c) and (d) received during each month but not responded to within the required time frames and the number of such inquiries pending as of the close of business on the last business day of each month;

(8) Any document, resolution, contract, appointment or other writing, any supporting document, concerning the appointment and the termination of such appointment of such registered transfer agent to act in any capacity for any issue on behalf of the issuer, on behalf of itself as the issuer or on behalf of any person who was engaged by the issuer to act on behalf of the issuer;

(9) Any record of an active (i.e., unreleased) stop order, notice of adverse claim or any other restriction on transfer;

(10) A copy of any transfer journal and registrar journal prepared by such registered transfer agent; and

(11) Any document upon which the transfer agent bases its determination that an item received for transfer was received in connection with a reorganization, tender offer, exchange, redemption, liquidation, conversion or the sale of securities registered pursuant to the Securities Act of 1933 and, accordingly, was not routine under § 240.17Ad–1(i) (5) or (8).

(b) Every registered transfer agent which, under the terms of its agency, maintains securityholder records for an issue or which acts as a registrar for an issue shall, with respect to such issue, obtain from the issuer or its transfer agent and retain documentation setting forth the total number of shares or principal amount of debt securities or total number of units if relating to any other kind of security authorized and the total issued and outstanding pursuant to issuer authorization.

(c) Every registered transfer agent which, under the terms of its agency, maintains securityholder records for an issue shall, with respect to such issue, retain each cancelled registered bond, debenture, share, warrant or right, other registered evidence of indebtedness, or other certificate of ownership and all accompanying documentation, except legal papers returned to the presentor.

(Secs. 2, 17, 17A and 23(a) (15 U.S.C. 78b, 78q, 78q–1 and 78w(a)))

[42 FR 32413, June 24, 1977]

§ 240.17Ad–7 Record retention.

(a) The records required by § 240.17Ad–6(a)(1), (3)(i), (6) or (11) shall be maintained for a period of not less than two years, the first six months in an easily accessible place.

(b) The records required by § 240.17Ad–6(a) (2), (3)(ii), (4), (5) or (7) shall be maintained for a period of not less than two years, the first year in an easily accessible place.

(c) The records required by § 240.17Ad–6(a) (8), (9) and (10) and (b) shall be maintained in an easily accessible place during the continuance of the transfer agency and shall be maintained for one year after termination of the transfer agency.

(d) The records required by § 240.17Ad–6(c) shall be maintained for a period of not less than six years, the first six months in an easily accessible place.

(e) Every registered transfer agent shall maintain in an easily accessible place:

(1) All records required under § 240.17f–2(d) until at least three years after the termination of employment of those persons required by § 240.17f–2 to be fingerprinted; and

(2) All records required pursuant to § 240.17f–2(e).

(f) Subject to the conditions set forth in this section, the records required to be maintained pursuant to § 240.17Ad–6 may be retained using electronic or micrographic media and may be preserved in those formats for the time required by § 240.17Ad–7. Records stored electronically or micrographically in accordance with this paragraph may serve as a substitute for the hard copy records required to be maintained pursuant to § 240.17Ad–6.

(1) For purposes of this section:

(i) The term *micrographic media* means microfilm or microfiche or any similar medium.

(ii) The term *electronic storage media* means any digital storage medium or system.

(iii) The term *ARA* means your appropriate regulatory agency as that term is defined in 15 U.S.C. 78c(a)(34).

(2) If you as a registered transfer agent use electronic storage media or micrographic media to store your records, you must:

(i) Have available at all times for examination by the staffs of the Commission and of your ARA facilities to project or produce immediately easily readable images of such records;

(ii) Be ready at all times to provide such records that the staffs of the Commission and your ARA or their representatives may request;

(iii) Create an accurate index of such records, store the index with those records, and have the index available at all times for examination by the staffs of the Commission and your ARA;

(iv) Have quality assurance procedures to verify the quality and accuracy of the electronic or micrographic recording process; and

(v) Maintain separately from the originals duplicates of the records and the index that you store on electronic storage media or micrographic media. You may store the duplicates of the indexed records on any medium permitted by this section. You must preserve the duplicate records and index for the same time that is required by this section for the indexed records, and you must have them available at all times for examination by the staffs of the Commission and your ARA.

(3) Any electronic storage media that you use to store your records must:

(i) Ensure the security and integrity of the records by means of manual and automated controls that assure the authenticity and quality of the electronic facsimile, detect attempts to alter or remove the records, and provide means to recover altered, damaged, or lost records resulting from any cause;

(ii) Externally label all removable units of storage media using a unique identifier that allows the manual association of that removable storage unit with its place and order in the recordkeeping system; and

(iii) Uniquely identify files and internally label each file with its unique name, the date and time of file creation, the date and time of last modification or extension, and a file sequence number when the file spans more than one volume.

(4) If you use electronic storage media or micrographic media to store your records, you must establish an audit system that accounts for the inputting of and any changes to every record that is stored on electronic storage media or micrographic media. The results of such audit system must:

(i) Be available at all times for examination by the staffs of the Commission and your ARA; and

(ii) Be preserved for the same time that is required by this section for the underlying records.

(5) If you use electronic storage media or micrographic media to store your records, you must:

(i) Maintain, keep current, and provide promptly upon request by the staffs of the Commission and your ARA all information necessary to access the records and indexes stored on electronic storage media or micrographic media; and

(ii) Place, or have a third party place on your behalf, in escrow with an independent third party and keep current a copy of the physical and logical format of the electronic storage or micrographic media, the field format of all different information types written on the electronic storage media and source code, and the appropriate documentation and information necessary to access records and indexes. The independent escrow agent must file an undertaking signed by a duly authorized person with the Commission and your ARA stating that:

''[Name of Third Party] hereby undertakes to furnish promptly upon request to the U.S. Securities and Exchange Commission, its designees, or representatives, upon reasonable request, a current copy of the physical and logical format of the electronic storage or micrographic media, the field format of all different information types written on the electronic storage media and source code, and the appropriate documentation and information necessary to access the records and indexes of [Name of Transfer Agent]'s electronic records management system.

(6) (i) If you use a third party to maintain or preserve some or all of the required records using electronic storage media or micrographic media, such third party shall file a written undertaking signed by a duly authorized person with the Commission and your ARA stating that:

''With respect to any books and records maintained or preserved on behalf of [Name of Transfer Agent], [Name of Third Party] hereby undertakes to permit examination of such books and records at any time or from time to time during business hours by representatives or designees of the U.S. Securities and Exchange Commission, and to promptly furnish to said Commission or its designee true, correct, complete, and current hard copies of any or all or any part of such books and records.''

(ii) Agreement with a third party to maintain your records shall not relieve you from the responsibility to prepare and maintain records as specified in this section or in § 240.17Ad–6.

(g) If the records required to be maintained and preserved by a registered transfer agent pursuant to the requirements of §§ 240.17Ad–6 and 240.17Ad–7 are maintained and preserved on behalf of the registered transfer agent by an outside service bureau, other recordkeeping service or the issuer, the registered transfer agent shall obtain, from such outside service bureau, other recordkeeping service or the issuer, an agreement, in writing, to the effect that:

(1) Such records are subject at any time, or from time to time, to reasonable periodic, special, or other examinations by representatives of the Commission and the appropriate regulatory agency for such registered transfer agent if it is not the Commission; and

(2) The outside service bureau, recordkeeping service, or issuer will furnish to the Commission and the appropriate regulatory agency, upon demand, at either the principal office or at any regional office, complete, correct and current hard copies of any and all such records.

(h) When a registered transfer agent ceases to perform transfer agent functions for an issue, the responsibility of such transfer agent under § 240.17Ad–7 to retain the records required to be made and kept current under § 240.17Ad–6(a) (1), (6), (9), (10) and (11), (b) and (c) shall end upon the delivery of such records to the successor transfer agent.

(i) The records required by §§ 240.17Ad–17(d) and 240.17Ad–19(c) shall be maintained for a period of not less than three years, the first year in an easily accessible place.

[42 FR 32414, June 24, 1977, as amended at 47 FR 54063, Dec. 1, 1982; 62 FR 52237, Oct. 7, 1997; 66 FR 21659, May 1, 2001; 68 FR 74401, Dec. 23, 2003; 68 FR 75054, Dec. 29, 2003; 78 FR 4874, Jan. 23, 2013]

§ 240.17Ad–8 Securities position listings.

(a) For purposes of this section, the term *securities position listing* means, with respect to the securities of any issuer held by a registered clearing agency in the name of the clearing agency or its nominee, a list of those participants in the clearing agency on whose behalf the clearing agency holds the issuer's securities and of the participants' respective positions in such securities as of a specified date.

(b) Upon request, a registered clearing agency shall furnish a securities position listing promptly to each issuer whose securities are held in the name of the clearing agency or its nominee. A registered clearing agency may charge issuers requesting securities position listings a fee designed to recover the reasonable costs of providing the securities position listing to the issuer.

(Secs. 2, 17A, and 23(a) (15 U.S.C. 78b, 78q–1, and 78w(a)))

[44 FR 76777, Dec. 28, 1979]

§ 240.17Ad–9 Definitions.

As used in this section and §§ 240.17Ad–10, 240.17Ad–11, 240.17Ad–12 and 240.17Ad–13:

(a) *Certificate detail*, with respect to certificated securities, includes, at a minimum, all of the following, and with respect to uncertificated securities, includes items (2) through (8):

(1) The certificate number.

(2) The number of shares for equity securities or the principal dollar amount for debt securities;

(3) The securityholder's registration;

(4) The address of the registered securityholder;

(5) The issue date of the security;

(6) The cancellation date of the security;

(7) In the case of redeemable securities of investment companies, an appropriate description of each debit and credit (i.e., designation indicating purchase, redemption, or transfer); and

(8) Any other identifying information about securities and securityholders the transfer agent reasonably deems essential to its recordkeeping system for the efficient and effective research of record differences.

(b) *Master securityholder file* is the official list of individual securityholder accounts. With respect to uncertificated securities of companies registered under the Investment Company Act of 1940, the master securityholder file may consist of multiple, but linked, automated files.

(c) A *subsidiary file* is any list or record of accounts, securityholders, or certificates that evidences debits or credits that have not been posted to the master securityholder file.

(d) A *control book* is the record or other document that shows the total number of shares (in the case of equity securities) or the principal dollar amount (in the case of debt securities) authorized and issued by the issuer.

(e) A *credit* is an addition of appropriate certificate detail to the master securityholder file.

(f) A *debit* is a cancellation of appropriate certificate detail from the master securityholder file.

(g) A *record difference* occurs when either:

(1) The total number of shares or total principal dollar amount of securities in the master securityholder file does not equal the number of shares or principal dollar amount in the control book; or

(2) The security transferred or redeemed contains certificate detail different from the certificate detail currently on the master securityholder file, which difference cannot be immediately resolved.

(h) A *recordkeeping transfer agent* is the registered transfer agent that maintains and updates the master securityholder file.

(i) A *co-transfer agent* is the registered transfer agent that transfers securities but does not maintain and update the master securityholder file.

(j) A *named transfer agent* is the registered transfer agent that is engaged by an issuer to perform transfer agent functions for an issue of securities but has engaged a service company to perform some or all of those functions.

(k) A *service company* is the registered transfer agent engaged by a named transfer agent to perform transfer agent functions for that named transfer agent.

(l) A *file* includes automated and manual records.

(Secs. 2, 17(a), 17A(d) and 23(a) thereof, 15 U.S.C. 78b, 78q(a), 78q–1(d) and 78w(a))

[48 FR 28246, June 21, 1983]

§ 240.17Ad–10 Prompt posting of certificate detail to master securityholder files, maintenance of accurate securityholder files, communications between co-transfer agents and recordkeeping transfer agents, maintenance of current control book, retention of certificate detail and "buy-in" of physical over-issuance.

(a)(1) Every recordkeeping transfer agent shall promptly and accurately post to the master securityholder file debits and credits containing minimum and appropriate certificate detail representing every security transferred, purchased, redeemed or issued; *Provided, however*, That if a security transferred or redeemed contains certificate detail different from that currently posted to the master securityholder file, the credit shall be posted to the master securityholder file and the debit and related certificate detail shall be maintained in a subsidiary file until resolved. The recordkeeping transfer agent shall exercise diligent and continuous attention to resolve the resulting record difference and, once resolved, shall post to the master securityholder file the debit maintained in the subsidiary file. Postings of certificate detail shall remain on the master securityholder file until a debit to a securityholder acount is appropriate.

(2) As used in this paragraph, the term *promptly* means the following number of days after issuance, purchase, transfer, or redemption of a security:

(i) With respect to recordkeeping transfer agents (other than transfer agents that perform transfer agent functions with respect to redeemable securities issued by investment companies registered under section 8 of the Investment Company Act of 1940) that are exempt transfer agents under § 240.17Ad–4(b), 30 calendar days;

(ii) With respect to recordkeeping transfer agents (other than transfer agents that perform transfer agent functions with respect to redeemable securities issued by investment companies registered under section 8 of the Investment Company Act of 1940) that:

(A) Perform transfer agent functions solely for their own or their affiliated companies' securities issues, and

(B) Employ batch posting systems, ten business days; and

(iii) With respect to all other recordkeeping transfer agents, five business days; *Provided, however*, That all securities transferred, purchased, redeemed or issued prior to record date, but posted subsequent thereto, shall be posted as of the record date.

(3) With respect to posting certificate detail from transfer journals received by the recordkeeping transfer agent from a co-transfer agent, the time frames set forth in paragraph (a)(2) shall commence upon receipt of those journals by the recordkeeping transfer agent.

(b) Every recordkeeping transfer agent shall maintain and keep current an accurate master securityholder file and subsidiary files. If such transfer agent has any record difference, its master securityholder file and subsidiary files must accurately represent all relevant debits and credits until the record difference is resolve. The recordkeeping transfer agent shall exercise diligent and continuous attention to resolve all record differences.

(c)(1) Every co-transfer agent shall dispatch or mail promptly to the recordkeeping transfer agent a record of debits and credits for every security transferred or issued. For the purposes of this paragraph, ''promptly'' means within two business days following transfer of each security, and, with respect to transfers occurring within five business days of record date, daily.

(2) Within three business days following the end of each month, every co-transfer agent shall mail to the recordkeeping transfer agent for each issue of securities for which it acts as a co-transfer agent, a report setting forth:

(i) The principal dollar amount of debt securities or the number of shares and related market value of equity securities comprising any buy-in executed by the co-transfer agent during the preceding month pursuant to paragraph (g) of this section; and

(ii) The reason for the buy-in.

(d) Every co-transfer agent shall respond promptly to all inquiries from the recordkeeping transfer agent regarding records required to be dispatched or mailed by the co-transfer agent pursuant to §240.17Ad–10(c). For the purposes of this paragraph, ''promptly'' means within five business days of receipt of an inquiry from a recordkeeping transfer agent.

(e) Every recordkeeping transfer agent shall maintain and keep current an accurate control book for each issue of securities. A change in the control book shall not be made except upon written authorization from a duly authorized agent of the issuer.

(f) Every recordkeeping transfer agent shall retain a record of all certificate detail deleted from the master securityholder file for a period of six years from the date of deletion. In lieu of maintaining a hard copy, a recordkeeping transfer agent may comply with this paragraph by complying with §240.17Ad–7(f) or §240.17Ad–7(g).

(g)(1) A registered transfer agent, in the event of any actual physical overissuance that such transfer agent caused and of which it has knowledge, shall, within 60 days of the discovery of such overissuance, buy in securities equal to the number of shares in the case of equity securities or the principal dollar amount in the case of debt securities. During the sixty-day period, the registered transfer agent shall devote diligent attention to resolving the overissuance and recovering the certificates. This paragraph requires a buy-in only by the transfer agent that erroneously issued the certificate(s) giving rise to the physical overissuance, and applies only to those physical overissuances created by transfers or issuances subsequent to September 30, 1983.

(2) If a transfer agent obtains a letter from the party holding the overissued certificates that confirms that the overissued certificate(s) will be returned to the transfer agent not later than thirty days after the expiration of the sixty-day period, the transfer agent need not buy in securities by the sixtieth day. If, however, the certificate(s) are not returned to the transfer agent within the additional thirty-day period, the transfer agent immediately must execute the buy-in in accordance with paragraph (g)(1) of this section.

(3) If the certificates involved are covered by a surety bond indemnifying the transfer agent for all expenses incurred as a result of actual overissuance, the transfer agent need not buy in the securities. The transfer agent, however, shall devote diligent attention to resolving the overissuance and recovering the certificates.

(4) For purposes of this paragraph, *discovery of the overissuance* occurs when the transfer agent identifies the erroneously issued certificate(s) and the registered securityholder(s).

(h) Subsequent to the effective date of this section, registered transfer agents that:

(1) Assume the maintenance and updating of master securityholder files from predecessor transfer agents,

(2) Establish a new master securityholder file for a particular issue, or

(3) Convert from manual to automated systems,

must carry over any existing certificate detail required by this section on the master securityholder file.

A recordkeeping transfer agent shall not be required to add certificate detail to the master securityholder file respecting certificates issued prior to the effective date of this section.

(Secs. 2, 17(a), 17A(d) and 23(a) thereof, 15 U.S.C. 78b, 78q(a), 78q–1(d) and 78w(a))

[48 FR 28246, June 21, 1983, as amended at 51 FR 5708, Feb. 18, 1986]

§240.17Ad–11 Reports regarding aged record differences, buy-ins and failure to post certificate detail to master securityholder and subsidiary files.

(a) *Definitions.* (1) *Issuer capitalization* means the market value of the issuer's authorized and outstanding equity securities or, with respect to a municipal securities issuer, the market value of all debt issues for which the transfer agent performs recordkeeping functions on behalf of that issuer, determined by reference to the control book and current market prices.

(2) An *aged record difference* is a record difference that has existed for more than thirty calendar days.

(b) *Reports to Issuers.* (1) Within ten business days following the end of each month, every recordkeeping transfer agent shall report the information specified in paragraph (d)(1) of this section to the persons specified in paragraph (b)(3) of this section, when the aggregate market value of aged record differences in all equity securities issues or debt securities issues maintained on behalf of a particular issuer exceeds the thresholds set forth in the table below.

Issuer capitalization	Aggregate market value of aged record differences exceeds	
	For equity securities	For debt securities
(1) $5 million or less	$50,000	$100,000
(2) Greater than $5 million but less than $50 million	250,000	500,000
(3) Greater than $50 million but less than $150 million	500,000	1,000,000
(4) Greater than $150 million	1,000,000	2,000,000

(2) Within ten business days following the end of each month (or within ten days thereafter in the case of a named transfer agent that receives a report from a service company pursuant to paragraph (b)(3)(i)(C)), every recordkeeping transfer agent shall report the information specified in paragraph (d)(2) of this section to the persons specified in paragraph (b)(3) of this section, with respect to each issue of securities for which it acts as recordkeeping transfer agent, concerning any securities bought-in pursuant to §240.17Ad–10(g) or reported as bought-in pursuant to §240.17Ad–10(c) during the preceding month.

(3) The report shall be sent:

(i) By every recordkeeping transfer agent (other than a recordkeeping transfer agent that performs transfer agent functions solely for its own securities):

(A) To the official performing corporate secretary functions for the issuer of the securities for which the aged record difference exists or for which the buy-in occurred;

(B) With respect to an issue of municipal securities, to the chief financial officer of the issuer of the securities for which the aged record difference exists or for which the buy-in occurred; or

(C) If it acts as a service company, to the named transfer agent; and

(ii) By every named transfer agent that is engaged by an issuer to maintain and update the master securityholder file:

(A) To the official performing corporate secretary functions for the issuer of the securities for which the aged record difference exists or for which the buy-in occurred; or

(B) With respect to an issue of municipal securities, to the chief financial officer of the issuer of the securities for which the aged record difference exists or for which the buy-in occurred.

(c) *Reports to appropriate regulatory agencies* (1) Within ten business days following the end of each calendar quarter, every recordkeeping transfer agent shall report the information specified in paragraph (d)(1) of this section to its appropriate regulatory agency in accordance with §240.17Ad–2(h), when the aggregate market value of aged record differences for all issues for which it performs recordkeeping functions exceeds the thresholds specified below:

(i) $300,000 if it is a recordkeeping transfer agent for 5 or fewer issues;

(ii) $500,000 for 6–24 issues;

(iii) $800,000 for 25–49 issues;

(iv) $1 million for 50–74 issues;

(v) $1.2 million for 75–99 issues;

(vi) $1.4 million for 100–499 issues;

(vii) $1.6 million for 500–999 issues;

(viii) $2.6 million for 1,000–1,999 issues; and

(ix) An additional $1 million for each additional 1,000 issues.

(2) Within ten business days following the end of each calendar quarter, every recordkeeping transfer agent shall report the information specified in paragraph (d)(2) of this section to its appropriate regulatory agency in accordance with §240.17Ad–2(h), concerning buy-ins of all issues for which it acts as recordkeeping transfer agent, when the aggregate market value of all buy-ins executed pursuant to §240.17Ad–10(g) during that calendar quarter exceeds $100,000.

(3) When the recordkeeping transfer agent has any debits or credits for securities transferred, purchased, redeemed or issued that are unposted to the master securityholder and/or subsidiary files for more than five business days after debits and credits are required to be posted to the master securityholder file or subsidiary files

pursuant to § 240.17Ad–10, it shall immediately report such fact to its appropriate regulatory agency in accordance with § 240.17Ad–2(h) and shall state in that report what steps have been, and are being, taken to correct the situation.

(d) *Content of reports.* (1) Each report pursuant to paragraphs (b)(1) and (c)(1) of this section shall set forth with respect to each issue of securities:

(i) The principal dollar amount and related market value of debt securities or the number of shares and related market value of equity securities comprising the aged record difference (including information concerning aged record differences existing as of the effective date of this section);

(ii) The reasons for the aged record difference; and

(iii) The steps being taken or to be taken to resolve the aged record difference.

(2) Each report pursuant to paragraphs (b)(2) and (c)(2) of this section shall set forth with respect to each issue of securities:

(i) The principal dollar amount of debt securities and related market value or the number of shares and related market value of equity securities comprising any buy-in executed pursuant to § 240.17Ad–10(g);

(ii) The party that executed the buy-in; and

(iii) The reason for the buy-in.

(e) For purposes of this section, the market value of an issue shall be determined as of the last business day on which market value information is available during the reporting period.

(f) A copy of any report required under this section shall be retained by the reporting transfer agent for a period of not less than three years, the first year in an easily accessible place.

(Secs. 2, 17(a), 17A(d) and 23(a) thereof, 15 U.S.C. 78b, 78q(a), 78q–1(d) and 78w(a))

[48 FR 28247, June 21, 1983]

§ 240.17Ad–12 Safeguarding of funds and securities.

(a) Any registered transfer agent that has custody or possession of any funds or securities related to its transfer agent activities shall assure that:

(1) All such securities are held in safekeeping and are handled, in light of all facts and circumstances, in a manner reasonably free from risk of theft, loss or destruction (other than by a transfer agent's certificate destruction procedures pursuant to § 240.17Ad-19); and

(2) All such funds are protected, in light of all facts and circumstances, against misuse. In evaluating which particular safeguards and procedures must be employed, the cost of the various safeguards and procedures as well as the nature and degree of potential financial exposure are two relevant factors.

(b) For purposes of this section, the term *securities* shall have the same meaning as the term *securities certificate* as defined in § 240.17f–1(a)(6).

(Secs. 2, 17(a), 17A(d) and 23(a) thereof, 15 U.S.C. 78b, 78q(a), 78q–1(d) and 78w(a))

[48 FR 28248, June 21, 1983, as amended at 68 FR 74401, Dec. 23, 2003]

§ 240.17Ad–13 Annual study and evaluation of internal accounting control.

(a) *Accountant's report.* Every registered transfer agent, except as provided in paragraph (d) of this section, shall file annually with the Commission and the transfer agent's appropriate regulatory agency in accordance with § 240.17Ad–2(h), a report specified in paragraph (a)(1) of this section prepared by an independent accountant concerning the transfer agent's system of internal accounting control and related procedures for the transfer of record ownership and the safeguarding of related securities and funds. That report shall be filed within 90 calendar days of the date of the study and evaluation set forth in paragraph (a)(1).

(1) The accountant's report shall:

(i) State whether the study and evaluation was made in accordance with generally accepted auditing standards using the criteria set forth in paragraph (a)(3) of this section;

(ii) Describe any material inadequacies found to exist as of the date of the study and evaluation and any corrective action taken, or if no material inadequacy existed, the report shall so state;

(iii) Comment on the current status of any material inadequacy described in the immediately preceding report; and

(iv) Indicate the date of the study and evaluation.

(2) The study and evaluation of the transfer agent's system of internal accounting control for the transfer of record ownership and the safeguarding of related securities and funds shall cover the following:

(i) Transferring securities related to changes of ownership (i.e., cancellation of certificates or other instruments evidencing prior ownership and issuance of certificates or instruments evidencing current ownership);

(ii) Registering changes of ownership on the books and records of the issuer;

(iii) Transferring record ownership as a result of corporate actions (e.g., issuance, retirement, redemption, liquidation, conversion, exchange, tender offer or other types of reorganization);

(iv) Dividend disbursement or interest paying-agent activities;

(v) Administering dividend reinvestment programs; and

(vi) Distributing statements respecting initial offerings of securities.

(3) For purposes of this report, the objectives of a transfer agent's system of internal accounting control for the transfer of record ownership and the safeguarding of related securities and funds should be to provide reasonable, but not absolute, assurance that securities and funds are safeguarded against loss from unauthorized use or disposition and that transfer agent activities are performed promptly and accurately. For purposes of this report, a material inadequacy is a condition for which the independent accountant believes that the prescribed procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities, in amounts that would have a significant adverse effect on the transfer agent's ability promptly and accurately to transfer record ownership and safeguard related securities and funds, would occur or not be detected within a timely period by employees in the normal course of performing their assigned functions. Occurrence of errors or irregularities more frequently than in isolated instances may be evidence that the system has a material inadequacy. A significant adverse effect on a transfer agent's ability promptly and accurately to transfer record ownership and safeguard related securities and funds could result from any condition or conditions that individually, or taken as a whole, would reasonably be expected to:

(i) Inhibit the transfer agent from promptly and accurately discharging its responsibilities under its contractual agreement with the issuer;

(ii) Result in material financial loss to the transfer agent; or

(iii) Result in a violation of § 240.17Ad–2, 17Ad–10 or 17Ad–12(a).

(b) *Notice of corrective action.* If the accountant's report describes any material inadequacy, the transfer agent shall, within sixty calendar days after receipt of the report, notify the Commission and its appropriate regulatory agency in writing regarding the corrective action taken or proposed to be taken.

(c) *Record retention.* The accountant's report and any documents required by paragraph (b) of this section shall be maintained by the transfer agent for at least three years, the first year in an easily accessible place.

(d) *Exemptions.* The requirements of § 240.17Ad–13 shall not apply to registered transfer agents that qualify for exemptions pursuant to this paragraph, 17Ad–13(d).

(1) A registered transfer agent shall be exempt if it performs transfer agent functions solely for:

(i) Its own securities;

(ii) Securities issued by a subsidiary in which it owns 51% or more of the subsidiary's capital stock; and

(iii) Securities issued by another corporation that owns 51% or more of the capital stock of the registered transfer agent.

(2) A registered transfer agent shall be exempt if it:

(i) Is an exempt transfer agent pursuant to § 240.17AD–4(b); and

(ii) In the case of a transfer agent that performs transfer agent functions for redeemable securities issued by companies registered under section 8 of the Investment Company Act of 1940, maintains master securityholder files consisting of fewer than 1000 shareholder accounts, in the aggregate, for each of such issues for which it performs transfer agent functions.

(3) A registered transfer agent shall be exempt if it is a bank or financial institution subject to regulation by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency or the Federal Deposit Insurance Corporation, provided that it is not notified to the contrary by its appropriate regulatory agency and provided that a report similar in scope to the requirements of §240.17Ad–13(a) is prepared for either the bank's board of directors or an audit committee of the board of directors.

(Secs. 2, 17(a), 17A(d) and 23(a) thereof, 15 U.S.C. 78b, 78q(a), 78q–1(d) and 78w(a))

[48 FR 28248, June 21, 1983]

§ 240.17Ad–14 Tender agents.

(a) *Establishing book-entry depository accounts.* When securities of a subject company have been declared eligible by one or more qualified registered securities depositories for the services of those depositories at the time a tender or exchange offer is commenced, no registered transfer agent shall act on behalf of the bidder as a depositary, in the case of a tender offer, or an exchange agent, in the case of an exchange offer, in connection with a tender or exchange offer, unless that transfer agent has established, within two business days after commencement of the offer, specially designated accounts. These accounts shall be maintained throughout the duration of the offer, including protection periods, with all qualified registered securities depositories holding the subject company's securities, for purposes of receiving from depository participants securities being tendered to the bidder by book-entry delivery pursuant to transmittal letters and other documentation and for purposes of allowing tender agents to return to depository participants by book-entry movement securities withdrawn from the offer.

(b) *Exclusions.* The rule shall not apply to tender or exchange offers (1) that are made for a class of securities of a subject company that has fewer than (i) 500 security holders of record for that class, or (ii) 500,000 shares of that class outstanding; or (2) that are made exclusively to security holders of fewer than 100 shares of a class of securities.

(c) *Definitions.* For purposes of this rule, (1) the terms *subject company*, *business day*, *security holders*, and *transmittal letter* shall be given the meanings provided in §240.14d–1(b); (2) unless the context otherwise requires, a tender or exchange offer shall be deemed to have commenced as specified in §240.14d–2; (3) the term *bidder* shall mean any person who makes a tender or exchange offer or on whose behalf a tender or exchange offer is made; (4) a *qualified registered securities depository* shall mean a registered clearing agency having rules and procedures approved by the Commission pursuant to section 19 of the Securities Exchange Act of 1934 to enable book-entry delivery of the securities of the subject company to, and return of those securities from, the transfer agent through the facilities of that securities depository; and (5) the term *depositary* refers to that agent of the bidder receiving securities from tendering depository participants and paying those participants for shares tendered. The term *exchange agent* refers to the agent performing like functions in connection with an exchange offer.

(d) *Exemptions.* The Commission may exempt from the provisions of this rule, either unconditionally or on specified terms and conditions, any registered transfer agent, tender or exchange offer, or class of tender or exchange offers, if the Commission determines that an exemption is consistent with the public interest, the protection of investors, the prompt and accurate clearance and settlement of securities transactions, the maintenance of fair and orderly markets, or the removal of impediments to a national clearance and settlement system.

(Secs. 2, 11A(a)(1)(B), 14(d)(4), 15(c)(3), 15(c)(6), 17A(a), 17A(d)(1), and 23(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78b, 78k–1(a)(1)(B), 78n(d)(4), 78o(c)(3), 78o(c)(6), 78q–1(a), 78q–1(d)(1) and 78w(a)))

[49 FR 3071, Jan. 25, 1984]

§ 240.17Ad–15 Signature guarantees.

(a) *Definitions.* For purposes of this section, the following terms shall mean:

(1) *Act* means the Securities Exchange Act of 1934;

(2) *Eligible Guarantor Institution* means:

(i) Banks (as that term is defined in section 3(a) of the Federal Deposit Insurance Act [12 U.S.C. 1813(a)]);

(ii) Brokers, dealers municipal securities dealers, municipal securities brokers, government securities dealers, and government securities brokers, as those terms are defined under the Act;

(iii) Credit unions (as that term is defined in Section 19 (b)(1)(A) of the Federal Reserve Act [12 U.S.C. 461(b)]);

(iv) National securities exchanges, registered securities associations, clearing agencies, as those terms are used under the Act; and

(v) Savings associations (as that term is defined in section 3(b) of the Federal Deposit Insurance Act [12 U.S.C. 1813(b)]).

(3) *Guarantee* means a guarantee of the signature of the person endorsing a certificated security, or originating an instruction to transfer ownership of a security or instructions concerning transfer of securities.

(b) *Acceptance of signature guarantees.* A registered transfer agent shall not, directly or indirectly, engage in any activity in connection with a guarantee, including the acceptance or rejection of such guarantee, that results in the inequitable treatment of any eligible guarantor institution or a class of institutions.

(c) *Transfer agent's standards and procedures.* Every registered transfer agent shall establish:

(1) Written standards for the acceptance of guarantees of securities transfers from eligible guarantor institutions; and

(2) Procedures, including written guidelines where appropriate, to ensure that those standards are used in determining whether to accept or reject guarantees from eligible guarantor institutions. Such standards and procedures shall not establish terms and conditions (including those pertaining to financial condition) that, as written or applied, treat different classes of eligible guarantor institutions inequitably, or result in the rejection of a guarantee from an eligible guarantor institution solely because the guarantor institution is of a particular type specified in paragraphs (a)(2)(i)–(a)(2)(v) of this section.

(d) *Rejection of items presented for transfer.* (1) No registered transfer agent shall reject a request for transfer of a certificated or uncertificated security because the certificate, instruction, or documents accompanying the certificate or instruction includes an unacceptable guarantee, unless the transfer agent determines that the guarantor, if it is an eligible guarantor institution, does not satisfy the transfer agent's written standards or procedures.

(2) A registered transfer agent shall notify the guarantor and the presentor of the rejection and the reasons for the rejection within two business days after rejecting a transfer request because of a determination that the guarantor does not satisfy the transfer agent's written standards or procedures. Notification to the presentor may be accomplished by making the rejected item available to the presentor. Notification to the guarantor may be accomplished by telephone, facsimile, or ordinary mail.

(e) *Record retention.* (1) Every registered transfer agent shall maintain a copy of the standards and procedures specified in paragraph (c) of this section in an easily accessible place.

(2) Every registered transfer agent shall make available a copy of the standards and procedures specified in paragraph (c) of this section to any person requesting a copy of such standards and procedures. The registered transfer agent shall respond within three days of a request for such standards and procedures by sending the requesting party a copy of the requested transfer agent's standards and procedures.

(3) Every registered transfer agent shall maintain, for a period of three years following the date of the rejection, a record of transfers rejected, including the reason for the rejection, who the guarantor was and whether the guarantor failed to meet the transfer agent's guarantee standards.

(f) *Exclusions.* Nothing in this section shall prohibit a transfer agent from rejecting a request for transfer of a certificated or uncertificated security:

(1) For reasons unrelated to acceptance of the guarantor institution;

(2) Because the person acting on behalf of the guarantor institution is not authorized by that institution to act on its behalf, provided that the transfer agent maintains a list of people authorized to act on behalf of that guarantor institution; or

(3) Because the eligible guarantor institution of a type specified in paragraph (a)(2)(ii) of this section is neither a member of a clearing corporation nor maintains net capital of at least $100,000.

(g) *Signature guarantee program.* (1) A registered transfer agent shall be deemed to comply with paragraph (c) of this section if its standards and procedures include:

(i) Rejecting a request for transfer because the guarantor is neither a member of nor a participant in a signature guarantee program; or

(ii) Accepting a guarantee from an eligible guarantor institution who, at the time of issuing the guarantee, is a member of or participant in a signature guarantee program.

(2) Within the first six months after revising its standards and procedures to include a signature guarantee program, the transfer agent shall not reject a request for transfer because the guarantor is neither a member of nor participant in a signature guarantee program, unless the transfer agent has given that guarantor ninety days written notice of the transfer agent's intent to reject transfers with guarantees from non-participating or nonmember guarantors.

(3) For purposes of paragraph (g) of this section, the term ''signature guarantee program,'' means a program, the terms and conditions of which the transfer agent reasonably determines:

(i) To facilitate the equitable treatment of eligible guarantor institutions; and

(ii) To promote the prompt, accurate and safe transfer of securities by providing:

(A) Adequate protection to the transfer agent against risk of financial loss in the event persons have no recourse against the eligible guarantor institution; and

(B) Adequate protection to the transfer agent against the issuance of unauthorized guarantees.

[57 FR 1095, Jan. 10, 1992]

§ 240.17Ad–16 Notice of assumption or termination of transfer agent services.

(a) A registered transfer agent that ceases to perform transfer agent services on behalf of an issuer of securities, including a registered transfer agent that ceases to perform transfer agent services on behalf of an issuer of securities because of a merger or acquisition by another transfer agent, shall send written notice of such termination to the appropriate qualified registered securities depository on or before the later of ten calendar days prior to the effective date of such termination or the day the transfer agent is notified of the effective date of such termination. Such notice shall include the full name, address, telephone number, and Financial Industry Number Standard (''FINS'') number of the transfer agent ceasing to perform the transfer agent services for the issuer; the issuer's name; the issue or issues handled and their CUSIP number(s); and if known, the name, address, and telephone number of the transfer agent that thereafter will provide transfer services for the issuer. If no successor transfer agent is known, the notice shall include the name and address of a contact person at the issuer.

(b) A registered transfer agent that changes its name or address or that assumes transfer agent services on behalf of an issuer of securities, including a transfer agent that assumes transfer agent services on behalf of an issuer of securities because of a merger or acquisition of another transfer agent, shall send written notice of such to the appropriate qualified registered securities depository on or before the later of ten calendar days prior to the effective date of such change in status or the day the transfer agent is notified of the effective date of such change in status. A notice regarding a change of name or address shall include the full name, address, telephone number, and FINS number of the transfer agent and the location where certificates are received for transfer. A notice regarding the assumption of transfer agent services on behalf of an issuer of securities, including assumption of transfer agent services resulting from the merger or acquisition of another transfer agent, shall include the full name, address, telephone number, and FINS number of the transfer agent assuming the transfer agent services for the issuer; the issuer's name; and the issue or issues handled and their CUSIP number(s).

(c) The notice described in paragraphs (a) and (b) of this section shall be delivered by means of secure communication. For purposes of this section, secure communication shall include telegraph, overnight mail, facsimile, or any other form of secure communication.

(d)(1) The appropriate qualified registered securities depository that receives notices pursuant to paragraphs (a) and (b) of this section shall deliver within 24 hours a copy of such notices to each qualified registered securities depository. A qualified registered securities depository that receives notice pursuant to this section shall deliver a copy of such notices to its own participants within 24 hours.

(2) A qualified registered securities depository may comply with its notice requirements under paragraph (d)(1) of this section by making available the notice of all material information from the notice within 24 hours in a manner set forth in the rules of the qualified registered securities depository.

(3) A qualified registered securities depository shall maintain such notices for a period of not less than two years, the first six months in an easily accessible place. Such notice shall be made available to the Commission or other persons as the Commission may designate by order.

(4) A registered transfer agent that provides notice pursuant to paragraphs (a) and (b) of this section shall maintain such notice for a period of not less than two years, the first six months in an easily accessible place.

(e) For purposes of this section, a *qualified registered securities depository* shall mean a clearing agency registered under section 17A of the Act (15 U.S.C. 78q-1) that performs clearing agency functions as described in section 3(a)(23)(A)(i) of the Act (15 U.S.C. 78c(a)(23)(A)(i)) and that has rules and procedures concerning its responsibility for maintaining, updating, and providing appropriate access to the information it receives pursuant to this section.

(f) For purposes of this section, an *appropriate qualified registered securities depository* shall mean the qualified registered securities depository that the Commission so designates by order or, in the absence of such designation, the qualified registered securities depository that is the largest holder of record of all qualified registered securities depositories as of the most recent record date.

[59 FR 63661, Dec. 8, 1994]

§ 240.17Ad–17 Lost securityholders and unresponsive payees.

(a)(1) Every recordkeeping transfer agent whose master securityholder file includes accounts of lost securityholders and every broker or dealer that has customer security accounts that include accounts of lost securityholders shall exercise reasonable care to ascertain the correct addresses of such securityholders. In exercising reasonable care to ascertain such lost securityholders' correct addresses, each such recordkeeping transfer agent and each such broker or dealer shall conduct two database searches using at least one information database service. The transfer agent, broker, or dealer shall search by taxpayer identification number or by name if a search based on taxpayer identification number is not reasonably likely to locate the securityholder. Such database searches must be conducted without charge to a lost securityholder and with the following frequency:

(i) Between three and twelve months of such securityholder becoming a lost securityholder; and

(ii) Between six and twelve months after the first search for such lost securityholder by the transfer agent, broker, or dealer.

(2) A transfer agent, broker, or dealer may not use a search method or service to establish contact with lost

securityholders that results in a charge to a lost securityholder prior to completing the searches set forth in paragraph (a)(1) of this section.

(3) A transfer agent, broker, or dealer need not conduct the searches set forth in paragraph (a)(1) of this section for a lost securityholder if:

(i) It has received documentation that such securityholder is deceased; or

(ii) The aggregate value of assets listed in the lost securityholder's account, including all dividend, interest, and other payments due to the lost securityholder and all securities owned by the lost securityholder as recorded in the master securityholder files of the transfer agent or in the customer security account records of the broker or dealer, is less than $25; or

(iii) The securityholder is not a natural person.

(b) For purposes of this section:

(1) *Information data base service* means either:

(i) Any automated data base service that contains addresses from the entire United States geographic area, contains the names of at least 50% of the United States adult population, is indexed by taxpayer identification number or name, and is updated at least four times a year; or

(ii) Any service or combination of services which produces results comparable to those of the service described in paragraph (b)(1)(i) of this section in locating lost securityholders.

(2) *Lost securityholder* means a securityholder:

(i) To whom an item of correspondence that was sent to the securityholder at the address contained in the transfer agent's master securityholder file or customer security account records of the broker or dealer has been returned as undeliverable; provided, however, that if such item is re-sent within one month to the lost securityholder, the transfer agent, broker, or dealer may deem the securityholder to be a lost securityholder as of the day the resent item is returned as undeliverable; and

(ii) For whom the transfer agent, broker, or dealer has not received information regarding the securityholder's new address.

(c)(1) The paying agent, as defined in paragraph (c)(2) of this section, shall provide not less than one written notification to each unresponsive payee, as defined in paragraph (c)(3) of this section, stating that such unresponsive payee has been sent a check that has not yet been negotiated. Such notification may be sent with a check or other mailing subsequently sent to the unresponsive payee but must be provided no later than seven (7) months (or 210 days) after the sending of the not yet negotiated check. The paying agent shall not be required to send a written notice to an unresponsive payee if such unresponsive payee would be considered a lost securityholder by a transfer agent, broker, or dealer.

(2) The term *paying agent* shall include any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee, custodian, or any other person that accepts payments from the issuer of a security and distributes the payments to the holders of the security.

(3) A securityholder shall be considered an *unresponsive payee* if a check is sent to the securityholder by the paying agent and the check is not negotiated before the earlier of the paying agent's sending the next regularly scheduled check or the elapsing of six (6) months (or 180 days) after the sending of the not yet negotiated check. A securityholder shall no longer be considered an *unresponsive payee* when the securityholder negotiates the check or checks that caused the securityholder to be considered an *unresponsive payee*.

(4) A paying agent shall be excluded from the requirements of paragraph (c)(1) of this section where the value of the not yet negotiated check is less than $25.

(5) The requirements of paragraph (c)(1) of this section shall have no effect on state escheatment laws.

(d) Every recordkeeping transfer agent, every broker or dealer that has customer security accounts, and every paying agent shall maintain records to demonstrate compliance with the requirements set forth in this section, which records shall include written procedures that describe the transfer agent's, broker's, dealer's, or paying agent's methodology for complying with this section, and shall retain such records in accordance with Rule 17Ad–7(i) (§ 240.17Ad–7(i)).

[62 FR 52237, Oct. 7, 1997; 63 FR 1884, Jan. 12, 1998, as amended at 68 FR 14316, Mar. 25, 2003; 78 FR 4784, Jan. 23, 2013]

§ 240.17Ad–18 Year 2000 Reports to be made by certain transfer agents.

(a) Each registered non-bank transfer agent must file Part I of Form TA-Y2K (§ 249.619 of this chapter) with the Commission describing the transfer agent's preparation for Year 2000 Problems. Part I of Form TA-Y2K shall be filed no later than August 31, 1998, and April 30, 1999. Part I of Form TA-Y2K shall reflect the transfer agent's preparation for the Year 2000 as of July 15, 1998, and March 15, 1999, respectively.

(b) Each registered non-bank transfer agent, except for those transfer agents that qualify for the exemption in paragraph (d) of § 240.17Ad–13, must file with the Commission Part II of Form TA-Y2K (§ 249.619 of this chapter) in addition to Part I of Form TA-Y2K. Part II of Form TA-Y2K report shall address the following topics:

(1) Whether the board of directors (or similar body) of the transfer agent has approved and funded plans for preparing and testing its computer systems for Year 2000 Problems;

(2) Whether the plans of the transfer agent exist in writing and address all mission critical computer systems of the transfer agent wherever located throughout the world;

(3) Whether the transfer agent has assigned existing employees, has hired new employees, or has engaged third parties to provide assistance in addressing Year 2000 Problems; and if so, a description of the work that these groups of individuals have performed as of the date of each report;

(4) The current progress on each stage of preparation for potential problems caused by Year 2000 Problems. These stages are:

(i) Awareness of potential Year 2000 Problems;

(ii) Assessment of what steps the transfer agent must take to address Year 2000 Problems;

(iii) Implementation of the steps needed to address Year 2000 Problems;

(iv) Internal testing of software designed to address Year 2000 Problems, including the number and description of the material exceptions resulting from such testing that are unresolved as of the reporting date;

(v) Point-to point or industry-wide testing of software designed to address Year 2000 Problems (including testing with other transfer agents, other financial institutions, and customers), including the number and description of the material exceptions resulting from such testing that are unresolved as of the reporting date; and

(vi) Implementation of tested software that will address Year 2000 Problems;

(5) Whether the transfer agent has written contingency plans in the event that, after December 31, 1999, it has computer problems caused by Year 2000 Problems; and

(6) What levels of the transfer agent's management are responsible for addressing potential problems caused by Year 2000 Problems, including a description of the responsibilities for each level of management regarding the Year 2000 Problems;

(7) Any additional material information in both reports concerning its management of Year 2000 Problems that could help the Commission assess the transfer agent's readiness for the Year 2000.

(8) Part II of Form TA-Y2K (§ 249.619 of this chapter) shall be filed no later than August 31, 1998, and April 30, 1999. Part II of Form TA-Y2K shall reflect the transfer agent's preparation for the Year 2000 as of July 15, 1998, and March 15, 1999, respectively.

(c) Any non-bank transfer agent that registers between the adoption of the final rule and December 31, 1999, must file with the Commission Part I of Form TA-Y2K (§ 249.619 of this chapter) no later than 30 days after their registration becomes effective. New transfer agents whose registration with the Commission becomes effective between January 1, 1999, and April 30, 1999, would be required to file the second report due on April 30, 1999.

(d) For purposes of this section, the term Year 2000 Problem shall include problems arising from:

(1) Computer software incorrectly reading the date ''01/01/00'' as being the year 1900 or another incorrect year;

(2) Computer software incorrectly identifying a date in the Year 1999 or any year thereafter;

(3) Computer software failing to detect that the Year 2000 is a leap year; or

(4) Any other computer software error that is directly or indirectly caused by paragraph (d)(1), (2), or (3) of this section.

(e) For purposes of this section, the term non-bank transfer agent means a transfer agent whose:

(1) Appropriate regulatory agency, as that term is defined by 15 U.S.C. 78(c)(34)(B), is the Securities and Exchange Commission; and

(2) Is not a savings association, as defined by Section 3 of the Federal Deposit Insurance Act, 12 U.S.C. 1813, which is regulated by the Office of Thrift Supervision.

(f) *Nature and form of reports.* No later than April 30, 1999, every non-bank transfer agent required to file Part II of Form TA-Y2K (§ 249.619 of this chapter) pursuant to paragraph (b)(8) of this section shall file with its Form TA-Y2K an original and two copies of a report prepared by an independent public accountant regarding the non-bank transfer agent's process, as of March 15, 1999, for addressing Year 2000 Problems with the Commission's principal office in Washington, DC. The independent public accountant's report shall be prepared in accordance with standards that have been reviewed by the Commission and that have been issued by a national organization that is responsible for promulgating authoritative accounting and auditing standards.

[63 FR 37693, July 13, 1998, as amended at 63 FR 58635, Nov. 2, 1998]

§ 240.17Ad–19 Requirements for cancellation, processing, storage, transportation, and destruction or other disposition of securities certificates.

(a) *Definitions.* For purposes of this section:

(1) The terms *cancelled* or *cancellation* means the process in which a securities certificate:

(i) Is physically marked to clearly indicate that it no longer represents a claim against the issuer; and

(ii) Is voided on the records of the transfer agent.

(2) The term *cancelled certificate facility* means any location where securities certificates are cancelled and thereafter processed, stored, transported, destroyed or otherwise disposed of.

(3) The term *certificate number* means a unique identification or serial number that is assigned and affixed by an issuer or transfer agent to each securities certificate.

(4) The term *controlled access* means the practice of permitting the entry of only authorized personnel to areas where securities certificates are cancelled and thereafter processed, stored, transported, destroyed or otherwise disposed of.

(5) The term *CUSIP number* means the unique identification number that is assigned to each securities issue.

(6) The term *destruction* means the physical ruination of a securities certificate by a transfer agent as part of the certificate destruction procedures that make the reconstruction of the certificate impossible.

(7) The term *otherwise disposed of* means any disposition other than by destruction.

(8) The term *securities certificate* has the same meaning that it has in § 240.17f-1(a)(6).

(b) *Required procedures for the cancellation, storage, transportation, destruction, or other disposition of securities certificates.* Every transfer agent involved in the handling, processing, or storage of securities certificates shall establish and implement written procedures for the cancellation, storage, transportation, destruction, or other disposition of securities certificates. This requirement applies to any agent that the transfer agent uses to perform any of these activities.

(c) *Written procedures.* The written procedures required by paragraph (b) of this section at a minimum shall provide that:

(1) There is controlled access to any cancelled certificate facility;

(2) Each cancelled certificate be marked with the word ''CANCELLED'' by stamp or perforation on the face of

the certificate unless the transfer agent has procedures adopted pursuant to this rule for the destruction of cancelled certificates within three business days of their cancellation;

(3) A record that is indexed and retrievable by CUSIP and certificate number that contains the CUSIP number, certificate number with any prefix or suffix, denomination, registration, issue date, and cancellation date of each cancelled certificate;

(4) A record that is indexed and retrievable by CUSIP and certificate number of each destroyed securities certificate or securities certificate otherwise disposed of, the records must contain for each destroyed or otherwise disposed of certificate the CUSIP number, certificate number with any prefix or suffix, denomination, registration, issue date, and cancellation date, and additionally for any certificate otherwise disposed of a record of how it was disposed of, the name and address of the party to whom it was disposed, and the date of disposition;

(5) The physical transportation of cancelled certificates be made in a secure manner and that the transfer agent maintain separately a record of the CUSIP number and certificate number of each certificate in transit;

(6) Authorized personnel of the transfer agent or its designee supervise and witness the intentional destruction of any cancelled certificate and retain copies of all records relating to certificates which were destroyed; and

(7) Reports to the Lost and Stolen Securities Program be effected in a timely and complete manner, as provided in § 240.17f–1 of any cancelled certificate that is lost, stolen, missing, or counterfeit.

(d) *Recordkeeping*. Every transfer agent subject to this section shall maintain records that demonstrate compliance with the requirements set forth in this section and that describe the transfer agent's methodology for complying with this section for three years, the first year in an easily accessible place.

(e) *Exemptive authority*. Upon written application or upon its own motion, the Commission may grant an exemption from any of the provisions of this section, either unconditionally or on specific terms and conditions, to any transfer agent or any class of transfer agents and to any securities certificate or any class of securities certificates.

[68 FR 74401, Dec. 23, 2003]

§ 240.17Ad–20 Issuer restrictions or prohibitions on ownership by securities intermediaries.

(a) Except as provided in paragraph (c) of this section, no registered transfer agent shall transfer any equity security registered pursuant to section 12 or any equity security that subjects an issuer to reporting under section 15(d) of the Act (15 U.S.C. 78*l* or 15 U.S.C. 78o(d)) if such security is subject to any restriction or prohibition on transfer to or from a securities intermediary in its capacity as such.

(b) The term *securities intermediary* means a clearing agency registered under section 17A of the Act (15 U.S.C. 78q–1) or a person, including a bank, broker, or dealer, that in the ordinary course of its business maintains securities accounts for others in its capacity as such.

(c) The provisions of this section shall not apply to any equity security issued by a partnership as defined in rule 901(b) of Regulation S–K (§ 229.901(b) of this chapter).

[70 FR 70862, Dec. 7, 2004]

§ 240.17Ad–21T Operational capability in a Year 2000 environment.

(a) This section applies to every registered non-bank transfer agent that uses computers in the conduct of its business as a transfer agent.

(b)(1) You have a material Year 2000 problem if, at any time on or after August 31, 1999:

(i) Any of your mission critical computer systems incorrectly identifies any date in the Year 1999 or the Year 2000, and

(ii) The error impairs or, if uncorrected, is likely to impair, any of your mission critical systems under your control.

(2) You will be presumed to have a material Year 2000 problem if, at any time on or after August 31, 1999, you:

(i) Do not have written procedures reasonably designed to identify, assess, and remediate any material Year 2000 problems in your mission critical systems under your control;

(ii) Have not verified your Year 2000 remediation efforts through reasonable internal testing of your mission critical systems under your control and reasonable testing of your external links under your control; or

(iii) Have not remediated all exceptions related to your mission critical systems contained in any independent public accountant's report prepared on your behalf pursuant to § 240.17Ad–18(f).

(c) If you have or are presumed to have a material Year 2000 problem, you must immediately notify the Commission and your issuers of the problem. You must send this notice to the Commission by overnight delivery to the Division of Market Regulation, U.S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–6628 Attention: Y2K Compliance.

(d)(1) If you are a registered nonbank transfer agent that has or is presumed to have a material Year 2000 problem, you may not, on or after August 31, 1999, engage in any transfer agent function, including:

(i) Countersigning such securities upon issuance;

(ii) Monitoring the issuance of such securities with a view to preventing unauthorized issuance;

(iii) Registering the transfer of such securities;

(iv) Exchanging or converting such securities; or

(v) Transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates.

(2) Notwithstanding paragraph (d)(1) of this section, you may continue to engage in transfer agent functions:

(i) Until December 1, 1999, if you have submitted a certificate to the Commission in compliance with paragraph (e) of this section; or

(ii) Solely to the extent necessary to effect an orderly cessation or transfer of these functions.

(e)(1)(i) If you are a registered nonbank transfer agent that has or is presumed to have a material Year 2000 problem, you may, in addition to providing the Commission the notice required by paragraph (c) of this section, provide the Commission and your issuers a certificate signed by your chief executive officer (or an individual with similar authority) stating:

(A) You are in the process of remediating your material Year 2000 problem;

(B) You have scheduled testing of your affected mission critical systems to verify that the material Year 2000 problem has been remediated, and specify the testing dates;

(C) The date by which you anticipate completing remediation of the material Year 2000 problem in your mission critical systems; and

(D) Based on inquiries and to the best of the chief executive officer's knowledge, you do not anticipate that the existence of the material Year 2000 problem in your mission critical systems will impair your ability, depending on the nature of your business, to assure the prompt and accurate transfer and processing of securities, the maintenance of master securityholder files, or the production and retention of required records; and you anticipate that the steps referred to in paragraphs (e)(1)(i)(A) through (C) of this section will result in remedying the material Year 2000 problem on or before November 15, 1999.

(ii) If the information contained in any certificate provided to the Commission pursuant to paragraph (e) of this section is or becomes misleading or inaccurate for any reason, you must promptly file an updated certificate correcting such information. In addition to the information contained in the certificate, you may provide the Commission with any other information necessary to establish that your mission critical systems will not have material Year 2000 problems on or after November 15, 1999.

(2) If you have submitted a certificate pursuant to paragraph (e)(1) of this section, you must submit a certificate to the Commission and your issuers signed by your chief executive officer (or an individual with similar authority) on or before November 15, 1999, stating that, based on inquiries and to the best of the chief executive officer's knowledge, you have remediated your Year 2000 problem or that you will cease operations. This certificate must be sent to the Commission by overnight delivery to the Division of

Market Regulation, U.S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–6628 Attention: Y2K Compliance.

(f) Notwithstanding paragraph (d)(2) of this section, you must comply with the requirements of paragraph (d)(1) of this section if you have been so ordered by the Commission or by a court.

(g) Beginning August 31, 1999, and ending March 31, 2000, you must make backup records for all master securityholder files at the close of each business day and must preserve these backup records for a rolling five business day period in a manner that will allow for the transfer and conversion of the records to a successor transfer agent. If you have a material Year 2000 problem, you must preserve for at least one year the five day backup records immediately preceding the day the problem was discovered. In addition, you must make at the close of business on December 27 through 31, 1999, a backup copy for all master securityholder files and preserve these records for at least one year. Such backup records must permit the timely restoration of such systems to their condition existing prior to experiencing the material Year 2000 problem. Copies of the backup records must be kept in an easily accessible place but must not be located with or held in the same computer system as the primary records, and you must be able to immediately produce or reproduce them. You must furnish promptly to a representative of the Commission such legible, true, and complete copies of those records, as may be requested.

(h) For the purposes of this section:

(1) The term *mission critical system* means any system that is necessary, depending on the nature of your business, to assure the prompt and accurate transfer and processing of securities, the maintenance of master securityholder files, and the production and retention of required records as described in paragraph (d) of this section;

(2) The term *customer* includes an issuer, transfer agent, or other person for which you provide transfer agent services;

(3) The term *registered non-bank transfer agent* means a transfer agent, whose appropriate regulatory agency is the Commission and not the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation; and

(4) The term *master securityholder file* has the same definition as defined in §240.17Ad–9(b).

(i) This temporary section will expire on July 1, 2001.

[64 FR 42029, Aug. 3, 1999, as amended at 73 FR 32228, June 5, 2008]

§ 240.17Ad–22 Standards for clearing agencies.

(a) *Definitions.* For purposes of this section:

(1) *Backtesting* means an ex-post comparison of actual outcomes with expected outcomes derived from the use of margin models.

(2) *Central counterparty* means a clearing agency that interposes itself between the counterparties to securities transactions, acting functionally as the buyer to every seller and the seller to every buyer.

(3) *Central securities depository services* means services of a clearing agency that is a securities depository as described in Section 3(a)(23)(A) of the Act (15 U.S.C. 78c(a)(23)(A)).

(4) *Clearing agency involved in activities with a more complex risk profile* means a clearing agency registered with the Commission under Section 17A of the Act (15 U.S.C. 78q–1) that:

(i) Provides central counterparty services for security-based swaps;

(ii) Has been determined by the Commission to be involved in activities with a more complex risk profile at the time of its initial registration; or

(iii) Is subsequently determined by the Commission to be involved in activities with a more complex risk profile pursuant to §240.17Ab2–2(b).

(5) *Covered clearing agency* means a designated clearing agency or a clearing agency involved in activities with a more complex risk profile for which the Commodity Futures Trading Commission is not the Supervisory Agency as defined in Section 803(8) of the Payment, Clearing, and Settlement Supervision Act of 2010 (12 U.S.C. 5461 *et seq.*).

(6) *Designated clearing agency* means a clearing agency registered with the Commission under Section 17A of the

Exchange Act (15 U.S.C. 78q–1) that is designated systemically important by the Financial Stability Oversight Council pursuant to the Payment, Clearing, and Settlement Supervision Act of 2010 (12 U.S.C. 5461 *et seq.*) and for which the Commission is the supervisory agency as defined in Section 803(8) of the Payment, Clearing, and Settlement Supervision Act of 2010 (12 U.S.C. 5461 *et seq.*).

(7) *Financial market utility* has the same meaning as defined in Section 803(6) of the Payment, Clearing, and Settlement Supervision Act of 2010 (12 U.S.C. 5462(6)).

(8) *Link* means, for purposes of paragraph (e)(20) of this section, a set of contractual and operational arrangements between two or more clearing agencies, financial market utilities, or trading markets that connect them directly or indirectly for the purposes of participating in settlement, cross margining, expanding their services to additional instruments or participants, or for any other purposes material to their business.

(9) *Model validation* means an evaluation of the performance of each material risk management model used by a covered clearing agency (and the related parameters and assumptions associated with such models), including initial margin models, liquidity risk models, and models used to generate clearing or guaranty fund requirements, performed by a qualified person who is free from influence from the persons responsible for the development or operation of the models or policies being validated.

(10) *Net capital* as used in paragraph (b)(7) of this section means net capital as defined in § 240.15c3–1 for broker-dealers or any similar risk adjusted capital calculation for all other prospective clearing members.

(11) *Normal market conditions* as used in paragraphs (b)(1) and (2) of this section means conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time.

(12) *Participant family* means that if a participant directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, another participant then the affiliated participants shall be collectively deemed to be a single participant family for purposes of paragraphs (b)(3), (d)(14), (e)(4), and (e)(7) of this section.

(13) *Potential future exposure* means the maximum exposure estimated to occur at a future point in time with an established single-tailed confidence level of at least 99 percent with respect to the estimated distribution of future exposure.

(14) *Qualifying liquid resources* means, for any covered clearing agency, the following, in each relevant currency:

(i) Cash held either at the central bank of issue or at creditworthy commercial banks;

(ii) Assets that are readily available and convertible into cash through prearranged funding arrangements, such as:

(A) Committed arrangements without material adverse change provisions, including:

(*1*) Lines of credit;

(*2*) Foreign exchange swaps; and

(*3*) Repurchase agreements; or

(B) Other prearranged funding arrangements determined to be highly reliable even in extreme but plausible market conditions by the board of directors of the covered clearing agency following a review conducted for this purpose not less than annually; and

(iii) Other assets that are readily available and eligible for pledging to (or conducting other appropriate forms of transactions with) a relevant central bank, if the covered clearing agency has access to routine credit at such central bank in a jurisdiction that permits said pledges or other transactions by the covered clearing agency.

(15) *Security-based swap* means a security-based swap as defined in Section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)).

(16) *Sensitivity analysis* means an analysis that involves analyzing the sensitivity of a model to its assumptions, parameters, and inputs that:

(i) Considers the impact on the model of both moderate and extreme changes in a wide range of inputs, parameters, and assumptions, including correlations of price movements or returns if relevant, which reflect a variety of historical and hypothetical market conditions. Sensitivity analysis must use actual portfolios and, where applicable, hypothetical portfolios that reflect the characteristics of proprietary positions and customer positions;

(ii) When performed by or on behalf of a covered clearing agency involved in activities with a more complex risk profile, considers the most volatile relevant periods, where practical, that have been experienced by the markets served by the clearing agency; and

(iii) Tests the sensitivity of the model to stressed market conditions, including the market conditions that may ensue after the default of a member and other extreme but plausible conditions as defined in a covered clearing agency's risk policies.

(17) *Stress testing* means the estimation of credit or liquidity exposures that would result from the realization of potential stress scenarios, such as extreme price changes, multiple defaults, or changes in other valuation inputs and assumptions.

(18) *Systemically important in multiple jurisdictions* means, with respect to a covered clearing agency, a covered clearing agency that has been determined by the Commission to be systemically important in more than one jurisdiction pursuant to § 240.17Ab2–2.

(19) *Transparent* means, for the purposes of paragraphs (e)(1), (2), and (10) of this section, to the extent consistent with other statutory and Commission requirements on confidentiality and disclosure, that documentation required under paragraphs (e)(1), (2), and (10) is disclosed to the Commission and, as appropriate, to other relevant authorities, to clearing members and to customers of clearing members, to the owners of the covered clearing agency, and to the public.

(b) A registered clearing agency that performs central counterparty services shall establish, implement, maintain and enforce written policies and procedures reasonably designed to:

(1) Measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants under normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

(2) Use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements and review such margin requirements and the related risk-based models and parameters at least monthly.

(3) Maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions; provided that a registered clearing agency acting as a central counterparty for security-based swaps shall maintain additional financial resources sufficient to withstand, at a minimum, a default by the two participant families to which it has the largest exposures in extreme but plausible market conditions, in its capacity as a central counterparty for security-based swaps. Such policies and procedures may provide that the additional financial resources may be maintained by the security-based swap clearing agency generally or in separately maintained funds.

(4) Provide for an annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who is free from influence from the persons responsible for the development or operation of the models being validated.

(5) Provide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership on fair and reasonable terms at the clearing agency to clear securities for itself or on behalf of other persons.

(6) Have membership standards that do not require that participants maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume.

(7) Provide a person that maintains net capital equal to or greater than $50 million with the ability to obtain

membership at the clearing agency, provided that such persons are able to comply with other reasonable membership standards, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency; provided, however, that the clearing agency may provide for a higher net capital requirement as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application.

(c) *Record of financial resources and annual audited financial statements.* (1) Each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon Commission request, a registered clearing agency that performs central counterparty services shall calculate and maintain a record, in accordance with § 240.17a–1 of this chapter, of the financial and qualifying liquid resources necessary to meet the requirements, as applicable, of paragraphs (b)(3), (e)(4), and (e)(7) of this section, and sufficient documentation to explain the methodology it uses to compute such financial resources or qualifying liquid resources requirement.

(2) Within 60 days after the end of its fiscal year, each registered clearing agency shall post on its Web site its annual audited financial statements. Such financial statements shall:

(i) Include, for the clearing agency and its subsidiaries, consolidated balance sheets as of the end of the two most recent fiscal years and statements of income, changes in stockholders' equity and other comprehensive income and cash flows for each of the two most recent fiscal years;

(ii) Be prepared in accordance with U.S. generally accepted accounting principles, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the consolidated financial statements may be prepared in accordance with U.S. generally accepted accounting principles or International Financial Reporting Standards as issued by the International Accounting Standards Board;

(iii) Be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with 17 CFR 210.2–01; and

(iv) Include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of 17 CFR 210.2–02.

(d) Each registered clearing agency that is not a covered clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:

(1) Provide for a well-founded, transparent, and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.

(2) Require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency; have procedures in place to monitor that participation requirements are met on an ongoing basis; and have participation requirements that are objective and publicly disclosed, and permit fair and open access.

(3) Hold assets in a manner that minimizes risk of loss or of delay in its access to them; and invest assets in instruments with minimal credit, market and liquidity risks.

(4) Identify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures; implement systems that are reliable, resilient and secure, and have adequate, scalable capacity; and have business continuity plans that allow for timely recovery of operations and fulfillment of a clearing agency's obligations.

(5) Employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants; and require funds transfers

to the clearing agency to be final when effected.

(6) Be cost-effective in meeting the requirements of participants while maintaining safe and secure operations.

(7) Evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear or settle trades, and ensure that the risks are managed prudently on an ongoing basis.

(8) Have governance arrangements that are clear and transparent to fulfill the public interest requirements in Section 17A of the Act (15 U.S.C. 78q–1) applicable to clearing agencies, to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures.

(9) Provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using its services.

(10) Immobilize or dematerialize securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides central securities depository services.

(11) Make key aspects of the clearing agency's default procedures publicly available and establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default.

(12) Ensure that final settlement occurs no later than the end of the settlement day; and require that intraday or real-time finality be provided where necessary to reduce risks.

(13) Eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

(14) Institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant family exposure fully, that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides central securities depository services and extends intraday credit to participants.

(15) State to its participants the clearing agency's obligations with respect to physical deliveries and identify and manage the risks from these obligations.

(e) Each covered clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:

(1) Provide for a well-founded, clear, transparent, and enforceable legal basis for each aspect of its activities in all relevant jurisdictions.

(2) Provide for governance arrangements that:

(i) Are clear and transparent;

(ii) Clearly prioritize the safety and efficiency of the covered clearing agency;

(iii) Support the public interest requirements in Section 17A of the Act (15 U.S.C. 78q–1) applicable to clearing agencies, and the objectives of owners and participants;

(iv) Establish that the board of directors and senior management have appropriate experience and skills to discharge their duties and responsibilities;

(v) Specify clear and direct lines of responsibility; and

(vi) Consider the interests of participants' customers, securities issuers and holders, and other relevant stakeholders of the covered clearing agency.

(3) Maintain a sound risk management framework for comprehensively managing legal, credit, liquidity, operational, general business, investment, custody, and other risks that arise in or are borne by the covered clearing agency, which:

(i) Includes risk management policies, procedures, and systems designed to identify, measure, monitor, and manage the range of risks that arise in or are borne by the covered clearing agency, that are subject to review on a specified periodic basis and approved by the board of directors annually;

(ii) Includes plans for the recovery and orderly wind-down of the covered clearing agency necessitated by credit losses, liquidity shortfalls, losses from general business risk, or any other losses;

(iii) Provides risk management and internal audit personnel with sufficient authority, resources, independence from management, and access to the board of directors;

(iv) Provides risk management and internal audit personnel with a direct reporting line to, and oversight by, a risk management committee and an independent audit committee of the board of directors, respectively; and

(v) Provides for an independent audit committee.

(4) Effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes, including by:

(i) Maintaining sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence;

(ii) To the extent not already maintained pursuant to paragraph (e)(4)(i) of this section, for a covered clearing agency providing central counterparty services that is either systemically important in multiple jurisdictions or a clearing agency involved in activities with a more complex risk profile, maintaining additional financial resources at the minimum to enable it to cover a wide range of foreseeable stress scenarios that include, but are not limited to, the default of the two participant families that would potentially cause the largest aggregate credit exposure for the covered clearing agency in extreme but plausible market conditions;

(iii) To the extent not already maintained pursuant to paragraph (e)(4)(i) of this section, for a covered clearing agency not subject to paragraph (e)(4)(ii) of this section, maintaining additional financial resources at the minimum to enable it to cover a wide range of foreseeable stress scenarios that include, but are not limited to, the default of the participant family that would potentially cause the largest aggregate credit exposure for the covered clearing agency in extreme but plausible market conditions;

(iv) Including prefunded financial resources, exclusive of assessments for additional guaranty fund contributions or other resources that are not prefunded, when calculating the financial resources available to meet the standards under paragraphs (e)(4)(i) through (iii) of this section, as applicable;

(v) Maintaining the financial resources required under paragraphs (e)(4)(ii) and (iii) of this section, as applicable, in combined or separately maintained clearing or guaranty funds;

(vi) Testing the sufficiency of its total financial resources available to meet the minimum financial resource requirements under paragraphs (e)(4)(i) through (iii) of this section, as applicable, by:

(A) Conducting stress testing of its total financial resources once each day using standard predetermined parameters and assumptions;

(B) Conducting a comprehensive analysis on at least a monthly basis of the existing stress testing scenarios, models, and underlying parameters and assumptions, and considering modifications to ensure they are appropriate for determining the covered clearing agency's required level of default protection in light of current and evolving market conditions;

(C) Conducting a comprehensive analysis of stress testing scenarios, models, and underlying parameters and assumptions more frequently than monthly when the products cleared or markets served display high volatility or become less liquid, or when the size or concentration of positions held by the covered clearing agency's participants increases significantly; and

(D) Reporting the results of its analyses under paragraphs (e)(4)(vi)(B) and (C) of this section to appropriate decision makers at the covered clearing agency, including but not limited to, its risk management committee or board of directors, and using these results to evaluate the adequacy of and adjust its margin methodology, model parameters, models used to generate clearing or guaranty fund requirements, and any other relevant aspects of its credit risk management framework, in supporting compliance with the minimum financial resources requirements set forth in paragraphs (e)(4)(i) through (iii) of this section;

(vii) Performing a model validation for its credit risk models not less than annually or more frequently as may be contemplated by the covered clearing agency's risk management framework established pursuant to paragraph (e)(3) of this section;

(viii) Addressing allocation of credit losses the covered clearing agency may face if its collateral and other resources are insufficient to fully cover its credit exposures, including the repayment of any funds the covered clearing agency may borrow from liquidity providers; and

(ix) Describing the covered clearing agency's process to replenish any financial resources it may use following a default or other event in which use of such resources is contemplated.

(5) Limit the assets it accepts as collateral to those with low credit, liquidity, and market risks, and set and enforce appropriately conservative haircuts and concentration limits if the covered clearing agency requires collateral to manage its or its participants' credit exposure; and require a review of the sufficiency of its collateral haircuts and concentration limits to be performed not less than annually.

(6) Cover, if the covered clearing agency provides central counterparty services, its credit exposures to its participants by establishing a risk-based margin system that, at a minimum:

(i) Considers, and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market;

(ii) Marks participant positions to market and collects margin, including variation margin or equivalent charges if relevant, at least daily and includes the authority and operational capacity to make intraday margin calls in defined circumstances;

(iii) Calculates margin sufficient to cover its potential future exposure to participants in the interval between the last margin collection and the close out of positions following a participant default;

(iv) Uses reliable sources of timely price data and uses procedures and sound valuation models for addressing circumstances in which pricing data are not readily available or reliable;

(v) Uses an appropriate method for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products;

(vi) Is monitored by management on an ongoing basis and is regularly reviewed, tested, and verified by:

(A) Conducting backtests of its margin model at least once each day using standard predetermined parameters and assumptions;

(B) Conducting a sensitivity analysis of its margin model and a review of its parameters and assumptions for backtesting on at least a monthly basis, and considering modifications to ensure the backtesting practices are appropriate for determining the adequacy of the covered clearing agency's margin resources;

(C) Conducting a sensitivity analysis of its margin model and a review of its parameters and assumptions for backtesting more frequently than monthly during periods of time when the products cleared or markets served display high volatility or become less liquid, or when the size or concentration of positions held by the covered clearing agency's participants increases or decreases significantly; and

(D) Reporting the results of its analyses under paragraphs (e)(6)(vi)(B) and (C) of this section to appropriate decision makers at the covered clearing agency, including but not limited to, its risk management committee or board of directors, and using these results to evaluate the adequacy of and adjust its margin methodology, model parameters, and any other relevant aspects of its credit risk management framework; and

(vii) Requires a model validation for the covered clearing agency's margin system and related models to be performed not less than annually, or more frequently as may be contemplated by the covered clearing agency's risk management framework established pursuant to paragraph (e)(3) of this section.

(7) Effectively measure, monitor, and manage the liquidity risk that arises in or is borne by the covered clearing agency, including measuring, monitoring, and managing its settlement and funding flows on an ongoing and timely basis, and its use of intraday liquidity by, at a minimum, doing the following:

(i) Maintaining sufficient liquid resources at the minimum in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of foreseeable stress scenarios that includes, but is not limited to, the default of the participant family that would generate the largest aggregate payment obligation for the covered clearing agency in extreme but plausible market conditions;

(ii) Holding qualifying liquid resources sufficient to meet the minimum liquidity resource requirement under paragraph (e)(7)(i) of this section in each relevant currency for which the covered clearing agency has payment obligations owed to clearing members;

(iii) Using the access to accounts and services at a Federal Reserve Bank, pursuant to Section 806(a) of the Payment, Clearing, and Settlement Supervision Act of 2010 (12 U.S.C. 5465(a)), or other relevant central bank, when available and where determined to be practical by the board of directors of the covered clearing agency, to enhance its management of liquidity risk;

(iv) Undertaking due diligence to confirm that it has a reasonable basis to believe each of its liquidity providers, whether or not such liquidity provider is a clearing member, has:

(A) Sufficient information to understand and manage the liquidity provider's liquidity risks; and

(B) The capacity to perform as required under its commitments to provide liquidity to the covered clearing agency;

(v) Maintaining and testing with each liquidity provider, to the extent practicable, the covered clearing agency's procedures and operational capacity for accessing each type of relevant liquidity resource under paragraph (e)(7)(i) of this section at least annually;

(vi) Determining the amount and regularly testing the sufficiency of the liquid resources held for purposes of meeting the minimum liquid resource requirement under paragraph (e)(7)(i) of this section by, at a minimum:

(A) Conducting stress testing of its liquidity resources at least once each day using standard and predetermined parameters and assumptions;

(B) Conducting a comprehensive analysis on at least a monthly basis of the existing stress testing scenarios, models, and underlying parameters and assumptions used in evaluating liquidity needs and resources, and considering modifications to ensure they are appropriate for determining the clearing agency's identified liquidity needs and resources in light of current and evolving market conditions;

(C) Conducting a comprehensive analysis of the scenarios, models, and underlying parameters and assumptions used in evaluating liquidity needs and resources more frequently than monthly when the products cleared or markets served display high volatility or become less liquid, when the size or concentration of positions held by the clearing agency's participants increases significantly, or in other appropriate circumstances described in such policies and procedures; and

(D) Reporting the results of its analyses under paragraphs (e)(7)(vi)(B) and (C) of this section to appropriate decision makers at the covered clearing agency, including but not limited to, its risk management committee or board of directors, and using these results to evaluate the adequacy of and adjust its liquidity risk management methodology, model parameters, and any other relevant aspects of its liquidity risk management framework;

(vii) Performing a model validation of its liquidity risk models not less than annually or more frequently as may be contemplated by the covered clearing agency's risk management framework established pursuant to paragraph (e)(3) of this section;

(viii) Addressing foreseeable liquidity shortfalls that would not be covered by the covered clearing agency's liquid resources and seek to avoid unwinding, revoking, or delaying the same-day settlement of payment obligations;

(ix) Describing the covered clearing agency's process to replenish any liquid resources that the clearing agency may employ during a stress event; and

(x) Undertaking an analysis at least once a year that evaluates the feasibility of maintaining sufficient liquid resources at a minimum in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of foreseeable stress scenarios that includes, but is not limited to, the default of the two participant families that would potentially cause the largest aggregate payment obligation for the covered clearing agency in extreme but plausible market conditions if the covered clearing agency provides central counterparty services and is either systemically important in multiple jurisdictions or a clearing agency involved in activities with a more complex risk profile.

(8) Define the point at which settlement is final to be no later than the end of the day on which the payment or obligation is due and, where necessary or appropriate, intraday or in real time.

(9) Conduct its money settlements in central bank money, where available and determined to be practical by the board of directors of the covered clearing agency, and minimize and manage credit and liquidity risk arising from conducting its money settlements in commercial bank money if central bank money is not used by the covered clearing agency.

(10) Establish and maintain transparent written standards that state its obligations with respect to the delivery of physical instruments, and establish and maintain operational practices that identify, monitor, and manage the risks associated with such physical deliveries.

(11) When the covered clearing agency provides central securities depository services:

(i) Maintain securities in an immobilized or dematerialized form for their transfer by book entry, ensure the integrity of securities issues, and minimize and manage the risks associated with the safekeeping and transfer of securities;

(ii) Implement internal auditing and other controls to safeguard the rights of securities issuers and holders and prevent the unauthorized creation or deletion of securities, and conduct periodic and at least daily reconciliation of securities issues it maintains; and

(iii) Protect assets against custody risk through appropriate rules and procedures consistent with relevant laws, rules, and regulations in jurisdictions where it operates.

(12) Eliminate principal risk by conditioning the final settlement of one obligation upon the final settlement of the other, regardless of whether the covered clearing agency settles on a gross or net basis and when finality occurs if the covered clearing agency settles transactions that involve the settlement of two linked obligations.

(13) Ensure the covered clearing agency has the authority and operational capacity to take timely action to contain losses and liquidity demands and continue to meet its obligations by, at a minimum, requiring the covered clearing agency's participants and, when practicable, other stakeholders to participate in the testing and review of its default procedures, including any close-out procedures, at least annually and following material changes thereto.

(14) Enable, when the covered clearing agency provides central counterparty services for security-based swaps or engages in activities that the Commission has determined to have a more complex risk profile, the segregation and portability of positions of a participant's customers and the collateral provided to the covered clearing agency with respect to those positions and effectively protect such positions and related collateral from the default or insolvency of that participant.

(15) Identify, monitor, and manage the covered clearing agency's general business risk and hold sufficient liquid net assets funded by equity to cover potential general business losses so that the covered clearing agency can continue operations and services as a going concern if those losses materialize, including by:

(i) Determining the amount of liquid net assets funded by equity based upon its general business risk profile and the length of time required to achieve a recovery or orderly wind-down, as appropriate, of its critical operations and services if such action is taken;

(ii) Holding liquid net assets funded by equity equal to the greater of either (x) six months of the covered clearing agency's current operating expenses, or (y) the amount determined by the board of directors to be sufficient to ensure a recovery or orderly wind-down of critical operations and services of the covered clearing agency, as contemplated by the plans established under paragraph (e)(3)(ii) of this section, and which:

(A) Shall be in addition to resources held to cover participant defaults or other risks covered under the credit risk standard in paragraph (b)(3) or paragraphs (e)(4)(i) through (iii) of this section, as applicable, and the liquidity risk standard in paragraphs (e)(7)(i) and (ii) of this section; and

(B) Shall be of high quality and sufficiently liquid to allow the covered clearing agency to meet its current and projected operating expenses under a range of scenarios, including in adverse market conditions; and

(iii) Maintaining a viable plan, approved by the board of directors and updated at least annually, for raising additional equity should its equity fall close to or below the amount required under paragraph (e)(15)(ii) of this section.

(16) Safeguard the covered clearing agency's own and its participants' assets, minimize the risk of loss and delay in access to these assets, and invest such assets in instruments with minimal credit, market, and liquidity risks.

(17) Manage the covered clearing agency's operational risks by:

(i) Identifying the plausible sources of operational risk, both internal and external, and mitigating their impact through the use of appropriate systems, policies, procedures, and controls;

(ii) Ensuring that systems have a high degree of security, resiliency, operational reliability, and adequate, scalable capacity; and

(iii) Establishing and maintaining a business continuity plan that addresses events posing a significant risk of disrupting operations.

(18) Establish objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access by direct and, where relevant, indirect participants and other financial market utilities, require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency, and monitor compliance with such participation requirements on an ongoing basis.

(19) Identify, monitor, and manage the material risks to the covered clearing agency arising from arrangements in which firms that are indirect participants in the covered clearing agency rely on the services provided by direct participants to access the covered clearing agency's payment, clearing, or settlement facilities.

(20) Identify, monitor, and manage risks related to any link the covered clearing agency establishes with one or more other clearing agencies, financial market utilities, or trading markets.

(21) Be efficient and effective in meeting the requirements of its participants and the markets it serves, and have the covered clearing agency's management regularly review the efficiency and effectiveness of its:

(i) Clearing and settlement arrangements;

(ii) Operating structure, including risk management policies, procedures, and systems;

(iii) Scope of products cleared or settled; and

(iv) Use of technology and communication procedures.

(22) Use, or at a minimum accommodate, relevant internationally accepted communication procedures and standards in order to facilitate efficient payment, clearing, and settlement.

(23) Provide for the following:

(i) Publicly disclosing all relevant rules and material procedures, including key aspects of its default rules and procedures;

(ii) Providing sufficient information to enable participants to identify and evaluate the risks, fees, and other material costs they incur by participating in the covered clearing agency;

(iii) Publicly disclosing relevant basic data on transaction volume and values;

(iv) A comprehensive public disclosure that describes its material rules, policies, and procedures regarding its legal, governance, risk management, and operating framework, accurate in all material respects at the time of publication, that includes:

(A) *Executive summary*. An executive summary of the key points from paragraphs (e)(23)(iv)(B), (C), and (D) of this section;

(B) *Summary of material changes since the last update of the disclosure*. A summary of the material changes since the last update of paragraph (e)(23)(iv)(C) or (D) of this section;

(C) *General background on the covered clearing agency*. A description of:

(*1*) The covered clearing agency's function and the markets it serves;

(*2*) Basic data and performance statistics on the covered clearing agency's services and operations, such as basic volume and value statistics by product type, average aggregate intraday exposures to its participants, and statistics on the covered clearing agency's operational reliability; and

(*3*) The covered clearing agency's general organization, legal and regulatory framework, and system design and operations; and

(D) *Standard-by-standard summary narrative*. A comprehensive narrative disclosure for each applicable standard set forth in paragraphs (e)(1) through (23) of this section with sufficient detail and context to enable a reader to understand the covered clearing agency's approach to controlling the risks and addressing the requirements in each standard; and

(v) Updating the public disclosure under paragraph (e)(23)(iv) of this section every two years, or more frequently following changes to its system or the environment in which it operates to the extent necessary to ensure statements previously provided under paragraph (e)(23)(iv) of this section remain accurate in all material respects.

(f) For purposes of enforcing the Payment, Clearing, and Settlement Supervision Act of 2010 (12 U.S.C. 5461 *et seq.*), a designated clearing agency for which the Commission acts as supervisory agency shall be subject to, and the Commission shall have the authority under, the provisions of paragraphs (b) through (n) of Section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818) in the same manner and to the same extent as if such designated clearing agency were an insured depository institution and the Commission were the appropriate Federal banking agency for such insured depository institution.

[77 FR 66285, Nov. 2, 2012, as amended at 81 FR 70901, Oct. 13, 2016]

SUSPENSION AND EXPULSION OF EXCHANGE MEMBERS

§ 240.19a3–1 [Reserved]

§ 240.19b–3 [Reserved]

§ 240.19b–4 Filings with respect to proposed rule changes by self-regulatory organizations.

(a) *Definitions*. As used in this section:

(1) The term *advance notice* means a notice required to be made by a designated clearing agency pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act (12 U.S.C. 5465(e));

(2) The term *designated clearing agency* means a clearing agency that is registered with the Commission, and for which the Commission is the Supervisory Agency (as determined in accordance with section 803(8) of the Payment, Clearing and Settlement Supervision Act (12 U.S.C. 5462(8)), that has been designated by the Financial Stability Oversight Council pursuant to section 804 of the Payment, Clearing and Settlement Supervision Act (12 U.S.C. 5463) as systemically important or likely to become systemically important;

(3) The term *Payment, Clearing and Settlement Supervision Act* means Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (124 Stat. 1802, 1803, 1807, 1809, 1811, 1814, 1816, 1818, 1820, 1821; 12 U.S.C. 5461 *et seq.*);

(4) The term *proposed rule change* has the meaning set forth in Section 19(b)(1) of the Act (15 U.S.C. 78s(b)(1));

(5) The term *security-based swap submission* means a submission of identifying information required to be made by a clearing agency pursuant to section 3C(b)(2) of the Act (15 U.S.C. 78c–3(b)(2)) for each security-based swap, or any group, category, type or class of

security-based swaps, that such clearing agency plans to accept for clearing;

(6) The term *stated policy, practice, or interpretation* means:

(i) Any material aspect of the operation of the facilities of the self-regulatory organization; or

(ii) Any statement made generally available to the membership of, to all participants in, or to persons having or seeking access (including, in the case of national securities exchanges or registered securities associations, through a member) to facilities of, the self-regulatory organization (''specified persons''), or to a group or category of specified persons, that establishes or changes any standard, limit, or guideline with respect to:

(A) The rights, obligations, or privileges of specified persons or, in the case of national securities exchanges or registered securities associations, persons associated with specified persons; or

(B) The meaning, administration, or enforcement of an existing rule.

(b)(1) Filings with respect to proposed rule changes by a self-regulatory organization, except filings with respect to proposed rules changes by self-regulatory organizations submitted pursuant to section 19(b)(7) of the Act (15 U.S.C. 78s(b)(7)), shall be made electronically on Form 19b–4 (17 CFR 249.819).

(2) For purposes of Section 19(b) of the Act and this rule, a ''business day'' is any day other than a Saturday, Sunday, Federal holiday, a day that the Office of Personnel Management has announced that Federal agencies in the Washington, DC area are closed to the public, a day on which the Commission is subject to a Federal government shutdown or a day on which the Commission's Washington, DC office is otherwise not open for regular business.

(c) A stated policy, practice, or interpretation of the self-regulatory organization shall be deemed to be a proposed rule change unless (1) it is reasonably and fairly implied by an existing rule of the self-regulatory organization or (2) it is concerned solely with the administration of the self-regulatory organization and is not a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization.

(d) Regardless of whether it is made generally available, an interpretation of an existing rule of the self-regulatory organization shall be deemed to be a proposed rule change if (1) it is approved or ratified by the governing body of the self-regulatory organization and (2) it is not reasonably and fairly implied by that rule.

(e) For the purposes of this paragraph, *new derivative securities product* means any type of option, warrant, hybrid securities product or any other security, other than a single equity option or a security futures product, whose value is based, in whole or in part, upon the performance of, or interest in, an underlying instrument.

(1) The listing and trading of a new derivative securities product by a self-regulatory organization shall not be deemed a proposed rule change, pursuant to paragraph (c)(1) of this section, if the Commission has approved, pursuant to section 19(b) of the Act (15 U.S.C. 78s(b)), the self-regulatory organization's trading rules, procedures and listing standards for the product class that would include the new derivative securities product and the self-regulatory organization has a surveillance program for the product class.

(2) Recordkeeping and reporting:

(i) Self-regulatory organizations shall retain at their principal place of business a file, available to Commission staff for inspection, of all relevant records and information pertaining to each new derivative securities product traded pursuant to this paragraph (e) for a period of not less than five years, the first two years in an easily accessible place, as prescribed in § 240.17a–1.

(ii) When relying on this paragraph (e), a self-regulatory organization shall submit Form 19b–4(e) (17 CFR 249.820) to the Commission within five business days after commencement of trading a new derivative securities product.

(f) A proposed rule change may take effect upon filing with the Commission pursuant to Section 19(b)(3)(A) of the Act, 15 U.S.C. 78s(b)(3)(A), if properly designated by the self-regulatory organization as:

(1) Constituting a stated policy, practice, or interpretation with respect to

the meaning, administration, or enforcement of an existing rule;

(2) Establishing or changing a due, fee, or other charge applicable only to a member;

(3) Concerned solely with the administration of the self-regulatory organization;

(4) Effecting a change in an existing service of a registered clearing agency that either:

(i)(A) Does not adversely affect the safeguarding of securities or funds in the custody or control of the clearing agency or for which it is responsible; and

(B) Does not significantly affect the respective rights or obligations of the clearing agency or persons using the service; or

(ii)(A) Primarily affects the clearing operations of the clearing agency with respect to products that are not securities, including futures that are not security futures, swaps that are not security-based swaps or mixed swaps, and forwards that are not security forwards; and

(B) Either

(*1*) Does not significantly affect any securities clearing operations of the clearing agency or any rights or obligations of the clearing agency with respect to securities clearing or persons using such securities-clearing service, or

(*2*) Does significantly affect any securities clearing operations of the clearing agency or the rights or obligations of the clearing agency with respect to securities clearing or persons using such securities-clearing service, but is necessary to maintain fair and orderly markets for products that are not securities, including futures that are not security futures, swaps that are not security-based swaps or mixed swaps, and forwards that are not security forwards. Proposed rule changes filed pursuant to this subparagraph II must also be filed in accordance with the procedures of Section 19(b)(1) for approval pursuant to Section 19(b)(2) and the regulations thereunder within fifteen days of being filed under Section 19(b)(3)(A).

(5) Effecting a change in an existing order-entry or trading system of a self-regulatory organization that:

(i) Does not significantly affect the protection of investors or the public interest;

(ii) Does not impose any significant burden on competition; and

(iii) Does not have the effect of limiting the access to or availability of the system; or

(6) Effecting a change that:

(i) Does not significantly affect the protection of investors or the public interest;

(ii) Does not impose any significant burden on competition; and

(iii) By its terms, does not become operative for 30 days after the date of the filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest; provided that the self-regulatory organization has given the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission.

(g) Proceedings to determine whether a proposed rule change should be disapproved will be conducted pursuant to 17 CFR 201.700–701 (Initiation of Proceedings for SRO Proposed Rule Changes).

(h) Notice of orders issued pursuant to section 19(b) of the Act will be given by prompt publication thereof, together with a statement of written reasons therefor.

(i) Self-regulatory organizations shall retain at their principal place of business a file, available to interested persons for public inspection and copying, of all filings, notices and submissions made pursuant to this section and all correspondence and other communications reduced to writing (including comment letters) to and from such self-regulatory organization concerning any such filing, notice or submission, whether such correspondence and communications are received or prepared before or after the filing, notice or submission of the proposed rule change, advance notice or security-based swap submission, as applicable.

(j) Filings by a self-regulatory organization submitted on Form 19b–4 (17

CFR 249.819) electronically shall contain an electronic signature. For the purposes of this section, the term *electronic signature* means an electronic entry in the form of a magnetic impulse or other form of computer data compilation of any letter or series of letters or characters comprising a name, executed, adopted or authorized as a signature. The signatory to an electronically submitted rule filing shall manually sign a signature page or other document, in the manner prescribed by Form 19b–4, authenticating, acknowledging or otherwise adopting his or her signature that appears in typed form within the electronic filing. Such document shall be executed before or at the time the rule filing is electronically submitted and shall be retained by the filer in accordance with § 240.17a–1.

(k) If the conditions of this section and Form 19b–4 (17 CFR 249.819) are otherwise satisfied, all filings submitted electronically on or before 5:30 p.m. Eastern Standard Time or Eastern Daylight Saving Time, whichever is currently in effect, on a business day, shall be deemed filed on that business day, and all filings submitted after 5:30 p.m. Eastern Standard Time or Eastern Daylight Saving Time, whichever is currently in effect, shall be deemed filed on the next business day.

(l) The self-regulatory organization shall post each proposed rule change, and any amendments thereto, on its Web site within two business days after the filing of the proposed rule change, and any amendments thereto, with the Commission. If a self-regulatory organization does not post a proposed rule change on its Web site on the same day that it filed the proposal with the Commission, then the self-regulatory organization shall inform the Commission of the date on which it posted such proposal on its Web site. Such proposed rule change and amendments shall be maintained on the self-regulatory organization's Web site until:

(1) In the case of a proposed rule change filed under section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)), the Commission approves or disapproves the proposed rule change or the self-regulatory organization withdraws the proposed rule change, or any amendments, or is notified that the proposed rule change is not properly filed; or

(2) In the case of a proposed rule change filed under section 19(b)(3)(A) of the Act (15 U.S.C. 78s(b)(3)(A)), or any amendment thereto, 60 days after the date of filing, unless the self-regulatory organization withdraws the proposed rule change or is notified that the proposed rule change is not properly filed; and

(3) In the case of proposed rule changes approved by the Commission pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) or noticed by the Commission pursuant to section 19(b)(3)(A) of the Act (15 U.S.C. 78s(b)(3)(A)), the self-regulatory organization updates its rule text as required by paragraph (m) of this section; and

(4) In the case of a proposed rule change, or any amendment thereto, that has been disapproved, withdrawn or not properly filed, the self-regulatory organization shall remove the proposed rule change, or any amendment, from its Web site within two business days of notification of disapproval, improper filing, or withdrawal by the SRO of the proposed rule change.

(m)(1) Each self-regulatory organization shall post and maintain a current and complete version of its rules on its Web site.

(2) A self-regulatory organization, other than a self-regulatory organization that is registered with the Commission under section 6(g) of the Act (15 U.S.C. 78f(g)) or pursuant to section 15A(k) of the Act (15 U.S.C. 78*o*–1(k)), shall update its Web site to reflect rule changes filed pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) within two business days after it has been notified of the Commission's approval of a proposed rule change, and to reflect rule changes filed pursuant to section 19(b)(3)(A) of the Act (15 U.S.C. 78s(b)(3)(A)) within two business days of the Commission's notice of such proposed rule change.

(3) A self-regulatory organization that is registered with the Commission under section 6(g) of the Act (15 U.S.C. 78f(g)) or pursuant to section 15A(k) of the Act (15 U.S.C. 78*o*–1(k)), shall update its Web site to reflect rule changes filed pursuant to section

19(b)(2) of the Act by two business days after the later of:

(A) Notification that the Commission has approved a proposed rule change; and

(B)(i) The filing of a written certification with the Commodity Futures Trading Commission under section 5c(c) of the Commodity Exchange Act (7 U.S.C. 7a–2(c));

(ii) Receipt of notice from the Commodity Futures Trading Commission that it has determined that review of the proposed rule change is not necessary; or

(iii) Receipt of notice from the Commodity Futures Trading Commission that it has approved the proposed rule change.

(4) If a rule change is not effective for a certain period, the self-regulatory organization shall clearly indicate the effective date in the relevant rule text.

(n)(1)(i) A designated clearing agency shall provide an advance notice to the Commission of any proposed change to its rules, procedures, or operations that could materially affect the nature or level of risks presented by such designated clearing agency. Except as provided in paragraph (n)(1)(ii) of this section, such advance notice shall be submitted to the Commission electronically on Form 19b–4 (referenced in 17 CFR 249.819). The Commission shall, upon the filing of any advance notice, provide for prompt publication thereof.

(ii) Any designated clearing agency that files an advance notice with the Commission prior to December 10, 2013, shall file such advance notice in electronic format to a dedicated email address to be established by the Commission. The contents of an advance notice filed pursuant to this paragraph (n)(1)(ii) shall contain the information required to be included for advance notices in the General Instructions for Form 19b–4 (referenced in 17 CFR 249.819).

(2)(i) For purposes of this paragraph (n), the phrase *materially affect the nature or level of risks presented*, when used to qualify determinations on a change to rules, procedures, or operations at the designated clearing agency, means matters as to which there is a reasonable possibility that the change could affect the performance of essential clearing and settlement functions or the overall nature or level of risk presented by the designated clearing agency.

(ii) Changes to rules, procedures, or operations that could materially affect the nature or level of risks presented by a designated clearing agency may include, but are not limited to, changes that materially affect participant and product eligibility, risk management, daily or intraday settlement procedures, default procedures, system safeguards, governance or financial resources of the designated clearing agency.

(iii) Changes to rules, procedures, or operations that may not materially affect the nature or level of risks presented by a designated clearing agency include, but are not limited to:

(A) Changes to an existing procedure, control, or service that do not modify the rights or obligations of the designated clearing agency or persons using its payment, clearing, or settlement services and that do not adversely affect the safeguarding of securities, collateral, or funds in the custody or control of the designated clearing agency or for which it is responsible; or

(B) Changes concerned solely with the administration of the designated clearing agency or related to the routine, daily administration, direction, and control of employees;

(3) The designated clearing agency shall post the advance notice, and any amendments thereto, on its Web site within two business days after the filing of the advance notice, and any amendments thereto, with the Commission. Such advance notice and amendments shall be maintained on the designated clearing agency's Web site until the earlier of:

(i) The date the designated clearing agency withdraws the advance notice or is notified that the advance notice is not properly filed; or

(ii) The date the designated clearing agency posts a notice of effectiveness as required by paragraph (n)(4)(ii) of this section.

(4)(i) The designated clearing agency shall post a notice on its Web site within two business days of the date that any change to its rules, procedures, or operations referred to in an advance notice has been permitted to take effect as such date is determined in accordance with Section 806(e) of the Payment, Clearing and Settlement Supervision Act (12 U.S.C. 5465).

(ii) The designated clearing agency shall post a notice on its Web site within two business days of the effectiveness of any change to its rules, procedures, or operations referred to in an advance notice.

(5) A designated clearing agency shall provide copies of all materials submitted to the Commission relating to an advance notice with the Board of Governors of the Federal Reserve System contemporaneously with such submission to the Commission.

(6) The publication and Web site posting requirements contained in paragraphs (n)(1), (n)(3), and (n)(4) of this section do not apply to any information contained in an advance notice for which a designated clearing agency has requested confidential treatment following the procedures set forth in §240.24b–2.

(o)(1) Every clearing agency that is registered with the Commission that plans to accept a security-based swap, or any group, category, type, or class of security-based swaps for clearing shall submit to the Commission a security-based swap submission and provide notice to its members of such security-based swap submission.

(2)(i) Except as provided in paragraph (o)(2)(ii) of this section, a clearing agency shall submit each security-based swap submission to the Commission electronically on Form 19b–4 (referenced in 17 CFR 249.819) with the information required to be submitted for a security-based swap submission, as provided in §240.19b–4 and Form 19b–4. Any information submitted to the Commission electronically on Form 19b–4 that is not complete or otherwise in compliance with this section and Form 19b–4 shall not be considered a security-based swap submission and the Commission shall so inform the clearing agency within twenty-one business days of the submission on Form 19b–4 (referenced in 17 CFR 249.819).

(ii) Any clearing agency that files a security-based swap submission with the Commission prior to December 10, 2013, shall file such security-based swap submission in electronic format to a dedicated email address to be established by the Commission. The contents of a security-based swap submission filed pursuant to this paragraph (o)(2)(ii) shall contain the information required to be included for security-based swap submissions in the General Instructions for Form 19b–4.

(3) A security-based swap submission submitted by a clearing agency to the Commission shall include a statement that includes, but is not limited to:

(i) How the security-based swap submission is consistent with Section 17A of the Act (15 U.S.C. 78q–1);

(ii) Information that will assist the Commission in the quantitative and qualitative assessment of the factors specified in Section 3C of the Act (15 U.S.C. 78c–3), including, but not limited to:

(A) The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data;

(B) The availability of a rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded;

(C) The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the clearing agency available to clear the contract;

(D) The effect on competition, including appropriate fees and charges applied to clearing; and

(E) The existence of reasonable legal certainty in the event of the insolvency of the relevant clearing agency or one or more of its clearing members with regard to the treatment of customer and security-based swap counterparty positions, funds, and property;

(iii) A description of how the rules of the clearing agency prescribe that all security-based swaps submitted to the clearing agency with the same terms and conditions are economically equivalent within the clearing agency and may be offset with each other within the clearing agency, as applicable to the security-based swaps described in the security-based swap submission; and

(iv) A description of how the rules of the clearing agency provide for non-discriminatory clearing of a security-based swap executed bilaterally or on or through the rules of an unaffiliated national securities exchange or security-based swap execution facility, as applicable to the security-based swaps described in the security-based swap submission.

(4) A clearing agency shall submit security-based swaps to the Commission for review by group, category, type or class of security-based swaps, to the extent reasonable and practicable to do so.

(5) A clearing agency shall post each security-based swap submission, and any amendments thereto, on its Web site within two business days after the submission of the security-based swap submission, and any amendments thereto, with the Commission. Such security-based swap submission and amendments shall be maintained on the clearing agency's Web site until the Commission makes a determination regarding the security-based swap submission or the clearing agency withdraws the security-based swap submission, or is notified that the security-based swap submission is not properly filed.

(6) In connection with any security-based swap submission that is submitted by a clearing agency to the Commission, the clearing agency shall provide any additional information requested by the Commission as necessary to assess any of the factors it determines to be appropriate in order to make the determination of whether the clearing requirement applies.

(7) Notices of orders issued pursuant to Section 3C of the Act (15 U.S.C. 78c–3), regarding security-based swap submissions will be given by prompt publication thereof, together with a statement of written reasons therefor.

[45 FR 73914, Nov. 7, 1980, as amended at 59 FR 66701, Dec. 28, 1994; 63 FR 70967, Dec. 22, 1998; 66 FR 43742, Aug. 20, 2001; 69 FR 60300, Oct. 8, 2004; 73 FR 16189, Mar. 27, 2008; 76 FR 4072, Jan. 24, 2011; 76 FR 20509, Apr. 13, 2011; 76 FR 41092, July 13, 2011; 77 FR 41648, July 13, 2012; 77 FR 73305, Dec. 10, 2012; 78 FR 21057, Apr. 9, 2013]

§ 240.19b–5 Temporary exemption from the filing requirements of Section 19(b) of the Act.

PRELIMINARY NOTES

1. The following section provides for a temporary exemption from the rule filing requirement for self-regulatory organizations that file proposed rule changes concerning the operation of a pilot trading system pursuant to section 19(b) of the Act (15 U.S.C. 78s(b), as amended). All other requirements under the Act that are applicable to self-regulatory organizations continue to apply.

2. The disclosures made pursuant to the provisions of this section are in addition to any other applicable disclosure requirements under the federal securities laws.

(a) For purposes of this section, the term *specialist* means any member subject to a requirement of a self-regulatory organization that such member regularly maintain a market in a particular security.

(b) For purposes of this section, the term *trading system* means the rules of a self-regulatory organization that:

(1) Determine how the orders of multiple buyers and sellers are brought together; and

(2) Establish non-discretionary methods under which such orders interact with each other and under which the buyers and sellers entering such orders agree to the terms of trade.

(c) For purposes of this section, the term *pilot trading system* shall mean a trading system operated by a self-regulatory organization that is not substantially similar to any trading system or pilot trading system operated by such self-regulatory organization at any time during the preceding year, and that:

(1)(i) Has been in operation for less than two years;

(ii) Is independent of any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b));

(iii) With respect to each security traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 5 percent of the average daily trading volume of such security in the United States; and

(iv) With respect to all securities traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 20 percent of the average daily trading volume of all trading systems operated by such self-regulatory organization; or

(2)(i) Has been in operation for less than two years;

(ii) With respect to each security traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 1 percent of the average daily trading volume of such security in the United States; and

(iii) With respect to all securities traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 20 percent of the average daily trading volume of all trading systems operated by such self-regulatory organization; or

(3)(i) Has been in operation for less than two years; and

(ii)(A) Satisfied the definition of *pilot trading system* under paragraph (c)(1) of this section no more than 60 days ago, and continues to be independent of any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)); or

(B) Satisfied the definition of *pilot trading system* under paragraph (c)(2) of this section no more than 60 days ago.

(d) A pilot trading system shall be deemed *independent* of any other trading system operated by a self-regulatory organization if:

(1) Such pilot trading system trades securities other than the issues of securities that trade on any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b));

(2) Such pilot trading system does not operate during the same trading hours as any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)); or

(3) No specialist or market maker on any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)), is permitted to effect transactions on the pilot trading system in securities in which they are a specialist or market maker.

(e) A self-regulatory organization shall be exempt temporarily from the requirement under section 19(b) of the Act, (15 U.S.C. 78s(b)), to submit on Form 19b–4, 17 CFR 249.819, proposed rule changes for establishing a pilot trading system, if the self-regulatory organization complies with the following requirements:

(1) *Form PILOT*. The self-regulatory organization:

(i) Files Part I of Form PILOT, 17 CFR 249.821, in accordance with the instructions therein, at least 20 days prior to commencing operation of the pilot trading system;

(ii) Files an amendment on Part I of Form PILOT at least 20 days prior to implementing a material change to the operation of the pilot trading system; and

(iii) Files a quarterly report on Part II of Form PILOT within 30 calendar days after the end of each calendar quarter in which the market has operated after the effective date of this section.

(2) *Fair access*. (i) The self-regulatory organization has in place written rules to ensure that all members of the self-regulatory organization have fair access to the pilot trading system, and that information regarding orders on the pilot trading system is equally available to all members of the self-regulatory organization with access to such pilot trading system.

(ii) Notwithstanding the requirement in paragraph (e)(2)(i) of this section, a specialist on the pilot trading system may have preferred access to information regarding orders that it represents in its capacity as specialist.

(iii) The rules established by a self-regulatory organization pursuant to paragraph (e)(2)(i) of this section will be considered rules governing the pilot trading system for purposes of the temporary exemption under this section.

(3) *Trading rules and procedures and listing standards.* (i) The self-regulatory organization has in place written trading rules and procedures and listing standards necessary to operate the pilot trading system.

(ii) The rules established by a self-regulatory organization pursuant to paragraph (e)(3)(i) of this section will be considered rules governing the pilot trading system for purposes of the temporary exemption under this section.

(4) *Surveillance.* The self-regulatory organization establishes internal procedures for the effective surveillance of trading activity on the self-regulatory organization's pilot trading system.

(5) *Clearance and settlement.* The self-regulatory organization establishes reasonable clearance and settlement procedures for transactions effected on the self-regulatory organizations pilot trading system.

(6) *Types of securities.* The self-regulatory organization permits to trade on the pilot trading system only securities registered under section 12 of the Act, (15 U.S.C. 78*l*).

(7) *Activities of specialists.* (i) The self-regulatory organization does not permit any member to be a specialist in a security on the pilot trading system and a specialist in a security on a trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)), or on another pilot trading system operated by such self-regulatory organization, if such securities are related securities, except that a member may be a specialist in related securities that the Commission, upon application by the self-regulatory organization, later determines is necessary or appropriate in the public interest and consistent with the protection of investors;

(ii) Notwithstanding paragraph (e)(7)(i) of this section, a self-regulatory organization may permit a member to be a specialist in any security on a pilot trading system, if the pilot trading system is operated during trading hours different from the trading hours of the trading system in which such member is a specialist.

(iii) For purposes of paragraph (e)(7) of this section, the term *related securities* means any two securities in which:

(A) The value of one security is determined, in whole or significant part, by the performance of the other security; or

(B) The value of both securities is determined, in whole or significant part, by the performance of a third security, combination of securities, index, indicator, interest rate or other common factor.

(8) *Examinations, inspections, and investigations.* The self-regulatory organization cooperates with the examination, inspection, or investigation by the Commission of transactions effected on the pilot trading system.

(9) *Recordkeeping.* The self-regulatory organization shall retain at its principal place of business and make available to Commission staff for inspection, all the rules and procedures relating to each pilot trading system operating pursuant to this section for a period of not less than five years, the first two years in an easily accessible place, as prescribed in § 240.17a–1.

(10) *Public availability of pilot trading system rules.* The self-regulatory organization makes publicly available all trading rules and procedures, including those established under paragraphs (e)(2) and (e)(3) of this section.

(11) Every notice or amendment filed pursuant to this paragraph (e) shall constitute a "report" within the meaning of sections 11A, 17(a), 18(a), and 32(a), (15 U.S.C. 78k–1, 78q(a), 78r(a), and 78ff(a)), and any other applicable provisions of the Act. All notices or reports filed pursuant to this paragraph (e) shall be deemed to be confidential until the pilot trading system commences operation.

(f)(1) A self-regulatory organization shall request Commission approval, pursuant to section 19(b)(2) of the Act, (15 U.S.C. 78s(b)(2)), for any rule change relating to the operation of a pilot trading system by submitting Form 19b–4, 17 CFR 249.819, no later than two years after the commencement of operation of such pilot trading system, or shall cease operation of the pilot trading system.

(2) Simultaneous with a request for Commission approval pursuant to section 19(b)(2) of the Act, (15 U.S.C. 78s(b)(2)), a self-regulatory organization may request Commission approval pursuant to section 19(b)(3)(A) of the Act, (15 U.S.C. 78s(b)(3)(A)), for any rule change relating to the operation of a pilot trading system by submitting Form 19b–4, 17 CFR 249.819, effective immediate upon filing, to continue operations of such trading system for a period not to exceed six months.

(g) Notwithstanding paragraph (e) of this section, rule changes with respect to pilot trading systems operated by a self-regulatory organization shall not be exempt from the rule filing requirements of section 19(b)(2) of the Act, (15 U.S.C. 78s(b)(2)), if the Commission determines, after notice to the SRO and opportunity for the SRO to respond, that exemption of such rule changes is not necessary or appropriate in the public interest or consistent with the protection of investors.

[63 FR 70920, Dec. 22, 1998]

§ 240.19b–7 Filings with respect to proposed rule changes submitted pursuant to Section 19(b)(7) of the Act.

PRELIMINARY NOTE: A self-regulatory organization also must refer to Form 19b–7 (17 CFR 249.822) for further requirements with respect to the filing of proposed rule changes.

(a) Filings with respect to proposed rule changes by a self-regulatory organization submitted pursuant to section 19(b)(7) of the Act (15 U.S.C. 78s(b)(7)) shall be made electronically on Form 19b–7 (17 CFR 249.822).

(b) A proposed rule change will not be deemed filed on the date it is received by the Commission unless:

(1) A completed Form 19b–7 (17 CFR 249.822) is submitted electronically; and

(2) In order to elicit meaningful comment, it is accompanied by:

(i) A clear and accurate statement of the basis and purpose of such rule change, including the impact on competition or efficiency, if any; and

(ii) A summary of any written comments (including e-mail) received by the self-regulatory organization on the proposed rule change.

(c) Self-regulatory organizations shall retain at their principle place of business a file, available to interested persons for public inspection and copying, of all filings made pursuant to this section and all correspondence and other communications reduced to writing (including comment letters) to and from such self-regulatory organization concerning such filing, whether such correspondence and communications are received or prepared before or after the filing of the proposed rule change.

(d) Filings with respect to proposed rule changes by a self-regulatory organization submitted on Form 19b–7 (17 CFR 249.822) electronically shall contain an electronic signature. For the purposes of this section, the term electronic signature means an electronic entry in the form of a magnetic impulse or other form of computer data compilation of any letter or series of letters or characters comprising a name, executed, adopted or authorized as a signature. The signatory to an electronically submitted rule filing shall manually sign a signature page or other document, in the manner prescribed by Form 19b–7, authenticating, acknowledging or otherwise adopting his or her signature that appears in typed form within the electronic filing. Such document shall be executed before or at the time the rule filing is electronically submitted and shall be retained by the filer in accordance with 17 CFR 240.17a–1.

(e) If the conditions of this section and Form 19b–7 (17 CFR 249.822) are otherwise satisfied, all filings submitted electronically on or before 5:30 p.m. Eastern Standard Time or Eastern Daylight Saving Time, whichever is currently in effect, on a business day, shall be deemed filed on that business day, and all filings submitted after 5:30 p.m. Eastern Standard Time or Eastern Daylight Saving Time, whichever is currently in effect, shall be deemed filed on the next business day.

(f) The self-regulatory organization shall post the proposed rule change, and any amendments thereto, submitted on Form 19b–7 (17 CFR 249.822), on its Web site within two business days after the filing of the proposed rule change, and any amendments thereto, with the Commission. Unless the self-regulatory organization withdraws the proposed rule change or is notified that the proposed rule change is not properly filed, such proposed rule change and amendments shall be maintained on the self-regulatory organization's Web site until 60 days after:

(1) The filing of a written certification with the Commodity Futures Trading Commission under section 5c(c) of the Commodity Exchange Act (7 U.S.C. 7a–2(c));

(2) The Commodity Futures Trading Commission determines that review of the proposed rule change is not necessary; or

(3) The Commodity Futures Trading Commission approves the proposed rule change; and

(4) In the case of a proposed rule change, or any amendment thereto, that has been withdrawn or not properly filed, the self-regulatory organization shall remove the proposed rule change, or any amendment, from its Web site within two business days of notification of improper filing or withdrawal by the self-regulatory organization of the proposed rule change.

(g)(1) Each self-regulatory organization shall post and maintain a current and complete version of its rules on its Web site.

(2) The self-regulatory organization shall update its Web site to reflect rule changes filed pursuant to section 19(b)(7) of the Act (15 U.S.C. 78s(b)(7)), by two business days after the later of:

(A) The Commission's notice of such proposed rule change; and

(B)(i) The filing of a written certification with the Commodity Futures Trading Commission under section 5c(c) of the Commodity Exchange Act (7 U.S.C. 7a–2(c));

(ii) Receipt of notice from the Commodity Futures Trading Commission that it has determined that review of the proposed rule change is not necessary; or

(iii) Receipt of notice from the Commodity Futures Trading Commission that it has approved the proposed rule change.

(3) If a rule change is not effective for a certain period, the self-regulatory organization shall clearly indicate the effective date in the relevant rule text.

[66 FR 43743, Aug. 20, 2001, as amended at 73 FR 16189, Mar. 27, 2008]

§ 240.19c–1 Governing certain off-board agency transactions by members of national securities exchanges.

The rules of each national securities exchange shall provide as follows:

No rule, stated policy, or practice of this exchange shall prohibit or condition, or be construed to prohibit or condition or otherwise limit, directly or indirectly, the ability of any member acting as agent to effect any transaction otherwise than on this exchange with another person (except when such member also is acting as agent for such other person in such transaction), in any equity security listed on this exchange or to which unlisted trading privileges on this exchange have been extended.

(Secs. 2, 3, 6, 11, 17, 19, 23, Pub. L. 78–291, 48 Stat. 881, 882, 885, 891, 897, 898, 901, as amended by secs. 2, 3, 6, 14, 16, 18, Pub. L. 94–29, 89 Stat. 97, 104, 110, 137, 146, 155 (15 U.S.C. 78b, 78c, 78f, 78k, 78q, 78s, 78w, as amended by Pub. L. 94–29 (June 4, 1975)); sec. 7 Pub. L. 94–29, 89 Stat. 111 (15 U.S.C. 78k–1))

[43 FR 1328, Jan. 9, 1978]

§ 240.19c–3 Governing off-board trading by members of national securities exchanges.

The rules of each national securities exchange shall provide as follows:

(a) No rule, stated policy or practice of this exchange shall prohibit or condition, or be construed to prohibit, condition or otherwise limit, directly or indirectly, the ability of any member to effect any transaction otherwise than on this exchange in any reported security listed and registered on this exchange or as to which unlisted trading privileges on this exchange have been extended (other than a put option or call option issued by the Options Clearing Corporation) which is not a covered security.

(b) For purposes of this rule,

(1) The term *Act* shall mean the Securities Exchange Act of 1934, as amended.

(2) The term *exchange* shall mean a national securities exchange registered as such with the Securities and Exchange Commission pursuant to section 6 of the Act.

(3) The term *covered security* shall mean (i) Any equity security or class of equity securities which

(A) Was listed and registered on an exchange on April 26, 1979, and

(B) Remains listed and registered on at least one exchange continuously thereafter;

(ii) Any equity security or class of equity securities which

(A) Was traded on one or more exchanges on April 26, 1979, pursuant to unlisted trading privileges permitted by section 12(f)(1)(A) of the Act, and

(B) Remains traded on any such exchange pursuant to such unlisted trading privileges continuously thereafter; and

(iii) Any equity security or class of equity securities which

(A) Is issued in connection with a statutory merger, consolidation or similar plan or reorganization (including a reincorporation or change of domicile) in exchange for an equity security or class of equity securities described in paragraph (b)(3)(i) or (ii) of this rule,

(B) Is listed and registered on an exchange after April 26, 1979, and

(C) Remains listed and registered on at least one exchange continuously thereafter.

(4) The term *reported security* shall mean any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan.

(5) The term *transaction report* shall mean a report containing the price and volume associated with a completed transaction involving the purchase or sale of a security.

(6) The term *effective transaction reporting plan* shall mean any plan approved by the Commission pursuant to § 242.601 of this chapter for collecting, processing, and making available transaction reports with respect to transactions in an equity security or class of equity securities.

[45 FR 41134, June 18, 1980, as amended at 70 FR 37618, June 29, 2005]

§ 240.19c–4 Governing certain listing or authorization determinations by national securities exchanges and associations.

(a) The rules of each exchange shall provide as follows: No rule, stated policy, practice, or interpretation of this exchange shall permit the listing, or the continuance of the listing, of any common stock or other equity security of a domestic issuer, if the issuer of such security issues any class of security, or takes other corporate action, with the effect of nullifying, restricting or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock of such issuer registered pursuant to section 12 of the Act.

(b) The rules of each association shall provide as follows: No rule, stated policy, practice, or interpretation of this association shall permit the authorization for quotation and/or transaction reporting through an automated interdealer quotation system (''authorization''), or the continuance of authorization, of any common stock or other equity security of a domestic issuer, if the issuer of such security issues any class of security, or takes other corporate action, with the effect of nullifying, restricting, or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock of such issuer registered pursuant to section 12 of the Act.

(c) For the purposes of paragraphs (a) and (b) of this section, the following shall be presumed to have the effect of nullifying, restricting, or disparately reducing the per share voting rights of an outstanding class or classes of common stock:

(1) Corporate action to impose any restriction on the voting power of shares of the common stock of the issuer held by a beneficial or record holder based on the number of shares held by such beneficial or record holder;

(2) Corporate action to impose any restriction on the voting power of shares of the common stock of the issuer held by a beneficial or record holder based on the length of time such shares have been held by such beneficial or record holder;

(3) Any issuance of securities through an exchange offer by the issuer for shares of an outstanding class of the common stock of the issuer, in which the securities issued have voting rights greater than or less than the per share voting rights of any outstanding class of the common stock of the issuer.

(4) Any issuance of securities pursuant to a stock dividend, or any other type of distribution of stock, in which the securities issued have voting rights greater than the per share voting rights of any outstanding class of the common stock of the issuer.

(d) For the purpose of paragraphs (a) and (b) of this section, the following, standing alone, shall be presumed not to have the effect of nullifying, restricting, or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock:

(1) The issuance of securities pursuant to an initial registered public offering;

(2) The issuance of any class of securities, through a registered public offering, with voting rights not greater than the per share voting rights of any outstanding class of the common stock of the issuer;

(3) The issuance of any class of securities to effect a bona fide merger or acquisition, with voting rights not greater than the per share voting rights of any outstanding class of the common stock of the issuer.

(4) Corporate action taken pursuant to state law requiring a state's domestic corporation to condition the voting rights of a beneficial or record holder of a specified threshold percentage of the corporation's voting stock on the approval of the corporation's independent shareholders.

(e) *Definitions.* The following terms shall have the following meanings for purposes of this section, and the rules of each exchange and association shall include such definitions for the purposes of the prohibition in paragraphs (a) and (b), respectively, of this section:

(1) The term *Act* shall mean the Securities Exchange Act of 1934, as amended.

(2) The term *common stock* shall include any security of an issuer designated as common stock and any security of an issuer, however designated, which, by statute or by its terms, is a common stock (e.g., a security which entitles the holders thereof to vote generally on matters submitted to the issuer's security holders for a vote).

(3) The term *equity security* shall include any equity security defined as such pursuant to Rule 3a11–1 under the Act (17 CFR 240.3a11–1).

(4) The term *domestic issuer* shall mean an issuer that is not a "foreign private issuer" as defined in Rule 3b–4 under the Act (17 CFR 240.3b–4).

(5) The term *security* shall include any security defined as such pursuant to section 3(a)(10) of the Act, but shall exclude any class of security having a preference or priority over the issuer's common stock as to dividends, interest payments, redemption or payments in liquidation, if the voting rights of such securities only become effective as a result of specified events, not relating to an acquisition of the common stock of the issuer, which reasonably can be expected to jeopardize the issuer's financial ability to meet its payment obligations to the holders of that class of securities.

(6) The term *exchange* shall mean a national securities exchange, registered as such with the Securities and Exchange Commission pursuant to section 6 of the Act (15 U.S.C. 78f), which makes transaction reports available pursuant to § 242.601 of this chapter; and

(7) The term *association* shall mean a national securities association registered as such with the Securities and Exchange Commission pursuant to section 15A of the Act.

(f) An exchange or association may adopt a rule, stated policy, practice, or interpretation, subject to the procedures specified by section 19(b) of the Act, specifying what types of securities issuances and other corporate actions are covered by, or excluded from, the prohibition in paragraphs (a) and (b) of this section, respectively, if such rule, stated policy, practice, or interpretation is consistent with the protection of investors and the public interest, and otherwise in furtherance of the purposes of the Act and this section.

[53 FR 26394, July 12, 1988, as amended at 70 FR 37618, June 29, 2005]

§ 240.19c–5 Governing the multiple listing of options on national securities exchanges.

(a) The rules of each national securities exchange that provides a trading market in standardized put or call options shall provide as follows:

(1) On and after January 22, 1990, but not before, no rule, stated policy, practice, or interpretation of this exchange shall prohibit or condition, or be construed to prohibit or condition or otherwise limit, directly or indirectly, the ability of this exchange to list any stock options class first listed on an exchange on or after January 22, 1990, because that options class is listed on another options exchange.

(2) During the period from January 22, 1990, to January 21, 1991, but not before, no rule, stated policy, practice, or interpretation of this exchange shall prohibit or condition, or be construed to prohibit or condition or otherwise limit, directly or indirectly, the ability of this exchange to list up to ten classes of standardized stock options overlying exchange-listed stocks that were listed on another options exchange before January 22, 1990. These ten classes shall be in addition to any option on an exchange-listed stock trading on this exchange that was traded on more than one options exchange before January 22, 1990.

(3) On and after January 21, 1991, but not before, no rule, stated policy, practice, or interpretation of this exchange shall prohibit or condition, or be construed to prohibit or condition or otherwise limit, directly or indirectly, the ability of this exchange to list any stock options class because that options class is listed on another options exchange.

(b) For purposes of paragraph (a)(2) of this Rule, if any options class is delisted from an options exchange as a result of a merger of the equity security underlying the option or a failure of the underlying security to satisfy that exchange's options listing standards, then the exchange is permitted to select a replacement option from among those standardized options overlying exchange-listed stocks that were listed on another options exchange before January 22, 1990.

(c) For purposes of this Rule, the term *exchange* shall mean a national securities exchange, registered as such with the Commission pursuant to Section 6 of the Securities Exchange Act of 1934, as amended.

(d) For purposes of this Rule, the term *standardized option* shall have the same meaning as that term is defined in Rule 9b–1 under the Securities Exchange Act of 1934, as amended, 17 CFR 240.9b–1.

(e) For purposes of this Rule, the term *options class* shall have the same meaning as that term is defined in Rule 9b–1 under the Securities Exchange Act of 1934, as amended, 17 CFR 240.9b–1.

[54 FR 23976, June 5, 1989]

§ 240.19d–1 Notices by self-regulatory organizations of final disciplinary actions, denials, bars, or limitations respecting membership, association, participation, or access to services, and summary suspensions.

(a) *General.* If any self-regulatory organization for which the Commission is the appropriate regulatory agency takes any action described in this rule to which the person affected thereby has consented and such action:

(1) Conditions or limits membership or participation in, association with a member of, or access to services offered by, such organization or a member thereof and

(2) Is based upon a statutory disqualification defined in section 3(a)(39) of the Act, notice thereof shall be filed under Rule 19h–1 and not under this rule.

(b) The notice requirement of section 19(d)(1) of the Act, concerning an action subject to such section taken by a self-regulatory organization for which the Commission is the appropriate regulatory agency, shall be satisfied by any notice with respect to such action (including a notice filed pursuant to this rule) which contains the information required in the statement supporting the organization's determination required by section 6(d) (1) or (2), section 15A(h) (1) or (2), or section 17A(b)(5) (A) or (B) of the Act, as appropriate.

(c)(1) Any self-regulatory organization for which the Commission is the appropriate regulatory agency that takes any final disciplinary action with respect to any person shall promptly file a notice thereof with the Commission in accordance with paragraph (d) of this section. For the purposes of this rule, a ''final disciplinary action'' shall mean the imposition of any final disciplinary sanction pursuant to section 6(b)(6), 15A(b)(7), or 17A(b)(3)(G) of the Act or other action of a self-regulatory organization which, after notice and opportunity for hearing, results in any final disposition of charges of:

(i) One or more violations of—

(A) The rules of such organization;

(B) The provisions of the Act or rules thereunder; or

(C) In the case of a municipal securities broker or dealer, the rules of the Municipal Securities Rulemaking Board;

(ii) Acts or practices constituting a statutory disqualification of a type defined in subparagraph (D) or (E) (except prior convictions) of section 3(a)(39) of the Act; or

(iii) In the case of a proceeding by a national securities exhange or registered securities association based on section 6(c)(3)(A)(ii), 6(c)(3)(B)(ii), 15A(g)(3)(A)(ii), or 15A(g)(3)(B)(ii) of the Act, acts or practices inconsistent with just and equitable principles of trade.

Provided, however, That in the case of a disciplinary action in which a national securities exchange imposes a fine not exceeding $1000 or suspends floor privileges of a clerical employee for not more than five days for violation of any of its regulations concerning personal decorum on a trading floor, the disposition shall not be considered ''final'' for purposes of this paragraph if the sanctioned person has not sought an adjudication, including a hearing, or otherwise exhausted his administrative remedies at the exchange with respect to the matter. *Provided further,* That this exemption from the notice requirement of this paragraph shall not be available where a decorum sanction is imposed at, or results from, a hearing on the matter.

(2) Any disciplinary action, other than a decorum sanction not deemed ''final'' under paragraph (c)(1) of this section, taken by a self-regulatory organization for which the Commission is the appropriate regulatory agency against any person for violation of a rule of the self-regulatory organization which has been designated as a minor rule violation pursuant to a plan or any amendment thereto filed with and declared effective by the Commission under this paragraph, shall not be considered ''final'' for purposes of paragraph (c)(1) of this section if the sanction imposed consists of a fine not exceeding $2500 and the sanctioned person has not sought an adjudication, including a hearing, or otherwise exhausted his administrative remedies at the self-regulatory organization with resepect to the matter. After appropriate notice of the terms of substance of the filing or a description of the subjects and issues involved and opportunity for interested persons to submit written comment, the Commission may, by order, declare such plan or amendment effective if it finds that such plan or amendment is consistent with the public interest, the protection of investors, or otherwise in furtherance of the purposes of the Act. The Commission in its order may restrict the categories of violations to be designated as minor rule violations and may impose any other terms or conditions to the plan (including abbreviated reporting of selected minor rule violations) and to the period of its effectiveness which it deems necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Act.

(d) *Contents of notice required by paragraph (c)(1).* Any notice filed pursuant to paragraph (c)(1) of this section, shall consist of the following, as appropriate:

(1) The name of the respondent concerned together with his last known place of residence or business as reflected on the records of the self-regulatory organization and the name of the person, committee, or other organizational unit which brought the charges involved; except that, as to any respondent who has been found not to have violated a provision covered by a charge, identifying information with respect to such person may be deleted insofar as the notice reports the disposition of that charge, unless, prior to

the filing of the notice, the respondent requests otherwise;

(2) A statement describing the investigative or other origin of the action;

(3) As charged in the proceeding, the specific provisions of the Act, the rules or regulations thereunder, the rules of the organization, and, in the case of a registered securities association, the rules of the Municipal Securities Rulemaking Board, and, in the event a violation of other statutes or rules constitutes a violation of any rule of the organization, such other statutes or rules; and a statement describing the answer of the respondent to the charges;

(4) A statement setting forth findings of fact with respect to any act or practice which such respondent was charged with having engaged in or omitted; the conclusion of the organization as to whether such respondent is deemed to have violated any provision covered by the charges; and a statement of the organization in support of the resolution of the principal issues raised in the proceedings;

(5) A statement describing any sanction imposed, the reasons therefor, and the date upon which such sanction has or will become effective, together with a finding if appropriate, as to whether such respondent was a cause of any sanction imposed upon any other person; and

(6) Such other matters as the organization may deem relevant.

(e) *Notice of final denial, bar, prohibition, termination or limitation based on qualification or administrative rules.* Any final action of a self-regulatory organization for which the Commission is the appropriate regulatory agency that is taken with respect to any person constituting a denial, bar, prohibition, or limitation of membership, participation or association with a member, or of access to services offered by a self-regulatory organization or a member thereof, and which is based on an alleged failure of any person to:

(1) Pass any test or examination required by the rules of the Commission or such organization;

(2) Comply with other qualification standards established by rules of the Commission or such organization; or

(3) Comply with any administrative requirements of such organization (including failure to pay entry or other dues or fees or to file prescribed forms or reports) not involving charges of violations which may lead to a disciplinary sanction shall not be considered a "disciplinary action" for purposes of paragraph (c) of this rule; but notice thereof shall be promptly filed with the Commission in accordance with paragraph (f) of this section, *Provided, however,* That no disposition of a matter shall be considered "final" pursuant to this paragraph which results merely from a notice of such failure to the person affected, if such person has not sought an adjudication, including a hearing, or otherwise exhausted his administrative remedies within such organization with respect to such a matter.

(f) *Contents of notice required by paragraph (e).* Any notice filed pursuant to paragraph (e) of this section shall consist of the following, as appropriate:

(1) The name of each person concerned together with his last known place of residence or business as reflected on the records of the organization;

(2) The specific provisions of the Act, the rules or regulations thereunder, the rules of the organization, and, in the case of a registered securities association, the rules of the Municipal Securities Rulemaking Board, upon which the action of the organization was based, and a statement describing the answer of the person concerned;

(3) A statement setting forth findings of fact and conclusions as to each alleged failure of the person to pass any required examination, comply with other qualification standards, or comply with administrative obligations, and a statement of the organization in support of the resolution of the principal issues raised in the proceeding;

(4) The date upon which such action has or will become effective; and

(5) Such other matters as the organization may deem relevant.

(g) *Notice of final action based upon prior adjudicated statutory disqualifications.* Any self-regulatory organization for which the Commission is the appropriate regulatory agency that takes any final action with respect to any person which:

(1) Denies or conditions membership or participation in, or association with a member of, such organization or prohibits or limits access to services offered by such organization or a member thereof; and

(2) Is based upon a statutory disqualification of a type defined in subparagraph (A), (B), or (C) of section 3(a)(39) of the Act or consisting of a prior conviction, as described in subparagraph (E) of said section 3(a)(39), shall promptly file a notice of such action with the Commission in accordance with paragraph (h) of this section, *provided, however,* That no disposition of a matter shall be considered ''final'' pursuant to this paragraph where such person has not sought an adjudication, including a hearing, or otherwise exhausted his administrative remedies within such organization with respect to such a matter.

(h) *Contents of notice required by paragraph (g).* Any notice filed pursuant to paragraph (g) of this section shall consist of the following, as appropriate:

(1) The name of the person concerned together with his last known place of residence or business as reflected on the record of the organization;

(2) A statement setting forth the principal issues raised, the answer of any person concerned, and a statement of the organization in support of the resolution of the principal issues raised in the proceeding;

(3) Any description furnished by or on behalf of the person concerned of the activities engaged in by the person since the adjudication upon which the disqualification is based;

(4) Any description furnished by or on behalf of the person concerned of the prospective business or employment in which the person plans to engage and the manner and extent of supervision to be exercised over and by such person;

(5) A copy of the order or decision of the court, the Commission or the self-regulatory organization which adjudicated the matter giving rise to such statutory disqualification;

(6) The nature of the action taken and the date upon which such action is to be made effective; and

(7) Such other matters as the organization deems relevant.

(i) *Notice of summary suspension of membership, participation, or association, or summary limitation or prohibition of access to services.* If any self-regulatory organization for which the Commission is the appropriate regulatory agency summarily suspends a member, participant, or person associated with a member, or summarily limits or prohibits any person with respect to access to or services offered by the organization or (in the case of a national securities exchange or a registered securities association) a member thereof pursuant to the provisions of section 6(d)(3), 15A(h)(3) or 17A(b)(5) (C) of the Act, such organization shall, within 24 hours of the effectiveness of such summary suspension, limitation or prohibition notify the Commission of such action, which notice shall contain at least the following information:

(1) The name of the person concerned together with his last known place of residence or business as reflected on the records of the organization;

(2) The date upon which such summary action has or will become effective;

(3) If such summary action is based upon the provisions of section 6(d)(3)(A), 15A(h)(3)(A), or 17A(b)(5) (C)(i) of the Act, a copy of the relevant order or decision of the self-regulatory organization;

(4) If such summary action is based upon the provisions of section 6(d)(3) (B) or (C), 15A(h)(3) (B) or (C), or 17A(b)(5)(C) (ii) or (iii) of the Act, a statement describing, as appropriate:

(i) The financial or operating difficulty of the member or participant upon which such organization determined the member or particpant could not be permitted to continue to do business with safety to investors, creditors, other members or participants, or the organization;

(ii) The pertinent failure to meet qualification requirements or other prerequisites for access and the basis upon which such organization determined that the person concerned could not be permitted to have access with safety to investors, creditors, other members, or the organization; or

(iii) The default of any delivery of funds or securities to a clearing agency by a participant.

(5) The nature and effective date of the suspension, limitation or prohibition; and

(6) Such other matters as the organization deems relevant.

(j) Notice of limitation or prohibition of access to services by delisting of security. Any national securities exchange for which the Commission is the appropriate regulatory agency that delists a security pursuant to section 12(d) of the Act (15 U.S.C. 78l(d)), and Sec. 240.12d2–2 must file a notice with the Commission in accordance with paragraph (k) of this section.

(k) Contents of notice required by paragraph (j) of this section. The national securities exchange shall file notice pursuant to paragraph (j) of this section on Form 25 (§ 249.25 of this chapter). Form 25 shall serve as notification to the Commission of such limitation or prohibition of access to services. The national securities exchange must attach a copy of its delisting determination to Form 25 and file Form 25 with the attachment on EDGAR.

[42 FR 36415, July 14, 1977, as amended at 49 FR 23831, June 8, 1984; 71 FR 42469, July 22, 2005]

§ 240.19d–2 Applications for stays of disciplinary sanctions or summary suspensions by a self-regulatory organization.

If any self-regulatory organization imposes any final disciplinary sanction as to which a notice is required to be filed with the Commission pursuant to Section 19(d)(1) of the Exchange Act, 15 U.S.C. 78s(d)(1), pursuant to Section 6(b)(6), 15A(b)(7) or 17A(b)(3)(G) of the Act (15 U.S.C. 78f(b)(6), 78*o*–3(b)(7) or 78q–1(b)(3)(G)), or summarily suspends or limits or prohibits access pursuant to Section 6(d)(3), 15A(h)(3) or 17A(b)(5)(C) of the Act (15 U.S.C. 78f(d)(3), 78*o*–3(h)(3) or 78q–1(b)(5)(C)), any person aggrieved thereby for which the Commission is the appropriate regulatory agency may file with the Commission a written motion for a stay of imposition of such action pursuant to Rule 401 of the Commission's Rules of Practice, § 201.401 of this chapter.

[60 FR 32825, June 23, 1995]

§ 240.19d–3 Applications for review of final disciplinary sanctions, denials of membership, participation or association, or prohibitions or limitations of access to services imposed by self-regulatory organizations.

Applications to the Commission for review of any final disciplinary sanction, denial or conditioning of membership, participation, bar from association, or prohibition or limitation with respect to access to services offered by a self-regulatory organization or a member thereof by any such organization shall be made pursuant to Rule 420 of the Commission's Rules of Practice, § 201.420 of this chapter.

[60 FR 32825, June 23, 1995]

§ 240.19d–4 Notice by the Public Company Accounting Oversight Board of disapproval of registration or of disciplinary action.

(a) *Definitions*—(1) *Board* means the Public Company Accounting Oversight Board.

(2) *Public accounting firm* shall have the meaning set forth in 15 U.S.C. 7201(a)(11).

(3) *Registered public accounting firm* shall have the meaning set forth in 15 U.S.C. 7201(a)(12).

(4) *Associated person* shall mean a person associated with a registered public accounting firm as defined in 15 U.S.C. 7201(a)(9).

(b)(1) *Notice of disapproval of registration.* If the Board disapproves a completed application for registration by a public accounting firm, the Board shall file a notice of its disapproval with the Commission within 30 days and serve a copy on the public accounting firm.

(2) *Contents of the notice.* The notice required by paragraph (b)(1) of this section shall provide the following information:

(i) The name of the public accounting firm and the public accounting firm's last known address as reflected in the Board's records;

(ii) The basis for the Board's disapproval, and a copy of the Board's written notice of disapproval; and

(iii) Such other information as the Board may deem relevant.

(c)(1) *Notice of disciplinary action.* If the Board imposes any final disciplinary sanction on any registered public accounting firm or any associated person of a registered public accounting firm under 15 U.S.C. 7215(b)(3) or 7215(c), the Board shall file a notice of the disciplinary sanction with the Commission within 30 days and serve a copy on the person sanctioned.

(2) *Contents of the notice.* The notice required by paragraph (c)(1) of this section shall provide the following information:

(i) The name of the registered public accounting firm or the associated person, together with the firm's or the person's last known address as reflected in the Board's records;

(ii) A description of the acts or practices, or omissions to act, upon which the sanction is based;

(iii) A statement of the sanction imposed, the reasons therefor, or a copy of the Board's statement justifying the sanction, and the effective date of such sanction; and

(iv) Such other information as the Board may deem relevant.

[69 FR 13182, Mar. 19, 2004]

§ 240.19g2–1 Enforcement of compliance by national securities exchanges and registered securities associations with the Act and rules and regulations thereunder.

(a) In enforcing compliance, within the meaning of section 19(g) of the Act, with the Act and the rules and regulations thereunder by its members and persons associated with its members, a national securities exchange or registered securities association is not required:

(1) To enforce compliance with sections 12 (other than sections 12(j) and 12(k)), 13, 14 (other than section 14(b)), 15(d) and 16 and the rules thereunder except to the extent of any action normally taken with respect to any person which is not a member or a person associated with a member;

(2) To enforce compliance with respect to persons associated with a member, other than securities persons or persons who control a member; and

(3) To conduct examinations as to qualifications of, require filing of periodic reports by, or conduct regular inspections (including examinations of books and records) of, persons associated with a member, other than securities persons whose functions are not solely clerical or ministerial.

(b) For the purpose of this rule:

(1) A *securities person* is a person who is a general partner or officer (or person occupying a similar status or performing similar functions) or employee of a member; *Provided, however,* That a registered broker or dealer which controls, is controlled by, or is under common control with, the member and the general partners and officers (and persons occupying similar status or performing similar functions) and employees of such a registered broker or dealer shall be securities persons if they effect, directly or indirectly, transactions in securities through the member by use of facilities maintained or supervised by such exchange or association; and

(2) *Control* means the power to direct or cause the direction of the management or policies of a company whether through ownership of securities, by contract or otherwise; *Provided, however,* That:

(i) Any person who, directly or indirectly, (A) has the right to vote 25 percent or more of the voting securities, (B) is entitled to receive 25 percent or more of the net profits, or (C) is a director (or person occupying a similar status or performing similar functions) of a company shall be presumed to be a person who controls such company;

(ii) Any person not covered by paragraph (b)(2)(i) of this section shall be presumed not to be a person who controls such company; and

(iii) Any presumption may be rebutted on an appropriate showing.

(Secs. 3, 6, 19, 23, 48 Stat. 882, 885, 898, as amended (15 U.S.C. 78c, 78f, 78s, 78w); sec. 15A, 52 Stat. 1070, as amended (15 U.S.C. 78*o*–3))

[41 FR 51808, Nov. 24, 1976]

§ 240.19h–1 Notice by a self-regulatory organization of proposed admission to or continuance in membership or participation or association with a member of any person subject to a statutory disqualification, and applications to the Commission for relief therefrom.

(a) *Notice of admission or continuance notwithstanding a statutory disqualification.* (1) Any self-regulatory organization proposing, conditionally or unconditionally, to admit to, or continue any person in, membership or participation or (in the case of a national securities exchange or registered securities association) association with a member, notwithstanding a statutory disqualification, as defined in section 3(a)(39) of the Act, with respect to such person, shall file a notice with the Commission of such proposed admission or continuance. If such disqualified person has not consented to the terms of such proposal, notice of the organization's action shall be filed pursuant to rule 19d–1 under the Act and not this rule.

(2) With respect to a person associated with a member of a national securities exchange or registered securities association, notices need be filed with the Commission pursuant to this rule only if such person:

(i) Controls such member, is a general partner or officer (or person occupying a similar status or performing similar functions) of such member, is an employee who, on behalf of such member, is engaged in securities advertising, public relations, research, sales, trading, or training or supervision of other employees who engage or propose to engage in such activities, except clerical and ministerial persons engaged in such activities, or is an employee with access to funds, securities or books and records, or

(ii) Is a broker or dealer not registered with the Commission, or controls such (unregistered) broker or dealer or is a general partner or officer (or person occupying a similar status or performing similar functions) of such broker or dealer.

(3) A notice need not be filed with the Commission pursuant to this rule if:

(i) The person subject to the statutory disqualification is already a participant in, a member of, or a person associated with a member of, a self-regulatory organization, and the terms and conditions of the proposed admission by another self-regulatory organization are the same in all material respects as those imposed or not disapproved in connection with such person's prior admission or continuance pursuant to an order of the Commission under paragraph (d) of this section or other substantially equivalent written communication.

(ii) The self-regulatory organization finds, after reasonable inquiry, that except for the identity of the employer concerned, the terms and conditions of the proposed admission or continuance are the same in all material respects as those imposed or not disapproved in connection with a prior admission or continuance of the person subject to the statutory disqualification pursuant to an order of the Commission under paragraph (d) of this section or other substantially equivalent written communication and that there is no intervening conduct or other circumstance that would cause the employment to be inconsistent with the public interest or the protection of investors;

(iii) The disqualification consists of (A) an injunction from engaging in any action, conduct, or practice specified in section 15(b)(4)(C) of the Act, which injunction was entered 10 or more years prior to the proposed admission or continuance—*Provided, however,* That in the case of a final or permanent injunction which was preceded by a preliminary injunction against the same person in the same court proceeding, such ten-year period shall begin to run from the date of such preliminary injunction—and/or (B) a finding by the Commission or a self-regulatory organization of a willful violation of the Act, the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, or a rule or regulation under one or more of such Acts and the sanction for such violation is no longer in effect;

(iv) The disqualification previously (A) was a basis for the institution of an administrative proceeding pursuant to a provision of the federal securities laws, and (B) was considered by the Commission in determining a sanction against such person in the proceeding; and the Commission concluded in such proceeding that it would not restrict or limit the future securities activities of such person in the capacity now proposed or, if it imposed any such restrictions or limitations for a specified time period, such time period has elapsed;

(v) The disqualification consists of a court order or judgment of injunction or conviction, and such order or judgment (A) expressly includes a provision that, on the basis of such order or judgment, the Commission will not institute a proceeding against such person pursuant to section 15(b) or 15B of the Act or that the future securities activities of such persons in the capacity now proposed will not be restricted or limited or (B) includes such restrictions or limitations for a specified time period and such time period has elapsed; or

(vi) In the case of a person seeking to become associated with a broker or dealer or municipal securities dealer, the Commission has previously consented to such proposed association pursuant to section 15(b)(6) or 15B(c)(4) of the Act.

In the case of an admission to membership, participation, or association, if an exception provided for in this paragraph (a)(3) is applicable, the self-regulatory organization shall, pursuant to its rules, determine when the admission to membership, participation, or association shall become effective.

(4) If a self-regulatory organization determines to admit to, or continue any person in, membership, participation, or association with a member pursuant to an exception from the notice requirements provided in paragraph (a)(3)(ii), (iv) or (v) of this section, such organization shall, within 14 calendar days of its making of such determination, furnish to the Commission, by letter, a notification setting forth, as appropriate:

(i) The name of the person subject to the statutory disqualification;

(ii) The name of the person's prospective and immediately preceding employers who are (were) brokers or dealers or municipal securities dealers;

(iii) The name of the person's prospective supervisor(s);

(iv) The respective places of such employments as reflected on the records of the self-regulatory organization;

(v) If applicable, the findings of the self-regulatory organization referred to in paragraph (a)(3)(ii) of this section and the nature (including relevant dates) of the previous Commission or court determination referred to in paragraph (a)(3)(iv) or (v) of this section; and

(vi) An identification of any other self-regulatory organization which has indicated its agreement with the terms and conditions of the proposed admission or continuance;

(5) If a notice or notification has been previously filed or furnished pursuant to this rule by a self-regulatory organization, any other such organization need not file or furnish a separate notice or notification pursuant to this rule with respect to the same matter if such other organization agrees with the terms and conditions of the membership, participation or association reflected in the notice or notification so filed or furnished, and such agreement is set forth in the notice or notification.

(6) The notice requirements of sections 6(c)(2), 15A(g)(2), and 17A(b)(4)(A) of the Act concerning an action of a self-regulatory organization subject to one (or more) of such sections and this paragraph (a) shall be satisfied by a notice with respect to such action filed in accordance with paragraph (c) of this section.

(7) The Commission, by written notice to a self-regulatory organization on or before the thirtieth day after receipt of a notice under this Rule, may direct that such organization not admit to membership, participation, or association with a member any person who is subject to a statutory disqualification for a period not to exceed an additional 60 days beyond the initial 30 day notice period in order that the Commission may extend its consideration of the proposal; *Provided, however*, That during such extended period of consideration, the Commission will not direct the self-regulatory organization to bar the proposed admission to membership, participation or association with a member pursuant to section 6(c)(2), 15A(g)(2), or 17A(b)(4)(A) of the Act, and the Commission will not institute proceedings pursuant to section 15(b) or 15B of the Act on the basis

of such disqualification if the self-regulatory organization has permitted the admission to membership, participation or association with a member, on a temporary basis, pending a final Commission determination.

(b) *Preliminary notifications.* Promptly after receiving an application for admission to, or continuance in, participation or membership in, or association with a member of, a self-regulatory organization which would be required to file with the Commission a notice thereof pursuant to paragraph (a) of this section if such admission or continuance is ultimately proposed by such organization, the organization shall file with the Commission a notification of such receipt. Such notification shall include, as appropriate:

(1) The date of such receipt;

(2) The names of the person subject to the statutory disqualification and the prospective employer concerned together with their respective last known places of residence or business as reflected on the records of the organization;

(3) The basis for any such disqualification including (if based on a prior adjudication) a copy of the order or decision of the court, the Commission, or the self-regulatory organization which adjudicated the matter giving rise to the disqualification; and

(4) The capacity in which the person concerned is proposed to be employed.

(c) *Contents of notice of admission or continuance.* A notice filed with the Commission pursuant to paragraph (a) of this section shall contain the following, as appropriate:

(1) The name of the person concerned together with his last known place of residence or business as reflected on the records of the self-regulatory organization;

(2) The basis for any such disqualification from membership, participation or association including (if based on a prior adjudication) a copy of the order or decision of the court, the Commission or the self-regulatory organization which adjudicated the matter giving rise to such disqualification;

(3) In the case of an admission, the date upon which it is proposed by the organization that such membership, participation or association shall become effective, which shall be not less than 30 days from the date upon which the Commission receives the notice;

(4) A description by or on behalf of the person concerned of the activities engaged in by the person since the disqualification arose, the prospective business or employment in which the person plans to engage and the manner and extent of supervision to be exercised over and by such person. This description shall be accompanied by a written statement submitted to the self-regulatory organization by the proposed employer setting forth the terms and conditions of such employment and supervision. The description also shall include (i) the qualifications, experience and disciplinary records of the proposed supervisors of the person and their family relationship (if any) to that person; (ii) the findings and results of all examinations conducted, during the two years preceding the filing of the notice, by self-regulatory organizations of the main office of the proposed employer and of the branch office(s) in which the employment will occur or be subject to supervisory controls; (iii) a copy of a completed Form U–4 with respect to the proposed association of such person and a certification by the self-regulatory organization that such person is fully qualified under all applicable requirements to engage in the proposed activities; and (iv) the name and place of employment of any other associated person of the proposed employer who is subject to a statutory disqualification (other than a disqualification specified in paragraph (a)(3)(iii) of this section);

(5) If a hearing on the matter has been held by the organization, a certified record of the hearing together with copies of any exhibits introduced therein;

(6) All written submissions not included in a certified oral hearing record which were considered by the organization in its disposition of the matter;

(7) An identification of any other self-regulatory organization which has indicated its agreement with the terms and conditions of the proposed admission or continuance;

(8) All information furnished in writing to the self-regulatory organization

by the staff of the Commission for consideration by the organization in its disposition of the matter or the incorporation by reference of such information, and a statement of the organization's views thereon; and

(9) Such other matters as the organization or person deems relevant.

If the notice contains assertions of material facts not a matter of record before the self-regulatory organization, such facts shall be sworn to by affidavit of the person or organization offering such facts for Commission consideration. The notice may be accompanied by a brief.

(d) *Application to the Commission for relief from certain statutory disqualifications.* The filing of a notice pursuant to paragraph (a) of this section shall neither affect nor foreclose any action which the Commission may take with respect to such person pursuant to the provisions of section 15(b), 15B or 19(h) of the Act or any rule thereunder. Accordingly, a notice filed pursuant to paragraph (a) of this section with respect to the membership, participation, or association of any person subject to an "applicable disqualification," as defined in paragraph (f) of this section, may be accompanied by an application by or on behalf of the person concerned to the Commission for an order declaring, as applicable, that notwithstanding such disqualification, the Commission:

(1) Will not institute proceedings pursuant to section 15(b)(1)(B), 15(b)(4), 15(b)(6), 15B(a)(2), 15B(c)(2), 19(h)(2) or 19(h)(3) of the Act if such person seeks to obtain or continue registration as a broker or dealer or municipal securities dealer or association with a broker or dealer or municipal securities dealer so registered, or membership or participation in a self-regulatory organization;

(2) Will not direct otherwise, as provided in section 6(c)(2), 15A(g)(2) or 17A(b)(4)(A) of the Act; and

(3) Will deem such person qualified pursuant to Rule G–4 of the Municipal Securities Rulemaking Board under the Act.

If a Commission consent is required in order to render a proposed association lawful under section 15(b)(6) or 15B(c)(4) of the Act, an application by or on behalf of the person seeking such consent shall accompany the notice of the proposed association filed pursuant to paragraph (a) of this section. The Commission may, in its discretion and subject to such terms and conditions as it deems necessary, issue such an order and consent should the Commission determine not to object to the position of the self-regulatory organization set forth in the notice or application; *Provided, however,* That nothing herein shall foreclose the right of any person, at his election, to apply directly to the Commission for such consent, if he makes such application pursuant to the terms of an existing order of the Commission under section 15(b)(6) or 15B(c)(4) of the Act limiting his association with a broker or dealer or municipal securities dealer but explicitly granting him such a right to apply for entry or reentry at a later time.

(e) *Contents of application to the Commission.* An application to the Commission pursuant to paragraph (d) of this section shall consist of the following, as appropriate:

(1) The name of the person subject to the disqualification together with his last known place of residence or business as reflected on the records of the self-regulatory organization;

(2) A copy of the order or decision of the court, the Commission or the self-regulatory organization which adjudicated the matter giving rise to such "applicable disqualification";

(3) The nature of the relief sought and the reasons therefor;

(4) A description of the activities engaged in by the person since the disqualification arose;

(5) A description of the prospective business or employment in which the person plans to engage and the manner and extent of supervision to be exercised over and by such person. This description shall be accompanied by a written statement submitted to the self-regulatory organization by the proposed employer setting forth the terms and conditions of such employment and supervision. The description also shall include (i) the qualifications, experience, and disciplinary records of the proposed supervisors of the person and their family relationship (if any)

to that person; (ii) the findings and results of all examinations conducted, during the two years preceding the filing of the application, by self-regulatory organizations of the main office of the proposed employer and of the branch office(s) in which the employment will occur or be subject to supervisory controls; (iii) a copy of a completed Form U–4 with respect to the proposed association of such person and a certification by the self-regulatory organization that such person is fully qualified under all applicable requirements to engage in the proposed activities; and (iv) the name and place of employment of any other associated person of the proposed employer who is subject to a statutory disqualification (other than a disqualification specified in paragraph (a)(3)(iii) of this section);

(6) If a hearing on the matter has been held by the organization, a certified copy of the hearing record, together with copies of any exhibits introduced therein;

(7) All written submissions not included in a certified oral hearing record which were considered by the organization in its disposition of the matter;

(8) All information furnished in writing to the self-regulatory organization by the staff of the Commission for consideration by the organization in its disposition of the matter or the incorporation by reference of such information, and a statement of the organization's views thereon; and

(9) Such other matters as the organization or person deems relevant.

If the application contains assertions of material facts not a matter of record before the organization, such facts shall be sworn to by affidavit of the person or organization offering such facts for Commission consideration.

(f) *Definitions.* For purposes of this rule:

(1) The term *applicable disqualification* shall mean:

(i) Any effective order of the Commission pursuant to section 15(b) (4) or (6), 15B(c) (2) or (4) or 19(h) (2) or (3) of the Act—

(A) Revoking, suspending or placing limitations on the registration, activities, functions, or operations of a broker or dealer;

(B) Suspending, barring, or placing limitations on the association, activities, or functions of an associated person of a broker or dealer;

(C) Suspending or expelling any person from membership or participation in a self-regulatory organization; or

(D) Suspending or barring any person from being associated with a member of a national securities exchange or registered securities association;

(ii) Any conviction of injunction of a type described in section 15(b)(4) (B) or (C) of the Act; or

(iii) A failure under the provisions of Rule G–4 of the Municipal Securities Rulemaking Board under the Act, to meet qualifications standards, and such failure may be remedied by a finding or determination by the Commission pursuant to such rule(s) that the person affected nevertheless meets such standards.

(2) The term *control* shall mean the power to direct or cause the direction of the management or policies of a company whether through ownership of securities, by contract or otherwise; *Provided, however,* That

(i) Any person who, directly or indirectly, (A) has the right to vote 10 percent or more of the voting securities, (B) is entitled to receive 10 percent or more of the net profits, or (C) is a director (or person occupying a similar status or performing similar functions) of a company shall be presumed to be a person who controls such company;

(ii) Any person not covered by paragraph (i) shall be presumed not to be a person who controls such company; and

(iii) Any presumption may be rebutted on an appropriate showing.

(g) Where it deems appropriate to do so, the Commission may determine whether to (1) direct, pursuant to section 6(c)(2), 15A(g)(2) or 17A(b)(4)(A) of the Act, that a proposed admission covered by a notice filed pursuant to paragraph (a) of this section shall be denied or an order barring a proposed association issued or (2) grant or deny an application filed pursuant to paragraph (d) of this section on the basis of the notice or application filed by the self-regulatory organization, the person subject to the disqualification, or other applicant (such as the proposed employer) on behalf of such person, without oral hearing. Any request for oral hearing or argument should be submitted with the notice or application.

(h) The Rules of Practice (17 CFR part 201) shall apply to proceedings under this rule to the extent that they are not inconsistent with this rule.

(15 U.S.C. 78a *et seq.*, as amended by Pub. L. 94–29 (June 4, 1975) and by Pub. L. 98–38 (June 6, 1983), particularly secs. 11A, 15, 19 and 23 thereof (15 U.S.C. 78k–1, 78*o*, 78s and 78w))

[46 FR 58661, Dec. 3, 1981, as amended at 48 FR 53691, Nov. 29, 1983]

SECURITIES WHISTLEBLOWER INCENTIVES AND PROTECTIONS

SOURCE: Sections 240.21F–1 through 240.21F–17 appear at 76 FR 34363, June 13, 2011.

§ 240.21F–1 General.

Section 21F of the Securities Exchange Act of 1934 (''Exchange Act'') (15 U.S.C. 78u-6), entitled ''Securities Whistleblower Incentives and Protection,'' requires the Securities and Exchange Commission (''Commission'') to pay awards, subject to certain limitations and conditions, to whistleblowers who provide the Commission with original information about violations of the Federal securities laws. These rules describe the whistleblower program that the Commission has established to implement the provisions of Section 21F, and explain the procedures you will need to follow in order to be eligible for an award. You should read these procedures carefully because the failure to take certain required steps within the time frames described in these rules may disqualify you from receiving an award for which you otherwise may be eligible. Unless expressly provided for in these rules, no person is authorized to make any offer or promise, or otherwise to bind the Commission with respect to the payment of any award or the amount thereof. The Securities and Exchange Commission's Office of the Whistleblower administers our whistleblower program. Questions about the program or these rules should be directed to the SEC Office of the Whistleblower, 100 F Street, NE., Washington, DC 20549–5631.

§ 240.21F–2 Whistleblower status and retaliation protection.

(a) *Definition of a whistleblower.* (1) You are a whistleblower if, alone or jointly with others, you provide the Commission with information pursuant to the procedures set forth in § 240.21F–9(a) of this chapter, and the information relates to a possible violation of the Federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur. A whistleblower must be an individual. A company or another entity is not eligible to be a whistleblower.

(2) To be eligible for an award, you must submit original information to the Commission in accordance with the procedures and conditions described in §§ 240.21F–4, 240.21F–8, and 240.21F–9 of this chapter.

(b) *Prohibition against retaliation.* (1) For purposes of the anti-retaliation protections afforded by Section 21F(h)(1) of the Exchange Act (15 U.S.C. 78u-6(h)(1)), you are a whistleblower if:

(i) You possess a reasonable belief that the information you are providing relates to a possible securities law violation (or, where applicable, to a possible violation of the provisions set forth in 18 U.S.C. 1514A(a)) that has occurred, is ongoing, or is about to occur, and;

(ii) You provide that information in a manner described in Section 21F(h)(1)(A) of the Exchange Act (15 U.S.C. 78u-6(h)(1)(A)).

(iii) The anti-retaliation protections apply whether or not you satisfy the requirements, procedures and conditions to qualify for an award.

(2) Section 21F(h)(1) of the Exchange Act (15 U.S.C. 78u-6(h)(1)), including any rules promulgated thereunder, shall be enforceable in an action or proceeding brought by the Commission.

§ 240.21F–3 Payment of awards.

(a) *Commission actions:* Subject to the eligibility requirements described in §§ 240.21F–2, 240.21F–8, and 240.21F–16 of this chapter, the Commission will pay an award or awards to one or more whistleblowers who:

(1) Voluntarily provide the Commission

(2) With original information

(3) That leads to the successful enforcement by the Commission of a Federal court or administrative action

(4) In which the Commission obtains monetary sanctions totaling more than $1,000,000.

NOTE TO PARAGRAPH (a): The terms *voluntarily, original information, leads to successful enforcement, action,* and *monetary sanctions* are defined in § 240.21F–4 of this chapter.

(b) *Related actions:* The Commission will also pay an award based on amounts collected in certain related actions.

(1) A *related action* is a judicial or administrative action that is brought by:

(i) The Attorney General of the United States;

(ii) An appropriate regulatory authority;

(iii) A self-regulatory organization; or

(iv) A state attorney general in a criminal case, and is based on the same original information that the whistleblower voluntarily provided to the Commission, and that led the Commission to obtain monetary sanctions totaling more than $1,000,000.

NOTE TO PARAGRAPH (b)(1): The terms *appropriate regulatory authority* and *self-regulatory organization* are defined in § 240.21F–4 of this chapter.

(2) In order for the Commission to make an award in connection with a related action, the Commission must determine that the same original information that the whistleblower gave to the Commission also led to the successful enforcement of the related action under the same criteria described in these rules for awards made in connection with Commission actions. The Commission may seek assistance and confirmation from the authority bringing the related action in making this determination. The Commission will deny an award in connection with the related action if:

(i) The Commission determines that the criteria for an award are not satisfied; or

(ii) The Commission is unable to make a determination because the Office of the Whistleblower could not obtain sufficient and reliable information that could be used as the basis for an award determination pursuant to § 240.21F–12(a) of this chapter. Additional procedures apply to the payment of awards in related actions. These procedures are described in §§ 240.21F–11 and 240.21F–14 of this chapter.

(3) The Commission will not make an award to you for a related action if you have already been granted an award by the Commodity Futures Trading Commission (''CFTC'') for that same action pursuant to its whistleblower award program under Section 23 of the Commodity Exchange Act (7 U.S.C. 26). Similarly, if the CFTC has previously denied an award to you in a related action, you will be precluded from relitigating any issues before the Commission that the CFTC resolved against you as part of the award denial.

§ 240.21F–4 Other definitions.

(a) *Voluntary submission of information.* (1) Your submission of information is made *voluntarily* within the meaning of §§ 240.21F–1 through 240.21F–17 of this chapter if you provide your submission before a request, inquiry, or demand that relates to the subject matter of your submission is directed to you or anyone representing you (such as an attorney):

(i) By the Commission;

(ii) In connection with an investigation, inspection, or examination by the Public Company Accounting Oversight Board, or any self-regulatory organization; or

(iii) In connection with an investigation by Congress, any other authority of the Federal government, or a state Attorney General or securities regulatory authority.

(2) If the Commission or any of these other authorities direct a request, inquiry, or demand as described in paragraph (a)(1) of this section to you or your representative first, your submission will not be considered voluntary, and you will not be eligible for an award, even if your response is not compelled by subpoena or other applicable law. However, your submission of information to the Commission will be considered voluntary if you voluntarily provided the same information to one of the other authorities identified above prior to receiving a request, inquiry, or demand from the Commission.

(3) In addition, your submission will not be considered voluntary if you are required to report your original information to the Commission as a result of a pre-existing legal duty, a contractual duty that is owed to the Commission or to one of the other authorities set forth in paragraph (a)(1) of this section, or a duty that arises out of a judicial or administrative order.

(b) *Original information.* (1) In order for your whistleblower submission to be considered *original information,* it must be:

(i) Derived from your independent knowledge or independent analysis;

(ii) Not already known to the Commission from any other source, unless you are the original source of the information;

(iii) Not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless you are a source of the information; and

(iv) Provided to the Commission for the first time after July 21, 2010 (the date of enactment of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*).

(2) *Independent knowledge* means factual information in your possession that is not derived from publicly available sources. You may gain independent knowledge from your experiences, communications and observations in your business or social interactions.

(3) *Independent analysis* means your own analysis, whether done alone or in combination with others. *Analysis* means your examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public.

(4) The Commission will not consider information to be derived from your independent knowledge or independent analysis in any of the following circumstances:

(i) If you obtained the information through a communication that was subject to the attorney-client privilege, unless disclosure of that information would otherwise be permitted by an attorney pursuant to § 205.3(d)(2) of this chapter, the applicable state attorney conduct rules, or otherwise;

(ii) If you obtained the information in connection with the legal representation of a client on whose behalf you or your employer or firm are providing services, and you seek to use the information to make a whistleblower submission for your own benefit, unless disclosure would otherwise be permitted by an attorney pursuant to § 205.3(d)(2) of this chapter, the applicable state attorney conduct rules, or otherwise; or

(iii) In circumstances not covered by paragraphs (b)(4)(i) or (b)(4)(ii) of this section, if you obtained the information because you were:

(A) An officer, director, trustee, or partner of an entity and another person informed you of allegations of misconduct, or you learned the information in connection with the entity's processes for identifying, reporting, and addressing possible violations of law;

(B) An employee whose principal duties involve compliance or internal audit responsibilities, or you were employed by or otherwise associated with a firm retained to perform compliance or internal audit functions for an entity;

(C) Employed by or otherwise associated with a firm retained to conduct an inquiry or investigation into possible violations of law; or

(D) An employee of, or other person associated with, a public accounting firm, if you obtained the information through the performance of an engagement required of an independent public accountant under the Federal securities laws (other than an audit subject to § 240.21F–8(c)(4) of this chapter), and that information related to a violation by the engagement client or the client's directors, officers or other employees.

(iv) If you obtained the information by a means or in a manner that is determined by a United States court to violate applicable Federal or state criminal law; or

(v) *Exceptions.* Paragraph (b)(4)(iii) of this section shall not apply if:

(A) You have a reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors;

(B) You have a reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct; or

(C) At least 120 days have elapsed since you provided the information to the relevant entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or your supervisor, or since you received the information, if you received it under circumstances indicating that the entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or your supervisor was already aware of the information.

(vi) If you obtained the information from a person who is subject to this section, unless the information is not excluded from that person's use pursuant to this section, or you are providing the Commission with information about possible violations involving that person.

(5) The Commission will consider you to be an *original source* of the same information that we obtain from another source if the information satisfies the definition of original information and the other source obtained the information from you or your representative. In order to be considered an original source of information that the Commission receives from Congress, any other authority of the Federal government, a state Attorney General or securities regulatory authority, any self-regulatory organization, or the Public Company Accounting Oversight Board, you must have voluntarily given such authorities the information within the meaning of these rules. You must establish your status as the original source of information to the Commission's satisfaction. In determining whether you are the original source of information, the Commission may seek assistance and confirmation from one of the other authorities described above, or from another entity (including your employer), in the event that you claim to be the original source of information that an authority or another entity provided to the Commission.

(6) If the Commission already knows some information about a matter from other sources at the time you make your submission, and you are not an original source of that information under paragraph (b)(5) of this section, the Commission will consider you an original source of any information you provide that is derived from your independent knowledge or analysis and that materially adds to the information that the Commission already possesses.

(7) If you provide information to the Congress, any other authority of the Federal government, a state Attorney General or securities regulatory authority, any self-regulatory organization, or the Public Company Accounting Oversight Board, or to an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law, and you, within 120 days, submit the same information to the Commission pursuant to § 240.21F–9 of this chapter, as you must do in order for you to be eligible to be considered for an award, then, for purposes of evaluating your claim to an award under §§ 240.21F–10 and 240.21F–11 of this chapter, the Commission will consider that you provided information as of the date of your original disclosure, report or submission to one of these other authorities or persons. You must establish the effective date of any prior disclosure, report, or submission, to the Commission's satisfaction. The Commission may seek assistance and confirmation from the other authority or person in making this determination.

(c) *Information that leads to successful enforcement.* The Commission will consider that you provided original information that led to the successful enforcement of a judicial or administrative action in any of the following circumstances:

(1) You gave the Commission original information that was sufficiently specific, credible, and timely to cause the staff to commence an examination, open an investigation, reopen an investigation that the Commission had

closed, or to inquire concerning different conduct as part of a current examination or investigation, and the Commission brought a successful judicial or administrative action based in whole or in part on conduct that was the subject of your original information; or

(2) You gave the Commission original information about conduct that was already under examination or investigation by the Commission, the Congress, any other authority of the Federal government, a state Attorney General or securities regulatory authority, any self-regulatory organization, or the PCAOB (except in cases where you were an original source of this information as defined in paragraph (b)(4) of this section), and your submission significantly contributed to the success of the action.

(3) You reported original information through an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law before or at the same time you reported them to the Commission; the entity later provided your information to the Commission, or provided results of an audit or investigation initiated in whole or in part in response to information you reported to the entity; and the information the entity provided to the Commission satisfies either paragraph (c)(1) or (c)(2) of this section. Under this paragraph (c)(3), you must also submit the same information to the Commission in accordance with the procedures set forth in § 240.21F–9 within 120 days of providing it to the entity.

(d) An *action* generally means a single captioned judicial or administrative proceeding brought by the Commission. Notwithstanding the foregoing:

(1) For purposes of making an award under § 240.21F–10 of this chapter, the Commission will treat as a Commission action two or more administrative or judicial proceedings brought by the Commission if these proceedings arise out of the same nucleus of operative facts; or

(2) For purposes of determining the payment on an award under § 240.21F–14 of this chapter, the Commission will deem as part of the Commission action upon which the award was based any subsequent Commission proceeding that, individually, results in a monetary sanction of $1,000,000 or less, and that arises out of the same nucleus of operative facts.

(e) *Monetary sanctions* means any money, including penalties, disgorgement, and interest, ordered to be paid and any money deposited into a disgorgement fund or other fund pursuant to Section 308(b) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7246(b)) as a result of a Commission action or a related action.

(f) *Appropriate regulatory agency* means the Commission, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and any other agencies that may be defined as appropriate regulatory agencies under Section 3(a)(34) of the Exchange Act (15 U.S.C. 78c(a)(34)).

(g) *Appropriate regulatory authority* means an appropriate regulatory agency other than the Commission.

(h) *Self-regulatory organization* means any national securities exchange, registered securities association, registered clearing agency, the Municipal Securities Rulemaking Board, and any other organizations that may be defined as self-regulatory organizations under Section 3(a)(26) of the Exchange Act (15 U.S.C. 78c(a)(26)).

§ 240.21F–5 Amount of award.

(a) The determination of the amount of an award is in the discretion of the Commission.

(b) If all of the conditions are met for a whistleblower award in connection with a Commission action or a related action, the Commission will then decide the percentage amount of the award applying the criteria set forth in § 240.21F–6 of this chapter and pursuant to the procedures set forth in §§ 240.21F–10 and 240.21F–11 of this chapter. The amount will be at least 10 percent and no more than 30 percent of the monetary sanctions that the Commission and the other authorities are able to collect. The percentage awarded in connection with a Commission action may differ from the percentage awarded in connection with a related action.

(c) If the Commission makes awards to more than one whistleblower in connection with the same action or related action, the Commission will determine an individual percentage award for each whistleblower, but in no event will the total amount awarded to all whistleblowers in the aggregate be less than 10 percent or greater than 30 percent of the amount the Commission or the other authorities collect.

§ 240.21F–6 Criteria for determining amount of award.

In exercising its discretion to determine the appropriate award percentage, the Commission may consider the following factors in relation to the unique facts and circumstances of each case, and may increase or decrease the award percentage based on its analysis of these factors. In the event that awards are determined for multiple whistleblowers in connection an action, these factors will be used to determine the relative allocation of awards among the whistleblowers.

(a) *Factors that may increase the amount of a whistleblower's award.* In determining whether to increase the amount of an award, the Commission will consider the following factors, which are not listed in order of importance.

(1) *Significance of the information provided by the whistleblower.* The Commission will assess the significance of the information provided by a whistleblower to the success of the Commission action or related action. In considering this factor, the Commission may take into account, among other things:

(i) The nature of the information provided by the whistleblower and how it related to the successful enforcement action, including whether the reliability and completeness of the information provided to the Commission by the whistleblower resulted in the conservation of Commission resources;

(ii) The degree to which the information provided by the whistleblower supported one or more successful claims brought in the Commission or related action.

(2) *Assistance provided by the whistleblower.* The Commission will assess the degree of assistance provided by the whistleblower and any legal representative of the whistleblower in the Commission action or related action. In considering this factor, the Commission may take into account, among other things:

(i) Whether the whistleblower provided ongoing, extensive, and timely cooperation and assistance by, for example, helping to explain complex transactions, interpreting key evidence, or identifying new and productive lines of inquiry;

(ii) The timeliness of the whistleblower's initial report to the Commission or to an internal compliance or reporting system of business organizations committing, or impacted by, the securities violations, where appropriate;

(iii) The resources conserved as a result of the whistleblower's assistance;

(iv) Whether the whistleblower appropriately encouraged or authorized others to assist the staff of the Commission who might otherwise not have participated in the investigation or related action;

(v) The efforts undertaken by the whistleblower to remediate the harm caused by the violations, including assisting the authorities in the recovery of the fruits and instrumentalities of the violations; and

(vi) Any unique hardships experienced by the whistleblower as a result of his or her reporting and assisting in the enforcement action.

(3) *Law enforcement interest.* The Commission will assess its programmatic interest in deterring violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws. In considering this factor, the Commission may take into account, among other things:

(i) The degree to which an award enhances the Commission's ability to enforce the Federal securities laws and protect investors; and

(ii) The degree to which an award encourages the submission of high quality information from whistleblowers by appropriately rewarding whistleblowers' submission of significant information and assistance, even in cases where the monetary sanctions available for collection are limited or potential monetary sanctions were reduced or eliminated by the Commission because an entity self-reported a securities violation following the whistleblower's related internal disclosure, report, or submission.

(iii) Whether the subject matter of the action is a Commission priority, whether the reported misconduct involves regulated entities or fiduciaries, whether the whistleblower exposed an industry-wide practice, the type and severity of the securities violations, the age and duration of misconduct, the number of violations, and the isolated, repetitive, or ongoing nature of the violations; and

(iv) The dangers to investors or others presented by the underlying violations involved in the enforcement action, including the amount of harm or potential harm caused by the underlying violations, the type of harm resulting from or threatened by the underlying violations, and the number of individuals or entities harmed.

(4) *Participation in internal compliance systems*. The Commission will assess whether, and the extent to which, the whistleblower and any legal representative of the whistleblower participated in internal compliance systems. In considering this factor, the Commission may take into account, among other things:

(i) Whether, and the extent to which, a whistleblower reported the possible securities violations through internal whistleblower, legal or compliance procedures before, or at the same time as, reporting them to the Commission; and

(ii) Whether, and the extent to which, a whistleblower assisted any internal investigation or inquiry concerning the reported securities violations.

(b) *Factors that may decrease the amount of a whistleblower's award*. In determining whether to decrease the amount of an award, the Commission will consider the following factors, which are not listed in order of importance.

(1) *Culpability*. The Commission will assess the culpability or involvement of the whistleblower in matters associated with the Commission's action or related actions. In considering this factor, the Commission may take into account, among other things:

(i) The whistleblower's role in the securities violations;

(ii) The whistleblower's education, training, experience, and position of responsibility at the time the violations occurred;

(iii) Whether the whistleblower acted with scienter, both generally and in relation to others who participated in the violations;

(iv) Whether the whistleblower financially benefitted from the violations;

(v) Whether the whistleblower is a recidivist;

(vi) The egregiousness of the underlying fraud committed by the whistleblower; and

(vii) Whether the whistleblower knowingly interfered with the Commission's investigation of the violations or related enforcement actions.

(2) *Unreasonable reporting delay*. The Commission will assess whether the whistleblower unreasonably delayed reporting the securities violations. In considering this factor, the Commission may take into account, among other things:

(i) Whether the whistleblower was aware of the relevant facts but failed to take reasonable steps to report or prevent the violations from occurring or continuing;

(ii) Whether the whistleblower was aware of the relevant facts but only reported them after learning about a related inquiry, investigation, or enforcement action; and

(iii) Whether there was a legitimate reason for the whistleblower to delay reporting the violations.

(3) *Interference with internal compliance and reporting systems*. The Commission will assess, in cases where the whistleblower interacted with his or her entity's internal compliance or reporting system, whether the whistleblower undermined the integrity of such system. In considering this factor, the Commission will take into account whether there is evidence provided to the Commission that the whistleblower knowingly:

(i) Interfered with an entity's established legal, compliance, or audit procedures to prevent or delay detection of the reported securities violation;

(ii) Made any material false, fictitious, or fraudulent statements or representations that hindered an entity's efforts to detect, investigate, or remediate the reported securities violations; and

(iii) Provided any false writing or document knowing the writing or document contained any false, fictitious or fraudulent statements or entries that hindered an entity's efforts to detect, investigate, or remediate the reported securities violations.

§ 240.21F–7 Confidentiality of submissions.

(a) Section 21F(h)(2) of the Exchange Act (15 U.S.C. 78u–6(h)(2)) requires that the Commission not disclose information that could reasonably be expected to reveal the identity of a whistleblower, except that the Commission may disclose such information in the following circumstances:

(1) When disclosure is required to a defendant or respondent in connection with a Federal court or administrative action that the Commission files or in another public action or proceeding that is filed by an authority to which we provide the information, as described below;

(2) When the Commission determines that it is necessary to accomplish the purposes of the Exchange Act (15 U.S.C. 78a) and to protect investors, it may provide your information to the Department of Justice, an appropriate regulatory authority, a self regulatory organization, a state attorney general in connection with a criminal investigation, any appropriate state regulatory authority, the Public Company Accounting Oversight Board, or foreign securities and law enforcement authorities. Each of these entities other than foreign securities and law enforcement authorities is subject to the confidentiality requirements set forth in Section 21F(h) of the Exchange Act (15 U.S.C. 78u–6(h)). The Commission will determine what assurances of confidentiality it deems appropriate in providing such information to foreign securities and law enforcement authorities.

(3) The Commission may make disclosures in accordance with the Privacy Act of 1974 (5 U.S.C. 552a).

(b) You may submit information to the Commission anonymously. If you do so, however, you must also do the following:

(1) You must have an attorney represent you in connection with both your submission of information and your claim for an award, and your attorney's name and contact information must be provided to the Commission at the time you submit your information;

(2) You and your attorney must follow the procedures set forth in § 240.21F–9 of this chapter for submitting original information anonymously; and

(3) Before the Commission will pay any award to you, you must disclose your identity to the Commission and your identity must be verified by the Commission as set forth in § 240.21F–10 of this chapter.

§ 240.21F–8 Eligibility.

(a) To be eligible for a whistleblower award, you must give the Commission information in the form and manner that the Commission requires. The procedures for submitting information and making a claim for an award are described in § 240.21F–9 through § 240.21F–11 of this chapter. You should read these procedures carefully because you need to follow them in order to be eligible for an award, except that the Commission may, in its sole discretion, waive any of these procedures based upon a showing of extraordinary circumstances.

(b) In addition to any forms required by these rules, the Commission may also require that you provide certain additional information. You may be required to:

(1) Provide explanations and other assistance in order that the staff may evaluate and use the information that you submitted;

(2) Provide all additional information in your possession that is related to the subject matter of your submission in a complete and truthful manner, through follow-up meetings, or in other forms that our staff may agree to;

(3) Provide testimony or other evidence acceptable to the staff relating to whether you are eligible, or otherwise satisfy any of the conditions, for an award; and

(4) Enter into a confidentiality agreement in a form acceptable to the Office of the Whistleblower, covering any non-public information that the Commission provides to you, and including a provision that a violation of the agreement may lead to your ineligibility to receive an award.

(c) You are not eligible to be considered for an award if you do not satisfy the requirements of paragraphs (a) and (b) of this section. In addition, you are not eligible if:

(1) You are, or were at the time you acquired the original information provided to the Commission, a member, officer, or employee of the Commission, the Department of Justice, an appropriate regulatory agency, a self-regulatory organization, the Public Company Accounting Oversight Board, or any law enforcement organization;

(2) You are, or were at the time you acquired the original information provided to the Commission, a member, officer, or employee of a foreign government, any political subdivision, department, agency, or instrumentality of a foreign government, or any other foreign financial regulatory authority as that term is defined in Section 3(a)(52) of the Exchange Act (15 U.S.C. 78c(a)(52));

(3) You are convicted of a criminal violation that is related to the Commission action or to a related action (as defined in § 240.21F–4 of this chapter) for which you otherwise could receive an award;

(4) You obtained the original information that you gave the Commission through an audit of a company's financial statements, and making a whistleblower submission would be contrary to requirements of Section 10A of the Exchange Act (15 U.S.C. 78j-a).

(5) You are the spouse, parent, child, or sibling of a member or employee of the Commission, or you reside in the same household as a member or employee of the Commission;

(6) You acquired the original information you gave the Commission from a person:

(i) Who is subject to paragraph (c)(4) of this section, unless the information is not excluded from that person's use, or you are providing the Commission with information about possible violations involving that person; or

(ii) With the intent to evade any provision of these rules; or

(7) In your whistleblower submission, your other dealings with the Commission, or your dealings with another authority in connection with a related action, you knowingly and willfully make any false, fictitious, or fraudulent statement or representation, or use any false writing or document knowing that it contains any false, fictitious, or fraudulent statement or entry with intent to mislead or otherwise hinder the Commission or another authority.

§ 240.21F–9 Procedures for submitting original information.

(a) To be considered a whistleblower under Section 21F of the Exchange Act (15 U.S.C. 78u–6(h)), you must submit your information about a possible securities law violation by either of these methods:

(1) Online, through the Commission's Web site located at *http://www.sec.gov;* or

(2) By mailing or faxing a Form TCR (Tip, Complaint or Referral) (referenced in § 249.1800 of this chapter) to the SEC Office of the Whistleblower, 100 F Street NE., Washington, DC 20549–5631, Fax (703) 813–9322.

(b) Further, to be eligible for an award, you must declare under penalty of perjury at the time you submit your information pursuant to paragraph (a)(1) or (2) of this section that your information is true and correct to the best of your knowledge and belief.

(c) Notwithstanding paragraphs (a) and (b) of this section, if you are providing your original information to the Commission anonymously, then your attorney must submit your information on your behalf pursuant to the procedures specified in paragraph (a) of this section. Prior to your attorney's submission, you must provide your attorney with a completed Form TCR (referenced in § 249.1800 of this chapter) that you have signed under penalty of perjury. When your attorney makes her submission on your behalf, your attorney will be required to certify that he or she:

(1) Has verified your identity;

(2) Has reviewed your completed and signed Form TCR (referenced in § 249.1800 of this chapter) for completeness and accuracy and that the information contained therein is true, correct and complete to the best of the attorney's knowledge, information and belief;

(3) Has obtained your non-waivable consent to provide the Commission with your original completed and signed Form TCR (referenced in § 249.1800 of this chapter) in the event that the Commission requests it due to concerns that you may have knowingly and willfully made false, fictitious, or fraudulent statements or representations, or used any false writing or document knowing that the writing or document contains any false fictitious or fraudulent statement or entry; and

(4) Consents to be legally obligated to provide the signed Form TCR (referenced in § 249.1800 of this chapter) within seven (7) calendar days of receiving such request from the Commission.

(d) If you submitted original information in writing to the Commission after July 21, 2010 (the date of enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act) but before the effective date of these rules, your submission will be deemed to satisfy the requirements set forth in paragraphs (a) and (b) of this section. If you were an anonymous whistleblower, however, you must provide your attorney with a completed and signed copy of Form TCR (referenced in § 249.1800 of this chapter) within 60 days of the effective date of these rules, your attorney must retain the signed form in his or her records, and you must provide of copy of the signed form to the Commission staff upon request by Commission staff prior to any payment of an award to you in connection with your submission. Notwithstanding the foregoing, you must follow the procedures and conditions for making a claim for a whistleblower award described in §§ 240.21F–10 and 240.21F–11 of this chapter.

§ 240.21F–10 Procedures for making a claim for a whistleblower award in SEC actions that result in monetary sanctions in excess of $1,000,000.

(a) Whenever a Commission action results in monetary sanctions totaling more than $1,000,000, the Office of the Whistleblower will cause to be published on the Commission's Web site a ''Notice of Covered Action.'' Such Notice will be published subsequent to the entry of a final judgment or order that alone, or collectively with other judgments or orders previously entered in the Commission action, exceeds $1,000,000; or, in the absence of such judgment or order subsequent to the deposit of monetary sanctions exceeding $1,000,000 into a disgorgement or other fund pursuant to Section 308(b) of the Sarbanes-Oxley Act of 2002. A claimant will have ninety (90) days from the date of the Notice of Covered Action to file a claim for an award based on that action, or the claim will be barred.

(b) To file a claim for a whistleblower award, you must file Form WB–APP, *Application for Award for Original Information Provided Pursuant to Section 21F of the Securities Exchange Act of 1934* (referenced in § 249.1801 of this chapter). You must sign this form as the claimant and submit it to the Office of the Whistleblower by mail or fax. All claim forms, including any attachments, must be received by the Office of the Whistleblower within ninety (90) calendar days of the date of the Notice of Covered Action in order to be considered for an award.

(c) If you provided your original information to the Commission anonymously, you must disclose your identity on the Form WB–APP (referenced in § 249.1801 of this chapter), and your identity must be verified in a form and manner that is acceptable to the Office of the Whistleblower prior to the payment of any award.

(d) Once the time for filing any appeals of the Commission's judicial or administrative action has expired, or where an appeal has been filed, after all appeals in the action have been concluded, the staff designated by the Director of the Division of Enforcement (''Claims Review Staff'') will evaluate all timely whistleblower award claims submitted on Form WB–APP (referenced in § 249.1801 of this chapter) in accordance with the criteria set forth in these rules. In connection with this process, the Office of the Whistleblower may require that you provide additional information relating to your eligibility for an award or satisfaction of any of the conditions for an award, as set forth in § 240.21F–(8)(b) of this chapter. Following that evaluation, the Office of the Whistleblower will send you a Preliminary Determination setting forth a preliminary assessment as to whether the claim should be allowed or denied and, if allowed, setting forth the proposed award percentage amount.

(e) You may contest the Preliminary Determination made by the Claims Review Staff by submitting a written response to the Office of the Whistleblower setting forth the grounds for your objection to either the denial of an award or the proposed amount of an award. The response must be in the form and manner that the Office of the Whistleblower shall require. You may also include documentation or other evidentiary support for the grounds advanced in your response.

(1) Before determining whether to contest a Preliminary Determination, you may:

(i) Within thirty (30) days of the date of the Preliminary Determination, request that the Office of the Whistleblower make available for your review the materials from among those set forth in § 240.21F–12(a) of this chapter that formed the basis of the Claims Review Staff's Preliminary Determination.

(ii) Within thirty (30) calendar days of the date of the Preliminary Determination, request a meeting with the Office of the Whistleblower; however, such meetings are not required and the office may in its sole discretion decline the request.

(2) If you decide to contest the Preliminary Determination, you must submit your written response and supporting materials within sixty (60) calendar days of the date of the Preliminary Determination, or if a request to review materials is made pursuant to paragraph (e)(1) of this section, then within sixty (60) calendar days of the Office of the Whistleblower making those materials available for your review.

(f) If you fail to submit a timely response pursuant to paragraph (e) of this section, then the Preliminary Determination will become the Final Order of the Commission (except where the Preliminary Determination recommended an award, in which case the Preliminary Determination will be deemed a Proposed Final Determination for purposes of paragraph (h) of this section). Your failure to submit a timely response contesting a Preliminary Determination will constitute a failure to exhaust administrative remedies, and you will be prohibited from pursuing an appeal pursuant to § 240.21F–13 of this chapter.

(g) If you submit a timely response pursuant to paragraph (e) of this section, then the Claims Review Staff will consider the issues and grounds advanced in your response, along with any supporting documentation you provided, and will make its Proposed Final Determination.

(h) The Office of the Whistleblower will then notify the Commission of each Proposed Final Determination. Within thirty 30 days thereafter, any Commissioner may request that the Proposed Final Determination be reviewed by the Commission. If no Commissioner requests such a review within the 30-day period, then the Proposed Final Determination will become the Final Order of the Commission. In the event a Commissioner requests a review, the Commission will review the record that the staff relied upon in making its determinations, including your previous submissions to the Office of the Whistleblower, and issue its Final Order.

(i) The Office of the Whistleblower will provide you with the Final Order of the Commission.

§ 240.21F–11 Procedures for determining awards based upon a related action.

(a) If you are eligible to receive an award following a Commission action that results in monetary sanctions totaling more than $1,000,000, you also may be eligible to receive an award based on the monetary sanctions that are collected from a related action (as defined in § 240.21F–3 of this chapter).

(b) You must also use Form WB–APP (referenced in § 249.1801 of this chapter) to submit a claim for an award in a related action. You must sign this form as the claimant and submit it to the Office of the Whistleblower by mail or fax as follows:

(1) If a final order imposing monetary sanctions has been entered in a related action at the time you submit your claim for an award in connection with a Commission action, you must submit your claim for an award in that related action on the same Form WB–APP (referenced in § 249.1801 of this chapter) that you use for the Commission action.

(2) If a final order imposing monetary sanctions in a related action has not been entered at the time you submit your claim for an award in connection with a Commission action, you must submit your claim on Form WB–APP (referenced in § 249.1801 of this chapter) within ninety (90) days of the issuance of a final order imposing sanctions in the related action.

(c) The Office of the Whistleblower may request additional information from you in connection with your claim for an award in a related action to demonstrate that you directly (or through the Commission) voluntarily provided the governmental agency, regulatory authority or self-regulatory organization the same original information that led to the Commission's successful covered action, and that this information led to the successful enforcement of the related action. The Office of the Whistleblower may, in its discretion, seek assistance and confirmation from the other agency in making this determination.

(d) Once the time for filing any appeals of the final judgment or order in a related action has expired, or if an appeal has been filed, after all appeals in the action have been concluded, the Claims Review Staff will evaluate all timely whistleblower award claims submitted on Form WB–APP (referenced in § 249.1801 of this chapter) in connection with the related action. The evaluation will be undertaken pursuant to the criteria set forth in these rules. In connection with this process, the Office of the Whistleblower may require that you provide additional information relating to your eligibility for an award or satisfaction of any of the conditions for an award, as set forth in § 240.21F–(8)(b) of this chapter. Following this evaluation, the Office of the Whistleblower will send you a Preliminary Determination setting forth a preliminary assessment as to whether the claim should be allowed or denied and, if allowed, setting forth the proposed award percentage amount.

(e) You may contest the Preliminary Determination made by the Claims Review Staff by submitting a written response to the Office of the Whistleblower setting forth the grounds for your objection to either the denial of an award or the proposed amount of an award. The response must be in the form and manner that the Office of the Whistleblower shall require. You may also include documentation or other evidentiary support for the grounds advanced in your response.

(1) Before determining whether to contest a Preliminary Determination, you may:

(i) Within thirty (30) days of the date of the Preliminary Determination, request that the Office of the Whistleblower make available for your review the materials from among those set forth in § 240.21F–12(a) of this chapter that formed the basis of the Claims Review Staff's Preliminary Determination.

(ii) Within thirty (30) days of the date of the Preliminary Determination, request a meeting with the Office of the Whistleblower; however, such meetings are not required and the office may in its sole discretion decline the request.

(2) If you decide to contest the Preliminary Determination, you must submit your written response and supporting materials within sixty (60) calendar days of the date of the Preliminary Determination, or if a request to review materials is made pursuant to paragraph (e)(1)(i) of this section, then within sixty (60) calendar days of the Office of the Whistleblower making those materials available for your review.

(f) If you fail to submit a timely response pursuant to paragraph (e) of this section, then the Preliminary Determination will become the Final Order of the Commission (except where the Preliminary Determination recommended an award, in which case the Preliminary Determination will be deemed a Proposed Final Determination for purposes of paragraph (h) of this section). Your failure to submit a timely response contesting a Preliminary Determination will constitute a failure to exhaust administrative remedies, and you will be prohibited from pursuing an appeal pursuant to § 240.21F–13 of this chapter.

(g) If you submit a timely response pursuant to paragraph (e) of this section, then the Claims Review Staff will consider the issues and grounds that you advanced in your response, along with any supporting documentation you provided, and will make its Proposed Final Determination.

(h) The Office of the Whistleblower will notify the Commission of each Proposed Final Determination. Within thirty 30 days thereafter, any Commissioner may request that the Proposed Final Determination be reviewed by the Commission. If no Commissioner requests such a review within the 30-day period, then the Proposed Final Determination will become the Final Order of the Commission. In the event a Commissioner requests a review, the Commission will review the record that the staff relied upon in making its determinations, including your previous submissions to the Office of the Whistleblower, and issue its Final Order.

(i) The Office of the Whistleblower will provide you with the Final Order of the Commission.

§ 240.21F–12 Materials that may form the basis of an award determination and that may comprise the record on appeal.

(a) The following items constitute the materials that the Commission and the Claims Review Staff may rely upon to make an award determination pursuant to §§ 240.21F–10 and 240.21F–11 of this chapter:

(1) Any publicly available materials from the covered action or related action, including:

(i) The complaint, notice of hearing, answers and any amendments thereto;

(ii) The final judgment, consent order, or final administrative order;

(iii) Any transcripts of the proceedings, including any exhibits;

(iv) Any items that appear on the docket; and

(v) Any appellate decisions or orders.

(2) The whistleblower's Form TCR (referenced in § 249.1800 of this chapter), including attachments, and other related materials provided by the whistleblower to assist the Commission with the investigation or examination;

(3) The whistleblower's Form WB–APP (referenced in § 249.1800 of this chapter), including attachments, and any other filings or submissions from the whistleblower in support of the award application;

(4) Sworn declarations (including attachments) from the Commission staff regarding any matters relevant to the award determination;

(5) With respect to an award claim involving a related action, any statements or other information that the entity provides or identifies in connection with an award determination, provided the entity has authorized the Commission to share the information with the claimant. (Neither the Commission nor the Claims Review Staff may rely upon information that the entity has not authorized the Commission to share with the claimant); and

(6) Any other documents or materials including sworn declarations from third-parties that are received or obtained by the Office of the Whistleblower to assist the Commission resolve the claimant's award application, including information related to the claimant's eligibility. (Neither the Commission nor the Claims Review Staff may rely upon information that the entity has not authorized the Commission to share with the claimant).

(b) These rules do not entitle claimants to obtain from the Commission any materials (including any predecisional or internal deliberative process materials that are prepared exclusively to assist the Commission in deciding the claim) other than those listed in paragraph (a) of this section. Moreover, the Office of the Whistleblower may make redactions as necessary to comply with any statutory restrictions, to protect the Commission's law enforcement and regulatory functions, and to comply with requests for confidential treatment from other law enforcement and regulatory authorities. The Office of the Whistleblower may also require you to sign a confidentiality agreement, as set forth in §240.21F–(8)(b)(4) of this chapter, before providing these materials.

§240.21F–13 Appeals.

(a) Section 21F of the Exchange Act (15 U.S.C. 78u–6) commits determinations of whether, to whom, and in what amount to make awards to the Commission's discretion. A determination of whether or to whom to make an award may be appealed within 30 days after the Commission issues its final decision to the United States Court of Appeals for the District of Columbia Circuit, or to the circuit where the aggrieved person resides or has his principal place of business. Where the Commission makes an award based on the factors set forth in §240.21F–6 of this chapter of not less than 10 percent and not more than 30 percent of the monetary sanctions collected in the Commission or related action, the Commission's determination regarding the amount of an award (including the allocation of an award as between multiple whistleblowers, and any factual findings, legal conclusions, policy judgments, or discretionary assessments involving the Commission's consideration of the factors in §240.21F–6 of this chapter) is not appealable.

(b) The record on appeal shall consist of the Preliminary Determination, the Final Order of the Commission, and any other items from those set forth in §240.21F–12(a) of this chapter that either the claimant or the Commission identifies for inclusion in the record. The record on appeal shall not include any pre-decisional or internal deliberative process materials that are prepared exclusively to assist the Commission in deciding the claim (including the staff's Draft Final Determination in the event that the Commissioners reviewed the claim and issued the Final Order).

§240.21F–14 Procedures applicable to the payment of awards.

(a) Any award made pursuant to these rules will be paid from the Securities and Exchange Commission Investor Protection Fund (the "Fund").

(b) A recipient of a whistleblower award is entitled to payment on the award only to the extent that a monetary sanction is collected in the Commission action or in a related action upon which the award is based.

(c) Payment of a whistleblower award for a monetary sanction collected in a Commission action or related action shall be made following the later of:

(1) The date on which the monetary sanction is collected; or

(2) The completion of the appeals process for all whistleblower award claims arising from:

(i) The Notice of Covered Action, in the case of any payment of an award for a monetary sanction collected in a Commission action; or

(ii) The related action, in the case of any payment of an award for a monetary sanction collected in a related action.

(d) If there are insufficient amounts available in the Fund to pay the entire amount of an award payment within a reasonable period of time from the time for payment specified by paragraph (c) of this section, then subject to the following terms, the balance of the payment shall be paid when amounts become available in the Fund, as follows:

(1) Where multiple whistleblowers are owed payments from the Fund based on awards that do not arise from the same Notice of Covered Action (or related action), priority in making these payments will be determined based upon the date that the collections for which the whistleblowers are owed payments occurred. If two or more of these collections occur on the same date, those whistleblowers owed payments based on these collections will be paid on a pro rata basis until sufficient amounts become available in the Fund to pay their entire payments.

(2) Where multiple whistleblowers are owed payments from the Fund based on awards that arise from the same Notice of Covered Action (or related action), they will share the same

payment priority and will be paid on a pro rata basis until sufficient amounts become available in the Fund to pay their entire payments.

§ 240.21F–15 No amnesty.

The Securities Whistleblower Incentives and Protection provisions do not provide amnesty to individuals who provide information to the Commission. The fact that you may become a whistleblower and assist in Commission investigations and enforcement actions does not preclude the Commission from bringing an action against you based upon your own conduct in connection with violations of the Federal securities laws. If such an action is determined to be appropriate, however, the Commission will take your cooperation into consideration in accordance with its Policy Statement Concerning Cooperation by Individuals in Investigations and Related Enforcement Actions (17 CFR 202.12).

§ 240.21F–16 Awards to whistleblowers who engage in culpable conduct.

In determining whether the required $1,000,000 threshold has been satisfied (this threshold is further explained in § 240.21F–10 of this chapter) for purposes of making any award, the Commission will not take into account any monetary sanctions that the whistleblower is ordered to pay, or that are ordered against any entity whose liability is based substantially on conduct that the whistleblower directed, planned, or initiated. Similarly, if the Commission determines that a whistleblower is eligible for an award, any amounts that the whistleblower or such an entity pay in sanctions as a result of the action or related actions will not be included within the calculation of the amounts collected for purposes of making payments.

§ 240.21F–17 Staff communications with individuals reporting possible securities law violations.

(a) No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement (other than agreements dealing with information covered by § 240.21F–4(b)(4)(i) and § 240.21F–4(b)(4)(ii) of this chapter related to the legal representation of a client) with respect to such communications.

(b) If you are a director, officer, member, agent, or employee of an entity that has counsel, and you have initiated communication with the Commission relating to a possible securities law violation, the staff is authorized to communicate directly with you regarding the possible securities law violation without seeking the consent of the entity's counsel.

INSPECTION AND PUBLICATION OF INFORMATION FILED UNDER THE ACT

§ 240.24b–1 Documents to be kept public by exchanges.

Upon action of the Commission granting an exchange's application for registration or exemption, the exchange shall make available to public inspection at its offices during reasonable office hours a copy of the statement and exhibits filed with the Commission (including any amendments thereto) except those portions thereof to the disclosure of which the exchange shall have filed objection pursuant to § 240.24b–2 which objection shall not have been overruled by the Commission pursuant to section 24(b) of the Act.

(Sec. 24, 48 Stat. 901; 15 U.S.C. 78x)

CROSS REFERENCE: For regulations relating to registration and exemption of exchanges, see §§ 240.6a–1 to 240.6a–3.

[13 FR 8214, Dec. 22, 1948]

§ 240.24b–2 Nondisclosure of information filed with the Commission and with any exchange.

PRELIMINARY NOTE: Except as otherwise provided in this rule, confidential treatment requests shall be submitted in paper format only, whether or not the filer is required to submit a filing in electronic format.

(a) Any person filing any registration statement, report, application, statement, correspondence, notice or other document (herein referred to as the material filed) pursuant to the Act may make written objection to the public disclosure of any information contained therein in accordance with the procedure set forth below. The procedure provided in this rule shall be the exclusive means of requesting confidential treatment of information required to be filed under the Act.

(b) Except as otherwise provided in paragraphs (g) and (h) of this section, the person shall omit from material filed the portion thereof which it desires to keep undisclosed (hereinafter called the confidential portion). In lieu thereof, it shall indicate at the appropriate place in the material filed that the confidential portion has been so omitted and filed separately with the Commission. The person shall file with the copies of the material filed with the Commission:

(1) One copy of the confidential portion, marked ''Confidential Treatment,'' of the material filed with the Commission. The copy shall contain an appropriate identification of the item or other requirement involved and, notwithstanding that the confidential portion does not constitute the whole of the answer, the entire answer thereto; except that in the case where the confidential portion is part of a financial statement or schedule, only the particular financial statement or schedule need be included. The copy of the confidential portion shall be in the same form as the remainder of the material filed;

(2) An application making objection to the disclosure of the confidential portion. Such application shall be on a sheet or sheets separate from the confidential portion, and shall contain (i) an identification of the portion; (ii) a statement of the grounds of objection referring to, and containing an analysis of, the applicable exemption(s) from disclosure under the Commission's rules and regulations adopted under the Freedom of Information Act (17 CFR 200.80), and a justification of the period of time for which confidential treatment is sought; (iii) a written consent to the furnishing of the confidential portion to other government agencies, offices or bodies and to the Congress; and (iv) the name of each exchange, if any, with which the material is filed.

(3) The copy of the confidential portion and the application filed in accordance with this paragraph (b) shall be enclosed in a separate envelope marked ''Confidential Treatment'' and addressed to The Secretary, Securities and Exchange Commission, Washington, DC 20549.

(c) Pending a determination as to the objection filed the material for which confidential treatment has been applied will not be made available to the public.

(d)(1) If it is determined that the objection should be sustained, a notation to that effect will be made at the appropriate place in the material filed. Such a determination will not preclude reconsideration whenever appropriate, such as upon receipt of any subsequent request under the Freedom of Information Act (5 U.S.C. 552) and, if appropriate, revocation of the confidential status of all or a portion of the information in question. Where an initial determination has been made under this rule to sustain objections to disclosure, the Commission will attempt to give the person requesting confidential treatment advance notice, wherever possible, if confidential treatment is revoked.

(2) In any case where an objection to disclosure has been disallowed or where a prior grant of confidential treatment has been revoked, the person who requested such treatment will be so informed by registered or certified mail to the person or his agent for service. Pursuant to § 201.431 of this chapter, persons making objections to disclosure may petition the Commission for review of a determination by the Division disallowing objections or revoking confidential treatment.

(e) The confidential portion shall be made available to the public at the time and according to the conditions specified in paragraphs (d) (1) and (2) of this section:

(1) Upon the lapse of five days after the dispatch of notice by registered or certified mail of a determination disallowing an objection, if prior to the lapse of such five days the person shall not have communicated to the Secretary of the Commission his intention to seek review by the Commission under § 201.431 of this chapter of the determination made by the Division; or

(2) If such a petition for review shall have been filed under § 201.431 of this chapter, upon final disposition thereof adverse to the petitioner.

(f) If the confidential portion is made available to the public, one copy thereof shall be attached to each copy of the material filed with the Commission and with each exchange.

(g) An SCI entity (as defined in § 242.1000 of this chapter) shall not omit the confidential portion from the material filed in electronic format on Form SCI pursuant to Regulation SCI, § 242.1000 *et. seq.*, and, in lieu of the procedures described in paragraph (b) of this section, may request confidential treatment of all information provided on Form SCI by completing Section IV of Form SCI.

(h) A security-based swap data repository shall not omit the confidential portion from the material filed in electronic format pursuant to section 13(n) of the Act (15 U.S.C. 78m(n)) and the rules and regulations thereunder. In lieu of the procedures described in paragraph (b) of this section, a security-based swap data repository shall request confidential treatment electronically for any material filed in electronic format pursuant to section 13(n) of the Act (15 U.S.C. 78m(n)) and the rules and regulations thereunder.

[41 FR 20578, May 19, 1976, as amended at 58 FR 14685, Mar. 18, 1993; 60 FR 32825, June 23, 1995; 60 FR 47692, Sept. 14, 1995; 61 FR 30404, June 14, 1996; 79 FR 72436, Dec. 5, 2014; 80 FR 14556, Mar. 19, 2015]

§ 240.24b–3 Information filed by issuers and others under sections 12, 13, 14, and 16.

(a) Except as otherwise provided in this section and in § 240.17a–6, each exchange shall keep available to the public under reasonable regulations as to the manner of inspection, during reasonable office hours, all information regarding a security registered on such exchange which is filed with it pursuant to section 12, 13, 14, or 16, or any rules or regulations thereunder. This requirement shall not apply to any information to the disclosure of which objection has been filed pursuant to § 240.24b–2, which objection shall not have been overruled by the Commission pursuant to section 24(b). The making of such information available pursuant to this section shall not be deemed a representation by any exchange as to the accuracy, completeness, or genuineness thereof.

(b) In the case of an application for registration of a security pursuant to section 12 an exchange may delay making available the information contained therein until it has certified to the Commission its approval of such security for listing and registration.

(Sec. 24, 48 Stat. 901, as amended; 15 U.S.C. 78x)

[16 FR 3109, Apr. 10, 1951]

§ 240.24c-1 Access to nonpublic information.

(a) For purposes of this section, the term ''nonpublic information'' means records, as defined in Section 24(a) of the Act, and other information in the Commission's possession, which are not available for public inspection and copying.

(b) The Commission may, in its discretion and upon a showing that such information is needed, provide nonpublic information in its possession to any of the following persons if the person receiving such nonpublic information provides such assurances of confidentiality as the Commission deems appropriate:

(1) A federal, state, local or foreign government or any political subdivision, authority, agency or instrumentality of such government;

(2) A self-regulatory organization as defined in Section 3(a)(26) of the Act, or any similar organization empowered with self-regulatory responsibilities under the federal securities laws (as defined in Section 3(a)(47) of the Act), the Commodity Exchange Act (7 U.S.C. 1, *et seq.*), or any substantially equivalent foreign statute or regulation;

(3) A foreign financial regulatory authority as defined in Section 3(a)(51) of the Act;

(4) The Securities Investor Protection Corporation or any trustee or counsel for a trustee appointed pursuant to Section 5(b) of the Securities Investor Protection Act of 1970;

(5) A trustee in bankruptcy;

(6) A trustee, receiver, master, special counsel or other person that is appointed by a court of competent jurisdiction or as a result of an agreement between the parties in connection with

litigation or an administrative proceeding involving allegations of violations of the securities laws (as defined in Section 3(a)(47) of the Act) or the Commission's Rules of Practice, 17 CFR part 201, or otherwise, where such trustee, receiver, master, special counsel or other person is specifically designated to perform particular functions with respect to, or as a result of, the litigation or proceeding or in connection with the administration and enforcement by the Commission of the federal securities laws or the Commission's Rules of Practice;

(7) A bar association, state accountancy board or other federal, state, local or foreign licensing or oversight authority, or a professional association or self-regulatory authority to the extent that it performs similar functions; or

(8) A duly authorized agent, employee or representative of any of the above persons.

(c) Nothing contained in this section shall affect:

(1) The Commission's authority or discretion to provide or refuse to provide access to, or copies of, nonpublic information in its possession in accordance with such other authority or discretion as the Commission possesses by statute, rule or regulation; or

(2) The Commission's responsibilities under the Privacy Act of 1974 (5 U.S.C. 552a), or the Right to Financial Privacy Act of 1978 (12 U.S.C. 3401–22) as limited by section 21(h) of the Act.

[58 FR 52419, Oct. 8, 1993]

§ 240.31 Section 31 transaction fees.

(a) *Definitions*. For the purpose of this section, the following definitions shall apply:

(1) *Assessment charge* means the amount owed by a covered SRO for a covered round turn transaction pursuant to section 31(d) of the Act (15 U.S.C. 78ee(d)).

(2) *Billing period* means, for a single calendar year:

(i) January 1 through August 31 (''billing period 1''); or

(ii) September 1 through December 31 (''billing period 2'').

(3) *Charge date* means the date on which a covered sale or covered round turn transaction occurs for purposes of determining the liability of a covered SRO pursuant to section 31 of the Act (15 U.S.C. 78ee). The charge date is:

(i) The settlement date, with respect to any covered sale (other than a covered sale resulting from the exercise of an option settled by physical delivery or from the maturation of a security future settled by physical delivery) or covered round turn transaction that a covered SRO is required to report to the Commission based on data that the covered SRO receives from a designated clearing agency;

(ii) The exercise date, with respect to a covered sale resulting from the exercise of an option settled by physical delivery;

(iii) The maturity date, with respect to a covered sale resulting from the maturation of a security future settled by physical delivery; and

(iv) The trade date, with respect to all other covered sales and covered round turn transactions.

(4) *Covered association* means any national securities association by or through any member of which covered sales or covered round turn transactions occur otherwise than on a national securities exchange.

(5) *Covered exchange* means any national securities exchange on which covered sales or covered round turn transactions occur.

(6) *Covered sale* means a sale of a security, other than an exempt sale or a sale of a security future, occurring on a national securities exchange or by or through any member of a national securities association otherwise than on a national securities exchange.

(7) *Covered round turn transaction* means a round turn transaction in a security future, other than a round turn transaction in a future on a narrow-based security index, occurring on a national securities exchange or by or through a member of a national securities association otherwise than on a national securities exchange.

(8) *Covered SRO* means a covered exchange or covered association.

(9) *Designated clearing agency* means a clearing agency registered under section 17A of the Act (15 U.S.C. 78q-1) that clears and settles covered sales or covered round turn transactions.

(10) *Due date* means:

(i) March 15, with respect to the amounts owed by covered SROs under section 31 of the Act (15 U.S.C. 78ee) for covered sales and covered round turn transactions having a charge date in billing period 2; and

(ii) September 30, with respect to the amounts owed by covered SROs under section 31 of the Act (15 U.S.C. 78ee) for covered sales and covered round turn transactions having a charge date in billing period 1.

(11) *Exempt sale* means:

(i) Any sale of a security offered pursuant to an effective registration statement under the Securities Act of 1933 (except a sale of a put or call option issued by the Options Clearing Corporation) or offered in accordance with an exemption from registration afforded by section 3(a) or 3(b) of the Securities Act of 1933 (15 U.S.C. 77c(a) or 77c(b)), or a rule thereunder;

(ii) Any sale of a security by an issuer not involving any public offering within the meaning of section 4(2) of the Securities Act of 1933 (15 U.S.C. 77d(2));

(iii) Any sale of a security pursuant to and in consummation of a tender or exchange offer;

(iv) Any sale of a security upon the exercise of a warrant or right (except a put or call), or upon the conversion of a convertible security;

(v) Any sale of a security that is executed outside the United States and is not reported, or required to be reported, to a transaction reporting association as defined in §242.600 of this chapter and any approved plan filed thereunder;

(vi) Any sale of an option on a security index (including both a narrow-based security index and a non-narrow-based security index);

(vii) Any sale of a bond, debenture, or other evidence of indebtedness; and

(viii) Any recognized riskless principal sale.

(12) *Fee rate* means the fee rate applicable to covered sales under section 31(b) or (c) of the Act (15 U.S.C. 78ee(b) or (c)), as adjusted from time to time by the Commission pursuant to section 31(j) of the Act (15 U.S.C. 78ee(j)).

(13) *Narrow-based security index* means the same as in section 3(a)(55)(B) and (C) of the Act (15 U.S.C. 78c(a)(55)(B) and (C)).

(14) *Recognized riskless principal sale* means a sale of a security where all of the following conditions are satisfied:

(i) A broker-dealer receives from a customer an order to buy (sell) a security;

(ii) The broker-dealer engages in two contemporaneous offsetting transactions as principal, one in which the broker-dealer buys (sells) the security from (to) a third party and the other in which the broker-dealer sells (buys) the security to (from) the customer; and

(iii) The Commission, pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)), has approved a proposed rule change submitted by the covered SRO on which the second of the two contemporaneous offsetting transactions occurs that permits that transaction to be reported as riskless.

(15) *Round turn transaction in a security future* means one purchase and one sale of a contract of sale for future delivery.

(16) *Physical delivery exchange-traded option* means a securities option that is listed and registered on a national securities exchange and settled by the physical delivery of the underlying securities.

(17) *Section 31 bill* means the bill sent by the Commission to a covered SRO pursuant to section 31 of the Act (15 U.S.C. 78ee) showing the total amount due from the covered SRO for the billing period, as calculated by the Commission based on the data submitted by the covered SRO in its Form R31 (§249.11 of this chapter) submissions for the months of the billing period.

(18) *Trade reporting system* means an automated facility operated by a covered SRO used to collect or compare trade data.

(b) *Reporting of covered sales and covered round turn transactions.* (1) Each covered SRO shall submit a completed Form R31 (§249.11 of this chapter) to the Commission within ten business days after the end of each month.

(2) A covered exchange shall provide on Form R31 the following data on covered sales and covered round turn transactions occurring on that exchange and having a charge date in that month:

(i) The aggregate dollar amount of covered sales that it reported to a designated clearing agency, as reflected in the data provided by the designated clearing agency;

(ii) The aggregate dollar amount of covered sales resulting from the exercise of physical delivery exchange-traded options or from matured security futures, as reflected in the data provided by a designated clearing agency that clears and settles options or security futures;

(iii) The aggregate dollar amount of covered sales that it captured in a trade reporting system but did not report to a designated clearing agency;

(iv) The aggregate dollar amount of covered sales that it neither captured in a trade reporting system nor reported to a designated clearing agency; and

(v) The total number of covered round turn transactions that it reported to a designated clearing agency, as reflected in the data provided by the designated clearing agency.

(3) A covered association shall provide on Form R31 the following data on covered sales and covered round turn transactions occurring by or through any member of such association otherwise than on a national securities exchange and having a charge date in that month:

(i) The aggregate dollar amount of covered sales that it captured in a trade reporting system;

(ii) The aggregate dollar amount of covered sales that it did not capture in a trade reporting system; and

(iii) The total number of covered round turn transactions that it reported to a designated clearing agency, as reflected in the data provided by the designated clearing agency.

(4) *Duties of designated clearing agency*. (i) A designated clearing agency shall provide a covered SRO, upon request, the data in its possession needed by the covered SRO to complete Part I of Form R31 (§ 249.11 of this chapter).

(ii) If a covered exchange trades physical delivery exchange-traded options or security futures that settle by physical delivery of the underlying securities, the designated clearing agency that clears and settles such transactions shall provide that covered exchange with the data in its possession relating to the covered sales resulting from the exercise of such options or from the matured security futures. If, during a particular month, the designated clearing agency cannot determine the covered exchange on which the options or security futures originally were traded, the designated clearing agency shall assign covered sales resulting from exercises or maturations as follows. To provide Form R31 data to the covered exchange for a particular month, the designated clearing agency shall:

(A) Calculate the aggregate dollar amount of all covered sales in the previous calendar month resulting from exercises and maturations, respectively, occurring on all covered exchanges for which it clears and settles transactions;

(B) Calculate, for the previous calendar month, the aggregate dollar amount of covered sales of physical delivery exchange-traded options occurring on each covered exchange for which it clears and settles transactions, and the aggregate dollar amount of covered sales of physical delivery exchange-traded options occurring on all such exchanges collectively;

(C) Calculate, for the previous calendar month, the total number of covered round turn transactions in security futures that settle by physical delivery that occurred on each covered exchange for which it clears and settles transactions, and the total number of covered round turn transactions in security futures that settle by physical delivery that occurred on all such exchanges collectively;

(D) Determine for the previous calendar month each covered exchange's percentage of the total dollar volume of physical delivery exchange-traded options (''exercise percentage'') and each covered exchange's percentage of the total number of covered round turn transactions in security futures that settle by physical delivery (''maturation percentage''); and

(E) In the current month, assign to each covered exchange for which it clears and settles covered sales the exercise percentage of the aggregate dollar amount of covered sales on all covered exchanges resulting from the exercise of physical delivery exchange-traded options and the maturation percentage of all covered sales on all covered exchanges resulting from the maturation of security futures that settle by physical delivery.

(5) A covered SRO shall provide in Part I of Form R31 only the data supplied to it by a designated clearing agency.

(c) *Calculation and billing of section 31 fees.* (1) The amount due from a covered SRO for a billing period, as reflected in its Section 31 bill, shall be the sum of the monthly amounts due for each month in the billing period.

(2) The monthly amount due from a covered SRO shall equal:

(i) The aggregate dollar amount of its covered sales that have a charge date in that month, times the fee rate; plus

(ii) The total number of its covered round turn transactions that have a charge date in that month, times the assessment charge.

(3) By the due date, each covered SRO shall pay the Commission, either directly or through a designated clearing agency acting as agent, the entire amount due for the billing period, as reflected in its Section 31 bill.

[69 FR 41078, July 7, 2004, as amended at 70 FR 37619, June 29, 2005]

§ 240.31T Temporary rule regarding fiscal year 2004.

(a) *Definitions.* (1) For the purpose of this section, the following definitions shall apply:

(i) *FY2004 adjustment amount* means the FY2004 recalculated amount minus the FY2004 prepayment amount.

(ii) *FY2004 prepayment amount* means the total dollar amount of fees and assessments paid by a covered SRO pursuant to the March 15, 2004, due date for covered sales and covered round turn transactions having a charge date between September 1, 2003, and December 31, 2003, inclusive.

(iii) *FY2004 recalculated amount* means the total dollar amount of fees and assessments owed by a covered SRO for covered sales and covered round turn transactions having a charge date between September 1, 2003, and December 31, 2003, inclusive, as calculated by the Commission based on the data submitted by the covered SRO in its Form R31 (§ 249.11 of this chapter) submissions for September 2003, October 2003, November 2003, and December 2003, and indicated on a Section 31 bill for these months.

(2) Any term used in this section that is defined in § 240.30(a) of this chapter shall have the same meaning as in § 240.30(a) of this chapter.

(b) By August 13, 2004, each covered SRO shall submit to the Commission a completed Form R31 for each of the months September 2003 to June 2004, inclusive.

(c) If the FY2004 adjustment amount of a covered SRO is a positive number, the covered SRO shall include the FY2004 adjustment amount with the payment for its next Section 31 bill.

(d) If the FY2004 adjustment amount is a negative number, the Commission shall credit the FY2004 adjustment amount to the covered SRO's next Section 31 bill.

(e) Notwithstanding paragraph (a)(1)(iii) of this section, any covered exchange that as of August 2003 was calculating its Section 31 fees based on the trade date of its covered sales shall not include on its September 2003 Form R31 data for any covered sale having a trade date before September 1, 2003.

(f) This temporary section shall expire on January 1, 2005.

[69 FR 41080, July 7, 2004]

§ 240.36a1–1 Exemption from Section 7 for OTC derivatives dealers.

PRELIMINARY NOTE: OTC derivatives dealers are a special class of broker-dealers that are exempt from certain broker-dealer requirements, including membership in a self-regulatory organization (§ 240.15b9–2), regular broker-dealer margin rules (§ 240.36a1–1), and application of the Securities Investor Protection Act of 1970 (§ 240.36a1–2). OTC derivative dealers are subject to special requirements, including limitations on the scope of their securities activities (§ 240.15a–1), specified internal risk management control systems (§ 240.15c3–4), recordkeeping obligations (§ 240.17a–3(a)(10)), and reporting responsibilities (§ 240.17a–12). They are also subject to alternative net capital treatment (§ 240.15c3–1(a)(5)).

(a) Except as otherwise provided in paragraph (b) of this section, transactions involving the extension of credit by an OTC derivatives dealer shall be exempt from the provisions of section 7(c) of the Act (15 U.S.C. 78g(c)), provided that the OTC derivatives dealer complies with Section 7(d) of the Act (15 U.S.C. 78g(d)).

(b) The exemption provided under paragraph (a) of this section shall not apply to extensions of credit made directly by a registered broker or dealer (other than an OTC derivatives dealer) in connection with transactions in eligible OTC derivative instruments for which an OTC derivatives dealer acts as counterparty.

[63 FR 59404, Nov. 3, 1998]

§ 240.36a1–2 Exemption from SIPA for OTC derivatives dealers.

PRELIMINARY NOTE: OTC derivatives dealers are a special class of broker-dealers that are exempt from certain broker-dealer requirements, including membership in a self-regulatory organization (§ 240.15b9–2), regular broker-dealer margin rules (§ 240.36a1–1), and application of the Securities Investor Protection Act of 1970 (§ 240.36a1–2). OTC derivative dealers are subject to special requirements, including limitations on the scope of their securities activities (§ 240.15a–1), specified internal risk management control systems (§ 240.15c3–4), recordkeeping obligations (§ 240.17a–3(a)(10)), and reporting responsibilities (§ 240.17a–12). They are also subject to alternative net capital treatment (§ 240.15c3–1(a)(5)).

OTC derivatives dealers, as defined in § 240.3b–12, shall be exempt from the provisions of the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa through 78lll).

[63 FR 59404, Nov. 3, 1998]

Subpart B—Rules and Regulations Under the Securities Investor Protection Act of 1970 [Reserved]

PART 241—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

Subject	Release No.	Date	Fed. Reg. Vol. and Page
Excerpt from letter relating to section 16(a)	21	Oct. 1, 1934	11 FR 10968.
Statement by Commission to correct the erroneous impression created by certain commercial institutions with respect to the necessity for filing reports with the Commission.	68	July 22, 1934	Do.
Letter of General Counsel relating to section 16(a)	116	Mar. 9, 1935	Do.
Opinion of General Counsel relating to section 16(a)	175	Apr. 16, 1935	Do.
Excerpt from a general letter relating to section 16(a)	227	May 14, 1935	Do.
Opinion of the Director of the Division of Forms and Regulations discussing the definition of "parent" as used in various forms under the Securities Act of 1933 and the Securities Exchange Act of 1934.	1131	Apr. 7, 1937	Do.
Statement by Commission with respect to the purpose of the disclosure requirements of section 14 and the rules adopted thereunder.	1350	Aug. 13, 1937	11 FR 10969.
Opinion of Director of the Trading and Exchange Division relating to Rules X–15C1–6 (17 CFR 240.15c1–6) and X–10B–2 (17 CFR 240.10b–2).	1411	Oct. 7, 1937	Do.
Opinion of Director of the Trading and Exchange Division relating to Rule X–15C1–1(a) (17 CFR, 240.15c1–1a).	1462	Nov. 15, 1937	Do.
Partial text of letter of February 2, 1938, from the Secretary of the New York Stock Exchange to its members, relating to Rules X–3B–3 (17 CFR 240.3b–3), X–10A–1 (17 CFR 240.10a–1), and X–10A–2 (17 CFR 240.10a–2), together with a letter from Director of Trading and Exchange Division, concurring in the opinions expressed by the Exchange.	1571	Feb. 5, 1938	Do.
Opinion of General Counsel relating to section 16(a)	1965	Dec. 21, 1938	11 FR 10970.
Letter of General Counsel concerning the services of former employees of the Commission in connection with matters with which such employees become familiar during their course of employment with the Commission.	2066	May 5, 1939	11 FR 10971.
Statement of Commission and separate statement by Commissioner Healy on the problem of regulating the "pegging, fixing and stabilizing" of security prices under sections 9(a)(2), 9(a)(6) and 15(c)(1) of the Securities Exchange Act.	2446	Mar. 18, 1940	Do.
Statement of Commission respecting distinctions between the reporting requirements of section 16(a) of the Securities Exchange Act of 1934 and section 30(f) of the Investment Company Act of 1940.	2687	Nov. 16, 1940	11 FR 10981.

Title 17: Commodity and Securities Exchanges
PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

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§240.17a-3 Records to be made by certain exchange members, brokers and dealers.

This section applies to the following types of entities: A member of a national securities exchange who transacts a business in securities directly with others than members of a national securities exchange; a broker or dealer who transacts a business in securities through the medium of a member of a national securities exchange; a broker or dealer, including an *OTC derivatives dealer* as that term is defined in §240.3b-12, registered pursuant to section 15 of the Act (15 U.S.C. 78*o*); a security-based swap dealer registered pursuant to section 15F of the Act (15 U.S.C. 78*o*-10) that is also a broker or dealer, including an OTC derivatives dealer, registered pursuant to section 15 of the Act; and a major security-based swap participant registered pursuant to section 15F of the Act that is also a broker or dealer, including an OTC derivatives dealer, registered pursuant to section 15 of the Act. Section 240.18a-5 (rather than this section) applies to the following types of entities: A security-based swap dealer registered pursuant to section 15F of the Act that is not also a broker or dealer, including an OTC derivatives dealer, registered pursuant to section 15 of the Act; and a major security-based swap participant registered pursuant to section 15F of the Act that is not also a broker or dealer, including an OTC derivatives dealer, registered pursuant to section 15 of the Act.

(a) Every member of a national securities exchange who transacts a business in securities directly with others than members of a national securities exchange, every broker or dealer who transacts a business in securities through the medium of any such member, and every broker or dealer registered pursuant to section 15 of the Act (15 U.S.C. 78*o*) must make and keep current the following books and records relating to its business:

(1) Blotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities (including security-based swaps), all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all other debits and credits. Such records must show the account for which each such purchase or sale was effected, the name and amount of securities, the unit and aggregate purchase or sale price, if any (including the financial terms for security-based swaps), the trade date, and the name or other designation of the person from whom such securities were purchased or received or to whom sold or delivered. For security-based swaps, such records must also show, for each transaction, the type of security-based swap, the reference security,

index, or obligor, the date and time of execution, the effective date, the scheduled termination date, the notional amount(s) and the currenc(ies) in which the notional amount(s) is expressed, the unique transaction identifier, and the counterparty's unique identification code.

(2) Ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts.

(3) Ledger accounts (or other records) itemizing separately as to each cash, margin, or security-based swap account of every customer and of such member, broker or dealer and partners thereof, all purchases, sales, receipts and deliveries of securities (including security-based swaps) and commodities for such account, and all other debits and credits to such account; and, in addition, for a security-based swap, the type of security-based swap, the reference security, index, or obligor, the date and time of execution, the effective date, the scheduled termination date, the notional amount(s) and the currenc(ies) in which the notional amount(s) is expressed, the unique transaction identifier, and the counterparty's unique identification code.

(4) Ledgers (or other records) reflecting the following:

(i) Securities in transfer;

(ii) Dividends and interest received;

(iii) Securities borrowed and securities loaned;

(iv) Moneys borrowed and moneys loaned (together with a record of the collateral therefor and any substitutions in such collateral);

(v) Securities failed to receive and failed to deliver;

(vi) All long and all short securities record differences arising from the examination, count, verification, and comparison pursuant to §§240.17a-5, 240.17a-12, 240.17a-13, and 240.18a-7, as applicable (by date of examination, count, verification, and comparison showing for each security the number of long or short count differences); and

(vii) Repurchase and reverse repurchase agreements.

(5) A securities record or ledger reflecting separately for each:

(i) Security, other than a security-based swap, as of the clearance dates all “long” or “short” positions (including securities in safekeeping and securities that are the subjects of repurchase or reverse repurchase agreements) carried by such member, broker or dealer for its account or for the account of its customers or partners, or others, and showing the location of all securities long and the offsetting position to all securities short, including long security count differences and short security count differences classified by the date of the physical count and verification in which they were discovered, and in all cases the name or designation of the account in which each position is carried.

(ii) Security-based swap, the reference security, index, or obligor, the unique transaction identifier, the counterparty's unique identification code, whether it is a “bought” or “sold” position in the security-based swap, whether the security-based swap is cleared or not cleared, and if cleared, identification of the clearing agency where the security-based swap is cleared.

(6)(i) A memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of a security, except for the purchase or sale of a security-based swap, whether executed or unexecuted.

(A) The memorandum must show the terms and conditions of the order or instructions and of any modification or cancellation thereof, the account for which entered, the time the order was received, the time of entry, the price at which executed, the identity of each associated person, if any, responsible for the account, the identity of any other person who entered or accepted the order on behalf of the customer, or, if a customer entered the order on an electronic system, a notation of that entry; and, to the extent feasible, the time of execution or cancellation. The memorandum need not show the identity of any person, other than the associated person responsible for the account, who may have entered or accepted the order if the order is entered into an electronic system that generates the memorandum and if that system is not capable of receiving an entry of the identity of any person other than the responsible associated person; in that circumstance, the member, broker or dealer must produce upon request by a representative of a securities regulatory authority a separate record which identifies each other person. An order entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, must be so designated. The term *instruction* must include instructions between partners and employees of a member, broker or dealer. The term *time of entry* means the time when the member, broker or dealer transmits the order or instruction for execution.

(B) The memorandum need not be made as to a purchase, sale or redemption of a security on a subscription way basis directly from or to the issuer, if the member, broker or dealer maintains a copy of the customer's or non-customer's subscription agreement regarding a purchase, or a copy of any other document required by the issuer regarding a sale or redemption.

(ii) A memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of a security-based swap, whether executed or unexecuted. The memorandum must show the terms and conditions of the order or instructions and of any modification or cancellation thereof; the account for which entered; the time the order was received; the time of entry; the price at which executed; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer, or, if a customer entered the order on an electronic system, a notation of that entry; and, to the extent feasible, the time of cancellation, if applicable. The memorandum also must include the type of the security-based swap, the reference security, index, or obligor, the date and time of execution, the effective date, the scheduled termination, the notional amount(s) and the currenc(ies) in which the notional amount(s) is expressed, the unique transaction identifier, and the counterparty's unique identification code. An order entered pursuant to the exercise of discretionary authority must be so designated.

(7)(i) A memorandum of each purchase or sale of a security, other than for the purchase or sale of a security-based swap, for the account of the member, broker or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where the purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt; the terms and conditions of the order and of any modification thereof; the account for which it was entered; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer, or, if a customer entered the order on an electronic system, a notation of that entry. The memorandum need not show the identity of any person other than the associated person responsible for the account who may have entered the order if the order is entered into an electronic system that generates the memorandum and if that system is not capable of receiving an entry of the identity of any person other than the responsible associated person. In the circumstance in the preceding sentence, the member, broker or dealer must produce upon request by a representative of a securities regulatory authority a separate record that identifies each other person. An order with a customer other than a member, broker or dealer entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, must be so designated.

(ii) A memorandum of each purchase or sale of a security-based swap for the account of the member, broker or dealer showing the price; and, in addition, where the purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt; the terms and conditions of the order and of any modification thereof; the account for which it was entered; the identity of any other person who entered or accepted the order on behalf of the customer, or, if a customer entered the order on an electronic system, a notation of that entry. The memorandum must also include the type of security-based swap, the reference security, index, or obligor, the date and time of execution, the effective date, the scheduled termination date, the notional amount(s) and the currenc(ies) in which the notional amount(s) is expressed, the unique transaction identifier, and the counterparty's unique identification code. An order entered pursuant to the exercise of discretionary authority must be so designated.

(8)(i) With respect to a security other than a security-based swap, copies of confirmations of all purchases and sales of securities, including all repurchase and reverse repurchase agreements, and copies of notices of all other debits and credits for securities, cash and other items for the account of customers and partners of such member, broker or dealer.

(ii) With respect to a security-based swap, copies of the security-based swap trade acknowledgment and verification made in compliance with §240.15Fi-2.

(9) A record with respect to each cash, margin, and security-based swap account with such member, broker or dealer indicating, as applicable:

(i) The name and address of the beneficial owner of such account;

(ii) Except with respect to exempt employee benefit plan securities as defined in §240.14a-1(d), but only to the extent such securities are held by employee benefit plans established by the issuer of the securities, whether or not the beneficial owner of securities registered in the name of such members, brokers or dealers, or a registered clearing agency or its nominee objects to disclosure of his or her identity, address, and securities positions to issuers;

(iii) In the case of a margin account, the signature of such owner; provided that, in the case of a joint account or an account of a corporation, such records are required only in respect of the person or persons authorized to transact business for such account; and

(iv) For each security-based swap account, a record of the unique identification code of such counterparty, the name and address of such counterparty, and a record of the authorization of each person the counterparty has granted authority to transact business in the security-based swap account.

(10) A record of all puts, calls, spreads, straddles, and other options in which such member, broker or dealer has any direct or indirect interest or which such member, broker or dealer, has granted or guaranteed, containing, at least, an identification of the security, and the number of units involved. An OTC derivatives dealer must also keep a record of all eligible OTC derivative instruments as defined in §240.3b-13 in which the OTC derivatives dealer has any direct or indirect interest or which it has written or guaranteed, containing, at a minimum, an identification of the security or other instrument, the number of units involved, and the identity of the counterparty.

(11) A record of the proof of money balances of all ledger accounts in the form of trial balances and a record of the computation of aggregate indebtedness and net capital, as of the trial balance date, pursuant to §240.15c3-1 or §240.18a-1, as applicable. The computation need not be made by any member, broker or dealer unconditionally exempt from §240.15c3-1 pursuant to §240.15c3-1(b)(1) or (3). Such trial balances and computations must be prepared currently at least once a month.

(12)(i) A questionnaire or application for employment executed by each *associated person* as that term is defined in paragraph (g)(4) of this section of the member, broker or dealer, which questionnaire or application must be approved in writing by an authorized representative of the member, broker or dealer and must contain at least the following information with respect to the associated person:

(A) The associated person's name, address, social security number, and the starting date of the associated person's employment or other association with the member, broker or dealer;

(B) The associated person's date of birth;

(C) A complete, consecutive statement of all the associated person's business connections for at least the preceding ten years, including whether the employment was part-time or full-time;

(D) A record of any denial of membership or registration, and of any disciplinary action taken, or sanction imposed, upon the associated person by any federal or state agency, or by any national securities exchange or national securities association, including any finding that the associated person was a cause of any disciplinary action or had violated any law;

(E) A record of any denial, suspension, expulsion, or revocation of membership or registration of any member, broker or dealer with which the associated person was associated in any capacity when such action was taken;

(F) A record of any permanent or temporary injunction entered against the associated person, or any member, broker, dealer, security-based swap dealer or major security-based swap participant with which the associated person was associated in any capacity at the time such injunction was entered;

(G) A record of any arrest or indictment for any felony, or any misdemeanor pertaining to securities, commodities, banking, insurance or real estate (including, but not limited to, acting or being associated with a broker or dealer, investment company, investment adviser, futures sponsor, bank, or savings and loan association), fraud, false statements or omissions, wrongful taking of property or bribery, forgery, counterfeiting, or extortion, and the disposition of the foregoing; and

(H) A record of any other name or names by which the associated person has been known or which the associated person has used.

(I) Provided, however, that if such associated person has been registered as a registered representative of such member, broker or dealer with, or the associated person's employment has been approved by a registered national securities association or a registered national securities exchange, then retention of a full, correct, and complete copy of any and all applications for such registration or approval will be deemed to satisfy the requirements of this paragraph (a)(12)(i).

(ii) A record listing every associated person of the member, broker or dealer which shows, for each associated person, every office of the member, broker or dealer, where the associated person regularly conducts the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security for the member, broker or dealer and the Central Registration Depository number, if any, and every internal identification number or code assigned to that person by the member, broker or dealer.

(ii) A record listing every associated person of the member, broker or dealer which shows, for each associated person, every office of the member, broker or dealer where the associated person regularly conducts the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security for the member, broker or dealer, and the Central Registration Depository number, if any, and every internal identification number or code assigned to that person by the member, broker or dealer.

dealer.

(13) Records required to be maintained pursuant to paragraph (d) of §240.17f-2.

(14) Copies of all Forms X-17F-1A filed pursuant to §240.17f-1, all agreements between reporting institutions regarding registration or other aspects of §240.17f-1, and all confirmations or other information received from the Commission or its designee as a result of inquiry.

(15) Records required to be maintained pursuant to paragraph (e) of §240.17f-2.

(16)(i) The following records regarding any internal broker-dealer system of which such a broker or dealer is the sponsor:

(A) A record of the broker's or dealer's customers that have access to an internal broker-dealer system sponsored by such broker or dealer (identifying any affiliations between such customers and the broker or dealer);

(B) Daily summaries of trading in the internal broker-dealer system, including:

(*1*) Securities for which transactions have been executed through use of such system; and

(*2*) Transaction volume (separately stated for trading occurring during hours when consolidated trade reporting facilities are and are not in operation):

(*i*) With respect to equity securities, stated in number of trades, number of shares, and total U.S. dollar value;

(*ii*) With respect to debt securities, stated in total settlement value in U.S. dollars; and

(*iii*) With respect to other securities, stated in number of trades, number of units of securities, and in dollar value, or other appropriate commonly used measure of value of such securities; and

(C) Time-sequenced records of each transaction effected through the internal broker-dealer system, including date and time executed, price, size, security traded, counterparty identification information, and method of execution (if internal broker-dealer system allows alternative means or locations for execution, such as routing to another market, matching with limit orders, or executing against the quotations of the broker or dealer sponsoring the system).

(ii) For purposes of paragraph (a) of this section, the term:

(A) *Internal broker-dealer system* means any facility, other than a national securities exchange, an exchange exempt from registration based on limited volume, or an alternative trading system as defined in Regulation ATS, §§242.300 through 242.303 of this chapter, that provides a mechanism, automated in full or in part, for collecting, receiving, disseminating, or displaying system orders and facilitating agreement to the basic terms of a purchase or sale of a security between a customer and the sponsor, or between two customers of the sponsor, through use of the internal broker-dealer system or through the broker or dealer sponsor of such system;

(B) *Sponsor* means any broker or dealer that organizes, operates, administers, or otherwise directly controls an internal broker-dealer trading system or, if the operator of the internal broker-dealer system is not a registered broker or dealer, any broker or dealer that, pursuant to contract, affiliation, or other agreement with the system operator, is involved on a regular basis with executing transactions in connection with use of the internal broker-dealer system, other than solely for its own account or as a customer with access to the internal broker-dealer system; and

(C) *System order* means any order or other communication or indication submitted by any customer with access to the internal broker-dealer system for entry into a trading system announcing an interest in purchasing or selling a security. The term “system order” does not include inquiries or indications of interest that are not entered into the internal broker-dealer system.

(17) For each account with a natural person as a customer or owner:

(i)(A) An account record including the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a member, broker or dealer), annual income, net worth (excluding value of primary residence), and the account's investment objectives. In the case of a joint account, the account record must include personal information for each joint owner who is a natural person; however, financial information for the individual joint owners may be combined. The account record must indicate whether it has been signed by the associated person responsible for the account, if any, and approved or accepted by a principal of the member, broker or dealer. For accounts in existence on the effective date of this section, the member, broker or dealer must obtain this information within three years of the effective date of the section.

(B) A record indicating that:

(*1*) The member, broker or dealer has furnished to each customer or owner within three years of the effective date of this section, and to each customer or owner who opened an account after the effective date of this section within thirty days of the opening of the account, and thereafter at intervals no greater than thirty-six months, a copy of the account record or an alternate document with all information required by paragraph (a)(17)(i)(A) of this section. The member, broker or dealer may elect to send this notification with the next statement mailed to the customer or owner after the opening of the account. The member, broker or dealer may choose to exclude any tax identification number and date of birth from the account record or alternative document furnished to the customer or owner. The member, broker or dealer must include with the account record or alternative document provided to each customer or owner an explanation of any terms regarding investment objectives. The account record or alternate document furnished to the customer or owner must include or be accompanied by prominent statements that the customer or owner should mark any corrections and return the account record or alternate document to the member, broker or dealer, and that the customer or owner should notify the member, broker or dealer of any future changes to information contained in the account record.

(*2*) For each account record updated to reflect a change in the name or address of the customer or owner, the member, broker or dealer furnished a notification of that change to the customer's old address, or to each joint owner, and the associated person, if any, responsible for that account, on or before the 30th day after the date the member, broker or dealer received notice of the change.

(*3*) For each change in the account's investment objectives the member, broker or dealer has furnished to each customer or owner, and the associated person, if any, responsible for that account a copy of the updated customer account record or alternative document with all information required to be furnished by paragraph (a)(17)(i)(B)(*1*) of this section, on or before the 30th day after the date the member, broker or dealer received notice of any change, or, if the account was updated for some reason other than the firm receiving notice of a change, after the date the account record was updated. The member, broker or dealer may elect to send this notification with the next statement scheduled to be mailed to the customer or owner.

(C) For purposes of this paragraph (a)(17), the neglect, refusal, or inability of a customer or owner to provide or update any account record information required under paragraph (a)(17)(i)(A) of this section will excuse the member, broker or dealer from obtaining that required information.

(D) The account record requirements in paragraph (a)(17)(i)(A) of this section will only apply to accounts for which the member, broker or dealer is, or has within the past 36 months been, required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member. Additionally, the furnishing requirement in paragraph (a)(17)(i)(B)(*1*) of this section will not be applicable to an account for which, within the last 36 months, the member, broker or dealer has not been required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member. This paragraph (a)(17)(i)(D) does not relieve a member, broker or dealer from any obligation arising from the rules of a self-regulatory organization of which it is a member regarding the collection of information from a customer or owner.

(ii) If an account is a discretionary account, a record containing the dated signature of each customer or owner granting the authority and the dated signature of each natural person to whom discretionary authority was granted.

(iii) A record for each account indicating that each customer or owner was furnished with a copy of each written agreement entered into on or after the effective date of this paragraph pertaining to that account and that, if requested by the customer or owner, the customer or owner was furnished with a fully executed copy of each agreement.

(18) A record:

(i) As to each associated person of each written customer complaint received by the member, broker or dealer concerning that associated person. The record must include the complainant's name, address, and account number; the date the complaint was received; the name of any other associated person identified in the complaint; a description of the nature of the complaint; and the disposition of the complaint. Instead of the record, a member, broker or dealer may maintain a copy of each original complaint in a separate file by the associated person named in the complaint along with a record of the disposition of the complaint.

(ii) Indicating that each customer of the member, broker or dealer has been provided with a notice containing the address and telephone number of the department of the member, broker or dealer to which any complaints as to the account may be directed.

(19) A record:

(i) As to each associated person listing each purchase and sale of a security attributable, for compensation purposes, to that associated person. The record must include the amount of compensation if monetary and a description of the compensation if non-monetary. In lieu of making this record, a member, broker or dealer may elect to produce the required information promptly upon request of a representative of a securities regulatory authority.

(ii) Of all agreements pertaining to the relationship between each associated person and the member, broker or dealer including a summary of each associated person's compensation arrangement or plan with the member, broker or dealer, including commission and concession schedules and, to the extent that compensation is based on factors other than remuneration per trade, the method by which the compensation is determined.

(20) A record, which need not be separate from the advertisements, sales literature, or communications, documenting that the member, broker or dealer has complied with, or adopted policies and procedures reasonably designed to establish compliance with, applicable federal requirements and rules of a self-regulatory organization of which the member, broker or dealer is a member which require that advertisements, sales literature, or any other communications with the public by a member, broker or dealer or its associated persons be approved by a principal.

(21) A record for each office listing, by name or title, each person at that office who, without delay, can explain the types of records the firm maintains at that office and the information contained in those records.

(22) A record listing each principal of a member, broker or dealer responsible for establishing policies and procedures that are reasonably designed to ensure compliance with any applicable federal requirements or rules of a self-regulatory organization of which the member, broker or dealer is a member that require acceptance or approval of a record by a principal.

(23) A record documenting the credit, market, and liquidity risk management controls established and maintained by the broker or dealer to assist it in analyzing and managing the risks associated with its business activities, *Provided,* that the records required by this paragraph (a)(23) need only be made if the broker or dealer has more than:

paragraph (a)(23) need only be made if the broker or dealer has more than:

(i) $1,000,000 in aggregate credit items as computed under §240.15c3-3a; or

(ii) $20,000,000 in capital, which includes debt subordinated in accordance with §240.15c3-1d.

(24) A record of the date that each Form CRS was provided to each retail investor, including any Form CRS provided before such retail investor opens an account.

(25) A record of the daily calculation of the current exposure and, if applicable, the initial margin amount for each account of a counterparty required under §240.18a-3(c).

(26) A record of compliance with possession or control requirements under §240.15c3-3(p)(2).

(27) A record of the reserve computation required under §240.15c3-3(p)(3).

(28) A record of each security-based swap transaction that is not verified under §240.15Fi-2 within five business days of execution that includes, at a minimum, the unique transaction identifier and the counterparty's unique identification code.

(29) A record documenting that the broker or dealer has complied with the business conduct standards as required under §240.15Fh-6.

(30) A record documenting that the broker or dealer has complied with the business conduct standards as required under §§240.15Fh-1 through 240.15Fh-5 and 240.15Fk-1.

(31)(i) A record of each security-based swap portfolio reconciliation, whether conducted pursuant to §240.15Fi-3 or otherwise, including the dates of the security-based swap portfolio reconciliation, the number of portfolio reconciliation discrepancies, the number of security-based swap valuation disputes (including the time-to-resolution of each valuation dispute and the age of outstanding valuation disputes, categorized by transaction and counterparty), and the name of the third-party entity performing the security-based swap portfolio reconciliation, if any.

(ii) A copy of each notification required to be provided to the Commission pursuant to §240.15Fi-3(c).

(iii) A record of each bilateral offset and each bilateral portfolio compression exercise or multilateral portfolio compression exercise in which it participates, whether conducted pursuant to §240.15Fi-4 or otherwise, including the dates of the offset or compression, the security-based swaps included in the offset or compression, the identity of the counterparties participating in the offset or compression, the results of the compression, and the name of the third-party entity performing the offset or compression, if any.

(32)-(34) [Reserved]

(35) For each retail customer to whom a recommendation of any securities transaction or investment strategy involving securities is or will be provided:

(i) A record of all information collected from and provided to the retail customer pursuant to §240.15*l*-1, as well as the identity of each natural person who is an associated person, if any, responsible for the account.

(ii) For purposes of this paragraph (a)(35), the neglect, refusal, or inability of the retail customer to provide or update any information described in paragraph (a)(35)(i) of this section shall excuse the broker, dealer, or associated person from obtaining that required information.

(b) A broker or dealer may comply with the recordkeeping requirements of the Commodity Exchange Act and chapter I of this title applicable to swap dealers and major swap participants in lieu of complying with paragraphs (a)(1), (3), and (5) of this section solely with respect to required information regarding security-based swap transactions and positions if:

(1) The broker or dealer is registered as a security-based swap dealer or major security-based swap participant pursuant to section 15F of the Act (15 U.S.C. 78*o*-10);

(2) The broker or dealer is registered as a swap dealer or major swap participant pursuant to section 4s of the Commodity Exchange Act and chapter I of this title;

(3) The broker or dealer is subject to 17 CFR 23.201, 23.202, 23.402, and 23.501 with respect to its swap-related books and records;

(4) The broker or dealer preserves all of the data elements necessary to create the records required by paragraphs (a)(1), (3), and (5) of this section as they pertain to security-based swap and swap transactions and positions;

(5) The broker or dealer upon request furnishes promptly to representatives of the Commission the records required by paragraphs (a)(1), (3), and (5) of this section as well as the records required by 17 CFR 23.201, 23.202, 23.402, and 23.501 as they pertain to security-based swap and swap transactions and positions in the format applicable to that category of record as set forth in this section; and

(6) The broker or dealer provides notice of its intent to utilize this paragraph (b) by notifying in writing the Commission, both at the principal office of the Commission in Washington, DC, and at the regional office of the Commission for the region in which the registrant has its principal place of business, as well as by notifying in writing the registrant's designated examining authority.

(c) A member of a national securities exchange, or a broker or dealer registered pursuant to section 15 of the Act (15 U.S.C. 78*o*), that introduces accounts on a fully-disclosed basis, is not required to make or keep such records of transactions cleared for such member, broker or dealer as are made and kept by a clearing broker or dealer pursuant to the requirements of this section and §240.17a-4. Nothing in this paragraph (c) will be deemed to relieve such member, broker or dealer from the responsibility that such books and records be accurately maintained and preserved as specified in this section and §240.17a-4.

(d) For purposes of transactions in municipal securities by municipal securities brokers and municipal securities dealers, compliance with Rule G-8 of the Municipal Securities Rulemaking Board or any successor rule will be deemed to be in compliance with this section.

(e) The provisions of this section will not apply to security futures product transactions and positions in a *futures account* (as that term is defined in §240.15c3-3(a)(15)); provided, that the Commodity Futures Trading Commission's recordkeeping rules apply to those transactions and positions.

(f) Every member, broker or dealer must make and keep current, as to each office, the books and records described in paragraphs (a)(1), (6), (7), (12), and (17), (a)(18)(i), and (a)(19) through (22) of this section.

(g) When used in this section:

(1) The term *office* means any location where one or more associated persons regularly conduct the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security.

(2) The term *principal* means any individual registered with a registered national securities association as a principal or branch manager of a member, broker or dealer or any other person who has been delegated supervisory responsibility over associated persons by the member, broker or dealer.

(3) The term *securities regulatory authority* means the Commission, any self-regulatory organization, or any securities commission (or any agency or office performing like functions) of the States.

(4) The term *associated person* means a “person associated with a broker or dealer” or “person associated with a security-based swap dealer or major security-based swap participant” as defined in sections 3(a)(18) and (70) of the Act (15 U.S.C. 78c(a)(18) and (70)) respectively, but does not include persons whose functions are solely clerical or ministerial.

Cross Reference: For interpretative release applicable to §240.17a-3, see No. 3040 in tabulation, part 241 of this chapter.

[13 FR 8212, Dec. 22, 1948]

Editorial Note: For Federal Register citations affecting §240.17a-3, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.govinfo.gov.*

Need assistance?

Title 17: Commodity and Securities Exchanges
PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

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§240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.

This section applies to the following types of entities: A member of a national securities exchange who transacts a business in securities directly with others than members of a national securities exchange; a broker or dealer who transacts a business in securities through the medium of a member of a national securities exchange; a broker or dealer, including an *OTC derivatives dealer* as that term is defined in §240.3b-12, registered pursuant to section 15 of the Act (15 U.S.C. 78*o*); a security-based swap dealer registered pursuant to section 15F of the Act (15 U.S.C. 78*o*-10) that is also a broker or dealer, including an OTC derivatives dealer, registered pursuant to section 15 of the Act; and a major security-based swap participant registered pursuant to section 15F of the Act that is also a broker or dealer, including an OTC derivatives dealer, registered pursuant to section 15 of the Act. Section 240.18a-6 (rather than this section) applies to the following types of entities: A security-based swap dealer registered pursuant to section 15F of the Act that is not also a broker or dealer, including an OTC derivatives dealer, registered pursuant to section 15 of the Act; and a major security-based swap participant registered pursuant to section 15F of the Act that is not also a broker or dealer, including an OTC derivatives dealer, registered pursuant to section 15 of the Act.

(a) Every member, broker or dealer subject to §240.17a-3 must preserve for a period of not less than 6 years, the first two years in an easily accessible place, all records required to be made pursuant to §240.17a-3(a)(1) through (3), (5), and (21) and (22), and analogous records created pursuant to §240.17a-3(d).

(b) Every member, broker or dealer subject to §240.17a-3 must preserve for a period of not less than three years, the first two years in an easily accessible place:

(1) All records required to be made pursuant to §240.17a-3(a)(4), (6) through (11), (16), (18) through (20), and (25) through (31), and analogous records created pursuant to §240.17a-3(e).

(2) All check books, bank statements, cancelled checks and cash reconciliations.

(3) All bills receivable or payable (or copies thereof), paid or unpaid, relating to the member, broker or dealer's business as such.

(4) Originals of all communications received and copies of all communications sent (and any approvals thereof) by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such, including all communications which are subject to rules of a self-regulatory organization of which the member, broker or dealer is a member regarding communications with the public. As used in this paragraph (b)(4), the term *communications* includes sales scripts and recordings of telephone calls required to be maintained pursuant to section 15F(g)(1) of the Act (15 U.S.C. 78*o*-10(g)(1)).

(5) All trial balances, computations of aggregate indebtedness and net capital (and working papers in connection therewith), financial statements, branch office reconciliations, and internal audit working papers, relating to the member, broker or dealer's business as such.

(6) All guarantees of accounts and all powers of attorney and other evidence of the granting of any discretionary authority given in respect of any account, and copies of resolutions empowering an agent to act on behalf of a corporation.

(7) All written agreements (or copies thereof) entered into by such member, broker or dealer relating to its business as such, including agreements with respect to any account. Written agreements with respect to a security-based swap customer or non-customer, including governing documents or any document establishing the terms and conditions of the customer's or non-customer's security-based swaps must be maintained with the customer's or non-customer's account records.

(8) Records which contain the following information in support of amounts included in the report prepared as of the fiscal year end on Part II or IIA of Form X-17A-5 (§249.617 of this chapter), as applicable, and in the annual financial statements filed with the Commission required by §240.17a-5(d), §240.17a-12(b), or §240.18a-7(c), as applicable:

(i) Money balance and position, long or short, including description, quantity, price, and valuation of each security including contractual commitments in customers' accounts, in cash and fully secured accounts, partly secured accounts, unsecured accounts, and in securities accounts payable to customers;

(ii) Money balance and position, long or short, including description, quantity, price and valuation of each security including contractual commitments in non-customers' accounts, in cash and fully secured accounts, partly secured and unsecured accounts, and in securities accounts payable to non-customers;

(iii) Position, long or short, including description, quantity, price and valuation of each security including contractual commitments included in the Computation of Net Capital as commitments, securities owned, securities owned not readily marketable, and other investments owned not readily marketable;

(iv) Amount of secured demand note, description of collateral securing such secured demand note including quantity, price and valuation of each security and cash balance securing such secured demand note;

(v) Description of futures commodity contracts or swaps, contract value on trade date, market value, gain or loss, and liquidating equity or deficit in customers' and non-customers' accounts;

(vi) Description of futures commodity contracts or swaps, contract value on trade date, market value, gain or loss, and liquidating equity or deficit in trading and investment accounts;

(vii) Description, money balance, quantity, price, and valuation of each spot commodity, and swap position or commitments in customers' and non-customers' accounts;

(viii) Description, money balance, quantity, price, and valuation of each spot commodity, and swap position or commitments in trading and investment accounts;

(ix) Number of shares, description of security, exercise price, cost and market value of put and call options including short out of the money options having no market or exercise value, showing listed and unlisted put and call options separately;

(x) Quantity, price, and valuation of each security underlying the haircut for undue concentration made in the Computation for Net Capital;

(xi) Description, quantity, price and valuation of each security and commodity position or contractual commitment, long or short, in each joint account in which the broker or dealer has an interest, including each participant's interest and margin deposit;

(xii) Description, settlement date, contract amount, quantity, market price, and valuation for each aged failed to deliver requiring a charge in the Computation of Net Capital pursuant to §240.15c3-1 or §240.18a-1, as applicable;

(xiii) Detail relating to information for possession or control requirements under §240.15c3-3 or §240.18a-4, as applicable and reported in Part II or IIA of Form X-17A-5 (§249.617 of this chapter), as applicable;

(xiv) Detail relating to information for security-based swap possession or control requirements under §240.15c3-3 or §240.18a-4, as applicable, and reported in Part II or IIA of Form X-17A-5 (§249.617 of this chapter);

(xv) Detail of all items, not otherwise substantiated, which are charged or credited in the Computation of Net Capital pursuant to §240.15c3-1 or §240.18a-1, as applicable, such as cash margin deficiencies, deductions related to securities values and undue concentration, aged securities differences, and insurance claims receivable;

(xvi) Detail relating to the calculation of the risk margin amount pursuant to §240.15c3-1(c)(17) or §240.18a-1(c)(6), as applicable; and

(xvii) Other schedules which are specifically prescribed by the Commission as necessary to support information reported as required by §§240.17a-5, 240.17a-12, and 240.18a-7, as applicable.

(9) The records required to be made pursuant to §240.15c3-3(d)(5) and (o) or §240.18a-4, as applicable.

(10) The records required to be made pursuant to §240.15c3-4 and the results of the periodic reviews conducted pursuant to §240.15c3-4(d).

(11) All notices relating to an internal broker-dealer system provided to the customers of the broker or dealer that sponsors such internal broker-dealer system, as defined in paragraph (a)(16)(ii)(A) of §240.17a-3. Notices, whether written or communicated through the internal broker-dealer trading system or other automated means, must be preserved under this paragraph (b)(11) if they are provided to all customers with access to an internal broker-dealer system, or to one or more classes of customers. Examples of notices to be preserved under this paragraph (b)(11) include, but are not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, and instructions pertaining to access to the internal broker-dealer system.

(12) The records required to be made pursuant to §240.15c3-1e(c)(4)(vi) or §240.18a-1(e)(2)(iii)(F)(*2*), as applicable.

(13) The written policies and procedures the broker-dealer establishes, documents, maintains, and enforces to assess creditworthiness for the purpose of §240.15c3-1(c)(2)(vi)(E), (c)(2)(vi)(F)(*1*) and (*2*), and (c)(2)(vi)(H) or §240.18a-1(c)(1)(vi)(*2*), as applicable.

(14) A copy of information required to be reported under §§242.901 through 242.909 of this chapter (Regulation SBSR).

(15) Copies of documents, communications, disclosures, and notices related to business conduct standards as required under §§240.15Fh-1 through 240.15Fh-6 and 240.15Fk-1.

(16) Copies of documents used to make a reasonable determination with respect to special entities, including information relating to the financial status, the tax status, the investment or financing objectives of the special entity as required under section 15F(h)(4)(C) and (5)(A) of the Act (15 U.S.C. 78*o*-10(h)(4)(C) and (5)(A)).

(c) Every member, broker or dealer subject to §240.17a-3 must preserve for a period of not less than six years after the closing of any customer's account any account cards or records which relate to the terms and conditions with respect to the opening and maintenance of the account.

(d) Every member, broker or dealer subject to §240.17a-3 must preserve during the life of the enterprise and of any successor enterprise all partnership articles or, in the case of a corporation, all articles of incorporation or charter, minute books, and stock certificate books (or, in the case of any other form of legal entity, all records such as articles of organization or formation, and minute books used for a purpose similar to those records required for corporations or partnerships), all Forms BD (§249.501 of this chapter), all Forms BDW (§249.501a of this chapter), all Forms SBSE-BD (§249.1600b of this chapter), all Forms SBSE-C (§249.1600c of this chapter), all Forms SBSE-W (§249.1601 of this chapter), all amendments to these forms, and all licenses or other documentation showing the registration of the member, broker or dealer with any securities regulatory authority or the Commodity Futures Trading Commission.

(e) Every member, broker or dealer subject to §240.17a-3 must maintain and preserve in an easily accessible place:

(1) All records required under §240.17a-3(a)(12) until at least three years after the associated person's employment and any other connection with the member, broker or dealer has terminated.

(2) All records required under §240.17a-3(a)(13) until at least three years after the termination of employment or association of those persons required by §240.17f-2 to be fingerprinted.

(3) All records required pursuant to §240.17a-3(a)(15) during the life of the enterprise.

(4) All records required pursuant to §240.17a-3(a)(14) for three years.

(5) All account record information required pursuant to §240.17a-3(a)(17) and all records required pursuant to §240.17a-3(a)(35), in each case until at least six years after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated.

(6) Each report which a securities regulatory authority or the Commodity Futures Trading Commission has requested or required the member, broker or dealer to make and furnish to it pursuant to an order or settlement, and each securities regulatory authority, Commodity Futures Trading Commission, or prudential regulator examination report until three years after the date of the report.

(7) Each compliance, supervisory, and procedures manual, including any updates, modifications, and revisions to the manual, describing the policies and practices of the member, broker or dealer with respect to compliance with applicable laws and rules, and supervision of the activities of each natural person associated with the member, broker or dealer until three years after the termination of the use of the manual.

(8) All reports produced to review for unusual activity in customer accounts until eighteen months after the date the report was generated. In lieu of maintaining the reports, a member, broker or dealer may produce promptly the reports upon request by a representative of a securities regulatory authority. If a report was generated in a computer system that has been changed in the most recent eighteen month period in a manner such that the report cannot be reproduced using historical data in the same format as it was originally generated, the report may be produced by using the historical data in the current system, but must be accompanied by a record explaining each system change which affected the reports. If a

report is generated in a computer system that has been changed in the most recent eighteen month period in a manner such that the report cannot be reproduced in any format using historical data, the member, broker or dealer must promptly produce upon request a record of the parameters that were used to generate the report at the time specified by a representative of a securities regulatory authority, including a record of the frequency with which the reports were generated.

(9) All records required pursuant to §240.17a-3(a)(23) until three years after the termination of the use of the risk management controls documented therein.

(10) All records required pursuant to §240.17a-3(a)(24), as well as a copy of each Form CRS, until at least six years after such record or Form CRS is created.

(11) The written policies and procedures required pursuant to §§240.15Fi-3, 240.15Fi-4, and 240.15Fi-5 until three years after termination of the use of the policies and procedures.

(12)(i) Each written agreement with counterparties on the terms of portfolio reconciliation with those counterparties as required to be created under §240.15Fi-3(a)(1) and (b)(1) until three years after the termination of the agreement and all transactions governed thereby.

(ii) Security-based swap trading relationship documentation with counterparties required to be created under §240.15Fi-5 until three years after the termination of such documentation and all transactions governed thereby.

(iii) A record of the results of each audit required to be performed pursuant to §240.15Fi-5(c) until three years after the conclusion of the audit.

(f) The records required to be maintained and preserved pursuant to §§240.17a-3 and 240.17a-4 may be immediately produced or reproduced on “micrographic media” (as defined in this section) or by means of “electronic storage media” (as defined in this section) that meet the conditions set forth in this section and be maintained and preserved for the required time in that form.

(1) For purposes of this section:

(i) The term *micrographic media* means microfilm or microfiche, or any similar medium; and

(ii) The term *electronic storage media* means any digital storage medium or system and, in the case of both paragraphs (f)(1)(i) and (f)(1)(ii) of this section, that meets the applicable conditions set forth in this paragraph (f).

(2) If electronic storage media is used by a member, broker, or dealer, it must comply with the following requirements:

(i) The member, broker, or dealer must notify its examining authority designated pursuant to section 17(d) of the Act (15 U.S.C. 78q(d)) prior to employing electronic storage media. If employing any electronic storage media other than optical disk technology (including CD-ROM), the member, broker, or dealer must notify its designated examining authority at least 90 days prior to employing such storage media. In either case, the member, broker, or dealer must provide its own representation or one from the storage medium vendor or other third party with appropriate expertise that the selected storage media meets the conditions set forth in this paragraph (f)(2).

(ii) The electronic storage media must:

(A) Preserve the records exclusively in a non-rewriteable, non-erasable format;

(B) Verify automatically the quality and accuracy of the storage media recording process;

(C) Serialize the original and, if applicable, duplicate units of storage media, and time-date for the required period of retention the information placed on such electronic storage media; and

(D) Have the capacity to readily download indexes and records preserved on the electronic storage media to any medium acceptable under this paragraph (f) as required by the Commission or the self-regulatory organizations of which the member, broker, or dealer is a member.

(3) If a member, broker, or dealer uses micrographic media or electronic storage media, it must:

(i) At all times have available, for examination by the staffs of the Commission and self-regulatory organizations of which it is a member, facilities for immediate, easily readable projection or production of micrographic media or electronic storage media images and for producing easily readable images.

(ii) Be ready at all times to provide, and immediately provide, any facsimile enlargement which the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer may request.

(iii) Store separately from the original, a duplicate copy of the record stored on any medium acceptable under §240.17a-4 for the time required.

(iv) Organize and index accurately all information maintained on both original and any duplicate storage media.

(A) At all times, a member, broker, or dealer must be able to have such indexes available for examination by the staffs of the Commission and the self- regulatory organizations of which the broker or dealer is a member.

(B) Each index must be duplicated and the duplicate copies must be stored separately from the original copy of the index.

(C) Original and duplicate indexes must be preserved for the time required for the indexed records.

(v) The member, broker, or dealer must have in place an audit system providing for accountability regarding inputting of records required to be maintained and preserved pursuant to §§240.17a-3 and 240.17a-4 to electronic storage media and inputting of any changes made to every original and duplicate record maintained and preserved thereby.

(A) At all times, a member, broker, or dealer must be able to have the results of such audit system available for examination by the staffs of the Commission and the self-regulatory organizations of which the broker or dealer is a member.

(B) The audit results must be preserved for the time required for the audited records.

(vi) The member, broker, or dealer must maintain, keep current, and provide promptly upon request by the staffs of the Commission or any self-regulatory organization of which the member, broker, or broker-dealer is a member all information necessary to access records and indexes stored on the electronic storage media; or place in escrow and keep current a copy of the physical and logical file format of the electronic storage media, the field format of all different information types written on the electronic storage media and the source code, together with the appropriate documentation and information necessary to access records and indexes.

(vii) For every member, broker or dealer exclusively using electronic storage media for some or all of its record preservation under this section, at least one third party (the undersigned), who has access to and the ability to download information from the member's, broker's or dealer's electronic storage media to any acceptable medium under this section, must file with the designated examining authority for the member, broker or dealer the following undertakings with respect to such records:

> The undersigned hereby undertakes to furnish promptly to the U.S. Securities and Exchange Commission ("Commission"), its designees or representatives, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer, upon reasonable request, such information as deemed necessary by the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer to download information kept on the member's, broker's or dealer's electronic storage media to any medium acceptable under §240.17a-4. Furthermore, the undersigned hereby undertakes to take reasonable steps to provide access to information contained on the member's, broker's or dealer's electronic storage media, including, as appropriate, arrangements for the downloading of any record required to be maintained and preserved by the member, broker or dealer pursuant to §§240.17a-3 and 240.17a-4 in a format acceptable to the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer. Such arrangements will provide specifically that in the event of a failure on the part of a member, broker or dealer to download the record into a readable format and after reasonable notice to the broker or dealer, upon being provided with the appropriate electronic storage medium, the undersigned will undertake to do so, as the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer may request.

(g) If a person who has been subject to §240.17a-3 ceases to transact a business in securities directly with others than members of a national securities exchange, or ceases to transact a business in securities through the medium of a member of a national securities exchange, or ceases to be registered pursuant to section 15 of the Act (15 U.S.C. 78*o*) such person must, for the remainder of the periods of time specified in this section, continue to preserve the records which it theretofore preserved pursuant to this section.

(h) For purposes of transactions in municipal securities by municipal securities brokers and municipal securities dealers, compliance with Rule G-9 of the Municipal Securities Rulemaking Board or any successor rule will be deemed to be in compliance with this section.

(i)(1) If the records required to be maintained and preserved pursuant to the provisions of §§240.17a-3 and 240.17a-4 are prepared or maintained by an outside service bureau, depository, bank which does not operate pursuant to §240.17a-3(b)(2), or other recordkeeping service on behalf of the member, broker or dealer required to maintain and preserve such records, such outside entity must file with the Commission a written undertaking in form acceptable to the Commission, signed by a duly authorized person, to the effect that such records are the property of the member, broker or dealer required to maintain and preserve such records and will be surrendered promptly on request of the member, broker or dealer and including the following provision:

With respect to any books and records maintained or preserved on behalf of [BD], the undersigned hereby undertakes to permit examination of such books and records at any time or from time to time during business hours by representatives or designees of the Securities and Exchange Commission, and to promptly furnish to said Commission or its designee true, correct, complete and current hard copy of any or all or any part of such books and records.

(2) Agreement with an outside entity will not relieve such member, broker or dealer from the responsibility to prepare and maintain records as specified in this section or in §240.17a-3.

(j) Every member, broker and dealer subject to this section must furnish promptly to a representative of the Commission legible, true, complete, and current copies of those records of the member, broker or dealer that are required to be preserved under this section, or any other records of the member, broker or dealer subject to examination under section 17(b) of the Act (15 U.S.C. 78*q*(b)) that are requested by the representative of the Commission.

(k) *Exchanges of futures for physical.* (1) Except as provided in paragraph (k)(2) of this section, upon request of any designee or representative of the Commission or of any self-regulatory organization of which it is a member, every member, broker or dealer subject to this section must request and obtain from its customers documentation regarding an exchange of security futures products for physical securities, including documentation of underlying cash transactions and exchanges. Upon receipt of such documentation, the member, broker or dealer must promptly provide that documentation to the requesting designee or representative.

(2) This paragraph (k) does not apply to an underlying cash transaction(s) or exchange(s) that was effected through a member, broker or dealer registered with the Commission and is of a type required to be recorded pursuant to §240.17a-3.

(l) Records for the most recent two year period required to be made pursuant to §240.17a-3(e) and paragraphs (b)(4) and (e)(7) of this section which relate to an office shall be maintained at the office to which they relate. If an office is a private residence where only one associated person (or multiple associated persons who reside at that location and are members of the same immediate family) regularly conducts business, and it is not held out to the public as an office nor are funds or securities of any customer of the member, broker or dealer handled there, the member, broker or dealer need not maintain records at that office, but the records must be maintained at another location within the same State as the member, broker or dealer may select. Rather than maintain the records at each office, the member, broker or dealer may choose to produce the records promptly at the request of a representative of a securities regulatory authority at the office to which they relate or at another location agreed to by the representative.

(m) When used in this section:

(1) The term *office* has the meaning set forth in §240.17a-3(g)(1).

(2) The term *principal* has the meaning set forth in §240.17a-3(g)(2).

(3) The term *securities regulatory authority* has the meaning set forth in §240.17a-3(g)(3).

(4) The term *associated person* has the meaning set forth in §240.17a-3(g)(4).

(5) The term *business as such* includes security-based swap activity.

Cross Reference: For interpretative releases applicable to §240.17a-4, see No. 3040 and No. 8024 in tabulation, part 241 of this chapter.

[13 FR 8212, Dec. 22, 1948]

Editorial Note: For Federal Register citations affecting §240.17a-4, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.govinfo.gov.*

Need assistance?

ATTACHMENT 4

FINANCIAL SERVICES COMMISSION
OFFICE OF FINANCIAL REGULATION
AGENDA ITEM # 4: REQUEST APPROVAL TO PUBLISH NOTICE OF PROPOSED RULE

Action Requested

The Office of Financial Regulation ("OFR") requests approval to publish a Notice of Proposed Rule regarding Rules 69U-100.002, 69U-100.003, 69U-100.004, 69U-100.03852, 69U-100.045, 69U-100.0451, 69U-100.057, 69U-100.600, 69U-100.948, 69U-100.956, 69U-100.963, and 69U-100.964, Florida Administrative Code ("F.A.C"), pertaining to financial institutions.

Summary and Justification of Rules

Rule 69U-100.002, F.A.C.: The OFR proposes to repeal Rule 69U-100.002, F.A.C., because it merely states that the rules pertain to international banking facilities. Therefore, it is not a rule under the definition of that term in section 120.52(16), Florida Statutes ("F.S.")

Rule 69U-100.003, F.A.C.: The OFR proposes to amend Rule 69U-100.003, F.A.C., regarding international banking facilities to incorporate by reference the currently-effective federal rule containing the list of foreign, international, and supranational entities, and to update citations.

Rule 69U-100.004, F.A.C.: The OFR proposes to amend Rule 69U-100.004, F.A.C., to update the agency's address and add the agency's email address to which notice of the intent to establish an international banking facility shall be sent.

Rule 69U-100.03852, F.A.C.: The OFR proposes to amend Rule 69U-100.03852, F.A.C., to incorporate an updated Form OFR-U-10 Interagency Biographical and Financial Report, an updated addendum Form OFR-U-10A Authorization for Release of Confidential Information that permits online and electronic notarization, and to adopt and incorporate by reference a notice regarding the agency's collection and use of social security numbers.

Rule 69U-100.045, F.A.C.: The OFR proposes to amend Rule 69U-100.045, F.A.C., to incorporate updated versions of the Federal Financial Institutions Examination Council Bank

Secrecy Act/Anti-Money Laundering Examination Manual and the Federal Deposit Insurance Corporation RMS Manual of Examination Policies, and to add the Federal Financial Institutions Examination Council Information Technology Examination Handbook on Information Security and the Federal Financial Institutions Examination Council Cybersecurity Assessment Tool.

Rule 69U-100.0451, F.A.C.: The OFR proposes to amend Rule 69U-100.0451, F.A.C., to clarify the OFR's procedure for imposing costs the OFR incurs in conducting examinations of unsafe and unsound financial institutions and the fines for a financial institution's late payment of such costs.

Rule 69U-100.057, F.A.C.: The OFR proposes to amend Rule 69U-100.057, F.A.C., regarding requests for public records of failed financial institutions to delete processes and language that duplicate statutory provisions in Chapter 120, F.S., and existing agency policies.

Rule 69U-100.600, F.A.C.: The OFR proposes to amend Rule 69U-100.600, F.A.C., to increase the total loan value appraisal exemption to $400,000 from $250,000.

Rule 69U-100.948, F.A.C.: The OFR proposes to amend Rule 69U-100.948, F.A.C., to update the agency's mailing address and add the agency's email address for reporting significant events or conditions.

Rule 69U-100.956, F.A.C.: The OFR proposes to amend Rule 69U-100.956, F.A.C., regarding conflicts of interest to clarify the definition of "family relationship" for agency employees, to update the incorporated ethical standards of the Office of Financial Regulation and the Department of Financial Services for agency employees, and to clarify the types of discipline applicable to violations of the standards.

Rule 69U-100.963, F.A.C.: The OFR proposes to amend Rule 69U-100.963, F.A.C., to delete unnecessary language regarding safety precautions financial institutions must disclose to automated teller machine customers.

Rule 69U-100.964, F.A.C.: The OFR proposes to amend Rule 69U-100.964, F.A.C., to incorporate the updated federal standards for due diligence policies, procedures, and controls regarding transactions relating to Iran or terrorism.

Proposed Text of Rules

69U-100.002 Scope.

Rulemaking Authority 120.53(1)(a), 655.012(3) FS. Law Implemented 655.071 FS. History–New 1-24-82, Formerly 3C-17.01, 3C-17.001, 3C-100.002, Repealed _____.

69U-100.003 Definitions.

For purposes of rule 69U-100.004, ~~this chapter,~~ the following definitions apply:

(1) no change

(a)1.-2.d. no change

e. A foreign national government, or an agency or instrumentality thereof (other than states, provinces, municipalities, or other regional or local governmental units or agencies or instrumentalities thereof) engaged principally in activities which are ordinarily performed in the United States by governmental entities; an international entity of which the United States is a member; or any other foreign, international or supranational entity s~~S~~pecifically designated by the Federal Reserve Board as exempt from 12 C.F.R. § 204.125 (9-1-2020), http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX, adopted and incorporated herein by reference and also available at the OFR's website at www.flofr.com; ~~12 U.S.C. §217.7;~~ or

(b) no change

(2)(a)1.-2.b. no change

c. A United States office or a non-United States office of the entity establishing the IBF; or

d. Another IBF; or

~~e. An institution whose time deposits are exempt from interest rate limitations under Section 217.3(g) of Regulation Q (12 C.F.R. 217.3(g)); or~~

(b)1.-2. no change

(3)(a)-(d) no change

(e) A foreign national government, or an agency or instrumentality thereof (other than states, provinces, municipalities, or other regional or local governmental units or agencies or instrumentalities thereof) engaged principally in activities which are ordinarily performed in the United States by governmental entities; an international entity of which the United States is a member; or any other foreign, international or supranational entity s~~S~~pecifically designated by the Federal Reserve Board as exempt from 12 C.F.R. § 204.125 (9-1-2020), incorporated herein by reference; ~~12 U.S.C. §217.7;~~ or

(f) no change

(4) Solely for the purpose of section 220.63(5), F.S., ~~pursuant to express statutory authority of sections 655.071(2) and 220.62(3), F.S.,~~ the terms "banking facility deposits," "borrowings," and "extensions of credit," fall within the general definition of the terms "loans to foreign persons," "deposits with ~~to~~ foreign persons," and "foreign exchange trading and hedging transactions," as such terms are used in section 220.63(5)(b)~~1~~., F.S. Further, solely for the purpose of section 220.62(3), ~~220.63(5),~~ F.S., the terms "banking facility deposits," "borrowings," and "extensions of credit," include, without limitation, the following transactions:

(a)-(i) no change

(5) no change

(a) All transactions by and between banking organizations, as defined in section ~~sections~~ 220.62(4), ~~220.63(1) and (4),~~ F.S., provided that the income from such transactions is derived by non-United States banking organizations; and,

(b) no change

Rulemaking Authority ~~120.53(1)(a), 220.62(3),~~ 655.012(2)~~(3)~~, 655.071 ~~663.13~~ FS. Law Implemented 220.62(3), 220.63(5), 655.071 FS. History–New 1-24-82, Amended 1-30-84, Formerly 3C-17.02, Amended 5-27-87, Formerly 3C-17.002, 3C-100.003, Amended _____.

69U-100.004 Notification.

(1) At least 14 days prior to establishing an International Banking Facility, a state chartered or state licensed banking organization shall notify the Office of Financial Regulation (OFR) of its intent.

(2) Such notification shall include a statement of intention by the banking organization that it will comply with the Financial Services Commission rules pertaining to International Banking Facilities and Federal International Banking Facility regulations concerning restrictions on sources and uses of funds, recordkeeping, and accounting requirements.

Notification shall ~~should~~ be sent by U.S. Mail or Email to:
~~Deputy~~ Director, Division of Financial Institutions
Office of Financial Regulation
200 East Gaines Street
Tallahassee, Florida 32399-0371~~.~~
OFRFinancialInstitutions@flofr.com

Rulemaking Authority 655.012(2)~~(3)~~, 655.071(3) ~~663.13~~ FS. Law Implemented 655.071(3) FS. History–New 4-25-85, Formerly 3C-17.03, 3C-17.003, 3C-100.004, Amended ____.

69U-100.03852 Disapproval of Directors or Executive Officers.

(1) no change

(2) Notice.

(a) A financial institution shall provide a complete written notice to OFR at least 60 days prior to the effective date of the appointment of a director or the employment of an executive officer, or equivalent position. Each notice shall include a completed Form OFR-U-10 Interagency Biographical and Financial Report, (effective __/____), ~~revised 3/2003,~~ http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX, ~~which is~~ adopted and ~~hereby~~ incorporated herein by reference. Form OFR-U-10 requests that the applicant provide his or her social security number. Please refer to the OFR's Notice Regarding the Collection and Use of Social Security Numbers (effective __/____), http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX, adopted and incorporated herein by reference. Form OFR-U-10 must be accompanied by a completed Form OFR-U-10A, Addendum, Authorization for Release of Confidential Information (effective __/____), http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX, adopted and incorporated herein by reference. Notices shall be submitted to, and Forms ~~Form~~ OFR-U-10 and OFR-U-10A may be obtained by request from, the Division of Financial Institutions, Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0371, Telephone (850) 410-9880. The forms and the Notice Regarding the Collection and Use of Social Security Numbers are ~~Form OFR-U-10 may~~ also available ~~be found~~ at OFR's website, www.flofr.com. ~~Internet website: http://www.dbf.state.fl.us/banking.html by using the icon "Download Office of Financial Regulation Application Forms" and by selecting the icon "OFR-U-10."~~

(b)-(c) no change

(3)-(5) no change

Rulemaking Authority 655.012(2), 655.0385(4) FS. Law Implemented 655.0385, 658.21, 658.33~~, 665.013~~ FS. History–New 12-14-93, Amended 3-20-00, 12-28-00, 2-3-02, Formerly 3C-100.03852, Amended 9-11-18, _____.

69U-100.045 Examination Manuals and Referenced Standards.

The OFR uses the examination manuals referenced by this rule in the implementation of its examination responsibilities. The OFR examiners use these manuals as reference guidelines when conducting safety and soundness examinations of financial institutions. The material incorporated by reference in this rule may also be obtained from the OFR's website at www.flofr.com. The following manuals are hereby incorporated by reference into the body of printed materials that the OFR uses for the purposes of conducting examinations of financial institutions to assess the performance and condition of such institutions:

(1) Federal Financial Institutions Examination Council, Bank Secrecy Act/Anti-Money Laundering Examination Manual (4/2020), ~~(2014),~~ accessible at https://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX. ~~05581.~~

(2) Federal Deposit Insurance Corporation, RMS Manual of Examination Policies (8/2020), ~~(4/2018),~~ accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref- XXXXX. ~~09661.~~

(3)-(6) no change

(7) Federal Financial Institutions Examination Council, Information Technology Examination Handbook, Information Security (9/2016), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.

(8) Federal Financial Institutions Examination Council, Cybersecurity Assessment Tool (5/2017), accessible at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.

Rulemaking Authority 655.012(2) FS. Law Implemented 655.045 FS. History–New 10-24-93, Formerly 3C-1.015, Amended 1-2-95, 6-4-95, 5-22-96, Formerly 3C-100.045, Amended 9-2-10, 7-27-15, 12-9-15, 9-11-18,_____.

69U-100.0451 Unsafe and Unsound Examination Fees.

(1) ~~Pursuant to paragraph 655.045(1)(b), F.S., OFR shall:~~

~~(a) Assess any state financial institution, subsidiary, or service corporation determined by OFR to be engaged in an unsafe and unsound practice with the costs of any review conducted pursuant to section 655.045(1)(a), F.S.; and,~~

~~(b) Recover the costs of the review conducted pursuant to section 655.045(1)(a), F.S., of any affiliate of a state financial institution which OFR concludes contributed to an unsafe and unsound practice at a state financial institution, subsidiary, or service corporation.~~

~~(c)~~ In making a determination to assess any costs pursuant to section 655.045(1)<u>(c)</u>~~(b)~~, F.S., OFR must consider the size and condition of the financial institution, the gravity of the violation, the prior conduct of the person(s) and institution involved, the time elapsed between the last state examinations, and the extent to which a material improvement has occurred in the condition of the financial institution, subsidiary, or service corporation, including, but not limited to<u>,</u> a change in ownership or management, or infusion of additional capital.

~~(2)(a) An unsafe and unsound practice means any practice or conduct found by OFR to be contrary to generally accepted standards applicable to the Specific financial institution, subsidiary, or service corporation, or a violation of any prior order of a state or federal regulatory agency, which practice, conduct, or violation creates the likelihood of loss, insolvency, or dissipation of assets or otherwise prejudices the interest of the specific financial institution or its depositors or members.~~

~~(b) A financial institution found to have unsafe and unsound practices has an immoderate volume of serious financial weaknesses or a combination of other conditions that are unsatisfactory. Major and serious problems or unsafe and unsound conditions may exist which are not being satisfactorily addressed or resolved. These conditions could reasonably develop into a situation that could impair future viability and constitute a threat to the interest of depositors or members. Such a financial institution requires close supervisory attention and financial surveillance and a definitive plan for corrective action.~~

~~(3) For the purposes of this section, “costs” means the salary and travel expenses directly attributable to the field staff examining the financial institution, subsidiary, or service corporation, and the travel expenses of any supervisory staff required as a result of examination findings. The salary and travel expenses of any field staff person in training shall be excluded from the calculation.~~

<u>(2)</u>~~(4)~~ <u>OFR shall give notice</u> ~~Notification~~ to the financial institution, subsidiary, service corporation, or affiliate of <u>the</u> costs incurred<u>. The notification shall</u> ~~must~~ contain the notice of opportunity for a hearing pursuant to <u>sections</u> ~~section~~ <u>120.569 and</u> 120.57, F.S. A request for hearing must be received by OFR within 21 days of receipt of such notification by the financial institution. If <u>the financial institution, subsidiary, service corporation, or affiliate does not timely request a hearing,</u> ~~no hearing is requested,~~ mailing of the payment <u>of the costs incurred</u> must be postmarked not later than 30 days after the date of receipt of <u>the notification</u> ~~notice~~ that such costs are due.

<u>(3)</u>~~(5)~~ OFR shall levy a late payment of $100 per day or part thereof that ~~a~~ payment <u>of the costs incurred</u> is overdue, unless it is excused for good cause <u>due to incidental and isolated clerical omissions or other minor errors.</u> ~~or is being reviewed by OFR for possible waiver due to incidental and isolated clerical errors or omissions.~~

<u>(4)</u>~~(6)~~ If the financial institution, subsidiary, service corporation, or affiliate <u>timely</u> requests a hearing <u>on the notification</u> pursuant to <u>sections</u> ~~section~~ <u>120.569 and</u> 120.57, F.S., no fines for late payment <u>of the costs incurred</u> shall begin to accrue until <u>31</u> ~~30~~ days <u>after</u> ~~following~~ <u>issuance of</u> a final <u>administrative order</u> ~~ruling.~~ <u>requiring payment of costs incurred or the exhaustion of all judicial appeals, whichever occurs later. Failure to remit payment on the 31st day shall constitute intentional late payment, and OFR shall levy an administrative fine of $1,000 per day for each day the payment of costs incurred is overdue.</u>

~~(7) If the financial institution, subsidiary, service corporation, or affiliate fails to respond to the notification of examination assessment within the time allowed in subsection (4), such failure constitutes a default and fines shall accrue from that time.~~

~~(8) Failure to remit the examination assessment within 30 days following the final ruling shall constitute intentional late payment and OFR shall levy an administrative fine of $1,000 per day for each day the payment is overdue.~~

Rulemaking Authority ~~120.53(1)(b),~~ 655.012<u>(2)</u>~~(3)~~ FS. Law Implemented ~~120.57, 655.005(1),~~ ~~655.012(3),~~ 655.045<u>(1)</u> FS. History–New 6-11-96, Formerly 3C-100.0451<u>, Amended _____</u>.

69U-100.057 Public Records Requests.

This rule contains information concerning requests for access to public records regarding failed state financial institutions.

(1) As used in this rule, ~~section,~~ the following definitions shall apply:

~~(a) "Condition reports" means a Consolidated Report of Condition or Consolidated Report of Income in the case of a commercial bank, trust company, or international agency, a Thrift Financial Report in the case of a savings association, or a call report in the case of a credit union, submitted to OFR in compliance with section 655.045(2), F.S.~~

(a)~~(b)~~ "Examination reports" means a Report of Examination conducted and prepared by OFR, pursuant to section 655.045(1)(a), F.S. "Examination report" does not include reports of examination prepared by any other state or appropriate federal regulatory agency, unless the department has received prior approval from such agency to release its examination reports. Any request to produce reports of examination conducted by any other state or federal regulatory agency (except those examination reports for which OFR has received prior approval to release) shall be made directly to such other state or federal agency.

(b)~~(c)~~ "Failed state financial institution" means a state financial institution that has been declared by OFR to be insolvent and a receiver, liquidator, or conservator has been appointed to wind up the affairs of the state financial institution.

(c)~~(d)~~ "Operation reports" means any audit report submitted to OFR pursuant to section 655.045(1)(e)~~(d)~~, F.S.

~~(2) OFR recommends (but does not require) that all requests for access to public records of the OFR be in writing, signed by the requestor, and addressed to the Deputy Director, Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0371. Such requests should state with Specificity the name of the state financial institution, the time period covered by the request, the type of information that is requested, and any other applicable information.~~

~~(3) All requests for access to public records shall be honored on a first in, first out basis and in as timely a manner as possible. Generally, all requests will be honored within a reasonable period of time after receipt of the request, as determined by staff availability, accessibility of records, and the volume of information requested.~~

~~(4) Unless otherwise determined by OFR, the public may inspect public records during regular business hours at the Tallahassee headquarters of OFR. No original document or public record file may be removed from OFR's premises.~~

~~(5) All photocopies of public records shall be made by OFR staff and OFR shall collect in advance a per page charge for each photocopy provided. OFR may also recover from any requester the actual cost of reviewing and preparing documents, retrieving records, preparing photocopies, or other costs incurred in complying with the public record request.~~

(2)~~(6)~~ ~~Pursuant to section 655.057(2)(g), F.S.,~~ A~~a~~ccess to OFR records concerning failed state financial institutions is limited to examination~~,~~ and operation~~, or condition~~ reports that have not previously been destroyed by OFR pursuant to section 655.057(10)~~(8)~~, F.S. Prior to public release of any such records, OFR shall review the failed state financial institution's examination~~,~~ and operation~~, or condition~~ reports and OFR shall prepare a public record file. The public file will not include information which is the property of any other state or federal regulatory agency, unless OFR has received prior approval from such agency to release its information. Additionally, the public file will not include information which discloses the identities of depositors, bondholders, members, borrowers, or stockholders, other than directors, officers or controlling stockholders of the failed state financial institution.

Rulemaking Authority 655.012(2) FS. Law Implemented 655.057(2) FS. History–New 11-1-92, Amended 4-23-96, Formerly 3C-100.057, Amended ______.

69U-100.600 Appraisals, and Appraisal Standards and Policies of State Financial Institutions.

(1) no change

(2) At a minimum, the appraisal standards and policies shall require that an appraisal prepared by a state-certified or state-licensed appraiser must be obtained prior to funding any loan or extension of credit that is based on the security of real estate, except:

(a) Loans with a total value of $400,000 ~~$250,000~~ or less;

(b)-(i) no change

(3)-(4) no change

Rulemaking Authority 655.012(2)~~(3)~~, 655.60(2) FS. Law Implemented 655.60 FS. History–New 11-2-92, Amended 9-27-94, 11-7-01, Formerly 3C-100.600, Amended ______.

69U-100.948 Reporting of Significant Events or Conditions.

(1) Section 655.948, F.S., requires state financial institutions, not exempted by OFR, to report the occurrence of certain conditions or events within 30 days of the occurrence of the condition or event. Aggregate monthly reports that are received by OFR by the 10th day of each month, covering all reportable events or occurrences that occurred during the previous month, will satisfy the reporting requirements of ~~this~~ section 655.948, F.S. All reports required by this rule shall be submitted by U.S. Mail or Email to: Director, Division of Financial Institutions, Office of Financial Regulation, 200 East Gaines Street, Tallahassee, Florida 32399-0371, OFRFinancialInstitutions@flofr.com. A report will not be required if a reportable event or condition did not occur during the previous month.

(2)-(4)(c) no change

(d) The acquisition or divestiture of an asset or related or similar assets, which in the aggregate on any single business day totals 20 percent or more of the state financial institution's capital reported in the most recent ~~Consolidated Report of Condition, quarterly Thrift Financial Report, or~~ Call Report. Assets listed in section 657.042(1) or 658.67(1), F.S., are exempted from this requirement;

(e) no change

(f) Any extension of credit to an executive officer or his related interests that, when aggregated with other extensions of credit to that executive officer or his related interests, exceeds 15 percent of the state financial institution's capital accounts as reported in the most recent ~~Consolidated Report of Condition, quarterly Thrift Financial Report, or~~ Call Report;

(g) The acquisition or reclassification of any earning asset to "non-accrual" status which, when combined with other non-accrual assets, in the aggregate totals 15 percent ~~15%~~ or more of the state financial institution's assets as reported in the most recent ~~Consolidated Report of Condition, quarterly Thrift Financial Report, or~~ Call Report; or

(h) no change

(5)-(6) no change

Rulemaking Authority 655.012(2) FS. Law Implemented 655.948 FS. History–New 11-2-92, Amended 6-20-00, 12-28-00, Formerly 3C-100.948, Amended 9-11-18,______.

69U-100.956 Conflict of Interest Policy.

(1)(a)-(b) no change

(c) "Family relationship" means any individual who is ~~related to the regulatory employee by affinity or consanguinity, including but not limited to~~ the regulatory employee's: father, mother, son, daughter, brother, sister, uncle, aunt, first cousin, nephew, niece, husband, wife, father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, sister-in-law, stepfather, stepmother, stepson, stepdaughter, stepsister, stepbrother, half brother, half sister, grandparent, great-grandparent, grandchild, great-grandchild, step-grandparent, step-great-grandparent, step-grandchild, step-great-grandchild, person who is engaged to be married to the regulatory employee or who otherwise holds himself or herself out as or is generally known as the person to whom the regulatory employee intends to marry or with whom the regulatory employee intends to form a household, or any other natural person having the same legal residence as the regulatory employee.

(d) no change

(2) no change

(3) Regulatory employees shall be provided a copy of this rule, chapter 112, part III, F.S.,~~;~~ Office of Financial Regulation Administrative Policies & Procedures 1-2, Ethics and Professional Responsibility, effective 05-20-2013 (OFR APP 1-2), http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX, adopted and incorporated herein by reference and Department of Financial Services Code of Ethics, Administrative Policies & Procedures 1-15, effective 10-28-2009 (DFS APP 1-15), http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX, adopted and incorporated herein by reference. The foregoing materials are also available at the OFR's website, www.flofr.com. ~~the Official Procedures of the Department of Banking and Finance, Discipline of Career Service Employees, Standards and Procedures, Effective: January 10, 1984.~~ Each regulatory employee is responsible for ensuring that, as applicable, they are in compliance with the principles of conduct set forth herein, chapter 112, part III, F.S., OFR APP 1-2, and DFS APP 1-15. ~~the Department's Discipline of Career Service Employees, Standards and Procedures.~~

(4) Any regulatory employee violating this rule, chapter 112, part III, F.S., OFR APP 1-2, or DFS APP 1-15, ~~the Official Procedures of the Department of Banking and Finance, Discipline of Career Service Employees, Standards and Procedures, Effective: January 10, 1984,~~ will be subject to one or more of the following disciplinary penalties:~~,~~ ~~which may include~~ divestment or suspension of conflicting interests, changes in assigned duties, disqualification for a particular assignment, written or oral reprimand, demotion, suspension, or termination of employment.

(5) No regulatory employee shall engage in any activity, whether or not s~~S~~pecifically prohibited by this rule, which would result in, or create the appearance of:

(a)-(e) no change

(6)-(14) no change

Rulemaking Authority 655.012(2)~~(3)~~ FS. Law Implemented ~~655.012(3) FS.,~~ Ch. 92-303, s.76, Laws of Fla. ~~Section 76, Chapter 92-303, Laws of Florida.~~ History–New 12-23-92, Formerly 3C-100.956, Amended _____.

69U-100.963 Automated Teller Machines and the Disclosure of Safety Information.

(1)-(2) no change

~~(3) The guidelines contained in subsection (2), are not an all-inclusive list of safety precautions which should be disclosed to automated teller machine customers. It is offered to exemplify some of the safety disclosure issues which should be included in the mandated disclosure requirements of section 655.963, F.S.~~

Rulemaking Authority ~~120.53(1)(b),~~ 655.012(2)~~(3)~~, 655.963 FS. Law Implemented 655.963 FS. History–New 1-31-95, Formerly 3C-100.963, Amended _____.

69U-100.964 Transactions Relating to Iran or Terrorism.

Florida state-chartered financial institutions shall comply with the federal standards set out by the U.S. Treasury Department, Office of Foreign Assets Control, in 31 C.F.R. Part 561, Subparts B, C, and D~~,~~ (2010), http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX, which are adopted and incorporated by reference, as the minimum standards for due diligence policies, procedures, and controls as required by section 655.968, F.S. The standards are also available at the OFR's website, www.flofr.com.

Rulemaking Authority 655.012(2), 655.968 FS. Law Implemented 655.968 FS. History–New 8-6-12, Amended _____.

Material Incorporated by Reference

[BEGINS ON NEXT PAGE]

Title 12: Banks and Banking
PART 204—RESERVE REQUIREMENTS OF DEPOSITORY INSTITUTIONS (REGULATION D)

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§204.125 Foreign, international, and supranational entities referred to in §§204.2(c)(1)(iv)(E) and 204.8(a)(2)(i)(B)(5).

The entities referred to in §§204.2(c)(1)(iv)(E) and 204.8(a)(2)(i)(B)(5) are:

Europe

Bank for International Settlements.

European Atomic Energy Community.

European Central Bank.

European Coal and Steel Community.

The European Communities.

European Development Fund.

European Economic Community.

European Free Trade Association.

European Fund.

European Investment Bank.

Latin America

Andean Development Corporation.

Andean Subregional Group.

Caribbean Development Bank.

Caribbean Free Trade Association

Caribbean Regional Development Agency.

Central American Bank for Economic Integration.

The Central American Institute for Industrial Research and Technology.

Central American Monetary Stabilization Fund.

East Caribbean Common Market.

Latin American Free Trade Association.

Organization for Central American States.

Permanent Secretariat of the Central American General Treaty of Economic Integration.

River Plate Basin Commission.

Africa

African Development Bank.

Banque Centrale des Etats de l'Afrique Equatorial et du Cameroun.

Banque Centrale des Etats d'Afrique del'Ouest.

Conseil de l'Entente.

East African Community.

Organisation Commune Africaine et Malagache.

Organization of African Unity.

Union des Etats de l'Afrique Centrale.

Union Douaniere et Economique de l'Afrique Centrale.

Union Douaniere des Etats de l'Afrique de l'Ouest.

Asia

Asia and Pacific Council.

Association of Southeast Asian Nations.

Bank of Taiwan.

Korea Exchange Bank.

Middle East

Central Treaty Organization.

Regional Cooperation for Development.

[Reg. D, 52 FR 47695, Dec. 16, 1987, as amended at 56 FR 15495, Apr. 17, 1991; 65 FR 12917, Mar. 10, 2000]

Office of Financial Regulation
200 East Gaines Street
Tallahassee, Florida 32399
www.flofr.com

Form OFR-U-10
Interagency Biographical and Financial Report

Instructions and General Information

The OFR adopts, as Form OFR-U-10, the attached Interagency Biographical and Financial Report form prescribed by the Federal Deposit Insurance Corporation (FDIC) (OMB No. 3064-0006 Approval expires June 30, 2021) and the Board of Governors of the Federal Reserve System (FRB) (OMB No. 7100-0134 Approval expires May 31, 2021).

Form OFR-U-10A (Addendum to Form OFR-U-10)

An applicant must also complete and submit the addendum Form OFR-U-10A, Addendum, Authorization for Release of Confidential Information (effective __/____), incorporated by reference in Rule 69U-100.03852, F.A.C., to the OFR along with the completed Form OFR-U-10. The form authorizes the OFR to obtain information and records from other agencies, companies, and institutions as necessary to complete the background investigation required pursuant to section 658.20, F.S.

Notice Regarding the Collection and Use of Social Security Numbers

Form OFR-U-10 requests that the applicant provide his or her social security number. Please refer to the OFR's Notice Regarding the Collection and Use of Social Security Numbers (effective __/____), incorporated by reference in Rule 69U-100.03852, F.A.C. The Notice is also available on the OFR's website at www.flofr.com.

Confidentiality and Public Records

Florida has a broad public records law. All information contained in applications to the OFR shall be open for public inspection and copying, with the exception of information specifically made confidential and exempt from disclosure pursuant to Florida Statutes.

Federal Deposit Insurance Corporation

INTERAGENCY BIOGRAPHICAL AND FINANCIAL REPORT

Public reporting burden for this collection of information is estimated to average 2.5 hours for biographical information and 2 hours for financial information. This estimate includes time to gather and maintain data in the required form, to review instructions, and to complete the information collection. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden to: Paperwork Reduction Act, Legal Division, Federal Deposit Insurance Corporation (FDIC), 550 17th Street, NW, Washington, DC 20429; Secretary, Board of Governors of the Federal Reserve System (Board), 20th and C Streets, NW, Washington, DC 20551; or Licensing Activities Division, Office of the Comptroller of the Currency (OCC), 400 7th St. SW, Washington, DC 20219; and to the Office of Management and Budget (OMB), Paperwork Reduction Project, Washington, DC 20503.

An organization or a person is not required to respond to a collection of information unless it displays a currently valid OMB control number.

GENERAL INFORMATION AND INSTRUCTIONS

This ***Interagency Biographical and Financial Report*** (report) is used by **individuals**[1] in conjunction with other corporate filings to the appropriate federal banking agency. This report is not a standalone document.

Preparation

Use of this report format is not mandatory. If an alternative format is used, it must provide all requested information, including the certification. All questions must be answered with complete and accurate information that is subject to verification. If the answer is “none,” “not applicable,” or “unknown,” so state. Answers of “unknown” or “yes” should be explained.

The questions are not intended to limit the presentation nor are the questions intended to duplicate information supplied on another form or in an exhibit. For example, a cross-reference to the information is acceptable. *Any cross-reference must be made to a specific cite or location in the documents, so the information can be located easily.* Use additional sheets as necessary. Each appropriate federal banking agency will provide additional instructions for use and preparation. If the report is not complete, the appropriate federal banking agency may either request additional information or return the filing. If you are a foreign national or a United States citizen who currently resides in a foreign country, additional information may be necessary.

Financial statements from individuals must have “as of” dates of not more than 90 days prior to the date the financial report is submitted. All amounts in this report must be based on current market value in United States dollars[2] and agree with any totals in the supplementary schedules. In addition to the sample financial schedules, you may wish to provide supplementary schedules for other items on the financial statement. If the sample financial statement is used, an answer is required to each item. If you submit an alternative Financial Report format, the information must respond to each request for information contained in the sample Financial Report.

In addition, each appropriate federal banking agency specifically reserves the right to require up to five years of financial data from any individual as well as the filing of additional information and/or statements, such as a federal income tax return or a current appraisal to support an asset's value.

[1]A **company** seeking to acquire direct or indirect control of a bank or savings association should consult with the appropriate federal banking agency for filing instructions.

[2]Provide the foreign currency exchange rate and conversion date, if applicable.

Preparation (continued)

If you have been convicted of any criminal offense involving dishonesty, breach of trust, or money laundering, or have agreed to enter into a pretrial diversion or similar program in connection with a prosecution of such offense (12 U.S.C. § 1829), you must obtain approval from the FDIC before you can own, control, participate in the affairs of, or become an institution-affiliated party of a depository institution.

Each individual must report promptly any material change in the biographical report or financial condition that occurs during the review period for the filing. For additional information regarding the processing procedures and guidelines, and any supplemental information that may be required, refer to the appropriate federal banking agency's procedural guidelines (for example, the OCC's Rules and Regulations (12 C.F.R. Part 5), the *Comptroller's Licensing Manual,* the FDIC's Rules and Regulations (12 C.F.R. Part 303), the Board's Regulations Y and LL (12 C.F.R. Part 225 and 12 C.F.R. Part 238, respectively), and relevant policy statements), contact the appropriate federal banking agency directly for specific instruction, or visit its website at www.occ.treas.gov, www.fdic.gov, or www.federalreserve.gov.

Definitions

For purposes of this document:

Affiliate means any company that owns or controls, is owned or controlled by, or is under common ownership or control with a depository institution or depository institution holding company.

Associated means associated as an officer, director, organizer, partner, trustee, or principal shareholder or owner.

Company means any corporation, association, partnership, limited liability company, business trust, sole proprietorship, joint venture, or other similar organization.

Depository institution means any bank (including a national, state, district, or foreign bank), savings association, savings bank, savings and loan association, building and loan association, homestead association, cooperative bank, trust company, industrial bank or loan company, or credit union. A United States office, including a branch or agency, of a foreign bank is a depository institution.

Management official includes a senior executive officer; director; advisory or honorary director of a depository institution with total assets of $100 million or more; branch manager; trustee of a depository organization under the control of trustees; and any person who has a representative or nominee serving in any of those capacities.

Principal shareholder or o*wner* means a person who directly or indirectly owns, controls, or holds (either individually or as a member of a group) the power to vote 10 percent or more of any class of voting securities or other voting equity interest of the entity.

Confidentiality

Any individual desiring confidential treatment of specific portions of the report must submit a request in writing with the report. The request must discuss the justification for the requested treatment. The individual's reasons for requesting confidentiality should specifically demonstrate the harm (for example, loss of competitive position, invasion of privacy) that would result from public release of information under the Freedom of Information Act (5 U.S.C. § 552). Information for which confidential treatment is requested should be: (1) specifically identified in the public portion of the report (by reference to the confidential section); (2) separately bound; and (3) labeled “Confidential.” The individual should follow the same procedure for a request for confidential treatment for the subsequent filing of supplemental information to the report.

The individual should contact the appropriate federal banking agency for specific instructions regarding requests for confidential treatment. The agency will determine whether the information will be treated as confidential and will advise the individual of any decision to make available to the public information labeled “Confidential.”

PRIVACY ACT STATEMENT

Purposes

This form is used by certain shareholders, directors, and executive officers, in conjunction with other filings to the appropriate banking agency. This Privacy Act statement is made pursuant to the requirements of the Privacy Act of 1974, 5 U.S.C. § 552a.

Authority

The solicitation and collection of this information, including a Social Security Number, is authorized by those statutes that require an appropriate federal banking agency to determine the competence, experience, integrity, and financial ability of individuals proposing to serve a federally regulated financial institution in an official capacity. These statutes include: 12 U.S.C. § 27 (national bank charters); 12 U.S.C. § 1464 (federal savings bank charters); 12 U.S.C. § 1815 (federal deposit insurance); 12 U.S.C. § 1817(j) (changes in control of insured depository institutions); and 12 U.S.C. § 1831(i) (agency disapproval of directors and senior executive officers of insured depository institutions or depository institution holding companies).

INFORMATION REGARDING DISCLOSURE OF YOUR SOCIAL SECURITY NUMBER UNDER PUBLIC LAW 93-579 SECTION 7(B), IF APPLICABLE

Disclosure by you of your Social Security Number is optional to obtain the services, benefits, or processes that you are seeking. The Social Security Number provided may be used to conduct a background check on the individual in order to evaluate the competence, experience, integrity, and financial ability of individuals proposing to serve a federally regulated financial institution in an official capacity.

Effects of Nondisclosure

Provision of the requested information, including Social Security Number, is voluntary. However, the failure to provide any requested information may result in the denial, disapproval, or delay in the processing of an application or notice.

Routine Uses for Board Filers

The information you provide will be stored by the Board in the System of Records entitled "*BGFRS-37: Electronic Applications.*" All or part of the information may be disclosed outside of the Board as follows:

1. To the appropriate federal, state, local, foreign, or self-regulatory organization or agency responsible for investigating, prosecuting, enforcing, implementing, issuing, or carrying out a statute, rule, regulation, order, policy, or license if the information may be relevant to a potential violation of civil or criminal law, rule, regulation, order, policy, or license;
2. To a federal agency in the executive, legislative, or judicial branch of government, or to a Federal Reserve Bank, in connection with the hiring, retaining, or assigning of an employee, the issuance of a security clearance, the conducting of a security or suitability investigation of an individual, the classifying of jobs, the letting of a contract, the issuance of a license, grant, or other benefits by the receiving entity, or the lawful statutory, administrative, or investigative purpose of the receiving entity to the extent that the information is relevant and necessary to the receiving entity's decision on the matter;
3. To a congressional office in response to an inquiry made by the congressional office at the request of the individual to whom the record pertains;
4. To the Department of Justice, a court, an adjudicative body or administrative tribunal, a party in litigation, or a witness if the Board (or in the case of an Office of Inspector General (OIG) system, the OIG) determines, in its sole discretion, that the information is relevant and necessary to the matter;

PRIVACY ACT STATEMENT

(continued)

5. To contractors, agents, or others performing work on a contract, service, cooperative agreement, job, or other activity for the Board and who have a need to access the information in the performance of their duties or activities for the Board;
6. To appropriate agencies, entities, and persons when (1) the Board suspects or confirms that the security or confidentiality of information in the system of records has been compromised; (2) the Board has determined that as a result of the suspected or confirmed compromise there is a risk of harm to economic or property interest, identity theft or fraud, or harm to the security or integrity of this system or other systems or programs (whether maintained by the Board or another agency or entity) that rely upon the compromised information; and (3) the disclosure is made to such agencies, entities, and persons who are reasonably necessary to assist in connection with the Board's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm; and
7. To other bank and thrift regulatory agencies pursuant to explicit information sharing agreements for regulatory comment purposes.

Routine Uses for FDIC Filers

The information you provide will be stored by the FDIC in the System of Records entitled "*FDIC 30-64-0002: Financial Institution Investigative and Enforcement Records*." All or part of the information may be disclosed outside of the FDIC as follows:

1. To federal, state, local, foreign, or self-regulatory authorities responsible for investigating or prosecuting a violation of, or for enforcing or implementing a statute, rule, regulation, or order issued, when the information indicates a violation or potential violation of law, whether civil, criminal, or regulatory in nature, and whether arising by general statute or particular program statute, or by regulation, rule, or order issued pursuant thereto;
2. To a court, magistrate, or other administrative body in the course of presenting evidence, including disclosures to counsel or witnesses in the course of civil discovery, litigation, or settlement negotiations or in connection with criminal proceedings, when the FDIC is a party to the proceeding or has a significant interest in the proceeding, to the extent that the information is determined to be relevant and necessary;
3. To a congressional office in response to an inquiry made by the congressional office at the request of the individual who is the subject of the record;
4. To appropriate agencies, entities, and persons when (1) FDIC suspects or has confirmed that there has been a breach of the system of records; (2) FDIC has determined that as a result of the suspected or confirmed breach there is a risk of harm to individuals, FDIC (including its information systems, programs, and operations), the federal government, or national security; and (3) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with FDIC's efforts to respond to the suspected or confirmed breach or to prevent, minimize, or remedy such harm;
5. To another federal agency or federal entity, when FDIC determines that information from this system of records is reasonably necessary to assist the recipient agency or entity in (1) responding to a suspected or confirmed breach or (2) preventing, minimizing, or remedying the risk of harm to individuals, the recipient agency or entity (including its information systems, programs, and operations), the federal government, or national security, resulting from a suspected or confirmed breach;
6. To federal, state, or foreign authorities in connection with hiring or retaining an individual, conducting a background security or suitability investigation, adjudication of liability, or eligibility for a license, contract, grant, or other benefit;
7. To contractors, grantees, volunteers, and others performing or working on a contract, service, grant, cooperative agreement, or project for the FDIC, the OIG, or the federal government for use in carrying out their obligations under such contract, grant, agreement or project;
8. To federal, state or foreign financial institutions supervisory authorities for regulatory or enforcement purposes; and
9. To a financial institution affected by enforcement activities or reported criminal activities.

PRIVACY ACT STATEMENT

(continued)

Routine Uses for OCC Filers

The information you provide on this form, if the form is submitted in connection with a notice of proposed change in employee, officer or director, may be stored by the OCC in the System of Records entitled "*Notice of Proposed Changes in Employees, Officers and Directors Tracking System.*" Information maintained in this system may be disclosed to:

1. A Section 5.51 entity, a Section 5.20(g)(2) entity, a part 163, subpart H entity, or a Section 1818(b) entity in connection with review and action on a notice filed by that entity;
2. Third parties to the extent necessary to obtain information that is pertinent to the OCC's review and action on a notice received under any authority cited herein;
3. Appropriate governmental or self-regulatory organizations when the OCC determines that the records are relevant and necessary to the governmental or self-regulatory organization's regulation or supervision of financial service providers, including the review of the qualifications and fitness of individuals who are or propose to become responsible for the business operations of such providers;
4. An appropriate governmental, tribal, self-regulatory, or professional organization if the information is relevant to a known or suspected violation of a law or licensing standard within that organization's jurisdiction;
5. The Department of Justice, a court, an adjudicative body, a party in litigation, or a witness if the OCC determines that the information is relevant and necessary to a proceeding in which the OCC, any OCC employee in his or her official capacity, any OCC employee in his or her individual capacity represented by the Department of Justice or the OCC, or the United States is a party or has an interest;
6. A congressional office when the information is relevant to an inquiry made at the request of the individual about whom the record is maintained;
7. A contractor or agent who needs to have access to this system of records to perform an assigned activity;
8. Third parties when mandated or authorized by statute; or
9. Appropriate agencies, entities, and persons when: (a) The Department suspects or has confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the Department has determined that as a result of the suspected or confirmed compromise there is a risk of harm to economic or property interests, identity theft or fraud; or harm to the security or integrity of this system or other systems or programs (whether maintained by the Department or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the Department's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.

Federal Deposit Insurance Corporation

INTERAGENCY BIOGRAPHICAL AND FINANCIAL REPORT

This is filed with respect to:

Name of Subject Institution or Holding Company ______ City, State ______

Type of Filing *(Check all that apply)*:

- ☐ Bank or Savings Association Charter
- ☐ Bank or Savings and Loan Holding Company
- ☐ Change in Bank Control
- ☐ Change in Senior Executive Officer or Director
- ☐ Citizen Waiver
- ☐ Charter Conversion
- ☐ Deposit Insurance
- ☐ Federal Branch or Agency
- ☐ Other ______

Position *(Check all that apply)*:

- ☐ Organizer
- ☐ Director
- ☐ Senior Executive Officer
- ☐ Principal Shareholder
- ☐ Trustee
- ☐ Manager
- ☐ Other ______

BIOGRAPHICAL REPORT

1. Personal Information

a. Name

Last ______ First ______ Middle (Full Name) ______

b. Residence

Street Address ______

City/Town ______ State/Province ______ ZIP/Postal Code ______ Country ______

c. If at a residence less than five years, list addresses and dates occupied for past five years.

Date From	Date To	Number and Street	City	State/Province	ZIP/Postal Code	Country

d. Date of Birth

Month / Day / Year ______

e. Place of Birth ______________ ______________ ______________

City State/Province Country

f. United States Social Security Number ______________

g. Are you a United States citizen? ◯Yes Date, if naturalized: ______________ ◯No

h. If not a United States citizen, or if you have dual citizenship, provide:

County of Citizenship ______________

Passport Number / Expiration Date ______________

Home Country Identification Number ______________

Immigration File Number ______________

Father's Full Name ______________

Mother's Full Name, including maiden name ______________

Telephone Number(s) where you can be reached during business hours ______________

Email Address ______________

i. List other names you used and the period of time you used them (for example, your maiden name, name by a former marriage, former name, alias, or nickname). If the other name is your maiden name, put “nee” in front of it.

Other Names Used	Period of Time Used	
	Beginning Date	Ending Date

2. Employment Record

a. List employment in reverse chronological order for the last five years. Provide the following information. (If the applicant has additional relevant employment experience, or additional information to support the application, provide an attachment.)

Beginning Date ____ Ending Date ____ Employer's Name ____ Street ____ City ____ State/Province ____

Nature of Business ____ Title or Position ____ Nature of Duties ____

Reason for Leaving ____

Beginning Date ____ Ending Date ____ Employer's Name ____ Street ____ City ____ State/Province ____

Nature of Business ____ Title or Position ____ Nature of Duties ____

Reason for Leaving ____

Beginning Date ____ Ending Date ____ Employer's Name ____ Street ____ City ____ State/Province ____

Nature of Business ____ Title or Position ____ Nature of Duties ____

Reason for Leaving ____

b. Have you ever been dismissed or asked to resign from any past employment, including a less than honorable discharge from military service?

◯ Yes ◯ No If Yes, provide the following information:

Employer's Name ____ Street ____ City ____ State/Province ____ Area Code/Phone Number ____

Title or Position ____ Date of Discharge ____ Explanation ____

3. Education and Professional Credentials

a. List each diploma or degree from high schools, colleges, universities, or other schools.

School's Name	Address	Date From	Date To	Degree

b. List each professional license or similar certificate you now hold or have held (for example: Attorney, Physician, CPA, NASD, or SEC registration)

License	Issuing Authority	Date Issued	Status	Expiration

4. Business and Banking Affiliations

a. List any company with which you are Associated and provide the following information:

Company Name Address Nature or Type of Business

%

Position Held or Relationship to the Company Ownership Percentage Start Date

Company Name Address Nature or Type of Business

%

Position Held or Relationship to the Company Ownership Percentage Start Date

Company Name Address Nature or Type of Business

%

Position Held or Relationship to the Company Ownership Percentage Start Date

b. List the name of any depository institution or depository institution holding company with which you are or were Associated and provide the following information:

Depository Institution/Holding Company Name | Address | Nature of Banking Activity

%
Position Held or Relationship to the Company | Ownership Percentage | Start Date | End Date

Depository Institution/Holding Company Name | Address | Nature of Banking Activity

%
Position Held or Relationship to the Company | Ownership Percentage | Start Date | End Date

Depository Institution/Holding Company Name | Address | Nature of Banking Activity

%
Position Held or Relationship to the Company | Ownership Percentage | Start Date | End Date

Depository Institution/Holding Company Name | Address | Nature of Banking Activity

%
Position Held or Relationship to the Company | Ownership Percentage | Start Date | End Date

c. Are you in the process of being considered for a Management official position at another depository institution or depository institution holding company?

◯Yes ◯No If Yes, provide the name of the depository institution or depository institution holding company and the position. If the application has been submitted for regulatory review, provide the name of the appropriate Federal banking agency.

Depository Institution/Holding Company Name | Position

Appropriate Federal Banking Agency

d. Are you now or are you proposed to be a Management official of another insured depository institution or depository institution holding company?

◯Yes ◯No If “yes,” explain either why the potential interlock is not a violation of the Depository Institution Management Interlocks Act (12 U.S.C. §§ 3201-3208) or what action will be taken to prevent a violation.

5. Legal and Related Matters *(If you answer Yes to any question, see question 5g)*

a. Have you been involved in any of the following filings where the filing was denied, disapproved, withdrawn, or otherwise returned without favorable action by a federal or state regulatory authority or a self-regulatory organization:

1. A charter or license application, a depository institution holding company application, or a federal deposit insurance application, in which you were listed as an organizer, director, senior executive officer, or a person that would own or control (either individually or as a member of a group) 10 percent or more of any class of voting securities or other voting equity interest of the institution, or similar position? ◯Yes ◯ No

2. A merger application in which you were listed as a director, senior executive officer, or similar position? ◯Yes ◯No

3. A notice of change in director or senior executive officer, or similar form, in which you were listed as a director, senior executive officer, or similar position? ◯Yes ◯No

4. A notice of change in control for a depository institution or other company, or a similar form, in which you were listed (either individually or as a member of a group) as an acquirer or transferee? ◯Yes ◯No

5. Any other application, notice, or other regulatory or administrative request which was filed with a federal or state regulatory authority or a self-regulatory organization in which you were listed in some capacity? ◯Yes ◯No

b. Have you or any depository institution or depository institution holding company with which you are or were Associated been subject to any supervisory agreement, enforcement action, civil money penalty, prohibition or removal order, or other supervisory or administrative action taken or imposed by any federal or state regulatory authority or other governmental entity? ◯Yes ◯No

c. Has any depository institution with which you are or were Associated:

1. Been placed into conservatorship or receivership or otherwise failed? ◯Yes ◯No

2. Received financial assistance from a federal agency or instrumentality (for example: FDIC, Resolution Trust Corporation, Federal Savings and Loan Insurance Corporation)? ◯Yes ◯No

3. Merged with or been acquired by an institution that received financial assistance from a federal agency or instrumentality in connection with the transaction? ◯Yes ◯No

d. Have you or any company with which you are or were Associated:

1. Filed a petition under any chapter of the Bankruptcy Code or had an involuntary bankruptcy petition filed against you or the company? ◯Yes ◯No

2. Defaulted on a loan or financial obligation of any sort, whether as obligor, cosigner, or guarantor? ◯Yes ◯No

3. Forfeited property in full or partial satisfaction of any financial obligation? ◯Yes ◯No

4. Had a lien placed against property for failure to pay taxes or other debts? ◯Yes ◯No

5. Had wages or income garnished for any reason? ◯Yes ◯No

6. Failed or refused to pay any outstanding judgments? ◯Yes ◯No

7. Failed to satisfy any federal, state, or local tax obligations? ◯Yes ◯No

e. Have you or any company or depository institution with which you are or were Associated been involved in any criminal or civil lawsuit, formal or informal investigation, examination, or administrative proceeding that may result in, or resulted in, any penalty (including, but not limited to, any sanction, fine, order to pay damages, loss of right or benefit, forfeiture of property interest, suspension, removal, disbarment, or revocation of license), agreement (including a deferred prosecution agreement, consent order, written agreement or memorandum of understanding), undertaking, consent, judgment, or order imposed by or entered into with any of the following entities:

1. Any state, federal, or foreign court? ◯Yes ◯No

2. Any department, agency, or commission of the United States government? ◯Yes ◯No

3. Any state, municipal, or foreign governmental entity? ◯Yes ◯No

4. Any self-regulatory organization (for example: NASD, FASB, state bar)? ◯Yes ◯No

f. Have you or any company or depository institution with which you are or were Associated ever been arrested for, charged with, indicted for, convicted of, or pleaded *nolo contendere* to, any criminal matter (including, but not limited to, driving under the influence, reckless driving and disorderly conduct)? ◯Yes ◯No

g. If you answer Yes to any question in 5(a) through 5(f), provide your explanation by identifying the number of the question, describing the situation in detail (providing supplemental documentation as appropriate), and, where relevant, including the:

- Date of any relevant event;
- Name of any regulatory agency or self-regulatory organization involved;
- Name and location of any institution, company or party involved;
- Nature of your association with any institution or company (for example: officer, director, organizer, principal shareholder, or owner);
- Type of any application, notice, or other regulatory or administrative request;
- Nature of any supervisory, enforcement, or administrative action;
- Direct and indirect debt terms, defaulted amount, and creditor regarding any financial obligation;
- Nature of any lawsuit, charge, proceeding, conviction, or finding;
- Jurisdiction and court in which any legal proceeding occurred; and
- Resolution or disposition of the matter.

For any of the matters noted above, indicate whether any insured depository institution suffered a loss as a result. If so, identify the insured depository institution and the amount of the loss, and indicate whether the institution was ever made whole.

6. Additional Information

Present any other information you believe is important to evaluate your filing. If you are involved in the organization of a new depository institution or depository institution holding company, discuss your specific role.

FINANCIAL REPORT

Financial Statement as of ___________________
Month/Year

ASSETS		LIABILITIES AND NET WORTH	
Cash on hand and in depository institutions	$	Accounts payable	$
Marketable securities (Schedule A)		Notes payable and other loans (Schedule F)	
Notes receivable (Schedule B)		Real estate mortgages (Schedule C)	
Real estate (Schedule C, current market value)		Other liabilities (Schedule G)	
Proprietary interests and other securities (Schedule D)		TOTAL LIABILITIES	
Retirement funds and other assets (Schedule E)		Net worth (Total assets less total liabilities)	
TOTAL ASSETS	$	TOTAL LIABILITIES AND NET WORTH	$

*For any debt reported on any of the supporting schedules, indicate any liability that is contractually delinquent and provide a discussion on how the delinquency will be resolved.

OMB No. for FDIC 3064-0006; Expiration Date: June 30, 2021
OMB No. for Federal Reserve 7100-0134; Expiration Date: May 31, 2021
OMB No. for OCC 1557-0014; Expiration Date: February 28, 2021

CONTINGENT LIABILITIES

In addition to the liabilities listed on the Financial Statement, have you endorsed, guaranteed, or become otherwise indirectly or contingently liable for the debts of others or through a pending lawsuit? ◯Yes ◯No

If Yes, complete the following:

Debtor or Obligor	Creditor or Obligee	Description and Value of Collateral	Due Date	Current Amount
Name	Name			$
Address	Address			
Name	Name			
Address	Address			
Name	Name			
Address	Address			
Name	Name			
Address	Address			
Name	Name			
Address	Address			
			Total:	$

SUPPORTING SCHEDULES

Schedules must agree in total with the appropriate item contained in the Financial Statement on page 14 of this report.

Schedule A — Marketable Securities

Indicate all debt and equity securities listed on an exchange or otherwise regularly traded in an open market. Separate debt and equity securities. Securities of closely held corporations should be listed on Schedule D - Proprietary Interests. The description should include the name of the issuer, the principal amount or number of shares held, and the interest rate, if applicable. Small holdings may be aggregated and shown as "other" provided that they account for no more than 10 percent of marketable securities.

Description	Market Value
	$
Total	$

Schedule B — Notes Receivable

The description should include the name of the obligor, the note's maturity and terms of repayment, and a description of any collateral. If the note is payable to you and others jointly, indicate only your beneficial interest under Current Balance.

Description	Current Balance
	$
Total	$

Schedule C — Real Estate and Related Loans

List all real estate in which you hold a beneficial interest. Submit year-end financial statements, including profit and loss statements, for the last two years for each investment (exclude residence) in which you have an interest equal to 10 percent or more of your net worth. Also submit a cash flow statement on any investment property valued at 10 percent or more of net worth.

Description and Address of Property	Owner of Property	Percent Ownership	Mortgage Holder	Maturity Date	Current Mortgage Balance[1]	Current Market Value[2]
		%			$	$
		%				
		%				
		%				
		%				
				TOTAL	$	$

[1]Carry total forward to Liabilities, Real estate mortgages
[2]Carry total forward to Assets, Real estate

Schedule D — Proprietary Interests and Other Securities

List all companies, the shares of which are not listed on a securities exchange or otherwise regularly traded, in which you hold a beneficial interest. *(Submit year-end financial statements, including profit and loss and cash flow statements, for the last two years for each business interest in which you have an interest equal to 10 percent or more of your net worth.)*

Name and Address of Company	Legal Form of Company	Nature of Business	Percent Ownership	Current Value
			%	$
			%	
			%	
			%	
			%	
			TOTAL	$

Schedule E - Other Assets

Include retirement funds (for example, 401K, IRA, Keogh), accounts receivable, merchandise and inventory at lower of cost or market value, machinery and equipment (less depreciation), and life insurance at its cash surrender value.

Description	Basis for Valuation	Current Value
		$
	TOTAL	$

Schedule F — Notes Payable and Other Loans

Indicate all loans or notes payable, including loans on life insurance and retirement funds (but not real estate mortgages listed in Schedule C). Loan origination information must include the original date, loan amount, and co-makers, if any, and their percent obligation. Small obligations may be aggregated and shown as "other," provided that they account for no more than 20 percent of other loans and notes payable. Indicate any debt that is contractually delinquent by an asterisk next to the current balance.

Name and Address of Creditor and Loan Origination Information	Description and Value of Collateral	Maturity Date	Current Balance
			$
		TOTAL	$

Schedule G - Other Liabilities

Include interest and taxes due and unpaid, other debts accrued, and other liabilities.

Payable To	Description	Maturity Date	Current Balance
			$
		TOTAL	$

CASH FLOW STATEMENT[1]

Sources of Cash	Year	Year	Projected Current Year	Projected Next Year
Salaries, wages, commissions, and other employment income				
Rents, royalties, and investments				
Income from dividends and interest				
Income and other distributions from partnerships				
Other sources[2]				
Total cash received				
Uses of Cash				
Personal living expenses (rent, household)				
Fixed obligations[3]				
Income taxes				
Capital contributions to partnerships				
Other uses[2]				
Total cash outlay				
Net Cash Flow (deficit)				

[1]Discuss any significant changes from one year to the next on a separate page.
[2]Itemize on a separate page any items amounting to 10 percent or more of total cash received or total cash outlay.
[3]Fixed obligations include debt service on all loans and any budgeted capital improvement expenditures for real estate investments. Any loan proceeds or debt service related to this transaction should be included in projections for other sources or uses.

CERTIFICATIONS

Biographical and Financial Report Certification (Individual Applicant)

I understand that the appropriate federal banking agency may conduct extensive checks into my background, experience, and related matters in conjunction with my application or filing. I certify that the information contained in the biographical report and financial report, including all attachments, has been carefully examined by me and is true, correct, and complete. I acknowledge that any misrepresentation or omission of a material fact constitutes fraud in the inducement and may subject me to legal sanctions provided by 18 U.S.C. §§ 1001 and 1007.

Signed this _____ day of _______________ , _______________ .
Day Month Year

Signature	Signature
Print or Type Name	Print or Type Name
Title (if applicable)	Title (if applicable)

Financial Report Certification (If filing joint financial statements, Individual Applicant's spouse must complete the following certification.)

I understand that the appropriate federal banking agency may conduct extensive checks in conjunction with the information contained in the joint financial report. I certify that the information contained in the joint financial report, including all attachments, has been carefully examined by me and is true, correct, and complete. I acknowledge that any misrepresentation or omission of a material fact constitutes fraud in the inducement and may subject me to legal sanctions provided by 18 U.S.C. §§ 1001 and 1007.

Signed this _____ day of _______________ , _______________ .
Day Month Year

Signature	Signature
Print or Type Name	Print or Type Name
Title (if applicable)	Title (if applicable)

NOTICE REGARDING THE COLLECTION AND USE OF SOCIAL SECURITY NUMBERS
Office of Financial Regulation
Incorporated by Reference in Rule 69U-100.03852, F.A.C
(effective __/____)

Form OFR-U-10, which is incorporated by reference in Rule 69U-100.03852, F.A.C., requests that the applicant provide his or her social security number. In accordance with section 119.071(5)(a), Florida Statutes ("F.S."), the OFR gives the following notice to applicants regarding the OFR's collection and use of social security numbers:

(a) The OFR's collection of social security numbers is not expressly authorized by or mandatory under federal or state law, but it is imperative for the performance of the OFR's duties and responsibilities as prescribed by sections 655.0385, 658.20, 658.235, and 658.28, F.S., to ensure the safe and sound management and operations of financial institutions in this state.

(b) Social security numbers collected by the OFR may not be used by the OFR for any purpose other than the purpose provided in this notice.

(c) Social security numbers held by the OFR are confidential and exempt from section 119.07(1), F.S., and Section 24(a), Article I of the State Constitution. This exemption does not supersede any federal law prohibiting the release of social security numbers or any other applicable public records exemption for social security numbers existing prior to May 13, 2002, or created thereafter.

(d) Social security numbers held by the OFR may be disclosed if any of the following apply:

1. The disclosure of the social security number is expressly required by federal or state law or a court order;

2. The disclosure of the social security number is necessary for the receiving agency or governmental entity to perform its duties and responsibilities;

3. The individual expressly consents in writing to the disclosure of his or her social security number;

4. The disclosure of the social security number is made to comply with the USA Patriot Act of 2001, Pub. L. No. 107-56, or Presidential Executive Order 13224;

5. The disclosure of the social security number is made to a commercial entity for the permissible uses set forth in the federal Driver's Privacy Protection Act of 1994, 18 U.S.C. sections 2721 et seq.; the Fair Credit Reporting Act, 15 U.S.C. sections 1681 et seq.; or the Financial Services Modernization Act of 1999, 15 U.S.C. sections 6801 et seq., provided that the authorized commercial entity complies with the requirements of this paragraph;

6. The disclosure of the social security number is for the purpose of the administration of health benefits for an agency employee or his or her dependents;

7. The disclosure of the social security number is for the purpose of the administration of a pension fund administered for the agency employee's retirement fund, deferred compensation plan, or defined contribution plan; or

8. The disclosure of the social security number is for the purpose of the administration of the Uniform Commercial Code by the office of the Secretary of State.

FORM OFR-U-10A
(ADDENDUM TO FORM OFR-U-10)
AUTHORIZATION FOR RELEASE OF CONFIDENTIAL INFORMATION

Please fully execute each authorization below. This form permits physical presence or online notarization in accordance with Chapter 117, Parts I and II, Florida Statutes (2019). Electronic notarization that complies with section 117.021, Florida Statutes, is permitted as well. The notarial certificate may be modified as necessary to conform with those requirements.

TO WHOM IT MAY CONCERN:

I, ____, hereby authorize and request every person, firm, officer, corporation, association, organization or institution having control of any documents, records or other information pertaining to me to furnish the original or copies of any such documents, records or other information to the Florida Office of Financial Regulation or any of its authorized representatives for purposes of inspection or copying pursuant to Florida Statutes.

____
SIGNATURE (Valid for 6 months from date signed)

STATE OF FLORIDA
COUNTY OF ____________________

The foregoing instrument was acknowledged before me by means of ☐ physical presence or ☐ online notarization, this ____ day of _________________, ______, by ____.

____
Signature of Notary Public – State of Florida

____
Print, Type or Stamp Commissioned Name of Notary Public

☐ Personally Known OR ☐ Produced Identification - Type:_____________________________________

TO WHOM IT MAY CONCERN:

I, ____, hereby authorize and request every person, firm, officer, corporation, association, organization or institution having control of any documents, records or other information pertaining to me to furnish the original or copies of any such documents, records or other information to the Florida Office of Financial Regulation or any of its authorized representatives for purposes of inspection or copying pursuant to Florida Statutes.

____
SIGNATURE (Valid for 6 months from date signed)

STATE OF FLORIDA
COUNTY OF ____________________

The foregoing instrument was acknowledged before me by means of ☐ physical presence or ☐ online notarization, this ____ day of _________________, ______, by ____.

____
Signature of Notary Public – State of Florida

____
Print, Type or Stamp Commissioned Name of Notary Public

☐ Personally Known OR ☐ Produced Identification - Type:_____________________________________

Bank Secrecy Act/ Anti-Money Laundering Examination Manual

Federal Financial Institutions Examination Council

Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation,
National Credit Union Administration, Office of the Comptroller of the Currency,
Consumer Financial Protection Bureau and State Liaison Committee

April 2020 Update

Contents

SCOPING AND PLANNING

SCOPING AND PLANNING INTRODUCTION

Objective: *Develop an understanding of the bank's money laundering, terrorist financing (ML/TF), and other illicit financial activity risk profile. Based on the bank's risk profile, develop a risk-focused examination scope, and document the Bank Secrecy Act/anti-money laundering (BSA/AML) examination plan.*

Examiners assess the adequacy of the bank's Bank Secrecy Act/anti-money laundering (BSA/AML) compliance program, relative to its risk profile, and the bank's compliance with BSA regulatory requirements. The scoping and planning process enables examiners to understand the money laundering, terrorist financing (ML/TF), and other illicit financial activity risk profile of the bank. The scoping and planning process also enables examiners to focus their reviews of risk management practices and compliance with BSA requirements on areas of greatest ML/TF and other illicit financial activity risks. Examiners assess whether the bank has developed and implemented adequate processes to identify, measure, monitor, and control those risks and comply with BSA regulatory requirements.

The scoping and planning process should include determining BSA/AML examination staffing needs, including technical expertise, and identifying the BSA/AML examination and testing procedures to be completed. The federal banking agencies generally allocate more resources to higher-risk areas and fewer resources to lower-risk areas. Each section in this Manual includes an introductory overview and accompanying examination and testing procedures, as applicable, for examiners to follow.

Whenever possible, the scoping and planning process should be completed before the onsite portion of the examination, although some information may not be available during this process. The scope of a BSA/AML examination varies by bank and should be tailored primarily to the bank's risk profile. Other factors to consider in determining the examination scope may include the bank's size or complexity, and organizational structure. The request letter should also be tailored to, and correspond with, the planned examination scope.[1]

The scoping and planning process generally begins with a review of the bank's BSA/AML risk assessment, independent testing (audit), analyses and conclusions from previous examinations, other information available through offsite and ongoing monitoring processes, and request letter items received from the bank.[2] Subsections of *Scoping and Planning* provide information to help examiners understand the bank's risk profile and develop the BSA/AML examination plan.

Many banks rely on technology to aid in BSA/AML compliance and, therefore, the scoping and planning process should include developing an understanding of the bank's information

[1] For purposes of this Manual, a request letter also means a pre-examination request list or a first day request letter.
[2] For purposes of this Manual, references to the terms "independent testing" and "audit" are synonymous.

technology sources, systems, and processes used in the BSA/AML compliance program. This information assists examiners in the scoping and planning process to determine what, if any, additional examiner subject matter expertise is warranted.

Office of Foreign Assets Control (OFAC) regulations are not part of the BSA, and an OFAC review is not required during each examination cycle. However, OFAC compliance programs are frequently assessed in conjunction with BSA/AML examinations. Factors to consider when determining whether to include a review of OFAC compliance in the examination scope include the bank's OFAC risk profile, in particular the number, dollar amount, and type of international activity; the bank's size or complexity; and organizational structure. The federal banking agencies' primary role relative to OFAC is to evaluate the sufficiency of the bank's implementation of policies, procedures, and processes for complying with OFAC-administered laws and regulations, not to identify apparent OFAC violations.[3] If OFAC compliance will be part of the review, examiners should also review the bank's OFAC risk assessment and related independent testing to determine the appropriate scope of the review. Refer to the *Office of Foreign Assets Control* section for more information.

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[3] OFAC determines violations of its regulations.

RISK-FOCUSED BSA/AML SUPERVISION

Objective: *Based on the bank's risk profile, determine the BSA/AML examination activities necessary to assess the adequacy of the bank's BSA/AML compliance program and the bank's compliance with BSA regulatory requirements.*

The agencies use a risk-focused approach for planning and performing BSA/AML examinations, which is reinforced in the "Joint Statement on the Risk-Focused Approach to BSA/AML Supervision."[4] Examiners should assess the adequacy of the bank's BSA/AML compliance program, relative to its risk profile, and the bank's compliance with BSA regulatory requirements. The extent of BSA/AML examination activities necessary to assess the bank generally depends on the bank's risk profile and the quality of risk management processes to identify, measure, monitor, and control risks, and to report potential ML/TF and other illicit financial activity. Given that banks vary in size, complexity, and organizational structure, each bank has a unique risk profile, and the scope of a BSA/AML examination varies by bank.

To conduct risk-focused BSA/AML examinations, examiners should tailor their examination plans, including examination and testing procedures, to each bank's risk profile. To understand the bank's risk profile, examiners should consider available information including, but not limited to, the following:

- The bank's BSA/AML risk assessment.
- Independent testing or audits.
- Analyses and conclusions from previous examinations.
- Management's responses, including the current status of issues, regarding independent testing or audit results and examination findings.
- Offsite and ongoing monitoring.
- Information received from the bank in response to the request letter.
- Other communications with the bank.
- BSA reporting available from the Financial Crimes Enforcement Network (FinCEN).

As explained in more detail below, examiners should review the bank's BSA/AML risk assessment and independent testing when evaluating the bank's ability to identify, measure, monitor, and control risks. BSA/AML risk assessments and independent testing that properly consider and test all risk areas (including products, services, customers, and geographic

[4] "Joint Statement on the Risk-Focused Approach to BSA/AML Supervision," issued by the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Financial Crimes Enforcement Network (FinCEN), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC), July 22, 2019.

locations in which the bank operates and conducts business) are used in determining the BSA/AML examination and testing procedures that should be performed.[5]

BSA/AML Risk Assessment

The scoping and planning process is guided by examiner review of the BSA/AML risk assessment for the bank. The information contained in the BSA/AML risk assessment assists examiners in developing an understanding of the bank's risk profile, risk-focusing the examination scope, and assessing the adequacy of the bank's overall BSA/AML compliance program and its compliance with BSA regulatory requirements.

The *BSA/AML Risk Assessment* section provides information and procedures for examiners in determining whether the bank has developed a risk assessment process that adequately identifies the ML/TF and other illicit financial activity risks within its banking operations. If the bank has not developed a BSA/AML risk assessment, this fact should be discussed with management. Whenever the bank has not completed a BSA/AML risk assessment, or the BSA/AML risk assessment is inadequate, examiners must develop a BSA/AML risk assessment for the bank.

Independent Testing

Examiners should obtain and evaluate independent testing (audit) report(s) of the bank's BSA/AML compliance program, including any scope and supporting workpapers. The independent testing should be conducted by the internal audit department, outside auditors, consultants, or other qualified independent parties (not involved in the function being tested or other BSA-related functions at the bank that may present a conflict of interest or lack of independence). Independent testing results should be reported directly to the board of directors or a designated board committee composed primarily, or completely, of outside directors.

The scope and quality of independent testing may provide examiners with information regarding the bank's particular risks, how these risks are being managed and controlled, and the status of the bank's BSA compliance. Independent testing report(s) and supporting workpapers can assist examiners in understanding audit coverage and the quality and quantity of transaction testing that was performed as part of the independent testing. This knowledge assists examiners in risk-focusing the BSA/AML examination plan by identifying areas for greater (or lesser) review, and by identifying when additional examination and testing procedures may be necessary.

If the bank's independent testing is adequate, findings from the independent testing may be leveraged to reduce the examination areas covered and the testing necessary to assess the bank's BSA/AML compliance program. To determine the adequacy of the bank's independent testing, examiners should determine whether the testing was independent and

[5] As appropriate, examiners should consider aspects of these risk areas, including transaction activity (such as the number and dollar amount of cash and wire transfer activity) and distribution channels (such as mobile banking or third parties), which may impact the risks.

assessed all appropriate ML/TF and other illicit financial activity risks within the bank's operations. Examiners must have access to the appropriate independent testing scope and supporting workpapers to leverage findings from the bank's independent testing. Refer to the *BSA/AML Independent Testing* section for more information.

BSA Reporting Available From FinCEN

FinCEN Query is the system used to access all BSA reports. BSA/AML examination planning should include an analysis of BSA reports that the bank has filed, such as Suspicious Activity Reports (SARs), Currency Transaction Reports (CTRs), and CTR exemptions, for a defined time period. SARs, CTRs, and CTR exemptions may be exported, downloaded, or obtained directly online from FinCEN Query. Each federal banking agency has staff authorized to obtain this data from FinCEN Query. When requesting searches from FinCEN Query, examiners should contact the appropriate person(s) within their agency sufficiently in advance of the examination start date to obtain the requested information. When a bank has recently purchased or merged with another bank, examiners should obtain SARs, CTRs, and CTR exemptions data on the acquired bank.[6]

Downloaded information from FinCEN Query may be important to the examination, as it helps examiners:

- Identify high-volume currency customers.
- Identify the volume and characteristics of SARs filed.
- Identify frequent SAR subjects.
- Identify the volume and nature of CTRs and CTR exemptions.
- Select accounts, transactions, or BSA filings for testing, if warranted.

The federal banking agencies do not have targeted volumes or "quotas" for SAR and CTR filings. Examiners should not criticize a bank solely because the number of SARs or CTRs filed is lower than the number of SARs or CTRs filed by "peer" banks. However, as part of the examination, examiners should consider significant changes in the volume or nature of BSA filings and assess potential reasons for these changes.

Information available through FinCEN Query is sensitive, and in some instances confidential, and may only be retrieved and used by examiners for official business. The dissemination of information obtained through FinCEN Query is subject to specific legal requirements, restrictions, and conditions. Examiners must adhere to the "FinCEN Re-Dissemination Guidelines for Bank Secrecy Act Information" and the "FinCEN Bank Secrecy Act Information Access Security Plan" when accessing information through FinCEN

[6] If a bank merges with a non-bank financial institution covered by BSA filing obligations (such as an insurance company, a money services business, or a broker-dealer), the examiner should obtain relevant filings from FinCEN Query.

Query. These documents can be obtained through each agency's FinCEN Query coordinator and should be reviewed by anyone accessing FinCEN Query.

Risk-Focused Testing

Examiners perform testing to assess the adequacy of the bank's BSA/AML compliance program, relative to its risk profile, and the bank's compliance with BSA regulatory requirements. Examiners also perform testing to assess the implementation of policies, procedures, and processes, and to evaluate controls, information technology sources, systems, and processes used for BSA compliance.

Testing performed during BSA/AML examinations should be risk-focused and can take the form of testing specific transactions, or performing analytical or other reviews. Examiners must perform some testing during each BSA/AML examination cycle. Testing may focus on any of the regulatory requirements and may address different areas of the BSA/AML compliance program, but may not be necessary for every regulation or BSA area examined. Where transaction testing typically involves reviewing specific transactions or files, analytical reviews are usually higher level without transaction or file details, such as analyzing reports.

Under a risk-focused examination approach, the size and composition of the sample selected for testing, as well as the type of testing, should be commensurate with the bank's risk profile and the examination scope. While examiners generally test different areas in successive examinations, it may be appropriate to test the same areas in successive examinations based on previous examination findings, as well as the bank's risk profile and risk assessment, including any changes therein. Examiners should limit the extent and type of testing for smaller or less complex institutions with lower risk profiles for ML/TF and other illicit financial activity. Examples of testing may include the following:

- Sampling suspicious activity alerts, discussing (at a high level) the investigation process with staff, and reviewing the decision-making process regarding SAR filings.
- Determining whether reports, such as SARs and CTRs, are complete and accurate.
- Comparing filed CTRs against reportable transactions that can be identified on the bank's large cash transaction report.
- Determining whether eligible Phase II CTR-exempt customers (non-listed businesses) have been exempted appropriately by reviewing annual reportable cash transactions.
- Confirming the bank has collected and verified Customer Identification Program (CIP) and collected customer due diligence (CDD) data on a sample of new accounts.
- Determining whether the bank has collected beneficial ownership information on a sample of legal entity customers by comparing internal reports with customer files.
- Determining whether independent testing findings have been reported to the board of directors, or to a designated board committee, by reviewing the board or committee minutes.

- Comparing staff training records with the standards outlined in the bank's training policy.

When determining the testing to perform, examiners should consider changes in the bank's business strategies, geographic locations, transaction activity, products, services, customer types, operations, and/or technology. Banks that have had significant changes in these areas since the previous BSA/AML examination may need more extensive testing to determine the adequacy of the BSA/AML compliance program.

Testing should be sufficient to assess the bank's adherence to, and the appropriateness of, its policies, procedures, and processes. Procedures for testing are found within the specific examination procedures sections of this Manual. Examiners should document in the BSA/AML examination plan the rationale regarding the extent and type of testing to be performed. The scope of testing can be expanded to address any issues or concerns identified as part of examination activities. Examiners should also document the rationale for changes to the scope of testing.

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RISK-FOCUSED BSA/AML SUPERVISION EXAMINATION PROCEDURES

Objective: *Determine the examination activities necessary to assess the adequacy of the bank's BSA/AML compliance program, relative to its risk profile, and the bank's compliance with BSA regulatory requirements. If included within the scope of the examination, determine appropriate OFAC compliance examination activities.*

1. Obtain and review the following documents, as appropriate:
   - Prior examination reports, supporting workpapers, management's responses to any previously identified BSA issues, and any recommendations for the next examination.
   - The BSA/AML risk assessment, if one has been completed by the bank. If the bank has not developed a BSA/AML risk assessment, examiners must develop one. Refer to the *BSA/AML Risk Assessment* section for more information.
   - The bank's internal and external BSA/AML independent testing (audit) report(s), including any scope and supporting workpapers.
   - Management's responses, including the current status of issues, regarding independent testing or audit results and examination findings.
   - Any other information available through the offsite and ongoing monitoring process or from information received from the bank in response to the request letter. This may include:
     - BSA reporting available from FinCEN.
     - Any other information or correspondence obtained between examinations related to the BSA/AML compliance program, including systems and processes the bank uses to monitor and file on currency transactions and suspicious activity, law enforcement inquiries or engagements, or higher-risk banking operations.
2. Determine whether independent testing is adequate and may be leveraged for use in assessing the bank's BSA/AML compliance program and the bank's compliance with BSA regulatory requirements. To determine the adequacy, consider whether testing was independent and assessed all appropriate ML/TF and other illicit financial activity risks within the bank's operations, and consider whether access was provided to the appropriate independent testing scope and supporting workpapers.
3. Review SARs, CTRs, and CTR exemption information. As appropriate, determine accounts that should be considered for further testing. Consider and analyze the information below for unusual patterns.
   - High-volume currency customers.
   - The volume and characteristics of SARs filed.
   - Frequent SAR subjects.
   - The volume and nature of CTRs and CTR exemptions.

- The volume of SARs and CTRs in relation to the bank's products and services, size, asset or deposit growth, and geographic locations

4. Review correspondence between the bank and its regulator(s), if not already completed by the examiner-in-charge or other examination personnel. In addition, review correspondence that the bank and its regulator(s) have received from, or sent to, outside regulatory and law enforcement agencies relating to BSA/AML compliance. Communications, particularly those received from FinCEN, may provide information relevant to the examination, such as the following:

   - Filing errors for SARs, CTRs, and CTR exemptions from FinCEN's BSA E-Filing System.
   - Civil money penalties issued by, or in process from, FinCEN or state agencies.
   - Law enforcement subpoenas, seizures, or "keep-open" requests.
   - Notification of mandatory account closures of noncooperative foreign customers holding correspondent accounts as directed by the Secretary of the Treasury or the U.S. Attorney General.
   - Law enforcement letters acknowledging that the bank provided highly useful information, as necessary and relevant.
   - Participation in law enforcement-related information exchanges, as necessary and relevant.

5. Review the bank's information technology sources, systems, and processes used in its BSA/AML compliance program to determine whether additional examiner subject matter expertise is warranted.

6. If included within the scope of the examination, review the bank's policies, procedures, and processes for complying with OFAC-administered laws and regulations. This should include the bank's OFAC risk assessment, independent testing of its OFAC compliance program, and any correspondence between the bank and OFAC (e.g., periodic reporting of prohibited transactions and, if applicable, annual OFAC reports on blocked property, voluntary self-disclosures, and Cautionary or No Action Letters from OFAC). Also, review the bank's use of information technology sources, systems, and processes used in its OFAC compliance program to determine whether additional examiner subject matter expertise is warranted.

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DEVELOPING THE BSA/AML EXAMINATION PLAN

Objective: *Based on the bank's risk profile, develop and document the BSA/AML examination plan, including the BSA/AML examination and testing procedures to be completed.*

Examiners must review a bank's BSA/AML compliance program during each examination cycle by conducting appropriate examination and testing procedures.[7] While the BSA/AML examination plan may be adjusted as a result of examination findings, an initial examination plan enables the examiner to establish the examination and testing procedures needed to assess the adequacy of the bank's BSA/AML compliance program, relative to its risk profile, and the bank's compliance with BSA regulatory requirements.

Examiners should develop and document an initial BSA/AML examination plan based on their review of the information highlighted in the *Risk-Focused BSA/AML Supervision* section in this Manual. At a minimum, examiners should assess the adequacy of the BSA/AML compliance program using the examination and testing procedures included in this section (*Developing the BSA/AML Examination Plan*) and in the *Risk-Focused BSA/AML Supervision*, *BSA/AML Risk Assessment*, *Assessing the BSA/AML Compliance Program*, and *Developing Conclusions and Finalizing the Examination* sections.

In addition to the minimum examination and testing procedures, the following factors should be considered when determining additional examination and testing procedures, if any, to assess the adequacy of the bank's BSA/AML compliance program and the bank's compliance with BSA regulatory requirements:

- The bank's risk profile, size or complexity, and organizational structure.
- The quality of independent testing.
- Changes to the bank's BSA/AML compliance officer or department.
- Expansionary activities.
- Innovations and new technologies.[8]
- Other relevant factors.

Examiners should consider which examination and testing procedures in the *Assessing Compliance with BSA Regulatory Requirements* section are appropriate. BSA/AML examination and testing procedures specific to the bank's products, services, customers, and geographic locations are found in *Risks Associated with Money Laundering and Terrorist Financing*. Not all of the examination and testing procedures are likely to be applicable to

[7] Section 8(s) of the Federal Deposit Insurance Act and section 206(q) of the Federal Credit Union Act require a BSA/AML compliance examination during each supervisory cycle. (12 USC 1818(s); 12 USC1786(q)).
[8] "Joint Statement on Innovative Efforts to Combat Money Laundering and Terrorist Financing," issued by the Federal Reserve, FDIC, FinCEN, NCUA, and OCC, December 3, 2018.

every bank or during every examination. Examiners should document any changes to the examination plan resulting from findings that occur after the examination has started.

At larger or more complex banking organizations, examiners may complete various types of BSA/AML examinations or targeted reviews throughout the supervisory plan or cycle to assess BSA/AML compliance. These reviews, which are used to collectively assess the bank's BSA/AML compliance program and compliance with BSA regulatory requirements, may focus on one or more business lines or customer types (e.g., private banking, trade finance, foreign correspondent banking relationships, or currency exchangers), or bank systems (e.g., suspicious activity monitoring or customer due diligence) based on the bank's BSA/AML risk assessment, independent testing, and previous BSA/AML examination findings.

Examiners should determine examination staffing needs based on the scope of work in the examination plan. Consideration should be given to specific BSA/AML expertise needs based on the risk and complexity of the institution as well as information technology sources, systems and processes.

Request Letter Items

Once the examiner determines the necessary examination and testing procedures to be performed, the examiner should prepare a request letter to the bank. Request letter items should be based on the bank's products, services, customers, and geographic locations and should be tailored to the examination plan areas that will be reviewed rather than submitting a comprehensive list to the bank. Additional materials may be requested as needed. Examples of request letter items are detailed in *Appendix H - Request Letter Items*.

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DEVELOPING THE BSA/AML EXAMINATION PLAN EXAMINATION PROCEDURES

Objective: *Based on the bank's risk profile, develop and document a BSA/AML examination plan that includes the BSA/AML examination and testing procedures to be completed.*

1. Based on the review of relevant examination documents, in conjunction with the review of the bank's BSA/AML risk assessment, develop and document an initial BSA/AML examination plan. At a minimum, the plan should address:
   - The risk profile of the bank.
   - The scope and adequacy of the bank's BSA/AML independent testing and whether the independent testing can be leveraged to assist in the assessment of the bank's BSA/AML compliance program and the bank's compliance with BSA regulatory requirements.
   - The examination staffing needs, including any subject matter expertise (BSA and non-BSA).
   - The scope of the BSA/AML examination, including the examination and testing procedures necessary to assess the adequacy of the bank's BSA/AML compliance program, the bank's compliance with BSA regulatory requirements, and the bank's adherence to, and the appropriateness of, its policies, procedures, and processes.
2. Based on the review of relevant examination information and the bank's risk profile, determine the examination and testing procedures to be completed. Determine the request letter items that are necessary to complete those examination and testing procedures. Examples of request letter items are detailed in *Appendix H - Request Letter Items*. Examiners are expected to review the request letter items provided by the bank prior to their onsite work.

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BSA/AML RISK ASSESSMENT

Objective: *Review the bank's BSA/AML risk assessment process, and determine whether the bank has adequately identified the ML/TF and other illicit financial activity risks within its banking operations.*

Examiners must develop an understanding of the bank's ML/TF and other illicit financial activity risks to evaluate the bank's BSA/AML compliance program. This is primarily achieved by reviewing the bank's BSA/AML risk assessment during the scoping and planning process. This section is designed to provide standards for examiners to assess the adequacy of the bank's BSA/AML risk assessment process.

BSA/AML Risk Assessment Process

To assure that BSA/AML compliance programs are reasonably designed to meet BSA regulatory requirements, banks structure their compliance programs to be risk-based. While not a specific legal requirement, a well-developed BSA/AML risk assessment assists the bank in identifying ML/TF and other illicit financial activity risks and in developing appropriate internal controls (i.e., policies, procedures, and processes). Understanding its risk profile enables the bank to better apply appropriate risk management processes to the BSA/AML compliance program to mitigate and manage risk and comply with BSA regulatory requirements. The BSA/AML risk assessment process also enables the bank to better identify and mitigate any gaps in controls. The BSA/AML risk assessment should provide a comprehensive analysis of the bank's ML/TF and other illicit financial activity risks. Documenting the BSA/AML risk assessment in writing is a sound practice to effectively communicate ML/TF and other illicit financial activity risks to appropriate bank personnel. The BSA/AML risk assessment should be provided to all business lines across the bank, the board of directors, management, and appropriate staff.

The development of the BSA/AML risk assessment generally involves the identification of specific risk categories (e.g., products, services, customers, and geographic locations) unique to the bank, and an analysis of the information identified to better assess the risks within these specific risk categories.

Identification of Specific Risk Categories

Generally, the first step in developing the risk assessment is to identify the bank's risk categories. Money laundering, terrorist financing, or other illicit financial activities can occur through any number of different methods or channels. A spectrum of risks may be identifiable even within the same risk category. The bank's BSA/AML risk assessment process should address the varying degrees of risk associated with its products, services, customers, and geographic locations, as appropriate. Improper identification and assessment of risk can have a cascading effect, creating deficiencies in multiple areas of internal controls and resulting in an overall weakened BSA/AML compliance program.

The identification of risk categories is bank-specific, and a conclusion regarding the risk categories should be based on a consideration of all pertinent information. There are no required risk categories, and the number and detail of these categories vary based on the bank's size or complexity, and organizational structure. Any single indicator does not necessarily determine the existence of lower or higher risk.

The subsections within *Risks Associated with Money Laundering and Terrorist Financing* provide information and discussions on certain products, services, customers, and geographic locations that may present unique challenges and exposures, which banks may need to address through specific policies, procedures, and processes.

Analysis of Specific Risk Categories

Generally, the second step in developing the BSA/AML risk assessment entails an analysis of the information obtained when identifying specific risk categories. The purpose of this analysis is to assess ML/TF and other illicit financial activity risks in order to develop appropriate internal controls to mitigate overall risk. This step may involve evaluating transaction data pertaining to the bank's activities relative to products, services, customers, and geographic locations. For example, it may be useful to quantify risk by assessing the number and dollar amount of domestic and international funds transfers, the nature of private banking customers or foreign correspondent accounts, the existence of payable through accounts, and the domestic and international geographic locations where the bank conducts or transacts business. A detailed analysis is important, because the risks associated with the bank's activities vary. Additionally, the appropriate level and sophistication of the analysis varies by bank.

The following example illustrates the value of the two-step risk assessment process. The information collected by two banks in the first step reflects that each sends 100 international funds transfers per day. Further analysis by the first bank shows that approximately 90 percent of its funds transfers are recurring well-documented transactions for long-term customers. Further analysis by the second bank shows that 90 percent of its funds transfers are nonrecurring or are processed for noncustomers. While these percentages appear to be the same, the risks may be different. This example illustrates that information collected for purposes of the bank's customer identification program and developing the customer due diligence customer risk profile is important when conducting a detailed analysis. Refer to the *Customer Identification Program*, *Customer Due Diligence*, and *Appendix J – Quantity of Risk Matrix* sections for more information.

Various methods and formats may be used to complete the BSA/AML risk assessment; therefore, there is no expectation for a particular method or format. Bank management designs the appropriate method or format and communicates the ML/TF and other illicit financial activity risks to all appropriate parties. When the bank has established an appropriate BSA/AML risk assessment process, and has followed existing policies, procedures, and processes, examiners should not criticize the bank for individual risk or process decisions unless those decisions impact the adequacy of some aspect of the bank's BSA/AML compliance program or the bank's compliance with BSA regulatory requirements.

Updating the Risk Assessment

Generally, risk assessments are updated (in whole or in part) to include changes in the bank's products, services, customers, and geographic locations and to remain an accurate reflection of the bank's ML/TF and other illicit financial activity risks. For example, the bank may need to update its BSA/AML risk assessment when new products, services, and customer types are introduced or the bank expands through mergers and acquisitions. However, there is no requirement to update the BSA/AML risk assessment on a continuous or specified periodic basis.

Assessing the Bank's BSA/AML Risk Assessment

When evaluating the BSA/AML risk assessment, examiners should focus on whether the bank has effective processes resulting in a well-developed BSA/AML risk assessment. Examiners should not take any single indicator as determinative of the existence of a lower- or higher-risk profile for the bank. The assessment of risk factors is bank-specific, and a conclusion regarding the risk profile should be based on a consideration of all pertinent information. The bank may determine that some factors should be weighted more heavily than others. For example, the number of funds transfers may be one factor the bank considers when assessing risk. However, to identify and weigh the risks, the bank's risk assessment process may need to consider other factors associated with those funds transfers, such as whether they are international or domestic, the dollar amounts involved, and the nature of the customer relationships. Regardless of the bank's approach, sound practice would be to document the factors considered, including any weighting.

Examiners should assess whether the bank has developed a BSA/AML risk assessment that identifies its ML/TF and other illicit financial activity risks. Examiners should also assess whether the bank has considered all products, services, customers, and geographic locations, and whether the bank analyzed the information relative to those risk categories.

For the purposes of the examination, whenever the bank has not developed a BSA/AML risk assessment, or the BSA/AML risk assessment is inadequate, examiners must develop a BSA/AML risk assessment for the bank based on available information. An examiner-developed BSA/AML risk assessment generally is not as comprehensive as one developed by the bank. Examiners should have a general understanding of the bank's ML/TF and other illicit financial activity risks from the examination scoping and planning process. This information should be evaluated using the two-step approach detailed in the BSA/AML Risk Assessment Process subsection above. Examiners may also refer to *Appendix J - Quantity of Risk Matrix* when completing this evaluation.

Developing a BSA/AML Compliance Program Based on the BSA/AML Risk Assessment

The bank structures its BSA/AML compliance program to address its risk profile, based on the bank's assessment of risks, as well as to comply with BSA regulatory requirements. Specifically, the bank should develop appropriate policies, procedures, and processes to monitor and control its ML/TF and other illicit financial activity risks. For example, the bank's monitoring system to identify, research, and report suspicious activity should be risk-based to incorporate any necessary additional screening for higher-risk products, services, customers, and geographic locations as identified by the bank's BSA/AML risk assessment. Independent testing (audit) should review the bank's BSA/AML risk assessment, including how it is used to develop the BSA/AML compliance program. Refer to *Appendix I - Risk Assessment Link to the BSA/AML Compliance Program* for a chart depicting the expected link of the BSA/AML risk assessment to the BSA/AML compliance program.

Consolidated BSA/AML Risk Assessment

Banks that choose to implement a consolidated or partially consolidated BSA/AML compliance program should assess risk within business lines and across activities and legal entities. Consolidating ML/TF and other illicit financial activity risks for larger or more complex banking organizations may assist senior management and the board of directors in identifying, understanding, and appropriately mitigating risks within and across the banking organization. To understand ML/TF and other illicit financial activity risk exposures, the banking organization should communicate across all business lines, activities, and legal entities. Identifying a vulnerability in one aspect of the banking organization may indicate vulnerabilities elsewhere. Refer to the *BSA/AML Compliance Program Structures* section for more information.

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BSA/AML RISK ASSESSMENT EXAMINATION PROCEDURES

Objective. *Determine the adequacy of the bank's BSA/AML risk assessment process, and determine whether the bank has adequately identified the ML/TF and other illicit financial activity risks within its banking operations.*

1. Determine whether the bank has identified ML/TF and other illicit financial activity risks associated with the products, services, customers, and geographic locations unique to the bank.
2. Determine whether the bank has analyzed, and assessed the ML/TF and other illicit financial activity risks within the products, services, customers, and geographic locations unique to the bank.
3. Determine whether the bank has a process for updating its BSA/AML risk assessment as necessary to reflect changes in the bank's products, services, customers, and geographic locations and to remain an accurate reflection of its ML/TF and other illicit financial activity risks.
4. If the bank has not developed a BSA/AML risk assessment, or if the BSA/AML risk assessment is inadequate, complete a BSA/AML risk assessment for the bank.
5. Document and discuss with the bank any findings related to the BSA/AML risk assessment process.

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ASSESSING THE BSA/AML COMPLIANCE PROGRAM

Objective: *Assess whether the bank has designed, implemented, and maintains an adequate BSA/AML compliance program that complies with BSA regulatory requirements.*

Banks must establish and maintain procedures reasonably designed to assure and monitor compliance with BSA regulatory requirements (BSA/AML compliance program).[9] The BSA/AML compliance program[10] must be written, approved by the board of directors,[11] and noted in the board minutes. To achieve the purposes of the BSA, the BSA/AML compliance program should be commensurate with the bank's ML/TF and other illicit financial activity risk profile. Refer to the *BSA/AML Risk Assessment* section and *Appendix I - Risk Assessment Link to the BSA/AML Compliance Program* for more information.

Written policies, procedures, and processes alone are not sufficient to have an adequate BSA/AML compliance program; practices that correspond with the bank's written policies, procedures, and processes are needed for implementation. Importantly, policies, procedures, processes, and practices should align with the bank's unique ML/TF and other illicit financial activity risk profile. The BSA/AML compliance program must provide for the following requirements:[12]

- A system of internal controls to assure ongoing compliance.
- Independent testing for compliance to be conducted by bank personnel or by an outside party.
- Designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance (BSA compliance officer).
- Training for appropriate personnel.

In addition, the BSA/AML compliance program must include a customer identification program (CIP) with risk-based procedures that enable the bank to form a reasonable belief that it knows

[9] 12 USC 1818(s) and 12 USC 1786(q).
[10] The Federal Reserve requires Edge and agreement corporations and U.S. branches, agencies, and other offices of foreign banks supervised by the Federal Reserve to establish and maintain procedures reasonably designed to ensure and monitor compliance with the BSA and related regulations (refer to Regulation K, 12 CFR 211.5(m)(1) and 12 CFR 211.24(j)(1)). Because the BSA does not apply extraterritorially, foreign offices of domestic banks are expected to have policies, procedures, and processes in place to protect against risks of money laundering and terrorist financing (12 CFR 208.63, 12 CFR 326.8, and 12 CFR 21.21).
[11] The Federal Reserve, the FDIC, and the OCC, each require the U.S. branches, agencies, and representative offices of the foreign banks they supervise operating in the United States to develop written BSA compliance programs that are approved by their respective bank's board of directors and noted in the minutes, or that are approved by delegates acting under the express authority of their respective bank's board of directors to approve the BSA compliance programs. "Express authority" means the head office must be aware of its U.S. AML program requirements and there must be some indication of purposeful delegation.
[12] 12 CFR 208.63, 12 CFR 211.5(m), and 12 CFR 211.24(j) (Federal Reserve); 12 CFR 326.8 (FDIC); 12 CFR 748.2 (NCUA); 12 CFR 21.21 (OCC).

the true identity of its customers. The BSA/AML compliance program must also include appropriate risk-based procedures for conducting ongoing customer due diligence (CDD) and complying with beneficial ownership requirements for legal entity customers as set forth in regulations issued by Financial Crimes Enforcement Network (FinCEN). Refer to the *Customer Identification Program*, *Customer Due Diligence*, and *Beneficial Ownership Requirements for Legal Entity Customers* sections for more information.

The assessment of the adequacy of the bank's BSA/AML compliance program is bank-specific, and examiners should consider all pertinent information. A review of the bank's written policies, procedures, and processes is a first step in determining the overall adequacy of the BSA/AML compliance program. The completion of examination and testing procedures is necessary to support overall conclusions regarding the BSA/AML compliance program. BSA/AML examination findings should be discussed with relevant bank management, and findings must be included in the report of examination (ROE) or supervisory correspondence.

Preliminary Evaluation

Once examiners complete the review of the bank's BSA/AML compliance program, they should develop and document a preliminary assessment of the bank's program. At this point, examiners should revisit the initial BSA/AML examination plan to determine whether additional areas of review are necessary to assess the adequacy of the bank's BSA/AML compliance program, relative to its risk profile, and the bank's compliance with BSA regulatory requirements. These adjustments to the initial examination plan could be based on information identified during the review, such as a new product or business line at the bank or independent testing report findings. Examiners should document and support any changes to the examination plan, if necessary, then proceed to the applicable examination and testing procedures in *Assessing Compliance with BSA Regulatory Requirements*, *Risks Associated with Money Laundering and Terrorist Financing*, and *Office of Foreign Assets Control*. Once all relevant examination and testing procedures are completed as documented in the examination plan, examiners should proceed to *Developing Conclusions and Finalizing the Examination*.

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ASSESSING THE BSA/AML COMPLIANCE PROGRAM EXAMINATION PROCEDURES

Objective: *Determine whether the bank has designed, implemented, and maintains an adequate BSA/AML compliance program that complies with BSA regulatory requirements.*

1. Confirm that the bank's BSA/AML compliance program is written, has been approved by the board of directors, and that the approval was noted in the board minutes.
2. Review the BSA/AML compliance program and determine whether it is tailored to the bank's ML/TF and other illicit financial activity risk profile. Determine whether the bank's compliance program contains the following requirements:
   - A system of internal controls to assure ongoing compliance.
   - Independent testing for compliance to be conducted by bank personnel or an outside party.
   - Designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance (BSA compliance officer).
   - Training for appropriate personnel.
3. Determine whether the bank's CIP, risk-based CDD, and beneficial ownership procedures are included as part of the BSA/AML compliance program.
4. Determine whether the initial BSA/AML examination plan should be adjusted based on new information identified during the examination. Document and support any changes made.

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BSA/AML INTERNAL CONTROLS

Objective: *Assess the bank's system of internal controls to assure ongoing compliance with BSA regulatory requirements.*

The board of directors, acting through senior management, is ultimately responsible for ensuring that the bank maintains a system of internal controls to assure ongoing compliance with BSA regulatory requirements.[13] Internal controls are the bank's policies, procedures, and processes designed to mitigate and manage ML/TF and other illicit financial activity risks and to achieve compliance with BSA regulatory requirements. The board of directors plays an important role in establishing and maintaining an appropriate culture that places a priority on compliance, and a structure that provides oversight and holds senior management accountable for implementing the bank's BSA/AML internal controls. The system of internal controls, including the level and type, should be commensurate with the bank's size or complexity, and organizational structure. Large or more complex banks may implement specific departmental internal controls for BSA/AML compliance. Departmental internal controls typically address risks and compliance requirements unique to a particular line of business or department and are part of a comprehensive, bank-wide BSA/AML compliance program.

Examiners should determine whether the bank's internal controls are designed to assure ongoing compliance with BSA regulatory requirements and:

- Incorporate the bank's BSA/AML risk assessment and the identification of ML/TF and other illicit financial activity risks, along with any changes in those risks.
- Provide for program continuity despite changes in operations, management, or employee composition or structure.
- Facilitate oversight of information technology sources, systems, and processes that support BSA/AML compliance.
- Provide for timely updates in response to changes in regulations.
- Incorporate dual controls and the segregation of duties to the extent possible. For example, employees who complete the reporting forms (such as suspicious activity reports (SARs), currency transaction reports (CTRs), and CTR exemptions) generally should not also be responsible for the decision to file the reports or grant the exemptions.
- Include mechanisms to identify and inform the board of directors, or a committee thereof, and senior management of BSA compliance initiatives, identified compliance deficiencies and corrective action taken, and notify the board of directors of SARs filed.
- Identify and establish specific BSA compliance responsibilities for bank personnel and provide oversight for execution of those responsibilities, as appropriate.

[13] 12 CFR 208.63(c)(1), (Federal Reserve); 12 CFR 326.8(c)(1) (FDIC); 12 CFR 748.2(c)(1) (NCUA); 12 CFR 21.21(d)(1) (OCC).

This list is not all-inclusive and should be tailored to reflect the bank's ML/TF and other illicit financial activity risk profile. More information concerning individual regulatory requirements and specific risk areas is in the *Assessing Compliance with BSA Regulatory Requirements* and *Risks Associated with Money Laundering and Terrorist Financing* sections.

Examiners should determine whether the bank's system of internal controls is designed to mitigate and manage the ML/TF and other illicit financial activity risks, and comply with BSA regulatory requirements. Examiners should assess the adequacy of internal controls based on the factors listed above.

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BSA/AML INTERNAL CONTROLS EXAMINATION PROCEDURES

Objective: *Determine whether the bank has implemented a system of internal controls that assures ongoing compliance with BSA regulatory requirements.*

1. Determine whether the bank's system of internal controls (i.e., policies, procedures, and processes) is designed to:
   - Mitigate and manage ML/TF and other illicit financial activity risks, and
   - Assure ongoing compliance with BSA regulatory requirements.
2. Determine whether the internal controls:
   - Incorporate the bank's BSA/AML risk assessment and the identification of ML/TF and other illicit financial activity risks, along with any changes in those risks.
   - Provide for program continuity despite changes in operations, management, or employee composition or structure.
   - Facilitate oversight of information technology sources, systems, and processes that support BSA/AML compliance.
   - Provide for timely updates to implement changes in regulations.
   - Incorporate dual controls and the segregation of duties to the extent possible.
   - Include mechanisms to identify and escalate BSA compliance issues to management and the board of directors, or a committee thereof, as appropriate.
   - Inform the board of directors, or a committee thereof, and senior management of compliance initiatives, identified compliance deficiencies, and corrective action taken, and notify the board of directors of SARs filed.
   - Identify and establish specific BSA compliance responsibilities for bank personnel and provide oversight for execution of those responsibilities, as appropriate.

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BSA/AML INDEPENDENT TESTING

Objective: *Assess the adequacy of the bank's independent testing program.*

The purpose of independent testing (audit) is to assess the bank's compliance with BSA regulatory requirements, relative to its risk profile, and assess the overall adequacy of the BSA/AML compliance program. Independent testing should be conducted by the internal audit department, outside auditors, consultants, or other qualified independent parties.[14]

Banks that do not employ outside auditors or consultants or do not have internal audit departments may comply with this requirement by using qualified bank staff who are not involved in the function being tested. Banks engaging outside auditors or consultants should ensure that the persons conducting the BSA/AML independent testing are not involved in other BSA-related functions at the bank that may present a conflict of interest or lack of independence, such as training or developing policies and procedures. Regardless of who performs the independent testing, the party conducting the BSA/AML independent testing should report directly to the board of directors or to a designated board committee comprised primarily, or completely, of outside directors. Banks with a community focus, less complex operations, and lower-risk profiles for ML/TF and other illicit financial activities may consider utilizing a shared resource as part of a collaborative arrangement to conduct independent testing.[15]

There is no regulatory requirement establishing BSA/AML independent testing frequency. Independent testing, including the frequency, should be commensurate with the ML/TF and other illicit financial activity risk profile of the bank and the bank's overall risk management strategy. The bank may conduct independent testing over periodic intervals (for example, every 12-18 months) and/or when there are significant changes in the bank's risk profile, systems, compliance staff, or processes. More frequent independent testing may be appropriate when errors or deficiencies in some aspect of the BSA/AML compliance program have been identified or to verify or validate mitigating or remedial actions.

Independent testing of specific BSA requirements should be risk-based and evaluate the quality of risk management related to ML/TF and other illicit financial activity risks for significant banking operations across the organization. Risk-based independent testing focuses on the bank's risk assessment to tailor independent testing to the areas identified as being of greatest risk and concern. Risk-based independent testing programs vary depending on the bank's size or complexity, organizational structure, scope of activities, risk profile, quality of control functions, geographic diversity, and use of technology. Risk-based independent testing should include evaluating pertinent internal controls and information technology sources, systems, and processes used to support the BSA/AML compliance program. Consideration should also be given to the expansion into new product lines, services, customer types, and geographic locations through organic growth or merger activity.

[14] 12 CFR 208.63(c)(2) (Federal Reserve); 12 CFR 326.8(c)(2) (FDIC); 12 CFR 748.2(c)2) (NCUA); 12 CFR 21.21(d)(2) (OCC)
[15] For detailed information on collaborative arrangements see "Interagency Statement on Sharing Bank Secrecy Act Resources," issued by Federal Reserve, FDIC, FinCEN, NCUA, and OCC, October 3, 2018.

The independent testing should evaluate the overall adequacy of the bank's BSA/AML compliance program and the bank's compliance with BSA regulatory requirements. This evaluation helps inform the board of directors and senior management of weakness, or areas in need of enhancements or stronger controls. Typically, this evaluation includes an explicit statement in the report(s) about the bank's overall compliance with BSA regulatory requirements. At a minimum, the independent testing should contain sufficient information for the reviewer (e.g., board of directors, senior management, BSA compliance officer, review auditor, or an examiner) to reach a conclusion about the overall adequacy of the BSA/AML compliance program.

To contain sufficient information to reach this conclusion, independent testing of the BSA/AML compliance program and BSA regulatory requirements may include a risk-based review of whether:

- The bank's BSA/AML risk assessment aligns with the bank's risk profile (products, services, customers, and geographic locations).
- The bank's policies, procedures, and processes for BSA compliance align with the bank's risk profile.
- The bank adheres to its policies, procedures, and processes for BSA compliance.
- The bank complies with BSA recordkeeping and reporting requirements (e.g., customer information program (CIP), customer due diligence (CDD), beneficial ownership, suspicious activity reports (SARs), currency transaction reports (CTRs) and CTR exemptions, and information sharing requests).
- The bank's overall process for identifying and reporting suspicious activity is adequate. This review may include evaluating filed or prepared SARs to determine their accuracy, timeliness, completeness, and conformance to the bank's policies, procedures, and processes.
- The bank's information technology sources, systems, and processes used to support the BSA/AML compliance program are complete and accurate. These may include reports or automated programs used to: identify large currency transactions, aggregate daily currency transactions, record monetary instrument sales and funds transfer transactions, and provide analytical and trend reports.
- Training is provided for appropriate personnel, tailored to specific functions and positions, and includes supporting documentation.
- Management took appropriate and timely action to address any violations and other deficiencies noted in previous independent testing and regulatory examinations, including progress in addressing outstanding supervisory enforcement actions, if applicable.

Auditors should document the independent testing scope, procedures performed, transaction testing completed, and any findings. All independent testing documentation and supporting workpapers should be available for examiner review. Violations; exceptions to bank policies, procedures, or processes; or other deficiencies noted during the independent testing should be documented and reported to the board of directors or a designated board committee in a timely manner. The board of directors, or a designated board committee, and appropriate staff should track deficiencies and document progress implementing corrective actions.

Examiners should review relevant documents such as the auditor's report(s), scope, and supporting workpapers, as needed. Examiners should determine whether there is an explicit statement in the report(s) about the bank's overall compliance with BSA regulatory requirements or, at a minimum, sufficient information to reach a conclusion about the overall adequacy of the BSA/AML compliance program. Examiners should determine whether the testing was conducted in an independent manner. Examiners may also evaluate, as applicable,[16] the subject matter expertise, qualifications, and independence of the person or persons performing the independent testing. Examiners should determine whether the independent testing sufficiently covers ML/TF and other illicit financial activity risks within the bank's operations and whether the frequency is commensurate with the bank's risk profile. Examiners should also review whether violations; exceptions to policies, procedures, or processes; or other deficiencies are reported to the board of directors or a designated board committee in a timely manner, whether they are tracked, and whether corrective actions are documented.

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[16] For more information, *see e.g.*, OCC Safety and Soundness Standards, 12 C.F.R. Part 30 App. D, II.L.

BSA/AML INDEPENDENT TESTING EXAMINATION PROCEDURES

Objective: *Determine whether the bank has designed, implemented, and maintains an adequate BSA/AML independent testing program for compliance with BSA regulatory requirements.*

1. Determine whether the BSA/AML independent testing (audit) is independent (i.e., performed by a person or persons not involved with the function being tested or other BSA-related functions at the bank that may present a conflict of interest or lack of independence).
2. Determine whether independent testing addresses the overall adequacy of the BSA/AML compliance program, including policies, procedures, and processes. Typically, the report includes an explicit statement about the bank's overall compliance with BSA regulatory requirements. At a minimum, the independent testing should contain sufficient information for the reviewer to reach a conclusion about the overall adequacy of the BSA/AML compliance program.
3. Through a review of board minutes or other board of directors' materials, determine whether persons conducting the independent testing reported directly to the board of directors or to a designated board committee comprised primarily, or completely, of outside directors. Determine whether independent testing results were provided to the board of directors and senior management.
4. Review independent testing reports, scope, and supporting workpapers to determine whether they are comprehensive, accurate, adequate, and timely, relative to the bank's risk profile. As applicable,[17] evaluate the qualifications and subject matter expertise of the person or persons performing the independent test. Although there are no specific regulatory requirements for the development of an independent test, consider whether the independent testing includes, as applicable, an evaluation of:
   - The BSA/AML risk assessment.
   - The relevant changes in bank activities since the last independent test.
   - The policies, procedures, and processes governing the BSA/AML compliance program and other BSA regulatory requirements, and personnel's adherence to those policies, procedures, and processes.
   - The bank's adherence to BSA reporting and recordkeeping requirements.
   - The bank's information technology sources, systems, and processes used to support the BSA/AML compliance program and whether they are complete and accurate. These may include reports or automated programs used to: identify large currency transactions, aggregate daily currency transactions, record monetary instrument sales and funds transfer transactions, and provide analytical and trend reports.

[17] For more information, *see e.g.*, OCC Safety and Soundness Standards, 12 C.F.R. Part 30 App. D, II.L.

- Training for appropriate personnel and whether it is tailored to specific functions and positions and includes supporting documentation.
- Management's actions to appropriately and timely address any violations and other deficiencies noted in previous independent testing and regulatory examinations, including progress in addressing outstanding supervisory enforcement actions, if applicable.

5. Determine whether independent testing includes, as applicable, an evaluation of suspicious activity monitoring systems and the system's ability to identify potentially suspicious activity. Although there are no specific regulatory requirements for the development of an independent test, consider whether the independent testing includes, as applicable, an evaluation of:
    - The system's methodology for monitoring transactions and accounts for potentially suspicious activity.
    - The system's ability to generate monitoring reports.
    - Filtering criteria, as appropriate, to determine whether they are reasonable, tailored to the bank's risk profile, and include higher-risk products, services, customers, and geographic locations.
    - Policies, procedures, and processes for suspicious activity monitoring systems.
6. Determine whether the independent testing includes a review and evaluation of the overall suspicious activity monitoring and reporting process. Although there are no specific regulatory requirements for the development of an independent test, consider whether the independent testing includes, as applicable, an evaluation of:
    - The identification or alert process.
    - The management of alerts, research, SAR decision making, SAR completion and filing, and monitoring of continuous activity.
    - Policies, procedures, and processes for referring potentially suspicious activity from all operational areas and business lines (such as, trust services, private banking, foreign correspondent banking) to the personnel or department responsible for evaluating potentially suspicious activity.
7. Determine whether the independent testing performed was adequate, relative to the bank's risk profile.

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BSA COMPLIANCE OFFICER

Objective: *Confirm that the bank's board of directors has designated a qualified individual or individuals (BSA compliance officer) responsible for coordinating and monitoring day-to-day compliance with BSA regulatory requirements. Assess whether the BSA compliance officer has the appropriate authority, independence, access to resources, and competence to effectively execute all duties.*

The bank's board of directors must designate a qualified individual or individuals to serve as the BSA compliance officer.[18] The BSA compliance officer is responsible for coordinating and monitoring day-to-day BSA/AML compliance. The BSA compliance officer is also charged with managing all aspects of the BSA/AML compliance program, including managing the bank's compliance with BSA regulatory requirements. The board of directors is ultimately responsible for the bank's BSA/AML compliance and should provide oversight for senior management and the BSA compliance officer in the implementation of the bank's board-approved BSA/AML compliance program.[19]

The act by the bank's board of directors of appointing a BSA compliance officer is not, by itself, sufficient to meet the regulatory requirement to establish and maintain a BSA/AML compliance program reasonably designed to assure and monitor compliance with the BSA. The board of directors is responsible for ensuring that the BSA compliance officer has appropriate authority, independence, and access to resources to administer an adequate BSA/AML compliance program based on the bank's ML/TF and other illicit financial activity risk profile. The BSA compliance officer should regularly report the status of ongoing compliance with the BSA to the board of directors and senior management so that they can make informed decisions about existing risk exposure and the overall BSA/AML compliance program. Reporting to the board of directors or a designated board committee about the status of ongoing compliance should include pertinent BSA-related information, including the required notification of suspicious activity report (SAR) filings.

The BSA compliance officer is responsible for carrying out the board's direction, including the implementation of the bank's BSA/AML policies, procedures, and processes. The BSA compliance officer may delegate BSA/AML duties to staff, but the officer is responsible for overseeing the day-to-day BSA/AML compliance program.

The BSA compliance officer should be competent, as demonstrated by knowledge of the BSA and related regulations, implementation of the bank's BSA/AML compliance program, and understanding of the bank's ML/TF and other illicit financial activity risk profile associated with its banking activities. The actual title of the individual responsible for overall BSA compliance is not important; however, the individual's authority, independence, and access to resources within the bank is critical.

[18] 12 CFR 208.63(c)(3), (Federal Reserve); 12 CFR 326.8(c)(3) (FDIC); 12 CFR 748.2(c)(3) (NCUA); 12 CFR 21.21(d)(3) (OCC).

[19] FinCEN (2014), "Advisory to U.S. Financial Institutions on Promoting a Culture of Compliance," FIN-2014-A007.

Indicators of appropriate authority of the BSA compliance officer may include senior management seeking the BSA compliance officer's input regarding: the ML/TF and other illicit financial activity risks related to expansion into new products, services, customer types and geographic locations; or operational changes, such as the implementation of, or adjustments to, systems that impact the BSA compliance function. Indicators of appropriate independence of the BSA compliance officer may include, but are not limited to: clear lines of reporting and communication ultimately up to the board of directors or a designated board committee that do not compromise the BSA compliance officer's independence, the ability to undertake the BSA compliance officer's role without undue influence from the bank's business lines, and identification and reporting of issues to senior management and the board of directors.

The BSA compliance officer should have access to suitable resources. This may include, but is not limited to: adequate staffing with the skills and expertise necessary for the bank's overall risk level (based on products, services, customers, and geographic locations), size or complexity, and organizational structure; and systems to support the timely identification, measurement, monitoring, reporting, and management of the bank's ML/TF and other illicit financial activity risks.

Examiners should confirm that the bank's board of directors has designated an individual or individuals responsible for the overall BSA/AML compliance program who are appropriately qualified. Examiners should review reports to the board of directors and senior management regarding the status of ongoing compliance and pertinent BSA-related information, including the required notification of SAR filings. Examiners should confirm that the BSA compliance officer has the appropriate authority, independence, and access to resources.

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BSA COMPLIANCE OFFICER EXAMINATION PROCEDURES

Objective: *Confirm that the bank's board of directors has designated a qualified individual or individuals (BSA compliance officer) responsible for coordinating and monitoring day-to-day compliance with BSA regulatory requirements. Determine whether the BSA compliance officer has the appropriate authority, independence, access to resources, and competence to effectively execute all duties.*

1. Confirm that the bank's board of directors has designated an individual or individuals responsible for the overall BSA/AML compliance program.
2. Confirm that the BSA compliance officer regularly updates the board of directors and senior management about the status of ongoing compliance with the BSA and pertinent BSA-related information, including the required notification of SAR filings.
3. Determine whether the BSA compliance officer is competent, as demonstrated by knowledge of the BSA and related regulations, implementation of the bank's BSA/AML compliance program, and understanding of the bank's ML/TF and other illicit financial activity risk profile associated with its banking activities.
4. Determine whether the BSA compliance officer has the appropriate authority.
5. Determine whether the BSA compliance officer has the appropriate independence. Indicators of appropriate independence may include, but are not limited to:
    - Clear lines of reporting and communication ultimately up to the board of directors, or a designated board committee, that do not compromise the BSA compliance officer's independence.
    - The ability to undertake the BSA compliance officer's role without undue influence from the bank's business lines.
    - Identification and reporting of issues to senior management and the board of directors.
6. Determine whether the BSA compliance officer has access to suitable resources. Indicators of suitable resources may include, but are not limited to:
    - Adequate staffing with the skills and expertise for the bank's overall risk level (based on products, services, customers, and geographic locations), size or complexity, and organizational structure.
    - Systems to support the identification, measurement, monitoring, reporting, and management of the bank's ML/TF and other illicit financial activity risks.

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BSA/AML TRAINING

Objective: *Confirm that the bank has developed a BSA/AML training program and delivered training to appropriate personnel.*

Banks must provide training for appropriate personnel.[20] Training should cover the aspects of the BSA that are relevant to the bank and its risk profile, and appropriate personnel includes those whose duties require knowledge or involve some aspect of BSA/AML compliance. Training should cover BSA regulatory requirements, supervisory guidance, and the bank's internal BSA/AML policies, procedures, and processes. Training should be tailored to each individual's specific responsibilities, as appropriate. In addition, targeted training may be necessary for specific ML/TF and other illicit financial activity risks and requirements applicable to certain business lines or operational units, such as lending, trust services, foreign correspondent banking, and private banking. An overview of the purposes of the BSA and its regulatory requirements are typically provided to new staff during employee orientation or reasonably thereafter. The BSA compliance officer and BSA compliance staff should receive periodic training that is relevant and appropriate to remain informed of changes to regulatory requirements and changes to the bank's risk profile.

The board of directors and senior management should receive foundational training and be informed of changes and new developments in the BSA, including its implementing regulations, the federal banking agencies' regulations, and supervisory guidance. While the board of directors may not require the same degree of training as banking operations personnel, the training should provide board members with sufficient understanding of the bank's risk profile and BSA regulatory requirements. Without a general understanding of the BSA, it is more difficult for the board of directors to provide adequate oversight of the BSA/AML compliance program, including approving the written BSA/AML compliance program, establishing appropriate independence for the BSA/AML compliance function, and providing sufficient BSA/AML resources.

Periodic training for appropriate personnel should incorporate current developments and changes to BSA regulatory requirements; supervisory guidance; internal policies, procedures, and processes; and the bank's products, services, customers, and geographic locations. Changes to information technology sources, systems, and processes used in BSA compliance may be covered during training for appropriate personnel. The training program may be used to reinforce the importance that the board of directors and senior management place on the bank's compliance with the BSA and that all employees understand their role in maintaining an adequate BSA/AML compliance program.

Training programs should include examples of money laundering and suspicious activity monitoring and reporting that are tailored, as appropriate, to each operational area. For example, training for tellers should focus on examples involving large currency transactions

[20] 12 CFR 208.63(c)(4) (Federal Reserve); 12 CFR 326.8(c)(4) (FDIC); 12 CFR 748.2(c)(4) (NCUA); 12 CFR 21.21(d)(4) (OCC).

or suspicious activities, and training for the loan department should provide examples involving money laundering through lending arrangements. The bank should provide training for any agents who are responsible for conducting BSA-related functions on behalf of the bank. If the bank relies on another financial institution or other party to perform training, appropriate documentation should be maintained.[21]

Banks should document their training programs. Training and testing materials (if training-related testing is used by the bank), and the dates of training sessions should be maintained by the bank. Additionally, training materials and records should be available for auditor or examiner review. The bank should maintain documentation of attendance records and any failures of personnel to take the required training in a timely manner, as well as any corrective actions taken to address such failures.

Examiners should determine whether all personnel whose duties require knowledge of the BSA are included in the training program and whether materials include training on BSA regulatory requirements, supervisory guidance, and the bank's internal BSA/AML policies, procedures, and processes.

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[21] For more information on collaborative arrangements, see "Interagency Statement on Sharing Bank Secrecy Act Resources," issued by Federal Reserve, FDIC, FinCEN, NCUA, and OCC, October 3, 2018.

BSA/AML TRAINING EXAMINATION PROCEDURES

Objective: *Determine whether the bank has developed a BSA/AML training program and delivered training to appropriate personnel.*

1. Determine whether all personnel whose duties require knowledge of the BSA are included in the training program, that the BSA compliance officer and BSA compliance staff have received periodic training that is relevant and appropriate, and that the board of directors receives appropriate training that may include changes or new developments in the BSA.
2. Determine whether the bank's training program materials address:
   - The importance that the board of directors and senior management place on ongoing education, training, employee accountability, and compliance.
   - Results of previous findings of noncompliance with internal policies and regulatory requirements, if applicable.
   - An overview of the purposes of the BSA and its regulatory requirements, supervisory guidance, and the bank's internal policies, procedures, and processes.
   - Different forms of ML/TF and other illicit financial activity risks as they relate to identification and examples of suspicious activity.
   - Information tailored to specific risks of individual business lines or operational units.
   - Information on current developments and changes to the BSA regulatory requirements.
   - Adequate training for any agents who are responsible for conducting BSA-related functions on behalf of the bank.
3. Determine whether the bank maintains documentation of the dates of training sessions and training and testing materials (if testing is used by the bank). Documentation should include attendance records and any failures of personnel to take the requisite training in a timely manner, as well as any corrective actions taken to address such failures.

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DEVELOPING CONCLUSIONS AND FINALIZING THE EXAM

Objective: *Formulate conclusions about the adequacy of the bank's BSA/AML compliance program, relative to its risk profile, and the bank's compliance with BSA regulatory requirements; develop an appropriate supervisory response; and communicate BSA/AML examination findings to the bank.*

In the final phase of the BSA/AML examination, examiners should assemble all findings from the examination and testing procedures completed. From those findings, examiners should develop and document conclusions about the adequacy of the bank's BSA/AML compliance program, relative to its risk profile, and the bank's compliance with BSA regulatory requirements. When formulating conclusions, examiners are reminded that banks have flexibility in the design of their BSA/AML compliance programs, which will vary based on the bank's risk profile, size or complexity, and organizational structure. Examiners should primarily focus on whether the bank has established appropriate processes to manage ML/TF and other illicit financial activity risks, and that the bank has complied with BSA requirements.

Examiners should discuss with the bank their preliminary conclusions, which may include strengths, weaknesses, any deficiencies or violations, if applicable, and necessary remediation of any deficiencies or violations. Minor weaknesses, deficiencies, and technical violations alone are not indicative of an inadequate BSA/AML compliance program and should not be communicated as such. Conclusions regarding the adequacy of the bank's BSA/AML compliance program and any significant findings should be presented in a written format for inclusion in the report of examination (ROE).[22]

In formulating a written conclusion for the ROE, examiners do not need to discuss every procedure performed during the examination. Written comments should convey to the reader whether the overall BSA/AML compliance program is adequate. The comments should cover areas or subjects pertinent to examiner findings and conclusions. Examiners should prepare workpapers in sufficient detail to support discussions in the ROE. To the extent items are discussed in the workpapers but not the ROE, the workpapers should appropriately document each item, as well as any other aspect of the bank's BSA/AML compliance program that merits attention but may not rise to the level of findings included in the ROE. Examiners should organize and reference workpapers and document conclusions and supporting information within internal agency systems, as appropriate.

Examiners should determine and document what supervisory response, if any, is recommended. The BSA/AML examination findings may include violations of laws or

[22] ROE may include other formal supervisory correspondence, such as Supervisory Letters.

regulations or other deficiencies. Any substantive deficiencies in the BSA/AML compliance program, including violations, should be included in the ROE in such a manner that allows the reader to understand the cause of the deficiencies. The extent to which violations and other deficiencies affect the examiner's evaluation of the adequacy of the bank's BSA/AML compliance program and the bank's compliance with BSA regulatory requirements is based on the nature, duration, and severity of the problem. In some cases, the appropriate supervisory response is for the bank to correct the violations or other deficiencies as part of the normal supervisory process. These remediation efforts should be documented in the ROE. In appropriate circumstances, however, an agency may take either informal or formal enforcement actions to address violations of BSA regulatory requirements.[23]

Violations or deficiencies can be caused by a number of issues including, but not limited to, the following:

- Management has not appropriately assessed the bank's ML/TF and other illicit financial activity risks.
- Management has not created or enhanced policies, procedures, and processes.
- Management or employees disregard, are unaware of, or misunderstand regulatory requirements or internal policies, procedures, or processes.
- Management has not adjusted the BSA/AML compliance program commensurate with growth in higher-risk operations (products, services, customers, and geographic locations).
- Management has not provided sufficient staffing for the bank's risk profile.
- Management has not appropriately communicated changes in internal policies, procedures, and processes.

Systemic or Repeat Violations

Systemic or repeat violations involve either a substantive deficiency or a repeated failure to comply with BSA regulatory requirements, including the requirement to establish and maintain a reasonably designed BSA/AML compliance program. A substantive deficiency or repeated failure to comply with BSA regulatory requirements could negatively affect the bank's ability to manage ML/TF and other illicit financial activity risks. Systemic violations are the result of substantively deficient systems or processes that fail to obtain, analyze, or maintain required information, or to report customers, accounts, or transactions, as required under various provisions of the BSA. Repeat violations are repetitive occurrences of the same or similar issues.

When evaluating whether deficiencies constitute systemic or repeat violations, examiners must analyze the pertinent facts and the totality of circumstances, including whether the

[23] The "Interagency Statement on Enforcement of Bank Secrecy Act/Anti-Money Laundering Requirements" (refer to Appendix R) explains the basis for the federal banking agencies' enforcement of specific requirements of the BSA.

deficiencies are frequently recurring, regular, or usual, and whether the deficiencies are of the same or similar nature.

Considerations in determining whether a violation is systemic include, but are not limited to:

- Whether the number of violations is high when compared to the bank's total activity. This evaluation usually is determined through a sampling of transactions or records. Based on this process, determinations are made concerning the overall level of noncompliance. However, even if the violations are few in number, they could reflect systemic noncompliance, depending on the severity (e.g., significant or egregious).
- Whether there is evidence of similar violations by the bank in a series of transactions or in different divisions or departments. This is not an exact calculation and examiners should consider the number, significance, and frequency of violations identified throughout the organization. Violations identified within various divisions or departments may or may not indicate a systemic violation. These violations should be evaluated in a broader context to determine if training or other compliance system weaknesses are also present.
- The relationship of the violations to one another (e.g., whether the violations occurred in the same area of the bank, in the same product line, in the same branch or department, or with one employee).
- The impact the violation or violations have on the bank's suspicious activity monitoring and reporting capabilities.
- Whether the violations appear to be grounded in a written or unwritten policy or established procedure, or result from a lack of an established procedure (e.g., the bank's currency transaction reporting thresholds are inconsistent with BSA regulations).
- Whether there is a common source or cause of the violations.
- Whether the violations were the result of errors in software programming or implementation.

Systemic or repeat violations of the BSA or other deficiencies could have a negative impact on the adequacy of the bank's BSA/AML compliance program.[24] When systemic instances of noncompliance are identified, examiners should consider the noncompliance in the context of the overall program (internal controls, independent testing, designated individual or individuals, and training) and refer to *Appendix R – Interagency Statement on Enforcement of Bank Secrecy Act/Anti-Money Laundering Requirements* for more information regarding when a bank's BSA/AML compliance program may be deficient as a result of systemic noncompliance. All systemic violations and substantive deficiencies should be brought to

[24] The violations or deficiencies may also constitute unsafe or unsound banking practices. See 12 CFR Part 30 (OCC).

the attention of the bank's board of directors and senior management and documented in the ROE or other supervisory correspondence directed to the board of directors.

Types of systemic or repeat violations may include, but are not limited to:

- Failure to establish a due diligence program that includes a risk-based approach, and when necessary, enhanced policies, procedures, and controls concerning foreign correspondent accounts.
- Failure to maintain a reasonably designed due diligence program for private banking accounts for non-U.S. persons (as defined in 31 CFR 1010.620).
- Frequent, consistent, or recurring late currency transaction report (CTR) or suspicious activity report (SAR) filings.
- A significant number of CTRs or SARs with errors or omissions of data elements.
- Consistently failing to obtain or verify required customer identification information at account opening.
- Consistently failing to complete searches on 314(a) information requests.
- Failure to consistently maintain or retain records required by the BSA.

Also, the "Interagency Statement on Enforcement of Bank Secrecy Act/Anti-Money Laundering Requirements" provides that "[t]he Agencies will cite a violation of the SAR regulations, and will take appropriate supervisory actions, if the organization's failure to file a SAR (or SARs) evidences a systemic breakdown in its policies, procedures, or processes to identify and research potentially suspicious activity, involves a pattern or practice of noncompliance with the filing requirement, or represents a significant or egregious situation."[25]

Isolated or Technical Violations

Isolated or technical violations are limited instances of noncompliance with the BSA that occur within an otherwise adequate system of policies, procedures, and processes. These violations generally do not prompt serious regulatory concern or reflect negatively on management's supervision or commitment to BSA compliance, unless the isolated violation represents a significant or egregious situation or is accompanied by evidence of bad faith. Corrective action for isolated or technical violations is usually undertaken by the bank within the normal course of business.

Multiple isolated or technical violations throughout bank departments or divisions can indicate systemic or repeat violations. Examiners should consider multiple isolated or

[25] Appendix R – "Interagency Statement on Enforcement of Bank Secrecy Act/ Anti-Money Laundering Requirements."

technical violations in the context of all examination findings, oversight provided by the bank's board of directors and senior management, and the bank's risk profile.

Types of isolated or technical violations may include, but are not limited to:

- Failure to file or late filing of CTRs that is infrequent, not consistent, or nonrecurring.
- Failure to obtain complete customer identification information for a monetary instrument sales transaction that is isolated and infrequent.
- Infrequent, not consistent, or nonrecurring incomplete or inaccurate information in SAR data fields.
- Failure to obtain or verify required customer identification information that is infrequent, not consistent, or nonrecurring.
- Failure to complete a 314(a) information request that is inadvertent or nonrecurring.

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DEVELOPING CONCLUSIONS AND FINALIZING THE EXAM EXAMINATION PROCEDURES

Objective: *Formulate conclusions about the adequacy of the bank's BSA/AML compliance program, relative to its risk profile, and the bank's compliance with BSA regulatory requirements; develop an appropriate supervisory response; and communicate BSA/AML examination findings to the bank.*

1. Accumulate all pertinent findings from the BSA/AML examination and testing procedures performed.
2. Formulate conclusions about the adequacy of the bank's BSA/AML compliance program. Prepare written comments for the ROE covering areas or subjects pertinent to findings and conclusions. Prepare workpapers in sufficient detail to support discussions in the ROE. Reach a preliminary conclusion as to whether:
    - The bank understands its ML/TF and other illicit financial activity risks. This may be determined by reviewing the bank's risk assessment process, including whether the risk assessment provides a comprehensive analysis of the ML/TF and other illicit financial activity risks of the bank and is provided to all business lines across the bank, the board of directors, management, and appropriate staff.
    - The BSA/AML compliance program is written, approved by the board of directors, and noted in the board minutes.
    - BSA/AML policies, procedures, and processes are reasonably designed to assure and monitor compliance with the BSA and appropriately address higher-risk operations (products, services, customers, and geographic locations). The bank's practices correspond to the policies, procedures, and processes.
    - Internal controls are reasonably designed to manage the bank's ML/TF and other illicit financial activity risks and to assure compliance with the BSA, especially for higher-risk operations (products, services, customers, and geographic locations).
    - Independent testing (audit) is adequate to assess the bank's compliance with BSA regulatory requirements and assess the overall adequacy of the BSA/AML compliance program. The overall independent testing coverage and frequency are appropriate in relation to the ML/TF and other illicit financial activity risk profile of the bank, as well as any expansionary activity. Transaction testing performed is adequate, particularly for higher-risk banking operations and suspicious activity monitoring systems.
    - The designated individual or individuals responsible for coordinating and monitoring day-to-day compliance is competent, has properly executed policies and procedures, and has the appropriate authority, independence, and access to resources.
    - Personnel are sufficiently trained to follow legal, regulatory, and policy requirements.
    - The board of directors and senior management are aware of BSA/AML regulatory requirements, adequately oversee BSA/AML compliance, and commit, as necessary, to corrective actions that address independent testing or regulatory examination

findings and recommendations in a timely manner. The board of directors and senior management clearly communicate the need and support for BSA/AML risk management and internal controls throughout the organization.

- Communication of policies, procedures, and processes is adequate throughout the bank.
- The BSA/AML compliance program is reasonably designed to assure and monitor compliance with the BSA relative to the bank's overall ML/TF and other illicit financial activity risks.

3. Prepare written comments for the ROE documenting any deficiencies or violations identified. Prepare written comments for workpapers regarding any supervisory response that may be appropriate. The written comments should discuss the nature, duration, and severity of the deficiencies or violations and the necessary remediation by the bank. Note whether deficiencies or violations were previously identified by the bank or independent testing, or were only identified as a result of an examination.
4. Discuss preliminary findings with the examiner-in-charge or the examiner responsible for the BSA/AML examination. Specifically, discuss any findings that have been or will be discussed with the bank, such as:

- A conclusion regarding the adequacy of the bank's BSA/AML compliance program and the bank's compliance with BSA regulatory requirements.
- Any identified deficiencies or violations, and an assessment of the severity of the issues.
- Actions needed by the bank to correct violations or deficiencies.
- Preliminary recommendations for a supervisory response, if necessary.
  - If the agency may need to take either an informal or formal enforcement action to address violations of BSA regulatory requirements, examiners should discuss this fact with appropriate agency supervision management and legal staff.

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FFIEC Information Technology Examination Handbook

Information Security

SEPTEMBER 2016

Contents

Introduction

This “Information Security” booklet is an integral part of the *Federal Financial Institutions Examination Council* (*FFIEC)*[1] *Information Technology Examination Handbook (IT Handbook)* and should be read in conjunction with the other booklets in the *IT Handbook*. This booklet provides guidance to examiners and addresses factors necessary to assess the level of security risks to a financial institution’s[2] information systems.[3] It also helps examiners evaluate the adequacy of the information security program’s integration into overall risk management.[4]

Information security is the process by which a financial institution protects the creation, collection, storage, use, transmission, and disposal of sensitive information, including the protection of hardware and infrastructure used to store and transmit such information. Information security promotes the commonly accepted objectives of confidentiality, integrity, and availability of information and is essential to the overall safety and soundness of an institution. Information security exists to provide protection from malicious and non-malicious actions that increase the risk of adverse effects on earnings, capital, or enterprise value. The potential adverse effects can arise from the following:

- Disclosure of information to unauthorized individuals.
- Unavailability or degradation of services.
- Misappropriation or theft of information or services.
- Modification or destruction of systems or information.
- Records that are not timely, accurate, complete, or consistent.

[1] The FFIEC was established on March 10, 1979, pursuant to Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, Public Law 95-630. The FFIEC is composed of the principals of the following: the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), the State Liaison Committee (SLC), and the Consumer Financial Protection Bureau (CFPB).

[2] The term “financial institution” includes national banks, federal savings associations, state savings associations, state member banks, state nonmember banks, and credit unions. The term is used interchangeably with “institution” in this booklet.

[3] Examiners should also use this booklet to evaluate the performance by third-party service providers, including technology service providers, of services on behalf of financial institutions.

[4] This booklet addresses regulatory expectations regarding the security of all information systems and information maintained by or on behalf of a financial institution, including a financial institution’s own information and that of all of its customers. An institution’s overall information security program must also address the specific information security requirements applicable to “customer information” set forth in the “Interagency Guidelines Establishing Information Security Standards” implementing section 501(b) of the Gramm–Leach–Bliley Act and section 216 of the Fair and Accurate Credit Transactions Act of 2003. See 12 CFR 30, appendix B (OCC); 12 CFR 208, appendix D-2 and 225, appendix F (FRB); 12 CFR 364, appendix B (FDIC); and 12 CFR 748, appendix A (NCUA) (collectively referenced in this booklet as the “Information Security Standards”).

Institutions should maintain effective information security programs commensurate with their operational complexities.[5] Information security programs should have strong board and senior management support, promote integration of security activities and controls throughout the institution's business processes, and establish clear accountability for carrying out security responsibilities. In addition, because of the frequency and severity of cyber attacks, the institution should place an increasing focus on cybersecurity controls, a key component of information security.

Institutions should also assess and refine their controls on an ongoing basis. The condition of a financial institution's controls, however, is just one indicator of its overall security posture. Other indicators include the ability of the institution's board and management to continually review the institution's security posture and react appropriately in the face of rapidly changing threats, technologies, and business conditions. Information security is far more effective when management does the following:

- Integrates processes, people, and technology to maintain a risk profile that is in accordance with the board's risk appetite.[6]
- Aligns the information security program with the enterprise risk management program and identifies, measures, mitigates, and monitors risk.

Because risk mitigation frequently depends on institution-specific factors, this booklet describes processes and controls that an institution can use to protect information and supporting systems from various threats. Management should be able to identify and characterize the threats, assess the risks, make decisions regarding the implementation of appropriate controls, and provide appropriate monitoring and reporting.

Financial institutions may outsource some or all of their IT-related functions. Although the use of outsourcing may change the location of certain activities from financial institutions to third-party service providers, outsourcing does not change the regulatory expectations for an effective information security program. Examiners should use this booklet when evaluating a financial institution's risk management process, including the duties, obligations, and responsibilities of the third-party service provider regarding information security and the oversight exercised by the financial institution.

[5] See also Information Security Standards, section II.A, requiring each financial institution to have a comprehensive written information security program, appropriate to its size and complexity, designed to (1) ensure the security and confidentiality of "customer information"; (2) protect against any anticipated threats or hazards to the security or integrity of such information; (3) protect against unauthorized access to or use of such information that could result in a substantial harm or inconvenience to any customer; and (4) ensure the proper disposal of both "customer information" and any "consumer information."

[6] Risk appetite can be defined as the amount of risk a financial institution is prepared to accept when trying to achieve its objectives.

I Governance of the Information Security Program

Action Summary

Management should promote effective IT governance by doing the following:

- Establishing an information security culture that promotes an effective information security program and the role of all employees in protecting the institution's information and systems.
- Clearly defining and communicating information security responsibilities and accountability throughout the institution.
- Providing adequate resources to effectively support the information security program.

While IT governance is generally addressed in the *IT Handbook's* "Management" booklet, this booklet addresses specific governance topics related to information security, including the following:

- Implementation and promotion of security culture.
- Assignment of responsibilities and accountability.
- Effective funding and use of resources.

I.A Security Culture

An institution's security culture contributes to the effectiveness of the information security program. The information security program is more effective when security processes are deeply embedded in the institution's culture.

The board and management should understand and support information security and provide appropriate resources for developing, implementing, and maintaining the information security program. The result of this understanding and support is a program in which management and employees are committed to integrating the program into the institution's lines of business, support functions, and third-party management program.

The introduction of new business initiatives (such as new service offerings or applications) can reveal the maturity of and degree to which information security is part of the institution's culture. An institution with a stronger security culture generally integrates information security into new initiatives from the outset and throughout the life cycles of services and applications. Another indicator of an effective culture is whether management and employees are held accountable for complying with the institution's information security program.

I.B Responsibility and Accountability

The board, or designated board committee, should be responsible for overseeing the development, implementation, and maintenance of the institution's information security program and holding senior management accountable for its actions. The board should reasonably understand the business case for information security and the business implications of information security risks; provide management with direction; approve information security plans, policies, and programs; review assessments of the information security program's effectiveness; and, when appropriate, discuss management's recommendations for corrective action. The board should provide management with its expectations and requirements and hold management accountable for central oversight and coordination, assignment of responsibility, and effectiveness of the information security program.

The board, or designated board committee, should approve the institution's written information security program; affirm responsibilities for the development, implementation, and maintenance of the program; and review a report on the overall status of the program at least annually.[7]

Management should provide a report to the board at least annually[8] that describes the overall status of the program and material matters related to the program, including the following:

- Risk assessment process, including threat identification and assessment.
- Risk management and control decisions, including risk acceptance and avoidance.
- Third-party service provider arrangements.
- Results of testing.
- Security breaches or violations of law or regulation and management's responses to such incidents.
- Recommendations for updates to the information security program.

When providing reports on information security, management should include the results of management assessments and reviews; internal and external audit activity related to information security; third-party reviews of the information security program and information security measures; and other internal or external reviews designed to assess the adequacy of the information security program, processes, policies, and controls.

Management also should do the following:

- Implement the board-approved information security program.
- Establish appropriate policies, standards, and procedures to support the information security program.
- Participate in assessing the effect of security threats or incidents on the institution and its lines of business and processes.
- Delineate clear lines of responsibility and communicate accountability for information security.

[7] See also Information Security Standards, section III.A, requiring the board of directors or an appropriate committee of the board of each financial institution to approve the institution's written information security program, and oversee the development, implementation, and maintenance of the program, including assigning specific responsibility for its implementation and reviewing management reports.

[8] See also Information Security Standards, section III.F, requiring each financial institution to report to its board or an appropriate committee of the board at least annually. The report should include a description of the institution's compliance with the Information Security Standards and discuss material matters related to its information security program.

- Adhere to board-approved risk thresholds relating to information security threats or incidents, including those relating to cybersecurity.
- Oversee risk mitigation activities that support the information security program.
- Implement a risk acceptance process that identifies the risk and when, how, to what extent, and who in management has accepted the risk associated with identified vulnerabilities.
- Establish segregation of duties.
- Coordinate information and physical security.
- Integrate security controls throughout the institution.
- Require that data with similar criticality and sensitivity be protected consistently throughout the institution.
- Establish and monitor the information security responsibilities of third parties, as further described in the "Oversight of Third-Party Service Providers" section of this booklet.
- Maintain job descriptions or employment contracts that include specific information security responsibilities.
- Provide information security and awareness training and ongoing security-related communications to employees, and ensure employees complete such training annually.

Management should designate at least one information security officer responsible and accountable for implementing and monitoring the information security program. Information security management responsibilities may be distributed across various lines of business depending on where the risk decisions are made and the institution's size, complexity, culture, nature of operations, or other factors.

Information security officers should report directly to the board or senior management and have sufficient authority, stature within the organization, knowledge, background, training, and independence to perform their assigned tasks. To ensure appropriate segregation of duties, the information security officers should be independent of the IT operations staff and should not report to IT operations management. Information security officers should be responsible for responding to security events by ordering emergency actions to protect the institution and its customers from imminent loss of information; managing the negative effects on the confidentiality, integrity, availability, or value of information; and minimizing the disruption or degradation of critical services.

Internal auditors should implement a risk-based audit program to ensure management maintains and the board oversees an effective information security program. Additionally, management should issue appropriate reports to the board. Refer to the *IT Handbook's* "Audit" booklet.

I.C Resources

Funding, along with technical and managerial talent, also contributes to the effectiveness of the information security program. Management should provide, and the board should oversee, adequate funding to develop, implement, and maintain a successful information security program. The program should be staffed by sufficient personnel who have skills that are aligned with the institution's technical and managerial needs and commensurate with its size, complexity, and risk profile. Knowledge of technology standards, practices, and risk methodologies is particularly important to the success of the information security program.

When third-party service providers supplement an institution’s technical and managerial capabilities, management oversight should be commensurate with the sensitivity and criticality of the information and business processes supported by the third-party service provider. Refer to the *IT Handbook’s* “Outsourcing Technology Services” booklet for more information.

II Information Security Program Management

Action Summary

Management should develop and implement an information security program that does the following:

- Supports the institution’s IT risk management (ITRM) process by identifying threats, measuring risk, defining information security requirements, and implementing controls.
- Integrates with lines of business and support functions in which risk decisions are made.
- Integrates third-party service provider activities with the information security program.

The institution should have a robust and effective information security program that supports the institution’s ITRM process.[9] An effective information security program includes the following:

- Risk identification
- Risk measurement
- Risk mitigation
- Risk monitoring and reporting

Refer to the *IT Handbook’s* “Management” booklet for more information. A comprehensive information security program should incorporate cybersecurity elements, and management should identify, measure, mitigate, monitor, and report cybersecurity-related risks in accordance with the information security program and the ITRM process. In addition, to determine the overall effectiveness of the information security program, management should have comprehensive assurance and testing processes.

Management should integrate the information security program with the institution’s lines of business and support functions. An integrated program provides management the ability to assess the likelihood and potential damage to the institution from an incident, identify the root cause(s) of the incident, and implement controls to address identified issues.

Institutions that outsource technology, line of business activities, and support functions should ensure integration of these activities with the information security program through an effective

[9] See also Information Security Standards, section III.B, requiring each financial institution to assess risk including through the identification of reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of “customer information” or “customer information systems,” and section III.C, requiring each financial institution to manage and control its risks by (1) designing an information security program to control risks it identifies commensurate with the sensitivity of the information and the complexity and scope of the institution’s activities, and (2) adopting an enumerated list of controls, as appropriate.

third-party service provider management program.[10] Effective integration of these programs is evident when the institution creates and enforces expectations that align with the internal information security program in such a way that the combined activities of the institution and its third-party service providers result in an acceptable level of risk. Refer to the *IT Handbook's* "Outsourcing Technology Services" booklet for more information.

II.A Risk Identification

Action Summary

Management should develop and implement a process to identify risk.

Risk is the potential that events, expected or unanticipated, may adversely affect the institution's earnings, capital, or reputation. Risk is considered in terms of categories, one of which is operational risk. Operational risk is the risk of failure or loss resulting from inadequate or failed processes, people, or systems. Internal and external events can affect operational risk. Internal events include human errors, misconduct, and insider attacks. External events affecting IT and the institution's ability to meet its operating objectives include natural disasters, cyber attacks, changes in market conditions, new competitors, new technologies, litigation, and new laws or regulations. These events pose risks and opportunities, and the institution should factor them into the risk identification process.

To be effective, an information security program should have documented processes to identify threats and vulnerabilities continuously. Risk identification should produce groupings of threats, including significant cybersecurity threats. A taxonomy[11] for categorizing threats, sources, and vulnerabilities can help support the risk identification process. Management should perform these risk identification activities to determine the institution's information security risk profile, including cybersecurity risk.

[10] See also Information Security Standards, section III.D, requiring each financial institution to oversee service provider arrangements by (1) exercising appropriate due diligence in selecting its service providers; (2) requiring its service providers by contract to implement appropriate measures designed to ensure the security and confidentiality of the institution's "customer information"; and (3) where indicated by the institution's risk assessment, monitoring its service providers to confirm that the service providers have satisfied their contractual obligations, including by reviewing audits, summaries of test results, or other equivalent evaluations of its service providers.

[11] A taxonomy is a method for classifying items into ordered categories. Institutions use taxonomies to find relevant information from a large collection of data and to better detect or understand the patterns and trends.

II.A.1 Threats

According to the National Institute of Standards and Technology (NIST), a threat is any circumstance or event with the potential to create loss.[12] A threat can be a natural occurrence, technology or physical failure, a person with intent to harm, or a person who unintentionally causes harm. Information about threats is available from public and private sources. Public sources include the news media, blogs, government publications and announcements, and various websites. Private sources include information security vendors and information-sharing organizations.

The threat identification process is a means to collect data on potential threats that can assist management in its identification of information security risks. Threat modeling is a structured approach that enables an institution to aggregate and quantify potential threats. Institutions should consider using threat modeling to better understand the nature, frequency, and sophistication of threats; evaluate the information security risks to the institution; and apply this knowledge to the institution's information security program. As threats evolve rapidly, however, it is understood that modeling may not account for attacks that have not previously been seen, such as zero-day attacks, but could have significant impacts.

II.A.2 Vulnerabilities

A vulnerability is a weakness in an information system, system security procedure, internal control, or implementation that could be exploited by a threat source.[13] A technical vulnerability can be a flaw in hardware, firmware, or software that leaves an information system open to potential exploitation. These flaws provide opportunities for hackers to gain access to a computer system, execute commands as another user, or access data contrary to specified access restrictions. Institutions can use automated vulnerability scanners to scan their computer systems for known security exposures, as well as services available from third parties, such as the Mitre Corporation's Common Vulnerability and Exposures (CVE),[14] to track vulnerabilities.

In addition to technology-based vulnerabilities, weaknesses in business operational processes can create security vulnerabilities, exposing financial institutions to unwarranted risk. These vulnerabilities can include weaknesses in security procedures, administrative controls, physical layout, or internal controls that could be exploited to gain unauthorized access to information or to disrupt critical services. For example, an institution's systems architecture may be designed based on management's assumption that manual validation of wire transfers takes place before execution, when in practice the business process does not perform that validation until after transfers have taken place.

[12] NIST SP (Special Publication) 800-30, revision 1, "Information Security: Guide for Conducting Risk Assessments," September 2012.

[13] Ibid.

[14] CVE is a dictionary of publicly known information security vulnerabilities and exposures. The Mitre Corporation maintains the system. CVE is sponsored by the U.S. Computer Emergency Readiness Team in the Office of Cybersecurity and Communications at the U.S. Department of Homeland Security.

In addition to the vulnerabilities within a financial institution's system, vulnerabilities may also arise from interdependent and interconnected systems. Financial institutions connect their systems through mergers and acquisitions and through relationships with third parties. Over time, as these systems become increasingly interdependent and complex, new vulnerabilities may be introduced. Moreover, financial institutions are dependent on a vast array of hardware and services that may result in vulnerabilities from their supply chains, including those found in hardware and software products.

Management should assess whether the institution has processes and procedures in place to identify and maintain a catalogue of relevant vulnerabilities, determine which pose a significant risk to the institution, and effectively mitigate and monitor the risks posed by those vulnerabilities. When management cannot or chooses not to mitigate a vulnerability, management should document the decision to accept the risk, the level of risk associated with the vulnerability, and the person accountable for accepting the risk. Refer to the "Security Operations" section of this booklet for more information.

II.A.3 Supervision of Cybersecurity Risk and Resources for Cybersecurity Preparedness

II.A.3(a) *Supervision of Cybersecurity Risk*

Cybersecurity is the process of protecting consumer and bank information by preventing, detecting, and responding to attacks. As part of cybersecurity, institutions should consider management of internal and external threats and vulnerabilities to protect information assets and the supporting infrastructure from technology-based attacks. In light of the increasing volume and sophistication of cybersecurity threats, examiners should focus on cybersecurity preparedness in assessing the effectiveness of an institution's overall information security program.

II.A.3(b) *Resources for Cybersecurity Preparedness*

The FFIEC members issued a voluntary Cybersecurity Assessment Tool[15] to help institution boards and management identify risks to their institutions and evaluate their institution's cybersecurity preparedness. In addition, there are other resources available to help management develop and evaluate information security and cyber resilience, such as the NIST Cybersecurity Framework, common approaches developed by the Mitre Corporation, and the U.S. Computer Emergency Readiness Team's (US-CERT)[16] National Cyber Awareness System. Institution management can select a single framework or use a combination of resources to help identify its risks and determine its cybersecurity preparedness. Regardless of the source, frameworks can help management identify a cybersecurity and resilience posture that is commensurate with the institution's risk and complexity.

[15] Refer to the Cybersecurity Assessment Tool on the FFIEC website.

[16] US-CERT, of the Department of Homeland Security, responds to major incidents, analyzes threats, and exchanges critical cybersecurity information with trusted partners around the world.

II.B Risk Measurement

Action Summary

Management should develop risk measurement processes that evaluate the inherent risk to the institution.

The risk measurement process should be used to understand the institution's inherent risk and determine the risk associated with different threats. Management should use its measurement of the risks to guide its recommendations for and use of mitigating controls.

Threat analysis tools assist in understanding and supporting the measurement of information security-related risks. Such tools can include event trees,[17] attack trees,[18] kill chains,[19] and other security-related schemata.[20] These tools help management deconstruct an event into stages, better understand the event, identify the most effective and efficient means of mitigating risk, and improve the information security program. Additionally, management could use a taxonomy for security-related events to help accomplish the following:

- Map threats and vulnerabilities.
- Incorporate legal and regulatory requirements.
- Improve consistency in risk measurement.
- Highlight potential areas for mitigation.
- Select proper controls to cover various attack stages, channels, and assets.
- Allow comparisons among different threats, events, and potential mitigating controls.

Refer to the *IT Handbook's* "Management" booklet for more information.

[17] An event tree is a diagram of a chronological series of events in a system or activity that displays sequence progression, end states, and dependencies across time.

[18] An attack tree is a diagram showing how an asset, or target, might be attacked through various attack scenarios. Using an attack tree helps describe threats on computer systems and possible attacks to realize those threats.

[19] A kill chain originally was used as a military concept related to the structure of an attack. In information security, a kill chain is a method for modeling intrusions on a computer network.

[20] Security-related schemata are lists of software vulnerabilities and include the Mitre Corporation's Common Attack Pattern Enumeration and Classification, CVE, Common Weakness Enumeration, "ATT&CK Matrix," and Malware Attribute Enumeration and Characterization, and Mandiant's Open Indicators of Compromise.

II.C Risk Mitigation

Action Summary

Management should develop and implement appropriate controls to mitigate identified risks.

Once management has identified and measured the risks, it should develop and implement an appropriate plan to mitigate those risks. This plan should include an understanding of the extent and quality of the current control environment. When conducting an evaluation of the strength of controls, or the ability to mitigate risk, the institution should consider the system of controls rather than any discrete control.

Management should also obtain, analyze, and respond to information from various sources (e.g., Financial Services Information Sharing and Analysis Center [FS-ISAC]) on cyber threats and vulnerabilities that may affect the institution. Management should incorporate available information on cyber events into the institution's information security program. Additionally, management should develop, maintain, and update a repository of cybersecurity threat and vulnerability information that may be used in conducting risk assessments and provide updates to senior management and the board on cyber risk trends.

II.C.1 Policies, Standards, and Procedures

Information security policies, standards, and procedures should define the institution's control environment through a governance structure and provide descriptions of required, expected, and prohibited activities. Policies, standards, and procedures guide decisions and activities of users, developers, administrators, and managers and inform those individuals of their information security responsibilities. Policies, standards, and procedures should also specify the mechanisms through which responsibilities can be met. In addition, they should provide guidance on acquiring, designing, implementing, configuring, operating, maintaining, and auditing information systems. Policies, standards, and procedures that address the information security program should describe the roles of the information security department, lines of business, and IT organization in administering the information security program. Information security policies, standards, and procedures form the means by which the objectives of the information security program are achieved. Key attributes that contribute to the success of information security policies, standards, and procedures include the following:

- Scope that describes the expectations for appropriate actions by affected parties.
- Sufficient details to guide behavior.
- Implementation through ordinary means, such as system administration procedures and acceptable use policies.
- Enforcement through security tools and restrictions.
- Delineation of the areas of responsibility for users, developers, administrators, and managers.
- Clear and easily understandable communications to all affected parties.
- Certification that employees have read and understand the policies.

- Flexibility to address changes in the environment.
- Annual board review and approval.

II.C.2 Technology Design

While technology can introduce risk, it can also serve as a mitigation tool. Management should understand the benefits and limitations of the technology that the institution uses and whether other types of controls are necessary to compensate for those limitations.

Information security issues arise when (a) the design of the technology and the policies governing its use do not effectively defend against identified and unidentified threats, (b) threats change in ways not envisioned by the designers, and (c) the controls are not operating as intended. Management should continually assess the capability of the institution's processes, people, and technologies to sustain the appropriate level of information security based on the institution's risk profile, size, complexity, and risk appetite.

II.C.3 Control Types

Management may mitigate information security risks by implementing controls. Controls may be categorized according to timing and nature.

Table 1: Examples of Timing- and Nature-Related Controls

Timing		
Control type	**Description**	**Example**
Preventive	Controls designed to prevent incidents from occurring	Access controls to applications and systems that prevent unauthorized individuals from performing transactions
Detective	Controls designed to alert management when incidents occur	Reports that show suspicious activity
Corrective	Controls that lessen impact to the institution when adverse incidents occur	Business continuity plans
Nature		
Control type	**Description**	**Example**
Administrative	Controls that align with the board-approved risk appetite and inform employees of management's expectations	Policies or procedures that guide implementation of the information security program
Technical	Software or hardware (or both) that prevents unauthorized activity	A firewall that prevents unauthorized logical access to or from a network
Physical	Devices to prevent unauthorized physical access to a facility or computer system	A deadbolt lock on a door

It is important to have a layered control system, which deploys different controls at different points of a business process and throughout an IT system so that the strength of one control can compensate for weaknesses in or possible failure of another control. Therefore, layered controls function in an integrated fashion to more effectively mitigate risk.

Economic and technical considerations generally affect prevention and detection or response choices in system design. Compensating controls are controls that adjust for weaknesses within the system or process. An example of compensating controls would be a review of activity logs for applications that do not allow proper segregation of duties.

II.C.4 Control Implementation

Management should implement controls that align security with the nature of the institution's operations and strategic direction. Based on the institution's risk assessment, the controls should include, but may not be limited to, patch management, asset and configuration management, vulnerability scanning and penetration testing, end-point security, resilience controls, logging and monitoring, and secure software development (including third-party software development). In implementing controls, management should ensure it has the necessary resources, personnel training, and testing to maximize the effectiveness of the controls.

The level at which controls are implemented should depend on the institution's size, complexity, and risk profile, but all institutions should implement appropriate controls. In light of increasing cybersecurity risks, management should implement risk-based controls for managing cybersecurity threats and vulnerabilities, such as interconnectivity risk. Management should review and update the security controls as necessary depending on changes to the internal and external operating environment, technologies, business processes, and other factors.

The institution can reference one or more recognized technology frameworks and industry standards. Several organizations have published control listings in addition to implementation guidance, including the following:

- **NIST 800 series of publications.** These publications provide descriptions of some management processes and technical guidance on many individual controls.
- **Control Objectives for Information and Related Technology (COBIT).** COBIT provides a broad and deep framework for governance and management of enterprise IT.
- **IT Infrastructure Library (ITIL).** ITIL provides a list of recognized practices for IT service management.
- **International Organization for Standardization (ISO)[21] 27000 series.** The ISO 27000 series provides control standards specific to information security.
- **Industry publications and sources.[22]** Management and staff may find these useful for discrete controls and processes.

[21] ISO is an independent, non-governmental, international organization that brings together experts to share knowledge and develop voluntary, consensus-based, market-relevant international standards.

[22] Some industry publications or organizations that provide security-related information include the ISACA Journal, SANS Institute, the Financial Services Roundtable, the Council on Cybersecurity, and the Open Web Application Security Project.

- **Vendor-provided publications, bulletin boards, and user groups.** Vendors often publish recommendations for securing their products. Additionally, some offer bulletin boards and user groups for clients to interact among themselves.

II.C.5 Inventory and Classification of Assets

Action Summary

Management should inventory and classify assets, including hardware, software, information, and connections.

Management should maintain and keep updated an inventory of technology assets that classifies the sensitivity and criticality of those assets, including hardware, software, information, and connections. Management should have policies to govern the inventory and classification of assets both at inception and throughout their life cycle, and wherever the assets are stored, transmitted, or processed. Inventories enable management and staff to identify assets and their functions. Classification enables the institution to determine the sensitivity and criticality of assets. Management should use this classification to implement controls required to safeguard the institution's physical and information assets. Additionally, management can use the inventory to discover specific vulnerabilities, such as unauthorized software.

Inventories are important for management to identify assets that require additional protection, such as those that store, transmit, or process sensitive customer information, trade secrets, or other information or assets that could be a target of cyber criminals. Knowing what information assets the institution has and where they are stored, transmitted, or processed helps management comply with federal and state laws and regulations regarding privacy and security of sensitive customer information.

After inventorying the assets, management should classify the information according to the appropriate level of protection needed. For example, systems containing sensitive customer information may require access controls based on job responsibilities. These systems should have stronger controls than systems containing information meant for the general public. Some institutions classify information as public, non-public, or institution-confidential, while others use the classifications high, moderate, and low. Additional classifications, such as critical and noncritical, may be helpful to certain types of institutions.

II.C.6 Mitigating Interconnectivity Risk

Business processes often require institutions to share information with other institutions and third-party service providers that require connectivity. The extent of interconnectivity is a function of network architecture, network complexity, traffic volume, and number of connections. Interconnectivity risk arises from misuse, mismanagement, or compromise of these connections.

To mitigate interconnectivity risk, management should do the following:

- Identify connections with third parties, including other financial institutions, financial institution intermediaries, and third-party service providers.
- Identify all access points and connection types that pose risk, such as local area network (LAN) connections to other networks or Internet service providers (ISP), Wi-Fi, and cellular connections.
- Identify connections between and access across low-risk and high-risk systems.
- Assess all connections with third parties that provide remote access capability or control over internal systems.
- Implement and assess the adequacy of controls to ensure the security of connections regardless of criticality or sensitivity.

Management should maintain network and connectivity diagrams and data flow charts to ensure adequacy of layered controls and to facilitate more timely recovery and restoration of systems when incidents occur.

II.C.7 User Security Controls

Action Summary

Management should mitigate the risks posed by users by doing the following:

- Establishing and administering security screening in IT hiring practices.
- Establishing and administering a user access program for physical and logical access.
- Employing segregation of duties.
- Obtaining agreements covering confidentiality, nondisclosure, and authorized use.
- Providing training to support awareness and policy compliance.

Users should be granted access to systems, applications, and databases based on their job responsibilities. Access rights should be granted in accordance with the institution's physical and logical access control policies. Authorized users with elevated or administrator privileges can pose a potential threat to systems and data. Employees, contractors, or third-party service providers can exploit their legitimate computer access for unauthorized purposes. Additionally, the degree of internal access granted to some users increases the risk of damage or loss of information and systems. Risk exposures from internal users include the following:

- Alteration of data.
- Deletion of production and backup data.
- Misdirected data.
- Disruption of systems.
- Destruction of systems.
- Misuse of systems for personal gain or to damage the institution.
- Appropriation of strategic or customer data for espionage or fraud schemes.
- Extortion for stolen data.
- Misuse of data following the termination or change in job responsibility of an employee.

Management should understand the risks to the institution’s information-processing environment and establish appropriate user access controls to mitigate these and other potential risks to the institution’s assets. Users should understand and confirm their understanding of their roles and responsibilities in maintaining a sound security environment, which includes both physical and logical areas.

II.C.7(a) *Security Screening in Hiring Practices*

Management should have a process to verify job application information for all new employees. The sensitivity of a particular job or access level may warrant additional screening and recurring background and credit checks. Management should verify that contractors are subject to similar screening procedures. In addition to initial screening, management should remain alert to changes in personal circumstances of employees and contractors that could increase incentives for system misuse or fraud.

II.C.7(b) *User Access Program*

Management should develop a user access program to implement and administer physical and logical access controls to safeguard the institution’s information assets and technology. This program should include the following elements:

- Principle of least privilege, which recommends minimum user profile privileges for both physical and logical access based on job necessity.
- Alignment of employee job descriptions to the user access program.
- Requirements for business and application owners to define user profiles.
- Ongoing reviews by business line and application owners to verify appropriate access based on job roles with changes reported on a timely basis to security administration personnel.
- Timely notification from human resources to security administrators to adjust user access based on job changes, including terminations.
- Periodic independent reviews that ensure effective administration of user access, both physical and logical.

For more information, refer to the “Physical Security” and “Logical Security” sections of this booklet.

II.C.7(c) *Segregation of Duties*

Segregation of duties, or job designs that require more than one person to complete critical or sensitive tasks, can help mitigate risk. Employees and third parties with access to sensitive resources could cause substantial damage and potential loss. System administrators, for instance, have the most powerful role in the user access process and have unlimited access to an institution’s information assets and technology. Given this extensive access, management should evaluate the process for determining which individuals should be granted system administrator privileges. Such access should be appropriately monitored for unauthorized or inappropriate activity. Management should incorporate independent reviews or approvals for individuals who perform multiple functions to minimize the potential for fraud, irregularities, and errors. Examples of segregation of duties include the following:

- Independent monitoring of the activities performed by the users with increased privileges (e.g., system administrators and super users[23]).
- Distribution of system administration activities so no administrator can hide his or her activities or control an entire system.
- Additional levels of approval as the criticality and sensitivity of decisions increase.

If an activity is conducted without appropriate segregation of duties, management should require an independent review (e.g., audit) of that activity.

II.C.7(d) *Confidentiality Agreements*

The institution should protect the confidentiality of customer and institution information. A breach in confidentiality could disclose proprietary information, increase fraud risk, damage the institution's reputation, violate customer privacy and associated rights, and violate laws or regulations. Confidentiality agreements can be used to put all parties on notice that the financial institution owns its information, expects strict confidentiality, and prohibits information sharing outside of that required for legitimate business needs. Management should obtain signed confidentiality agreements before granting employees and contractors access to IT systems.

II.C.7(e) *Training*

Training ensures personnel have the necessary knowledge and skills to perform their job functions.[24] Training should support security awareness and strengthen compliance with security and acceptable use policies. Ultimately, management's behavior and priorities heavily influence employee awareness and policy compliance, so training and the commitment to security should start with management. Management should educate users about their security roles and responsibilities and communicate them through acceptable use policies. Management should hold all employees, officers, and contractors accountable for complying with security and acceptable use policies and should ensure that the institution's information and other assets are protected. Management should have the ability to impose sanctions for noncompliance.

Training materials for most users focus on issues such as end-point security, log-in requirements, and password administration guidelines. Training programs should include scenarios capturing areas of significant and growing concern, such as phishing and social engineering attempts, loss of data through e-mail or removable media, or unintentional posting of confidential or proprietary information on social media. As the risk environment changes, so should the training. The institution should collect signed acknowledgments of the employee acceptable use policy as part of the annual training program.

[23] In computing, the super user is a special user account used for system administration. Depending on the operating system, the name of this account might be root, administrator, admin, or supervisor.

[24] See also Information Security Standards, section III.C.2, requiring each financial institution to train staff to implement its information security program.

II.C.8 Physical Security

Action Summary

Management should implement appropriate preventive, detective, and corrective controls for physical security.

Physical access and damage or destruction to physical components can impair the confidentiality, integrity, and availability of information. Management should implement appropriate preventive, detective, and corrective controls for mitigating the risks inherent to those physical security zones.

A data center houses an institution's most important information system components. When selecting a site for a data center, one major objective should be to limit the risk of exposure from internal and external threats, including, where possible, environmental threats inherent to physical locations (e.g., hurricanes, earthquakes, and blizzards). The selection process should include reviewing the surrounding area to determine whether it is relatively safe from exposure to fire, flood, explosion, or similar environmental hazards. Guards, fences, barriers, surveillance equipment, or other devices can deter intruders. Because access to key information systems' hardware and software should be limited, appropriate physical controls should be in place. Additionally, the location should not be identified or advertised by signage or other indicators.

Detection devices, when applicable, should be used to prevent theft and safeguard the equipment. The devices should provide continuous coverage. Detection devices have two purposes—to send alarms when responses are necessary and to support subsequent forensics. Alarms are useful only when response will occur. Some detection devices include the following:

- Switches that activate alarms when electrical circuits are broken.
- Light and laser beams, ultraviolet beams, sound, or vibration detectors that are invisible to intruders, and ultrasonic or radar devices that detect movement.
- Closed-circuit television (CCTV) that provides visual observation and records intrusions.

A combination of fire suppression, smoke alarms, raised flooring, and heat and moisture sensors should address risks from environmental threats (e.g., fire, flood, and excessive heat). Environmental threat monitoring should be continuous, and responses should occur when alarms activate.

Physical security devices frequently need preventive maintenance to function properly. The institution should be able to provide maintenance logs to demonstrate that physical security devices are regularly maintained. Periodic testing provides assurance that the devices are operating correctly.

The institution should have policies governing the duties and responsibilities of security guards. Employees who access secured areas should have proper identification and authorization to enter the areas. All non-employees should provide identification to a security guard before obtaining access. Security guards should be trained to restrict the removal of technology assets from the premises and to record the identity of anyone attempting to remove those assets. Management should implement a specific and formal authorization process for the removal of hardware and software from the premises.

Access should be restricted to the following equipment or areas:

- Operations centers (e.g., data center operations, security operations center, and network operations center) or server rooms; uninterruptible power supplies and backup generators.
- Funds transfer and automated clearinghouse routers.
- Telecommunications equipment.
- Media libraries.
- Equipment removed from the network and awaiting disposal.
- Spare or backup devices.

II.C.9 Network Controls

Action Summary

Management should secure access to computer networks through multiple layers of access controls by doing the following:

- Establishing zones (e.g., trusted and untrusted) according to the risk profile and criticality of assets contained within the zones and appropriate access requirements within and between each security zone.
- Maintaining accurate network diagrams and data flow charts.
- Implementing appropriate controls over wired and wireless networks.

Networks should be protected by a secure boundary, identifying “trusted” and “untrusted” zones. Internal zones, typically trusted, should segregate various components into distinct areas, each with the level of controls appropriate to the content and function of the assets within the zone. The institution’s trusted network should be protected through appropriate configuration and patch management, privileged access controls, segregation of duties, implementation of effective security policies, and use of perimeter devices and systems to prevent and detect unauthorized access. Tools used to enforce and detect perimeter protection include routers, firewalls, intrusion detection systems (IDS) and intrusion prevention systems, proxies, gateways, jump boxes,[25] demilitarized zones, virtual private networks (VPN), virtual LANs (VLAN), log monitoring and network traffic inspecting systems, data loss prevention (DLP) systems, and access control lists.

The trusted network should be further segregated into internal layers, including production, staging, and development environments. Within those environments, management should

[25] A jump box, or jump server, provides administrators with access to or control of other servers or devices in the network. Because of this capability, additional security measures should be implemented.

consider segregating sensitive traffic, by using Voice Over Internet Protocol[26] (VOIP) and network management (such as virtualization infrastructure that carries server boot images between storage devices and hosts). Each zone should have a security policy appropriate to its use, ensuring that zone restrictions are defined by risk, sensitivity of data, user roles, and appropriate access to application systems. Access to zones should be controlled according to the principle of least privilege and segregation of duties. To ensure appropriate network security, management should maintain accurate network and data flow diagrams, and store them securely, providing access only to essential personnel. These diagrams should identify hardware, software, and network components, internal and external connections, and types of information passed between systems to facilitate the development of a defense-in-depth security architecture.

II.C.9(a) *Wireless Network Considerations*

A wireless LAN (WLAN) is a medium of network connectivity, supported by radio wave transmissions that provides more convenient network access to employees or devices that need flexibility to connect to multiple locations within the institution’s facilities. Because the user is not physically connected to the network and the wireless signal is broadcast and available to others, wireless networks are inherently less secure than wired networks and require additional scrutiny, controls, and oversight. Wireless access points are the devices that broadcast the radio wave signals and should be physically secure to prevent compromise and securely configured to provide the same level of control as a wired connection. Wireless gateways can allow management to implement more complex access controls, including advanced identity management capabilities and services to detect and remediate malicious software.

Policies should prohibit installation of wireless access points and gateways without approval and formal inclusion in the hardware inventory. Network monitoring systems should be configured to detect the addition of new devices. Alternatively, network access control (NAC) systems could prevent the recognition of any unauthorized device.[27] Management should consider limiting the WLAN signal to authorized areas, within the boundaries of the institution, if feasible. Management should use an industry-accepted level of encryption with strength commensurate with the institution’s risk profile on the institution’s wireless networks.

Malicious insiders and attackers may also set up rogue or unauthorized wireless access points and trick employees into connecting. Such access points allow attackers to monitor employee activities. The institution should scan the network regularly to detect rogue access points and consider implementing NAC systems to prevent the successful connection of unauthorized devices.

[26] VOIP is the transmission of voice telephone conversations using the Internet or IP networks.

[27] A NAC system typically provides an IP address only after validating that the newly connected device is authorized, by means of some identification (such as a computer’s physical address—MAC address—or certificate) or pre-installed client software.

The institution may provide guests with access to a wired or wireless network. The guest network generally is used to provide access to the Internet and should be configured to prevent access to any portion of the production network.

Institutions often provide remote network connectivity for employees or third-party service providers[28] who are not located within or around the institution's facilities. This connectivity presents operational advantages, but steps should be taken to ensure that the connection is encrypted and secured. VPN connections should be used for both broadband networks and wireless air card connections to isolate and encrypt remote traffic to institution networks. IP geolocation information may not always be available when using broadband networks, which can limit the effectiveness of monitoring. Therefore, management should consider implementing compensating controls, such as restricting access to network resources.

II.C.10 Change Management Within the IT Environment

Action Summary

Management should have a process to introduce changes to the environment in a controlled manner. Changes to the IT environment include the following:

- Configuration management of IT systems and applications.
- Hardening of systems and applications.
- Use of standard builds.
- Patch management.

The IT environment consists of operating systems,[29] middleware,[30] applications, file systems, and communications protocols. The institution should have an effective process to introduce application and system changes, including hardware, software, and network devices, into the IT environment. The process for introducing software should encompass securely developing, implementing, and testing changes to both internally developed and acquired software.

Application and system control considerations for introducing changes to the IT environment before implementation should include the following:

- Developing procedures to guide the process of introducing changes to the environment.
- Clearly defining requirements for changes.
- Restricting changes to authorized users.

[28] In some cases, the institution provides remote access via VPN to a third-party service provider. Controls over third-party access should be commensurate with the sensitivity and criticality of the system and information accessed.

[29] An operating system is fundamental software that supports and manages software applications, allocates system resources, provides access and security controls, maintains file systems, and manages communications between end users and hardware devices.

[30] Middleware is software that connects two or more software components or applications.

- Reviewing the impact that changes have on security controls.
- Identifying all system components affected by the changes.
- Developing test scripts and implementation plans.
- Performing necessary tests of all changes to the environment (e.g., systems testing, integration testing, functional testing, user acceptance testing, and security testing).
- Defining rollback procedures in the event of unintended or negative consequences with the introduced changes.
- Ensuring the application or system owner has authorized changes in advance.
- Maintaining strict version control of all software updates.
- Validating that new hardware complies with institution policies.
- Ensuring network devices are properly configured and function appropriately within the environment.
- Maintaining an audit trail of all changes.

Refer to the *IT Handbook's* "Development and Acquisition" booklet for more information.

II.C.10(a) *Configuration Management*

Configuration management is a process to securely maintain the institution's technology by developing expected baselines for tracking, controlling, and managing systems settings. To mitigate information security risk, management should control configurations of systems, applications, and other technology. Effective configuration management relies on policies and procedures to ensure compliance with minimally acceptable system configuration requirements. When information systems change, management should update baselines; confirm security settings; and track, verify, and report configuration items. Configurations should be monitored for unauthorized changes, and misconfigurations should be identified. Management can use automated solutions to help track, manage, and identify necessary corrections.

II.C.10(b) *Hardening*

Institutions typically use commercial off-the-shelf (COTS) software for operating systems and applications, on such diverse platforms as network infrastructure, servers, desktops, laptops, and mobile devices. COTS systems generally provide more functions than are required for the specific purposes for which they are employed. A default installation of a server operating system may include mail, web, and file-sharing services on a system that does not require those functions. Unnecessary software and services represent a potential security weakness. Their presence increases the potential number of discovered and undiscovered vulnerabilities in the system. Additionally, system administrators may not install patches or monitor the unused software and services to the same degree as they would operational software and services. Protection against those risks begins when the systems are constructed and software installed through a process that is referred to as hardening a system.

Management should consult operating system and software vendor-recommended security controls. When deploying COTS applications and systems, management should harden the resulting applications and systems. Hardening can include the following actions:

- Determining the purpose of the applications and systems and documenting minimum software and hardware requirements and services to be included.
- Installing the minimum hardware, software, and services necessary to meet the requirements using a documented installation procedure.
- Installing necessary patches.
- Installing the most secure and up-to-date versions of applications.
- Configuring privilege and access controls by first denying all, then granting back the minimum necessary to each user (i.e., enforcing the principle of least privilege).
- Configuring security settings as appropriate, enabling allowed activity, and prohibiting non-approved activities.
- Enabling logging.
- Creating cryptographic hashes[31] of key files.
- Archiving the configuration and checksums[32] in secure storage before system deployment.
- Using secure replication procedures for additional, identically configured systems and making configuration changes on a case-by-case basis.
- Changing all default passwords.
- Testing the system to ensure a secure configuration.

Additionally, the systems should be audited periodically to ensure that the hardware, software, and services are authorized and properly configured.

II.C.10(c) *Standard Builds*

Consistency in system configuration makes security easier to implement and maintain. The institution should use standard builds, which allow one documented configuration to be applied to multiple computers in a controlled manner. Some institutions, depending on their size and complexity, may have many standard builds for the different system configurations needed to address various business functions. Through standard builds, an institution simplifies the following activities:

- Creating hardware and software inventories.
- Updating and patching systems.
- Restoring systems in the event of a disaster or outage.
- Investigating anomalous activity.
- Auditing configurations for conformance with the approved configuration.

The institution may not be able to meet all of its requirements from its standard builds. The use of nonstandard builds should be documented and approved by management, with appropriate changes made to patch management and disaster recovery plans.

[31] A hash is a fixed-length cryptographic output of variables, such as a message, being operated on by a formula or cryptographic algorithm.

[32] A checksum is a simple error-detection scheme in which each transmitted message is accompanied by a numerical value based on the number of set bits in the message, which allows the receiver to verify the accuracy of the message.

II.C.10(d) *Patch Management*

Frequently, security vulnerabilities are discovered in operating systems and other software after deployment. Hackers often will attempt to exploit these known vulnerabilities to try to gain access to the institution's systems. Third parties issue patches to address vulnerabilities found on institution systems and applications.[33] Management should implement automated patch management systems and software to ensure all network components (virtual machines, routers, switches, mobile devices, firewalls, etc.) are appropriately updated. In addition, management should use vulnerability scanners periodically to identify vulnerabilities in a timely manner.

As part of the institution's patch management process, management should establish and implement the following:

- A monitoring process that identifies the availability of software patches.
- A process to evaluate the patches against the threat and network environment.
- A prioritization process to determine which patches to apply across classes of computers and applications.
- A process for obtaining, testing, and securely installing patches, including in the institution's virtual environments.
- An exception process, with appropriate documentation, for patches that management decides to delay or not apply.
- A process to ensure that all patches installed in the production environment are also installed in the disaster recovery environment in a timely manner.
- A documentation process to ensure the institution's information assets and technology inventory and disaster recovery plans are updated as appropriate when patches are applied.

The institution should have procedures that include how to implement patches to mitigate risks of changing systems and address systems with unique configurations. Before applying a patch, management should back up the production system. Additionally, management should define appropriate patch windows and, whenever possible, restrict the implementation of patches to defined time frames to minimize business impact or potential down time.

Patches make direct changes to the software and configuration of each system to which they are applied. While patches are necessary and useful, they may have unintended negative consequences, such as introducing new vulnerabilities, reintroducing old vulnerabilities, or degrading system performance. The following actions can help ensure patches do not compromise the security of the institution's systems:

- Obtain the patch from a known, trusted source.
- Verify the integrity of the patch through comparisons of cryptographic hashes to ensure the patch obtained is correct and unaltered.
- Protect and monitor the systems used to distribute patches to ensure only authorized patches are distributed.

[33] If an institution develops or maintains software in-house, management should have a process to update the software with appropriate patches.

- Apply the patch to an isolated test system before installing on the production system to ensure the patch is compatible with other software used on systems, does not alter the system's security posture in unexpected ways (such as altering log settings), and corrects the pertinent vulnerability.
- Test the resulting system to validate the effectiveness of the applied patch.

II.C.11 End-of-Life Management

Management should plan for a system's life cycle, eventual end of life, and any corresponding security and business impacts. The institution's strategy should incorporate planned changes to systems, including an evaluation of the current environment to identify potential vulnerabilities, upgrade opportunities, or new defense layers. Also included in this strategy should be considerations for the support provided by third-party system vendors and the risks related to operating unsupported legacy systems. Management should have policies to manage both the hardware and software life cycles. Security risks related to reaching a system's end of life include (a) the increased potential for vulnerabilities because the third party no longer provides patches or support, (b) incompatibility with other systems in the institution's environment, and (c) limitations in security features in older or obsolete systems.

Effective end-of-life management should include the following:

- Maintaining inventories of systems and applications.
- Adhering to an approved end-of-life or sunset policy for older systems.
- Tracking changes made to the systems and applications, availability of updates, and the planned end of support by the vendor.
- Conducting risk assessments on systems and applications to help determine end-of-life.
- Planning for the replacement of systems nearing obsolescence and complying with policy requirements for implementing new systems or applications.
- Developing specific procedures for the secure destruction or data wiping of hard drives returned to vendors or donated, to prevent the inadvertent disclosure of sensitive information.

If an end-of-life system or application must remain in use, management should ensure appropriate mitigating controls are in place, which may include segregating the system or application from the network. Management should also have a plan to replace the system or application and implement compensating controls until replacement. Strategies for replacing and updating hardware and software should incorporate and align with overall information security and business strategies as appropriate.

II.C.12 Malware Mitigation

Attackers use malware to obtain access to an institution's environment and to execute an attack within the environment. Malware may enter through public or private networks and from devices attached to the network. Although protective mechanisms may block most malware before it does damage, even a single malicious executable[34] may create a significant potential for loss.

Management should implement defense-in-depth to protect, detect, and respond to malware. The institution can use many tools to block malware before it enters the environment and to detect it and respond if it is not blocked. Methods or systems that management should consider include the following:

- Hardware-based roots of trust, which use cryptographic means to verify the integrity of software.
- Servers that run active content at the gateway and disallow content based on policy.
- Blacklists that disallow code execution based on code fragments, Internet locations, and other factors that correlate with malicious code.
- White lists of allowed programs.
- Port monitoring to identify unauthorized network connections.
- Network segregation.
- Computer configuration to permit the least amount of privileges necessary to perform the user's job.
- Application sandboxing[35] to limit the access and functionality of executed code.
- Monitoring for unauthorized software and disallowing the ability to install unauthorized software.
- Monitoring for anomalous activity for malware and polymorphic code.
- Monitoring of network traffic.
- User education in awareness, safe computing practices, indicators of malicious code, and response actions.

II.C.13 Control of Information

Action Summary

Management should control and protect access to and transmission of information to avoid loss or damage and do the following:

- Establish and supervise compliance with policies for storing and handling information, including storing data on mobile devices and cloud services.
- Define and implement appropriate controls over the electronic transmission of information.
- Facilitate safe and secure disposal of sensitive information.
- Secure physical media in transit.

[34] In computing, an executable is a file or a program that is able to be run by a computer.

[35] Sandboxing is the use of a restricted, controlled execution environment that prevents potentially malicious software, such as mobile code, from accessing any system resources except those for which the software is authorized.

II.C.13(a) *Storage*

Management should implement policies to govern the secure storage of all types of sensitive information, whether on computer systems, on physical media, or in hard-copy documents. Management can achieve secure storage with physical controls,[36] logical controls (e.g., passwords, tokens, and biometrics), and environmental controls (e.g., fire and flood protection). In addition, stored information, in any form, should be classified and inventoried so that it can be retrieved when needed. Inventories should be updated periodically to remain current.

More sensitive information, such as system documentation, application source code, and production transaction data, should have more extensive controls to guard against alteration (e.g., integrity checkers and cryptographic hashes). Management should have appropriate logging and monitoring controls over stored information to ensure authorized access and appropriate use. Periodically, the security staff, audit staff, and data owners should review access rights to ensure the access rights remain appropriate and current.

Data storage in portable devices, such as laptops, smart phones, and tablets, poses unique problems. These devices may be lost, stolen, or subject to unauthorized and undetected use. Risk mitigation typically involves data encryption, host-provided access controls, homing beacons,[37] and remote deletion[38] capabilities. Management should implement appropriate controls (such as the use of a DLP program) over portable devices and the sensitive information contained on them.

Many institutions create or use a third-party cloud for storage. Cloud storage[39] provides unique issues and challenges. Management should understand the nature of the cloud technology being used; the physical location(s) where the data are stored and related legal jurisdiction; the access controls used and protection of the institution’s data (e.g., how access is controlled and how that information is retrieved); and the frequency and method of backup used by the cloud provider. Management should verify that the cloud provider offers the capability for the institution to monitor its system activity, significant security incidents, performance and uptime, and success and failure of backups.

II.C.13(b) *Electronic Transmission of Information*

Electronic transmission of information can include e-mail, file transfer protocol (FTP), secure FTP (sFTP), secure shell, dedicated line, short message service/texting, and transmission via the Internet. Management should determine the type of transmission method, sensitivity of the

[36] Refer to the “Physical Security” section of this booklet.

[37] Homing beacons send messages to the institution when they connect to a network and enable recovery of the device.

[38] Remote deletion is a technology that enables the institution to remotely delete certain data from a portable device.

[39] Cloud storage is a model of data storage in which the digital data are stored in logical pools, the physical storage spans multiple servers (and often locations), and the physical environment is typically owned and managed by a hosting company.

information to be transmitted, and types of safeguards available to protect information. Management should implement appropriate controls or, if they are not available, restrict the type of information that can be transmitted. When transmitting sensitive information over a public network, information should be encrypted to protect it from interception or eavesdropping. Techniques include secure e-mail protocols, sFTP, and secure sockets layer (SSL) certificates.

II.C.13(c) *Disposal of Information*

The institution should have appropriate disposal procedures for paper-based and electronic information.[40] Designating a single individual, department, or function to be responsible for disposal facilitates accountability and promotes compliance with disposal policies.

Policies should prohibit employees from discarding paper-based information containing sensitive information by using the same disposal system as regular garbage to avoid accidental disclosure. Many institutions shred paper-based media on-site while others use collection and disposal services to ensure the media are rendered unreadable and unlikely to be reconstructed. Institutions that contract with third-party service providers should conduct due diligence to ensure those third parties conduct adequate employee background checks and employ appropriate controls. Contracts with third-party disposal firms should address acceptable disposal procedures.

Electronic information and computer-based media present distinct disposal challenges. In addition to disk drives and other forms of storage, information frequently is contained in or on the memory of other devices (e.g., printers, fax machines, and cellphones). Residual data frequently remain on media, even after deletion. Because the data can be recovered, additional disposal techniques should be applied to devices containing sensitive data. Overwriting destroys data by replacing it with new, random data. Overwriting may be preferable when the media will be reused. To be effective, overwriting may have to be performed many times.

Another disposal technique is degaussing, which scrambles the data recorded on the media with powerful, varying magnetic fields. Physical destruction of the media can make the data unrecoverable. Data can sometimes be destroyed after overwriting. Management should determine the most effective method of disposal based on the type of information. Policies and procedures should address making data non-recoverable. The institution should base its disposal policies on the sensitivity of the information. Policies, procedures, and training should inform employees about what actions should be taken to securely dispose of computer-based media and protect the data from the risks of reconstruction. Management should log the disposal of sensitive media. Logs should record the party responsible for disposal, as well as the date, media type, hardware serial number, and method of disposal. In cases when such devices are rented, rather than owned, by the institution, media sanitization should be addressed contractually so that sensitive information is disposed of properly before returning equipment at the end of the rental period.

[40] See also Information Security Standards, section III.C.4., requiring each financial institution to develop, implement, and maintain, as part of its information security program, appropriate measures to properly dispose of "customer information" and "consumer information."

II.C.13(d) *Transit of Physical Media*

Management should implement policies for maintaining the security of physical media (including backup tapes) containing sensitive information while in transit, including to off-site storage, or when shared with third parties. Policies should include the following:

- Contractual requirements that incorporate necessary risk-based controls.
- Restrictions on the carriers used.
- Procedures to verify the identity of couriers.
- Requirements for appropriate packaging to protect the media from damage.
- Use of adequate encryption of sensitive information recorded on media that is being physically transported.
- Tracking of shipments to provide early indications of loss or damage.
- Security reviews or independent security reports of receiving companies.
- Use of nondisclosure agreements for couriers and third parties.

II.C.13(e) *Rogue or Shadow IT*

Management should have policies explaining that employees should not and are not authorized to use unsanctioned or unapproved IT resources (e.g., online storage services, unapproved mobile device applications, and unapproved devices). Security awareness or information security training should include procedures for identifying and reporting shadow IT.

II.C.14 Supply Chain

The typical institution purchases a wide variety of hardware and software, which often is manufactured or developed internationally. In a supply chain attack, a threat source incorporates unidentified and harmful features into the purchased items before delivery. During the risk identification process, management should identify factors that may increase risk from supply chain attacks and respond with appropriate risk mitigations. An effective information security program seeks to limit the potential for harm through techniques tailored to specific acquisitions and services. Examples of techniques to mitigate the risk from such attacks include the following:

- Only making purchases through reputable sellers who demonstrate an ability to control their own supply chains.
- Purchasing hardware and software through third parties to shield the institution’s identity.
- Reviewing hardware for anomalies.
- Using automated software testing and code reviews for software.
- Regularly reviewing the reliability of software and hardware items purchased through activity monitoring and evaluations by user groups.

II.C.15 Logical Security

Action Summary

Management should have an effective process to administer logical security access rights for the network, operating systems, applications, databases, and network devices, which should include the following:

- Assigning users and devices the access required to perform required functions.
- Updating access rights based on personnel or system changes.
- Reviewing users' access rights at an appropriate frequency based on the risk to the application or system.
- Designing appropriate acceptable-use policies and requiring users to agree to them.
- Controlling privileged access.
- Changing or disabling default user accounts and passwords.

System devices, programs, and data are system resources. Because users may access these resources through the institution's network, management should identify and restrict logical access to all system resources to the minimum required for legitimate and approved work activities, according to the principle of least privilege. Access beyond the minimum required for work to be performed exposes the institution's systems and information to a potential loss of confidentiality, integrity, and availability. The institution's logical security policy and procedures should address access rights and how those rights are to be administered. Management and system administrators should regularly evaluate information system access.

Logical user access rights administration consists of three processes:

- Enrolling new users to the system.
- Authorizing modifications to user access and deletions.
- Monitoring access rights granted to each user, including periodic review and validation of access rights.

The enrollment process establishes the user's identity and anticipated business needs for information and systems. Management should identify and evaluate all users, including new employees, IT outsourcing relationships, and contractors. The assignment of access rights is typically performed by the employee's manager and the application or data owners responsible for each accessed resource, with documented approval. The assignment of rights may also be established by the employee's role or group membership, which confers certain user access rights.

Management should have an authorization process to enable the employee's manager and the application or data owners to modify or delete existing user access rights to information and systems. The authorization process should include controls to verify that proper authorizations were granted or removed. Modifications to access rights should occur when an individual's business needs change. Job changes can result in an expansion, reduction, or deletion of needed access rights. Job changes that could trigger a modification or deletion of access rights include transfers, mandatory leave, resignations, and terminations. The institution should promptly review, and modify as needed, access rights for all users who experience job changes, particularly those with privileged access, remote access privileges, and access to customer information.

As part of the user access rights monitoring process, management should perform regular reviews to validate user access. Reviews should test whether access rights continue to be appropriate or whether they should be modified or deleted. Management should review access rights on a schedule commensurate with risk.

Logical user access rights administration also constrains user activities through an acceptable use policy that details permitted system uses, user activities, and the consequences of noncompliance. Management should maintain an acceptable use policy, and employees should be required to acknowledge and agree in writing to the policy. When implemented correctly, an acceptable use policy is a key control for user awareness and administrative policing of system activities. Elements of an acceptable use policy can include the following:

- Specific access devices that can be used to access the network.
- Hardware and software changes the user can make to his or her access device.
- Purpose and scope of network activity.
- Permitted network services.
- Information that can or cannot be transmitted, and authorized transmission methods.
- Bans on attempts to break into accounts, crack passwords, or disrupt service.
- Responsibilities for secure operation.
- Consequences of noncompliance.

Authorization for privileged access should be tightly controlled. Privileged access refers to the ability to override system or application controls, and may include system administrator access. All individuals who are granted privileged access should have the appropriate training commensurate with the risk and complexity of the systems and information they access. Prudent practices for controlling privileged access include the following:

- Identifying each privilege associated with each system resource.
- Implementing a process to allocate privileges on a need-to-use or an event-by-event basis.
- Documenting the granting and extent of privileged access.
- Assigning privileges to a unique user ID apart from the one used for normal business use.
- Prohibiting shared privileged user accounts.
- Logging and independent monitoring of the use of privileged access.
- Reviewing, by an independent party, privileged access rights and allocations at appropriate intervals.

Access rights to new software and hardware present a different problem. Typically, hardware and software are shipped with default users and at least one default user has privileged access. Lists of default accounts and passwords are readily available and can enable anyone with access to the system to obtain privileged access. These passwords should be changed, and the accounts should be disabled. Alternately, if these accounts are not disabled, access should be monitored closely.

II.C.15(a) *Operating System Access*

Access to the operating system and system utilities provide users with the authority to make fundamental changes to the system. System utilities are programs that perform repetitive functions, such as creating, deleting, changing, or copying files. System utilities also could include numerous types of system management software that can supplement operating system functionality by supporting common system tasks, such as security, system monitoring, or transaction processing.

Unauthorized access to the operating system and system utilities could result in significant financial and operational losses. System and security administrators should restrict and monitor privileged access to operating systems and system utilities. Many operating systems have integrated or third-party access control software, which is often essential to effective access control and can be used to integrate the security management of the operating system and applications. To prevent unauthorized access to or inappropriate activity on the operating system and system utilities, management should do the following:

- Implement effective user access to appropriately restrict system access for both users and applications and, depending on the sensitivity, extend protection at the program, file, record, or field level.
- Limit the number of employees with access to operating systems and grant only the minimum level of access required to perform job responsibilities.
- Restrict and log access to and activity on operating system parameters, system utilities (especially those with data-altering capabilities), and sensitive system resources (including files, programs, and processes), and supplement with additional security software, as necessary.
- Restrict operating system access to specific terminals in physically secure and monitored locations.
- Secure or remove external drives and portable media from system consoles, terminals, or personal computers (PC) running terminal emulations, residing outside of physically secure locations.
- Prohibit remote access to operating system and system utilities, where feasible, and, at a minimum, require strong authentication and encrypted sessions before allowing such remote access.
- Filter and review logs for potential security events and provide adequate reports and alerts.
- Independently monitor operating system access by user, terminal, date, and time of access.

II.C.15(b) *Application Access*

Sensitive or mission-critical applications should incorporate appropriate access controls that restrict which functions are available to users and other applications. These access controls allow authorized users and other applications to interface with related databases. Some security software programs integrate access control between the operating system and some applications.

Such software is useful when applications do not have their own access controls or when the institution uses security software instead of the application's native access controls. Management should understand the functionality and vulnerabilities of the application access control solutions and consider those issues in the risk management process.

Management should implement effective application access controls by doing the following:

- Implementing a robust authentication[41] method consistent with the criticality and sensitivity of the application.
- Easing the administrative burden of managing application access rights by using group profiles. Managing access rights individually can lead to inconsistent or inappropriate access levels.
- Periodically reviewing and approving the application access assigned to users for appropriateness.
- Communicating and enforcing the responsibilities of programmers, security administrators, and application owners for maintaining effective application access control.
- Setting time-of-day or terminal limitations for some applications or for more sensitive functions within an application.
- Logging access and events, defining alerts for significant events, and developing processes to monitor and respond to anomalies and alerts.

II.C.15(c) *Remote Access*

Management should develop policies to ensure that remote access by employees, whether using institution or personally owned devices, is provided in a safe and sound manner. Such policies and procedures should define how the institution provides remote access and the controls necessary to offer remote access securely. Management should employ the following measures:

- Disable remote communications if no business need exists.
- Tightly control remote access through management approvals and subsequent audits.
- Implement robust controls over configurations at both ends of the remote connection to prevent potential malicious use.
- Log and monitor all remote access communications.
- Secure remote access devices.
- Restrict remote access during specific times.
- Limit the applications available for remote access.
- Use robust authentication methods for access and encryption to secure communications.

There are several methods to provide remote access to employees. A prevalent form of remote access is through a VPN, which provides employees with a remote connection to the institution's network through a secure channel. The VPN connection uses public telecommunication infrastructure, such as the Internet, to provide remote offices or individual users with secure

[41] Stronger authentication and layered security methods, such as the use of tokens, public-key infrastructure-based systems, or out-of-band verification coupled with a robust identity and access management process, can reduce the potential for unauthorized access.

access to their organization's network. VPN provides an encrypted isolated “tunnel” or connection between a remote user’s computer and the internal network.

Because VPN connections provide access to sensitive internal networks, the connections require additional authentication from the remote user. Use of physical token devices is a common method that can provide one-time passwords to strongly authenticate remote users.

While VPNs effectively connect the remote computer to the internal network, other alternatives provide virtual desktop capability. In these cases, the remote computer connects to a special purpose software system (sometimes a website), authenticates the user, and establishes a secure connection to an internal network server. That server establishes a local internal network desktop session and connects it to the screen, keyboard, mouse, and speakers of the remote computer. This is an actual remote control environment, where the remote user’s actions have the same effect as if connected to an actual internal network desktop. The remote control configuration may permit file transfer between the remote and internal computers. If the remote access method allows users to store sensitive institution information, management should consider limiting this access to institution-owned devices.

Other methods of remote access are available, including remote control software and third-party services, file transfer software (e.g., FTP), conferencing/session sharing tools, and other remote desktop software. Management should conduct a risk assessment and implement appropriate controls before adopting any remote access solution.

If the institution allows employees to use authorized remote access methods with institution-owned devices, management should implement the following mitigating controls:

- Prevent users from installing software on the devices.
- Prohibit users from having administrative privileges on the devices.
- Use firewalls, host-based IDS, and packet content filtering to identify, monitor, and limit remote access activities.

II.C.15(d) *Use of Remote Devices*

Management may choose to allow employees to connect remotely to the institution’s network using either an institution-owned or a personally owned device (often referred to as BYOD or “bring your own device”). Institution-owned devices are easier to secure because the institution controls the devices’ configuration and often can implement remote wiping if the devices are lost or stolen. It may be more difficult to implement remote wiping or a similar measure on an employee’s personally owned device. BYOD is becoming more popular, however, with institutions and employees because it reduces costs to the institution and enables employees to carry one device instead of two.

For all remote devices, management should do the following to control employee remote access to the institution’s network:

- Disallow remote access unless a compelling business justification exists.

- Require management approval of employee remote access.
- Regularly review remote access approvals and rescind those that no longer have a compelling business justification.
- Restrict remote access to authorized network areas and applications by using VLANs, permissions, and other techniques.
- Log remote access communications (including date, time, user, user location, duration, and activity), analyze logs in a timely manner, and follow up on anomalies.
- Implement robust authentication methods for remote access.
- Use encryption to protect communications between the access device and the institution.
- Use application white-listing.[42]

For institution-owned devices, the institution should have the ability to manage the remote devices. The following controls should be implemented:

- Securely configure remote access devices.
- Protect remote access devices against malware.
- Patch, update, and maintain all software on remote access devices.
- Encrypt sensitive data residing on the access device.
- Implement secure containers with internal boundaries to store sensitive information, in a way that is not accessible to the device without permission.
- Periodically audit the access device configurations and patch levels.
- Remotely disable or wipe the device in the event of theft or loss.
- Use geolocation of the device to support device recovery efforts.

For personally owned devices, the institution may not have the ability to configure the devices; therefore, management should have an effective method or solution to ensure that such devices meet defined institution security standards, such as operating system version, patch levels, and anti-malware solutions, before such devices are allowed to log on to the network.

II.C.16 Customer Remote Access to Financial Services

Action Summary

Management should do the following:

- Develop and maintain policies and procedures to securely offer and strengthen the resilience of remote financial services, if the institution offers such services.
- Plan for actions that adversely affect the availability of remote banking services to customers.
- Coordinate appropriate responses with the institution’s ISPs and third-party service providers.
- Regularly test the institution’s response plans.

[42] Application white-listing is the maintenance and use of a list of applications and their components (e.g., libraries and configuration files) that are authorized to be present or active on a system according to a well-defined baseline.

Institutions increasingly offer services to customers through remotely accessible technology, such as the Internet and mobile financial services. If the institution offers such services, management should implement appropriate authentication techniques[43] commensurate with the risk from remote banking activities. Beyond authentication, remote access controls should include additional layered security controls and may include some combination of the following:

- Application time-outs with mandatory re-authentication.
- Fraud detection and monitoring systems that include consideration of customer history and behavior to alert management, and enable a timely and effective institution response.
- Dual customer authorization through different access devices.
- Out-of-band[44] verification for transactions.
- Positive pay,[45] debit blocks, and other techniques to appropriately limit the transactional use of the account.
- Supplementary controls over certain account activities, such as transaction value limits, restrictions on devices for adding payment recipients, limits on the number of transactions allowed per day, and allowable payment windows (e.g., days and times).
- Reputation-based tools to block connections to the institution's servers based on device or network indicators known or suspected to be associated with fraudulent activities.
- Device authentication with appropriate enrollment and de-enrollment processes.
- Policies for addressing customer devices identified as potentially compromised and identifying customers who may be facilitating fraud.
- Controls over changes to account maintenance activities (e.g., address or password changes) performed by customers either online or through customer service channels.
- Supplementary controls for system administrators who are granted privileges to set up or change system configurations of business accounts.[46]
- Customer education to increase awareness of the fraud risk and effective techniques customers can use to mitigate the risk.

Institution customers may also use e-mail or other electronic means to transmit instructions. All instructions received through such channels should be authenticated and validated in accordance with institution policies.

An area of heightened concern when financial institutions offer remote financial services is the potential for malicious activity against the institution's mobile or online services. Malicious actors may restrict availability to those services through denial of service (DOS) attacks that target the institution's ISPs, third-party service providers, infrastructure, or applications.

[43] Techniques include multiple factor authentication, device authentication, location consistency, and additional authentication for sensitive functions.

[44] Out-of-band refers to activity outside of the primary means of interfacing with the customer. For example, if a user is performing activity online, he or she may be authenticated through a one-time password sent via text message.

[45] Positive pay is a technique that can reduce check fraud by requesting businesses to send electronic files of information to the financial institution on all checks the business has issued.

[46] Refer to the FFIEC's "Supplement to Authentication in an Internet Banking Environment."

Additionally, attacks on organizations that share infrastructure with the institution, including domain name services, may adversely affect the availability of remote services. Management should develop and maintain policies and procedures to identify, measure, mitigate, monitor, and report on significant security incidents to ensure the resilience of remote financial services. Planning and coordination by the institution and its third-party service providers may improve the resilience of services in the face of those attacks. To prevent or minimize exposure to these incidents, management should do the following:

- Monitor threat alerts.
- Monitor service availability and diagnose causes of reduced availability.
- Monitor applications and network traffic for indicators of nefarious activity.
- Ensure traffic filtering by the institution's ISP or upstream ISP,[47] third-party service providers, and internal resources.
- Design and implement applications to withstand application-level DOS.
- Utilize distributed architecture.
- Limit traffic (e.g., allow valid traffic and block known bad traffic by port or IP address).
- Add bandwidth.
- Enable access to services through alternative channels.

The institution should develop and test an incident response plan in conjunction with the institution's ISPs and third-party service providers to mitigate the interruption of mobile or remote financial services. Refer to the "Incident Response" section of this booklet for more information.

Customers may be provided with a website disclosure with the institution's customer acceptable-use policy. Depending on the nature of the website, the institution may require customers to demonstrate knowledge of and agreement to abide by the terms of the acceptable use policy. That evidence can be paper-based or electronic.

Refer to appendix E[48] of the *IT Handbook's* "Retail Payment Systems" booklet for more information about mobile financial services.

II.C.16(a) *Customer Awareness*

The institution's customer awareness and education efforts should consider both retail and commercial account holders and include the following elements:

- An explanation of protections provided, and not provided, to account holders relative to electronic funds transfers under Regulation E, and a related explanation of the applicability of Regulation E to the types of accounts accessible online.

[47] An upstream ISP is usually a large ISP that provides Internet access to a local ISP.

[48] See the *IT Handbook's* "Retail Payment Systems" booklet, appendix E, "Mobile Financial Services."

- An explanation that while the institution may contact a customer regarding his or her account or suspicious activities related to his or her account, the institution should never ask the customer to provide his or her log-in credentials over the phone or via e-mail.
- A list of recommended controls and prudent practices that the customer should implement when using the institution's remote financial services.
- A suggestion that commercial online customers perform a related risk assessment and controls evaluation periodically.
- Recommendations of technical and business controls to commercial customers that can be implemented to mitigate the risks from fraud schemes such as Business Email Compromise.[49]
- A method to contact the institution if customers notice suspicious account activity.

II.C.17 Application Security

Action Summary

Management should use applications that have been developed following secure development practices and that meet a prudent level of security. Management should develop security control requirements for all applications, whether the institution acquires or develops them. Information security personnel should be involved in monitoring the application development process to verify that secure development practices are followed, security controls are implemented, and information security needs are met.

Institutions and their customers use a wide variety of applications. Such applications include core banking applications, web applications, and installable applications (e.g., downloadable mobile applications).

A secure software development life cycle ensures that Internet- and client-facing applications have the necessary security controls. The institution should ensure that all applications are securely developed. To verify the controls have been developed and implemented appropriately, management should perform appropriate tests (e.g., penetration tests, vulnerability assessments, and application security tests) before launching or making significant changes to external-facing applications. Issues noted from tests should be remediated before launching applications or moving changes into production. At institutions that employ third parties to develop applications, management should ensure that the third parties meet the same controls.

Applications should provide the ability for management to do the following:

- Implement a prudent set of security controls (e.g., password and audit policies), audit trails of security and access changes, and user activity logs for all applications.
- Establish user and group profiles for applications if not part of a centralized identity access management system.

[49] See Federal Bureau of Investigation, Alert I-012215-PSA.

- Change and disable default application accounts upon installation.
- Review and install patches for applications in a timely manner.
- Implement validation controls for data entry[50] and data processing.[51]
- Integrate additional authentication and encryption controls, as necessary, to ensure integrity and confidentiality of data and non-repudiation of transactions.
- Protect web or Internet-facing applications through additional controls, including web application firewalls, regular scanning for new or recurring vulnerabilities, mitigation or remediation of common security weaknesses, and network segregation to limit inappropriate access or connections to the application or other areas of the network.
- Mitigate risks from potential flaws in applications allowing remote access by customers and others through network, host, and application layer architecture considerations.
- Obtain attestation or evidence from third-party developers that the application acquired by the institution meets the necessary security requirements and that noted vulnerabilities or flaws are remediated in a timely manner.
- Perform ongoing risk assessments to consider the adequacy of application-level controls in light of changing threat, network, and host environments.
- Implement minimum controls recommended by the third-party service provider and consider supplemental controls as appropriate.
- Review available audit reports, and consider and implement appropriate control recommendations
- Collect data to build metrics and reporting of configuration management compliance, vulnerability management, and other measurable items as determined by management.

Whether the institution acquires or develops applications, management should establish security control requirements for new systems, system revisions, or new system acquisitions. Management should define the security control requirements based on its risk assessment process and evaluate the value of the information at risk and the potential impact of unauthorized access or damage within existing software development and acquisition processes. Management should have a process to determine risks posed by the system and necessary security requirements. Management may also refer to published, widely recognized industry standards as a starting point for establishing the institution's security requirements.

Information security personnel should be involved from the outset in the application development process to determine whether security controls are designed, tested, and implemented and information security needs are being met. Monitoring the development environment can help ensure that the implemented controls are functioning properly. Institutions that purchase applications typically rely on third-party service providers to develop applications with appropriate security built-in; management, however, should perform its own verification to

[50] Data entry validation controls include access controls over entry and changes to data, error checks, review of suspicious or unusual data, and dual entry or additional review and authorization for highly sensitive transactions or data.

[51] Data processing controls include batch control totals, hash totals of data for comparison after processing, identification of any changes made to data outside the application (e.g., data-altering utilities), and job control checks to ensure programs run in correct sequence.

determine whether the application meets the institution's security requirements. Management should analyze the environment where the application will reside. As the environment changes, the security requirements and assurance needs for the application may also change. Management should leverage available resources[52] to assist in risk identification and improve the institution's application security practices.

II.C.18 Database Security

Action Summary

Management should implement effective controls for databases and restrict access appropriately.

Databases are collections of information organized to be easily accessed, managed, and updated. Databases can be developed in-house or purchased from third parties and have their own controls and protective mechanisms configured to provide varying levels of protection. Along with many other security features, encryption helps to protect the stored information from theft or unauthorized viewing. Management should implement or enable controls commensurate with the sensitivity of the data stored in or accessed by the database.

Database users may be people (e.g., employees, customers, and contractors) or other applications. Users have different levels of access and authorization. Some users may have extensive privileges, including the ability to change the database configuration and access controls. Other users may have restrictions in what they can view, manipulate, or store. When a person is the database user, authorizations can be tailored to that person, greatly limiting the amount of information that could be exposed in a security incident. When an application is the database user, the access granted to the application can be more extensive than a person would require. Accordingly, an attack on a database through an application could expose a larger and more damaging collection of data. For application accounts, management should strengthen authentication and monitoring requirements to minimize the potential for unauthorized use.

Management should appropriately control user access and apply the principle of least privilege in assigning authorizations. The use and overall configuration of a database's security features should be part of a well-designed, layered security program.

II.C.19 Encryption

Action Summary

Management should implement the type and level of encryption commensurate with the sensitivity of the information.

[52] Resources include software tools, industry resources, specific certifications, and education courses.

Encryption is used to secure communications and data storage, particularly authentication credentials and the transmission of sensitive information. Encryption can be used throughout a technological environment, including the operating systems, middleware, applications, file systems, and communications protocols.

Encryption can be used as a preventive control, a detective control, or both. As a preventive control, encryption acts to protect data from disclosure to unauthorized parties. As a detective control, encryption is used to allow management to discover unauthorized changes to data. When prevention and detection are joined, encryption can be an important control in ensuring confidentiality, integrity, and availability.

Institution management should employ encryption strength sufficient to protect information from disclosure. Encryption methods should be reviewed periodically to ensure that the types and methods of encryption are still secure as technology and threats evolve. Decisions regarding what data to encrypt and at what points to encrypt the data are typically based on the risk of disclosure and the costs of encryption. The need to encrypt data is determined by the institution's data classification and risk assessment.

Passwords should be hashed or encrypted in storage. Passwords that are hashed also should be salted.[53] Files containing encrypted or hashed passwords used by systems to authenticate users should be readable only with elevated (or administrator) privileges.

Key management[54] is crucial to the effective use of encryption. Effective key management systems rely on an agreed set of standards, procedures, and secure methods that address the following:[55]

- Generating keys for different cryptographic systems and different applications.
- Generating and obtaining public keys.
- Distributing keys to intended users, including how keys should be activated when received.
- Storing keys, including how authorized users obtain access to keys.
- Changing or updating keys, including rules on when and how keys should be changed.
- Addressing compromised keys.
- Archiving, revoking, and specifying how keys should be withdrawn or deactivated.
- Recovering keys that are lost or corrupted as part of business continuity management.
- Logging the auditing of key management-related activities.
- Instituting defined activation and deactivation dates, and limiting the usage period of keys.

[53] In password protection, salt is a random string of data used to modify a password hash.

[54] Key management is the management of cryptographic keys. This includes dealing with the generation, exchange, storage, use, and replacement of keys.

[55] Refer to ISO/IEC 11770-1:2010, "Key Management—Part 1: Framework"; ISO/IEC 11770-2:2008, "Key Management—Part 2: Mechanisms Using Symmetric Techniques"; and ISO/IEC 11770-3:2015, "Key Management—Part 3: Mechanisms Using Asymmetric Techniques."

II.C.20 Oversight of Third-Party Service Providers

Action Summary

Management should oversee outsourced operations through the following:

- Appropriate due diligence in third-party research, selection, and relationship management.
- Contractual assurances for security responsibilities, controls, and reporting.
- Nondisclosure agreements regarding the institution's systems and data.
- Independent review of the third party's security through appropriate reports from audits and tests.
- Coordination of incident response policies and contractual notification requirements.
- Verification that information and cybersecurity risks are appropriately identified, measured, mitigated, monitored, and reported.

Management should conduct appropriate due diligence in selecting and monitoring third-party service providers. Management should be responsible for ensuring that such third parties use suitable information security controls when providing services to the institution. When indicated by the institution's risk assessment, management should monitor third-party service providers to confirm that they are maintaining appropriate controls. If the third-party service provider stores, transmits, processes, or disposes of customer information, management should require third-party service providers by contract to implement appropriate measures designed to meet the Information Security Standards.

Management should evaluate information security considerations of potential third-party service providers during initial due diligence. Refer to the *IT Handbook's* "Outsourcing Technology Services" booklet for more information.

Management should verify that third-party service providers implement and maintain controls sufficient to appropriately mitigate risks. The institution's contracts should do the following:

- Include minimum control and reporting standards.
- Provide for the right to require changes to standards as external and internal environments change.
- Specify that the institution or an independent auditor has access to the service provider to perform evaluations of the service provider's performance against the Information Security Standards.

Refer to the "Third-Party Reviews of Technology Service Providers" section of the *IT Handbook's* "Audit" booklet for more information.

Additionally, as part of the oversight of third-party service providers, management should determine whether cyber risks are identified, measured, mitigated, monitored, and reported by such third parties as third-party cyber threats can have an impact on the institution. Information security reporting by the institution should incorporate an assessment of these third-party risks to facilitate a comprehensive understanding of the institution's exposure to third-party cyber threats.

II.C.20(a) *Outsourced Cloud Computing*

As with other forms of outsourcing, information security implications are key in the cloud computing model. Management may need to revise information security policies, standards, and procedures to incorporate the activities related to a cloud computing service provider. Refer to the FFIEC's "Outsourced Cloud Computing" statement for more information.[56]

II.C.20(b) *Managed Security Service Providers*

Management may rely on third parties to provide security services; management, however, remains responsible for ensuring the security of the institution's systems and information by overseeing the effectiveness of the services provided by the managed security services provider. Additional information is available in appendix D of the *IT Handbook's* "Outsourcing Technology Services" booklet.

II.C.21 Business Continuity Considerations

Action Summary

Management should do the following:

- Identify personnel who will have critical information security roles during a disaster, and train personnel in those roles.
- Define information security needs for backup sites and alternate communication networks.
- Establish and maintain policies that address the concepts of information security incident response and resilience, and test information security incident scenarios.

Business continuity plans should be reviewed as an integral part of the security process. Strategies should consider the different risk environments and the degree of risk mitigation necessary to protect the institution if continuity plans must be implemented. Management should train personnel regarding their security roles during a disaster. Additionally, management should update technologies and plans for backup sites and communications networks. These security considerations should be integrated with the testing of the business continuity plan.

Information security events may trigger activation of the business continuity plan. Therefore, the institution's plan should include steps that explicitly address information security incident response and resilience. Resilience testing should incorporate information security event scenarios identified by the institution.

Refer to the *IT Handbook's* "Business Continuity Planning" booklet for more information.

[56] See FFIEC, "Outsourced Cloud Computing," July 10, 2012.

II.C.22 Log Management

Network and host activities typically are recorded on the host and sent across the network to a central logging repository. The data that arrive at the repository are in the format of the software that recorded the activity. The logging repository may process the data and can enable timely and effective log analysis. Management should have effective log retention policies that address the significance of maintaining logs for incident response and analysis needs.

Log files are critical to the successful investigation and prosecution of security incidents and can potentially contain sensitive information. Intruders often attempt to conceal unauthorized access by editing or deleting log files. Therefore, institutions should strictly control and monitor access to log files whether on the host or in a centralized logging repository. Considerations for securing the integrity of log files include the following:

- Encrypting log files that contain sensitive data or that are transmitted over the network.
- Ensuring adequate storage capacity to avoid gaps in data gathering.
- Securing backup and disposal of log files.
- Logging the data to a separate, isolated computer.
- Logging the data to read-only media.
- Setting logging parameters to disallow any modification to previously written data.
- Restricting access to log files to a limited number of authorized users.

Additionally, logging practices should be reviewed periodically by an independent party to ensure appropriate log management.

Logs are voluminous and challenging to read. They come from a variety of systems and can be difficult to manage and correlate. Security information and event management (SIEM) systems can provide a method for management to collect, aggregate, analyze, and correlate information from discrete systems and applications. Management can use SIEM systems to discern trends and identify potential information security incidents. SIEM systems can be used to gather information from the following:

- Network and security devices and systems.[57]
- Identity and access management applications.
- Vulnerability management and policy compliance tools.
- Operating system, database, and application logs.
- Physical and environmental monitoring systems.
- External threat data.

Regardless of the method of log management, management should develop processes to collect, aggregate, analyze, and correlate security information. Policies should define retention periods for security and operational logs. Institutions maintain event logs to understand an incident or cyber event after it occurs. Monitoring event logs for anomalies and relating that information

[57] These can include intrusion detection and prevention systems, DLP solutions, and firewalls.

with other sources of information broadens the institution’s ability to understand trends, react to threats, and improve reports to management and the board.

II.D Risk Monitoring and Reporting

Risk monitoring is a process by which the institution tracks information about its inherent risk profile and identifies gaps in the effectiveness of risk mitigation activities. Risk monitoring should address changing threat conditions in both the institution and the greater financial industry. Threats change frequently, particularly in terms of the threat’s capabilities and intentions, as well as the vulnerabilities they may exploit. Vulnerabilities in software are continually announced, and other vulnerabilities may emerge as the institution’s systems are modified or updated. External requirements, including the use of new third-party service providers, also may change the institution’s inherent risk profile.

Risk reporting is a process that produces information systems reports that address threats, capabilities, vulnerabilities, and inherent risk changes. Risk reporting should describe any information security events that the institution faces and the effectiveness of management’s response and resilience to those events. The reporting process should provide a method of disseminating those reports to appropriate members of management. The contents of the reports should prompt action, if necessary, in a timely manner to maintain appropriate levels of risk.

II.D.1 Metrics

A mature and effective information security program uses metrics to improve the program’s effectiveness and efficiency. Management should develop metrics that demonstrate the extent to which the security program is implemented and whether the program is effective. Metrics are used to measure security policy implementation, conformance with the information security program, the adequacy of security services delivery, and the impact of security events on business processes. The measurement of security characteristics can allow management to increase control and drive improvements to the security process. Metrics generally are formed to measure conformance to the standards and procedures that are used to implement policies.

Management should utilize metrics to quantify and report risks of the information security program. Metrics should be gathered from external sources and internal data. The scope of metrics should be comprehensive and commensurate with the complexity of the institution’s operations. Reports should incorporate metrics tailored for different audiences and stakeholders. These metrics and other monitoring reports of the information security program should feed into ITRM reporting.

III Security Operations

Action Summary

Management should design policies and procedures to effectively manage security operations with the following characteristics:

- Broadly scoped to address all ongoing security-related functions.
- Guided by defined processes.
- Integrated with lines of business and third parties.
- Appropriately staffed and supplied with technology for continual incident detection and response activities.

Security operations involve a wide range of activities. Those activities may be centralized in a security operations center, distributed within the information security department and business lines, or outsourced in whole or in part. Security operations activities can include the following:

- Security software and device management (e.g., maintaining the signatures on signature-based devices and firewall rules).
- Forensics (e.g., analysis of potentially compromised systems).
- Threat identification and assessment.
- Vulnerability identification (e.g., operation or supervision of vulnerability scans, self-assessments, penetration tests, and analysis of audit results).
- Vulnerability cataloging and remediation tracking.
- Physical security management (e.g., CCTV, guards, and badge systems).
- Law enforcement interface (e.g., data retention and lawful intercepts).
- Third-party integration (e.g., managed security services and incident detection services).
- Network, host, and application activity monitoring.
- Analysis of threat intelligence from external sources.
- Engagement with information sharing groups.
- Incident detection and management.
- Enforcement of access controls.

Management should establish defined processes and appropriate governance to facilitate the performance of security operations. Policies should address the timing and extent of the security operations activities, reporting, escalation triggers, and response actions. Many institutions use an issue tracking system[58] to record and manage requests and events. An issue tracking system can be a source of evidence, contain a variety of security information, and serve as a valuable tool to assist management when taking actions to strengthen the information security environment.

[58] An issue tracking system (also ITS, trouble ticket system, ticketing management system, support ticket system, request management system, or incident ticket system) is a computer software package that manages and maintains lists of security issues.

Management should coordinate security operation activities with the institution's lines of business and with third-party service providers. Regardless of how extensive the coordination is, the goal should be to maintain a sufficient security operation capability across the entire environment.

Sufficient technology and staff should be available to support continual incident detection and response activities. Some institutions may rely on or supplement their activities with third parties to gain the necessary scope and depth of coverage. Refer to the *IT Handbook's* "Outsourcing Technology Services" booklet for more information.

III.A Threat Identification and Assessment

Action Summary

Management should do the following:

- Identify and assess threats.
- Use threat knowledge to drive risk assessment and response.
- Design policies to allow immediate and consequential threats to be dealt with expeditiously.

Threat identification and assessment involves discovering knowledge about threat sources and vulnerabilities and analyzing the potential for exploitation. This is much more focused than the risk identification process described in the "Risk Identification" section of this booklet. Information gained from threat identification and assessment should be used in risk assessment and response to drive protective and detective strategies and tactics. Strategies involve the information security program's policies, standards, and procedures, and the implementing technologies. Examples of tactics include threat signatures used for incident identification and management of threat behaviors. NIST notes that types of threat sources include the following:

- Hostile cyber or physical attacks.
- Human errors of omission or commission.
- Structural failures of organization-controlled resources (e.g., hardware, software, and environmental controls).
- Natural and man-made disasters, accidents, and failures beyond the control of the organization.[59]

Management should develop procedures for obtaining, monitoring, assessing, and responding to evolving threat and vulnerability information. The identification of threats involves the sources of threats, their capabilities, and their objectives. Information about threats generally comes from government (e.g., US-CERT), information-sharing organizations (e.g., FS-ISAC), industry sources, the institution, and third parties. Third-party information may be from organizations that specifically track and report on threats or from third-party reports of past activity. Some of those

[59] NIST SP 800-30, revision 1, "Information Security: Guide for Conducting Risk Assessments," September 2012.

reports compile knowledge from incidents reported by many organizations worldwide. Different types of information supporting an assessment may be available through the following:

- Incident data from reports published by security providers and others.
- Attack data from sources including FS-ISAC and managed security service providers.
- Threat data through reports available either free or for a fee.

The availability of threat information is often ad hoc, although some providers present threat information within a defined framework that readily lends itself to analytical operations. By using a threat taxonomy, the institution may greatly reduce the complexity of threat assessment and enable efficient understanding of reasonable risk mitigations. Specific factors in the threat assessment may include a description, context for operation, capabilities and intent, and, from the threat-source perspectives, benefits and negative consequences associated with an attack.

Knowledge of threat sources is especially important to help identify vulnerabilities. Vulnerabilities can occur in many areas, such as the system design, the system operation, security procedures, business line controls, and the implementation of the system and controls. Self-assessments, audits, scans, penetration tests, and reviews of SIEM reports can identify vulnerabilities. Additionally, external individuals or groups can identify vulnerabilities.

Tools for analyzing vulnerabilities in a layered security environment include attack trees, event trees, and kill chains. These tools attempt to model an attacker’s actions to enable identification of the most effective and efficient remediation options.

Once a threat is identified and potential vulnerabilities are assessed, the significance of the threat should trigger a response. The response should be commensurate with the risk posed by the threat and should include remediation options. Management should design policies to allow for immediate and consequential threats to be dealt with expeditiously, while less significant threats are addressed as part of a broader risk management process. When management receives vulnerability information from external individuals or groups, management should have appropriate processes and procedures to evaluate the credibility of the information to appropriately address it.

III.B Threat Monitoring

Threat monitoring policies should provide for continual and ad hoc monitoring of threat intelligence communications and systems, effective incident detection and response, and the use of monitoring reports in subsequent legal procedures. Management should establish the responsibility and authority of security personnel and system administrators for monitoring. Additionally, management should review and approve the tools used and the conditions for use.

Threat monitoring should address indicators of vulnerabilities, attacks, compromised systems, and suspicious users, such as those who do not comply with or seek to evade security policies. Monitoring should address incoming and outgoing network traffic, seeking to identify malicious activity and data exfiltration. Additionally, the monitoring process should be established and documented to independently monitor administrators and other users with higher privileges.

III.C Incident Identification and Assessment

Action Summary

Management should have a process to enable the following:

- Identify indicators of compromise.
- Analyze the event associated with the indicators.
- Classify the event.
- Escalate the event consistent with the classification.
- Report internally and externally as appropriate.

Incident identification involves indicators and analysis. External indicators may arise through contact with customers, law enforcement, card organizations (e.g., credit or payment cards), other financial institutions, media, or others. Internal indicators may arise when internal users contact the help desk, IT operations follows up on anomalies, or security operations follows up on anomalies identified through security devices and network and systems activity. Indicators may also arise through the use of “hunt teams,” or dedicated analysts who actively search for indicators of compromise. Examples of technology-based intrusion identification systems and tools include the following:

- Threat intelligence data feeds (e.g., STIX/TAXII).[60]
- Intrusion detection and prevention systems for networks and hosts.
- End-point visibility tools (tools that can identify the function of end points and which end points contain or have access to sensitive information).
- DLP tools.
- Log correlation and analysis tools.
- File integrity tools.
- Malware detection tools.
- Network behavior analysis systems.
- “Big data” tools and analytics that aggregate and allow pre-formed and ad hoc analysis.

Technology-based indicators of compromise generally are anomalies in host state, host activity, and network traffic. A few examples are unexpected (1) processes, (2) changes to files, (3) packet source or destination, (4) protocols, (5) ports, (6) encryption, (7) log-ins, and (8) packet content. Other indicators include alerts triggered by black lists in anti-virus and network-monitoring products.

Management should have a process for identifying indicators of compromise and rapidly reporting those indicators for investigation. The report should instigate an analysis that seeks to

[60] There are efforts to automate and structure operational cybersecurity information-sharing techniques across the globe. Of these, STIX (the Structured Threat Information eXpression) and TAXII (the Trusted Automated eXchange of Indicator Information) are two of the technical specifications that allow an automated exchange of threat source data using standardized language.

confirm whether a compromise took place and how that compromise should be classified. Investigation may require additional information from outside and inside the institution, such as a forensic review. Management should perform due diligence to identify external assistance in advance of incidents to ensure available resources. Classification of a compromise may require information on the specific hosts affected, data lost, and business processes affected. Information developed in the analysis may be useful to guide response activities.

Analysis should result in a classification of the event, implementation of escalation procedures, and reporting. Analysis should be guided by the following:

- Classification policies should be sufficiently clear to enable timely classification of incidents by level of severity, enabling the use of response teams and responses depending on the type and severity of events.
- Escalation, response, and reporting should be commensurate with the level of severity.
- Escalation policies should address when different personnel within the organization will be contacted and the responsibility those personnel have in incident analysis and response.
- Escalation policies should include when to request or obtain external assistance, from both third parties and the federal government.
- Reporting policies should address internal and external reporting, including coordination with third parties and reporting to external organizations (e.g., FS-ISAC).

Additionally, a policy should address who is empowered to declare an incident. A defined process should guide responses to incidents. The institution should develop procedures to test the incident escalation, response, and reporting processes.

The sharing of attack data through organizations, such as FS-ISAC, also has the potential to benefit the industry at large by enabling other institutions to better assess and respond to current attacks. Management should consider whether to include such information sharing as a part of its strategy to protect the institution.

Management should determine whether the institution’s or its managed security service provider’s analysts are sufficiently trained to appropriately analyze network, host, and application activity and to use the monitoring and analysis tools made available to them. Additionally, security analysts should coordinate and collaborate with others in the institution with knowledge and authority for specific types of malicious activity, such as fraud.

III.D Incident Response

Management should have an incident response program.[61] The goal of incident response is to minimize damage to the institution and its customers. The institution’s program should have defined protocols to declare and respond to an identified incident. More specifically, the incident response program should include, as appropriate, containing the incident, coordinating with law

[61] See also “Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice,” supplementing the Information Security Standards.

enforcement and third parties, restoring systems, preserving data and evidence, providing assistance to customers, and otherwise facilitating operational resilience of the institution.

The response involves a combination of people and technologies. The quality of incident response is attributable to the institution's culture, policies, procedures, and training. Incident response is also a function of the relationships the institution formed before the incident with law enforcement, incident response consultants and attorneys, information-sharing entities (e.g., FS-ISAC), and others. Management should prepare for potential incidents by developing an incident response plan that is comprehensive, coordinated, and integrated with existing institution policies, procedures, and training. To validate the effectiveness of the institution's incident response program, management should periodically test it through different test types, including scenario planning and tabletop testing, and perform the tests with appropriate internal and external parties.

Preparation determines the success of any intrusion response. Such preparation involves defining the policies and procedures that guide the response; assigning responsibilities to individuals; providing appropriate training; formalizing information flows; and selecting, installing, and understanding the tools used in the response effort. Additionally, management should define thresholds for reporting significant security incidents, and consider developing processes for when the institution should notify its regulators of incidents that may affect the institution's operations, reputation, or sensitive customer information. These incidents may include those that could affect the financial system. Primary considerations for incident response include the following:

- How to balance concerns regarding confidentiality, integrity, and availability for devices and data. This consideration is a key driver for a containment strategy and may involve legal and liability considerations. Management may decide that some systems must be disconnected or shut down at the first sign of intrusion, while others must be left on line.
- When and under what circumstances to invoke the incident response activities, and how to ensure that the proper personnel are notified and available.
- When to involve outside experts and how to ensure the proper expertise will be available when needed. This consideration addresses both containment and restoration.
- Protocols to define when and under what circumstances to notify and involve regulators, customers, and law enforcement, including names and contact information for each group.
- Which personnel have authority to perform specific actions in the containment of the intrusion and restoration of the system. This consideration affects the internal communications strategy, the commitment of personnel, and procedures that escalate involvement and decisions within the organization.
- How, when, and what to communicate outside of the institution, whether to law enforcement, regulatory agencies, information-sharing organizations, customers, third-party service providers, potential victims, or others.
- How to document and maintain the evidence, the decisions made, and the actions taken.
- What criteria must be met before compromised services, equipment, and software are returned to the network.
- How to learn from the intrusion and use lessons learned to improve the institution's security.
- How and when to prepare and file a Suspicious Activities Report.

Successful implementation of any response policy or procedure requires the assignment of responsibilities, training, and testing. Some institutions formalize the response program with the creation of a security incident response team (SIRT). The SIRT typically is tasked with performing, coordinating, and supporting responses to security incidents and intrusions. Because of the wide range of technical and nontechnical issues posed by an intrusion, typical SIRT membership includes individuals with a wide range of backgrounds and expertise from different areas within the institution. Those areas include management, legal, and public relations, as well as IT staff. Other organizations may outsource some of the SIRT functions (e.g., forensic examinations). When SIRT functions are outsourced, management should require the third-party service provider to follow the institution’s policies and maintain the confidentiality of data.

Institutions should assess the adequacy of their preparation through testing. There are a variety of testing methods; therefore, management should consider the most applicable tests for its IT environment. Institutions can also participate with outside entities that provide testing activities (e.g., FS-ISAC).

While containment strategies between institutions can vary, they typically include the following broad elements:

- Isolation of compromised systems or enhanced monitoring of intruder activities.
- Search for additional compromised systems.
- Collection and preservation of evidence.
- Communication with affected parties and often the primary regulator, information-sharing organizations (e.g., FS-ISAC), or law enforcement.

Restoration and follow-up strategies should address the following:

- Elimination of an intruder’s means of access.
- Restoration of systems, programs, and data to a known good state.
- Initiation of customer notification and assistance activities consistent with laws, regulations, and interagency guidance.
- Monitoring to detect similar or further incidents.

Management should periodically review the actions taken in response to intrusions to identify improvements and implement those improvements through changes in policy, standards, procedures, training, and practices.

IV Information Security Program Effectiveness

The information security program should be subject to periodic review to ensure continual improvement in the program’s effectiveness. The review should address the program in the context of the environment in which the program now operates, both within the institution and outside. Lessons learned from experience, audit findings, and other indicators of opportunities for improvement should be identified and the program changed as appropriate.

IV.A Assurance and Testing

Action Summary

Management should ascertain that the information security program is operating securely, as expected, and reaching intended goals by doing the following:

- Testing and evaluating through self-assessments, tests, and audits with appropriate coverage, depth, and independence.
- Aligning personnel skills and program needs.
- Establishing and implementing a reporting process that includes the assembly and distribution of assurance reports that are timely, complete, transparent, and relevant to management decisions.

Assurance relates to the confidence that the information security program is mitigating risk as expected. Assurance targets two parts of the process: (1) the IT system's design and (2) the IT system's operation. The institution should carefully distinguish between the two because the former relates to risk decisions that change the security controls and the latter relates to the operation of the controls. Flaws in control design typically are corrected by a redesign, and flaws in operation typically are corrected through a compliance program.

The institution should have a documented testing and evaluation plan that addresses the integration of security controls, level of assurance desired, and strategies and activities performed in obtaining that assurance. The plan should identify specific components of the system to address, methods by which the components are to be addressed, timing and frequency of the tests and evaluations, and criteria used to ascertain whether the test and evaluation results are acceptable and provide assurance.[62]

IV.A.1 Key Testing Factors

Management should consider the following key factors when developing and implementing independent tests:

- **Scope.** The tests and methods utilized, in the aggregate, should be sufficient to validate the effectiveness of the security process in identifying and appropriately controlling the risk from information security-related events.
- **Personnel.** Technical testing is only as good as the personnel performing and supervising the test. Management should review qualifications of testing personnel to verify testers' capabilities are adequate to support the test objectives.
- **Notifications.** Management should consider whom to inform within the institution about the timing and nature of the tests. The need for protection of institution systems and the potential for disruptive false alarms should be balanced against the need to test personnel reactions to unexpected activities.

[62] See also Information Security Standards, section III.C.3, requiring each financial institution to test the key controls, systems, and procedures of its information security program using independent third parties or staff independent of those that develop or maintain the program.

- **Confidentiality, integrity, and availability.** Management should carefully control information security tests to limit the risks to confidentiality, integrity, and system availability. Because testing may uncover sensitive customer information, management should use appropriate safeguards to protect such information. Management should ensure that employee and contract personnel who perform the tests or have access to the test results have passed appropriate background checks and that contract personnel are appropriately bonded. Because certain tests may pose more risk to system availability than other tests, management should have personnel who perform those tests maintain logs of testing actions. Those logs are helpful if the systems react unexpectedly.
- **Confidentiality of test plans and data.** Because knowledge of test planning and results may facilitate a security breach, the institution should carefully limit the distribution of testing information. Management should restrict test plans and data only to those individuals involved in the testing. Results should be made available in a usable form only to those responsible for following up on tests. Additionally, management should require contractors to sign nondisclosure agreements and to return information they obtained in their testing to the institution.
- **Frequency.** The institution's ITRM process should determine the frequency of independent testing. Factors that may increase testing frequency include changes to network configurations, changes to or additions of systems and applications, significant changes in potential attacker profiles and techniques, and results of other testing. For instance, management should have a testing process for security and usability over the life cycle of testing (during development, before placing a new or modified system into production, and periodic testing of the production system or application).
- **Proxy testing.** Proxy testing refers to testing that is conducted on like systems and with like interfaces, rather than the actual system, to avoid disruptions on a system that may be too critical for a comprehensive continuity test. Proxy tests are conducted using the same hardware and operating software, are sometimes used as a replacement for actual tests, and should provide similar results. Independent testing of a proxy system is generally not effective in validating the effectiveness of a security process. Proxy testing, by its nature, does not test the operational system's policies and procedures or its integration with other systems. It also does not test the reaction of personnel to unusual events. Proxy testing may be the best choice, however, when management is unable to test the operational system without creating excessive risk.

IV.A.2 Types of Tests and Evaluations

Information security management may use several tools to gain confidence that the information security program is operating as expected and reaching the intended goals. The primary tools include self-assessments, penetration tests, vulnerability assessments, and audits. The coverage and depth of the various tools directly relates to the confidence gained in the information security program.

IV.A.2(a) *Self-Assessments*

Periodic self-assessments typically should be performed by the organizational unit being assessed. Self-assessments capture subjective opinions on the achievement of objectives.

Although they may provide valuable information related to perceived changes in the level of risk and effectiveness of controls, they are affected by the breadth and depth of the assessor's knowledge, the completeness and reliability of information used to complete the assessment, and the assessor's biases. Self-assessment frequency should be a function of the level of assurance needed by the institution, determined by the risk management process. Results from self-assessments can be informative to the overall test and evaluation process. Management should use the results to help strengthen the organizational unit's information security.

IV.A.2(b) *Penetration Tests*

A penetration test subjects a system to real-world attacks selected and conducted by the testers. A penetration test targets systems and users to identify weaknesses in business processes and technical controls. The test mimics a threat source's search for and exploitation of vulnerabilities to demonstrate a potential for loss. Some tests focus on only a subset of the institution's systems and may not accurately simulate a determined threat actor. There are many types of penetration tests (e.g., network, client-side, web application, and social engineering), and management should determine the level and types of tests employed to ensure effective and comprehensive coverage.

The frequency and scope of a penetration test should be a function of the level of assurance needed by the institution and determined by the risk assessment process. The test can be performed internally by independent groups, internally by the organizational unit, or by an independent third party. Management should determine the level of independence required of the test.

IV.A.2(c) *Vulnerability Assessments*

A vulnerability assessment is a process that defines, identifies, and classifies the vulnerabilities in a computer, network, or communications infrastructure. Technical vulnerabilities can be identified through the use of scanners and other tools. Scanners search for known vulnerabilities (e.g., Mitre's CVE) or for known vulnerability classes (e.g., Structured Query Language [SQL] injection and cross-site scripting). They also can search for compliance with approved configurations. Scanners identify vulnerabilities by inspecting network traffic or hosts. When inspecting hosts, they may require agents to be placed on the hosts with high-level access. If host agents are required, the security over the use of credentials in the scan should be a prime consideration for management.

Similar to penetration testing, the frequency of the performance of vulnerability assessments should be determined by the risk management process. Scanners and other tools can be run continuously, generating metrics that are reported and acted upon continuously. Alternatively, they can be run periodically. Vulnerability assessments can be performed internally or by external testers, but they are often run as part of internal testing processes.

IV.A.2(d) *Audits*

Independent internal departments or third parties typically perform audits. Audits should review every aspect of the information security program, the environment in which the program runs, and outputs of the program. Audits should assess the reasonableness and appropriateness of, and compliance with, policies, standards, and procedures; report on information security activity and control deficiencies to decision makers; identify root causes and recommendations to address deficiencies; and test the effectiveness of controls within the program. Internal audit should track the results and the remediation of control deficiencies reported in audits and additional technical reviews, such as penetration tests and vulnerability assessments.

Refer to the *IT Handbook's* "Audit" booklet for more information.

IV.A.3 Independence of Tests and Audits

Institutions frequently use independent organizations to test aspects of their information security programs. Independent tests have the potential to reduce bias, increase capabilities, and increase knowledge about threats and technologies. Independence gives credibility to the test results. To be considered independent, testing personnel should not be responsible for the design, installation, maintenance, and operation of the tested system, or the policies and procedures that guide its operation. The reports generated from the tests should be prepared by individuals who similarly are independent.

IV.A.4 Assurance Reporting

Reporting of self-assessments, penetration tests, vulnerability assessments, and audits supports management decision making. Those decisions may support a range of ITRM activities, including the prioritization and funding of resource allocations and improvement to existing information security policies and procedures.

Management should provide reports that are timely, complete, transparent, and relevant to management decisions. The reports should prioritize risk and findings in the order of importance, suggest options for remediation, and highlight repeat issues. Additionally, reports should address root causes. The reporting should be to individuals with authority and responsibility to act on the reports and to those accountable for the outcomes, as well as those responsible for advising or influencing risk decisions. Reporting should trigger appropriate, timely, and reliable escalation and response procedures. Summary reports should be made available to the board as appropriate.

Appendix A: Examination Procedures

Examination Objective

Determine the quality and effectiveness of the institution's information security. Examiners should use these procedures to measure the adequacy of the institution's culture, governance, information security program, security operations, and assurance processes. In addition, controls should be evaluated as additional evidence of program quality and effectiveness. Controls also should be evaluated for conformance with contracts, indicators of legal liability, and conformance with regulatory policy and guidance. Failure of management to implement appropriate controls may expose the institution to potential loss from fines, penalties, and customer litigation.

These examination procedures (commonly referred to as the work program) are intended to help examiners determine the effectiveness of the institution's information security process. Examiners may choose, however, to use only particular components of the work program based on the size, complexity, and nature of the institution's business. Examiners should also use these procedures to measure the adequacy of the institution's cybersecurity risk management processes.

Objective 1: Determine the appropriate scope and objectives for the examination.

1. Review past reports for outstanding issues or previous problems. Consider the following:

    a. Regulatory reports of examination.
    b. Internal and external audit reports.
    c. Independent security tests.
    d. Regulatory, audit, and security reports on service providers.

2. Review management's response to issues raised at, or since, the last examination. Consider the following:

    a. Adequacy and timing of corrective action.
    b. Resolution of root causes rather than just specific issues.
    c. Existence of any outstanding issues.

3. Interview management and review responses to pre-examination information requests to identify changes to technology infrastructure or new products and services that might increase the institution's risk. Consider the following:

    a. Products or services delivered to either internal or external users.
    b. Network topology or diagram including changes to configuration or components and all internal and external connections.
    c. Hardware and software inventories.
    d. Loss, addition, or change in duties of key personnel.
    e. Technology service providers and software vendor listings.

f. Communication lines with other business units (e.g., loan review, credit risk management, line of business quality assurance, and internal audit).
g. Credit or operating losses primarily attributable (or thought to be attributable) to IT (e.g., system problems, fraud occurring due to poor controls, and improperly implemented changes to systems).
h. Changes to internal business processes.
i. Internal reorganizations.

4. Determine the complexity of the institution's information security environment.

   a. Determine the degree of reliance on service providers for information processing and technology support, including security operation management.
   b. Identify unique products and services and any required third-party access requirements.
   c. Determine the extent of network connectivity internally and externally and the boundaries and functions of security domains.
   d. Identify the systems that have recently undergone significant change, such as new hardware, software, configuration, and connectivity. Correlate the changed systems with the business processes they support, the extent of customer data available to those processes, and the effect of those changes on institution operations.

Objective 2: Determine whether management promotes effective governance of the information security program through a strong information security culture, defined information security responsibilities and accountability, and adequate resources to support the program.

1. Determine whether the institution has a culture that contributes to the effectiveness of the information security program.

   a. Determine whether the institution's board and management understand and support information security and provide appropriate resources for the implementation of an effective security program.
   b. Determine whether the information security program is integrated with the institution's lines of business, support functions, and management of third parties.
   c. Review for indicators of an effective information security culture (e.g., method of introducing new business initiatives and manner in which the institution holds lines of business and employees accountable for promoting information security).

2. Determine whether the board, or a committee of the board, is responsible for overseeing the development, implementation, and maintenance of the institution's information security program.

3. Determine whether the board holds management accountable for the following:

   a. Central oversight and coordination.
   b. Assignment of responsibility.
   c. Support of the information security program.

d. Effectiveness of the information security program.

4. Determine whether the board approves a written information security program and receives a report on the effectiveness of the information security program at least annually. Determine whether the report to the board describes the overall status of the information security program and discusses material matters related to the program such as the following:

   a. Risk assessment process, including threat identification and assessment.
   b. Risk management and control decisions.
   c. Service provider arrangements.
   d. Results of security operations activities and summaries of assurance reports.
   e. Security breaches or violations and management's responses.
   f. Recommendations for changes or updates to the information security program.

5. Determine whether management responsibilities are appropriate and include the following:

   a. Implementation of the information security program by clearly communicating responsibilities and holding appropriate individuals accountable for carrying out these responsibilities.
   b. Establishment of appropriate policies, standards, and procedures to support the information security program.
   c. Participation in assessing the effect of security threats or incidents on the institution and its business lines and processes.
   d. Delineation of clear lines of responsibility and communication of accountability for information security.
   e. Adherence to risk thresholds established by the board relating to information security threats or incidents, including those relating to cybersecurity.
   f. Oversight of risk mitigation activities that support the information security program.
   g. Establishment of appropriate segregation of duties.
   h. Coordination of both information and physical security.
   i. Integration of security controls throughout the institution.
   j. Protection of data consistently throughout the institution.
   k. Definition of the information security responsibilities of third parties.
   l. Facilitation of annual information security and awareness training and ongoing security-related communications to employees.

6. Determine whether management has designated one or more individuals as an information security officer and determine appropriateness of the reporting line.

7. Determine whether security officers and employees know, understand, and are accountable for fulfilling their security responsibilities.

8. Determine the adequacy of audit coverage and reporting of the information security program by reviewing appropriate audit reports and board or audit committee minutes. (For further questions, refer to the *IT Handbook's* "Audit" booklet examination procedures.)[63]

9. Determine whether the board provides adequate funding to develop and implement a successful information security function. Review whether the institution has the following:

   a. Appropriate staff with the necessary skills to meet the institution's technical and managerial needs.
   b. Personnel with knowledge of technology standards, practices, and risk methodologies.
   c. Training to prepare staff for their short- and long-term security responsibilities.
   d. Oversight of third parties when they supplement an institution's technical and managerial capabilities.

10. Determine whether management has adequately incorporated information security into its overall ITRM process. (For further questions, refer to the *IT Handbook's* "Management" booklet examination procedures.)[64]

Objective 3: Determine whether management of the information security program is appropriate and supports the institution's ITRM process, integrates with lines of business and support functions, and integrates third-party service provider activities with the information security program.

1. Determine whether the institution has an effective information security program that supports the ITRM process. Review whether the program includes the following:

   a. Identification of threats and risks.
   b. Measurement of risks.
   c. Implementation of risk mitigation.
   d. Monitoring and reporting of risks.
   e. Methods to assess the program's effectiveness.

2. Determine whether management appropriately integrates the information security program across the institution's lines of business and support functions. Review whether management has the following:

   a. Security policies, standards, and procedures that are designed to support and to align with the policies in the lines of business.
   b. Incident response programs that include all affected lines of business and support units.
   c. Common awareness and enforcement mechanisms between lines of business and information security.
   d. Visibility to assess the likelihood of threats and potential damage to the institution.
   e. The ability to identify and implement controls over the root causes of an incident.

[63] See the *IT Handbook's* "Audit" booklet examination procedures.

[64] See the *IT Handbook's* "Management" booklet examination procedures.

3. If the institution outsources activities to a third-party service provider, determine whether management integrates those activities with the information security program. Verify that the third-party management program evidences expectations that align with the institution's information security program.

Objective 4: As part of the information security program, determine whether management has established risk identification processes.

1. Determine whether management effectively identifies threats and vulnerabilities continuously.

2. Determine whether the risk identification process produces manageable groupings of information security threats, including cybersecurity threats. Review whether management has the following:

   a. A threat assessment to help focus the risk identification efforts.
   b. A method or taxonomy for categorizing threats, sources, and vulnerabilities.
   c. A process to determine the institution's information security risk profile.
   d. A validation of the risk identification process through audits, self-assessments, penetration tests, and vulnerability assessments.
   e. A validation though audits, self-assessments, penetration tests, and vulnerability assessments that risk decisions are informed by appropriate identification and analysis of threats and other potential causes of loss.

3. Determine whether management has a means to collect data on potential threats to identify information security risks. Determine whether management uses threat modeling (e.g., development of attack trees) to assist in identifying and quantifying risk and in better understanding the nature, frequency, and sophistication of threats.

4. Determine whether management has continuous, established routines to identify and assess vulnerabilities. Determine whether management has processes to receive vulnerability information disclosed by external individuals or groups, such as security or vulnerability researchers.

5. Determine whether management adjusts the information security program for institutional changes and changes in legislation, regulation, regulatory policy, guidance, and industry practices. Review whether management has processes to do the following:

   a. Maintain awareness of new legal and regulatory requirements or changes to industry practices.
   b. Update the information security program to reflect changes.
   c. Report changes of the information security program to the board.

Objective 5: Determine whether management measures the risk to guide its recommendations for and use of mitigating controls.

1. Determine whether management uses tools to perform threat analysis and analyzes information security events to help do the following:

    a. Map threats and vulnerabilities.
    b. Incorporate legal and regulatory requirements.
    c. Improve consistency in risk measurement.
    d. Highlight potential areas for mitigation.
    e. Allow comparisons among different threats, events, and potential mitigating controls.

Objective 6: Determine whether management effectively implements controls to mitigate identified risk.

1. Determine whether policies, standards, and procedures are of sufficient scope and depth to guide information security-related decisions. Review whether policies, standards, and procedures have the following characteristics:

    a. Are appropriately implemented and enforced.
    b. Delineate areas of responsibility.
    c. Are communicated in a clear and understandable manner.
    d. Are reviewed and agreed to by employees.
    e. Are appropriately flexible to address changes in the environment.

2. Determine whether the information security policy is annually reviewed and approved by the board.

3. Determine whether the institution continually assesses the capability of technology needed to sustain an appropriate level of information security based on the size, complexity, and risk appetite of the institution.

4. Determine whether management implements an integrated control system characterized by the use of different control types that mitigates identified risks. Review whether management does the following:

    a. Implements a layered control system using different controls at different points in a transaction process.
    b. Uses controls of different classifications, including preventive, detective, and corrective.
    c. Verifies that compensating controls are used appropriately to compensate for weaknesses with the system or process.

5. Determine whether management implements controls that appropriately align security with the nature of the institution's operations and strategic direction. Specifically, review whether management does the following:

a. Implements controls based on the institution’s risk assessment to mitigate risk from information security threats and vulnerabilities, such as interconnectivity risk.
b. Evaluates whether the institution has the necessary resources, personnel training, and testing to maximize the effectiveness of the controls.
c. Reviews and improves or updates the security controls, where necessary.

6. Determine whether management effectively maintains an inventory(ies) of hardware, software, information, and connections. Review whether management does the following:

   a. Identifies assets that require protection, such as those that store, transmit, or process sensitive customer information, or trade secrets.
   b. Classifies assets appropriately.
   c. Uses the classification to determine the sensitivity and criticality of assets.
   d. Uses the classification to implement controls required to safeguard the institution’s assets.
   e. Updates the inventory(ies) appropriately.

7. Determine whether management comprehensively and effectively identifies, measures, mitigates, monitors, and reports interconnectivity risk. Review whether management does the following:

   a. Identifies connections with third parties.
   b. Identifies access points and connection types that pose risk.
   c. Identifies connections between and access across low-risk and high-risk systems.
   d. Measures the risk associated with connections with third parties with remote access.
   e. Implements and assesses the adequacy of appropriate controls to ensure the security of connections.
   f. Monitors and reports on the institution’s interconnectivity risk.

8. Determine whether management effectively mitigates risks posed by users. Review whether management does the following:

   a. Develops and maintains a culture that fosters responsible and controlled access for users.
   b. Establishes and effectively administers appropriate security screening in IT hiring practices.
   c. Establishes and appropriately administers a user access program for physical and logical access.
   d. Employs appropriate segregation of duties.
   e. Obtains agreements from employees, contractors, and service providers covering confidentiality, nondisclosure, and authorized use.
   f. Provides training to support awareness and policy compliance.

9. Determine whether management applies appropriate physical security controls to protect its premises and more sensitive areas, such as its data center(s).

10. Determine whether management secures access to its computer networks through multiple layers of access controls. Review whether management does the following:

    a. Establishes zones (e.g., trusted and untrusted) according to risk with appropriate access requirements within and between each zone.
    b. Maintains accurate network diagrams and data flow charts.
    c. Implements appropriate controls over wired and wireless networks.

11. Determine whether management has a process to introduce changes to the environment (e.g., configuration management of IT systems and applications, hardening of systems and applications, use of standard builds, and patch management) in a controlled manner. Determine whether management does the following:

    a. Maintains procedures to guide the process of introducing changes to the environment.
    b. Defines change requirements.
    c. Restricts changes to authorized users.
    d. Reviews the potential impact changes have on security controls.
    e. Identifies all system components affected by the changes.
    f. Develops test scripts and implementation plans.
    g. Performs necessary tests of all changes to the environment (e.g., systems testing, integration testing, functional testing, user acceptance testing, and security testing).
    h. Defines rollback procedures in the event of unintended or negative consequences with the introduced changes.
    i. Verifies the application or system owner has authorized changes in advance.
    j. Maintains strict version control of all software updates.
    k. Validates that new hardware complies with institution policies and guidelines.
    l. Verifies network devices are properly configured and function appropriately within the environment
    m. Maintains an audit trail of all changes.

12. Determine whether appropriate processes exist for configuration management (managing and controlling configurations of systems, applications, and other technology).

13. Determine whether management has processes to harden applications and systems (e.g., installing minimum services, installing necessary patches, configuring appropriate security settings, enforcing principle of least privilege, changing default passwords, and enabling logging).

14. Determine whether management uses standard builds, allowing one documented configuration to be applied to multiple computers in a controlled manner, to create hardware and software inventories, update or patch systems, restore systems, investigate anomalies, and audit configurations.

15. Determine whether management has a process to update and patch operating systems, network devices, and software applications, including internally developed software provided

to customers, for newly discovered vulnerabilities. Review whether patch management processes include the following:

a. An effective monitoring process that identifies the availability of software patches.
b. A process to evaluate the patches against the threat and network environment.
c. A prioritization process to determine which patches to apply across classes of computers and applications.
d. A process for obtaining, testing, and securely installing the patches.
e. An exception process, with appropriate documentation, for patches that an institution decides to delay or not apply.
f. A process to ensure that all patches installed in the production environment are also installed in the disaster recovery environment.
g. A documentation process to ensure the institution's information assets and technology inventory and disaster recovery plans are updated as appropriate when patches are applied.
h. Actions to ensure that patches do not compromise the security of the institution's systems.

16. Determine whether management plans for the life cycles of the institution's systems, eventual end of life, and any corresponding business impacts. Review whether the institution's life cycle management includes the following:

a. Maintaining inventories of systems and applications.
b. Adhering to an approved end-of-life or sunset policy for older systems.
c. Tracking changes made to the systems and applications, availability of updates, and the planned end of support by the vendor.
d. Planning for the update or replacement of systems nearing obsolescence.
e. Outlining procedures for the secure destruction or wiping of hard drives being returned to vendors or donated to prevent the inadvertent disclosure of sensitive information.

17. Determine whether management has implemented defense-in-depth to protect, detect, and respond to malware.

18. Determine whether management maintains policies and effectively controls and protects access to and transmission of information to avoid loss or damage. Review whether management does the following:

a. Requires secure storage of all types of sensitive information, whether on computer systems, portable devices, physical media, or hard-copy documents.
b. Establishes controls to limit access to data.
c. Requires appropriate controls over data stored in a cloud environment.
d. Implements appropriate controls over the electronic transmission of information or, if appropriate safeguards are unavailable, restricts the type of information that can be transmitted.
e. Has appropriate disposal procedures for both paper-based and electronic information.

f. Maintains the security of physical media, including backup tapes, containing sensitive information while in transit, including to off-site storage, or when shared with third parties.
g. Has policies restricting the use of unsanctioned or unapproved IT resources (e.g., online storage services, unapproved mobile device applications, and unapproved devices).

19. Determine whether management identifies factors that may increase risk from supply chain attacks and responds with appropriate risk mitigation. Review whether management implements the following as appropriate:

    a. Purchases are made only through reputable sellers.
    b. Purchases are made through a third party to shield the institution's identity.
    c. Hardware is reviewed for anomalies.
    d. Software is reviewed through both automated software testing and code reviews.
    e. Reliability of the items purchased is regularly reviewed post-implementation.

20. Determine whether management has an effective process to administer logical security access rights for the network, operating systems, applications, databases, and network devices. Review whether management has the following:

    a. An enrollment process to add new users to the system.
    b. An authorization process to add, delete, or modify authorized user access to operating systems, applications, directories, files, and specific types of information.
    c. A monitoring process to oversee and manage the access rights granted to each user on the system.
    d. A process to control privileged access.
    e. A process to change or disable default user accounts and passwords.

21. As part of management's process to secure the operating system and all system components, determine whether management does the following:

    a. Limits the number of employees with access to operating system and system utilities and grants only the minimum level of access required to perform job responsibilities.
    b. Restricts and logs access to and activity on operating system parameters, system utilities (especially those with data-altering capabilities), and sensitive system resources (including files, programs, and processes), and supplements with additional security software, as necessary.
    c. Restricts operating system access to specific terminals in physically secure and monitored locations.
    d. Secures or removes external drives and portable media from system consoles, terminals, or PCs running terminal emulations, residing outside of physically secure locations.
    e. Prohibits remote access to operating system and system utilities, where feasible, and, at a minimum, requires strong authentication and encrypted sessions before allowing such remote access.
    f. Filters and reviews logs for potential security events and provides adequate reports and alerts.

g. Independently monitors operating system access by user, terminal, date, and time of access.

22. Determine whether management controls access to applications. Review whether management does the following:

    a. Implements a robust authentication method consistent with the criticality and sensitivity of the application.
    b. Manages application access rights by using group profiles.
    c. Periodically reviews and approves the application access assigned to users for appropriateness.
    d. Communicates and enforces the responsibilities of programmers, security administrators, and application owners in maintaining effective application access control.
    e. Sets time-of-day or terminal limitations for some applications or for more sensitive functions within an application.
    f. Logs access and events, defines alerts for significant events, and develops processes to monitor and respond to anomalies and alerts.

23. Determine whether management has policies and procedures to ensure that remote access by employees, whether using institution or personally owned devices, is provided in a safe and sound manner. Review whether management does the following:

    a. Provides remote access in a safe and sound manner.
    b. Implements the controls necessary to offer remote access securely (e.g., disables unnecessary remote access, obtains approvals for and performs audits of remote access, maintains robust configurations, enables logging and monitoring, secures devices, restricts remote access during specific times, controls applications, enables strong authentication, and uses encryption).

24. Determine whether management effectively controls employees' use of remote devices. Review whether management does the following:

    a. Implements controls over institution owned and personally owned devices used by employees to access the network (e.g., disallows remote access without business justification, requires management approval, reviews remote access approvals, restricts access to authorized network areas, logs remote access, implements robust authentication, uses encryption, and uses application white-listing).
    b. Implements controls over remote devices provided by the institution (e.g., securely configures remote access devices, protects devices against malware, patches and updates software, encrypts sensitive data, implements secure containers, audits device access, uses remote disable and wipe capabilities, and uses geolocation).
    c. Uses an effective method to ensure personally owned devices meet defined institution security standards (e.g., such as operating system version, patch levels, and anti-malware solutions).

25. Determine whether management effectively provides secure customer access to financial services and plans for potential interruptions in service. Review whether management does the following:

    a. Develops and maintains policies and procedures to securely offer and ensure the resilience of remote financial services (e.g., using appropriate authentication, layered security controls, and fraud detection monitoring). (For additional questions, refer to the "Mobile Financial Services" examination procedures.)[65]
    b. Plans and coordinates with ISPs and third parties to minimize exposure to incidents and continue services when faced with an incident (e.g., monitors threat alerts, service availability, applications, and network traffic for indicators of nefarious activity, and ensures traffic filtering).
    c. Develops and tests a response plan in conjunction with the institution's ISPs and third-party service providers to mitigate the interruption of mobile or remote financial services.

26. Determine whether management develops customer awareness and education efforts that address both retail (consumer) and commercial account holders.

27. Determine whether management uses applications that were developed by following secure development practices and that meet a prudent level of security. Determine whether management develops security control requirements for applications, whether they are developed in-house or externally. Determine whether information security personnel are involved in monitoring the application development process to verify secure development practices. Review whether applications in use provide the following capabilities:

    a. Provide a prudent level of security (e.g., password and audit policies), audit trails of security and access changes, and user activity logs.
    b. Have user and group profiles to manage user access for applications if they are not part of a centralized identity access management system.
    c. Provide the ability to change and disable default application accounts upon installation.
    d. Allow administrators to review and install patches for applications in a timely manner.
    e. Use validation controls for data entry and data processing.
    f. Integrate additional authentication and encryption controls, as necessary.
    g. Protect web or Internet-facing applications through additional controls, including web application firewalls, regular scanning for new or recurring vulnerabilities, mitigation or remediation of common security weaknesses, and network segregation.

28. With respect to developed software, determine whether institution management does the following:

    a. Reviews mitigation of potential flaws in applications.
    b. Obtains attestation or evidence from third-party developers that the applications acquired by the institution meet the necessary security requirements and that noted vulnerabilities or flaws are remediated in a timely manner.

[65] Refer to appendix E of the *IT Handbook's* "Retail Payment Systems" booklet.

c. Performs ongoing risk assessments to consider the adequacy of application-level controls in light of changing threat, network, and host environments.
d. Implements minimum controls recommended by third-party service providers and considers supplemental controls as appropriate.
e. Reviews available audit reports, and considers and implements appropriate control recommendations.
f. Collects data to build metrics and reporting of configuration management compliance, and vulnerability management.

29. For database security, determine whether management implemented or enabled controls commensurate with the sensitivity of the data stored in or accessed by the database(s). Determine whether management appropriately restricts access and applies the rule of least privilege in assigning authorizations.

30. Determine how and where management uses encryption and if the type and strength are sufficient to protect information appropriately. Additionally, determine whether management has effective controls over encryption key management.

31. Determine whether management appropriately oversees the effectiveness of information security controls over outsourced operations and is accountable for the mitigation of risks involved with the use of third-party service providers. Review the due diligence involved, security controls to mitigate risk, and monitoring capabilities over the institution's third parties. Review the institution's policies, standards, and procedures related to the use of the following:

    a. Third-party service providers that facilitate operational activities (e.g., core processing, mobile financial services, cloud storage and computing, and managed security services).
    b. Due diligence in research and selection of third-party service providers.
    c. Contractual assurances from third-party service providers for security responsibilities, controls, and reporting.
    d. Nondisclosure agreements with third-party service providers with access to the institution's systems and data (including before, during, and following termination of the contract).
    e. Independent review of the third-party service provider's security through appropriate reports from audits and tests.
    f. Coordination of incident response policies and contractual notification requirements.
    g. Verification that information and cybersecurity risks are appropriately identified, measured, mitigated, monitored, and reported.

32. If the institution outsources cloud computing or storage to a third-party service provider, refer to the FFIEC's "Outsourced Cloud Computing" statement.[66]

[66] See the FFIEC's "Outsourced Cloud Computing" statement.

33. If the institution outsources the management of security services to a third-party service provider, refer to the information available in appendix D of the *IT Handbook's* "Outsourcing Technology Services" booklet and the related examination procedures.[67]

34. Determine whether management effectively manages the following information security considerations related to business continuity planning. Review management's ability to do the following:

    a. Identify personnel with key information security roles during a disaster and training of personnel in those roles.
    b. Define information security needs for backup sites and alternate communication networks.
    c. Develop policies that address the concepts of information security incident response and resilience and test information security incident scenarios.

35. Determine whether management has an effective log management process that involves a central logging repository, timely transmission of log files, and effective log analysis. Review whether management has the following:

    a. Log retention policies that meet incident response and analysis needs.
    b. Processes for the security and integrity of log files (e.g., encryption of log files, adequate storage capacity, secure backup and disposal of logs, logging to a separate computer, use of read-only media, controlled log parameters, and restricted access to log files).
    c. Independent review of logging practices.
    d. Processes to effectively collect, aggregate, analyze, and correlate security event information from discrete systems and applications.

Objective 7: Determine whether management has effective risk monitoring and reporting processes.

1. Determine whether the institution has risk monitoring and reporting processes that address changing threat conditions in both the institution and the greater financial industry. Determine whether these processes address information security events faced by the institution, the effectiveness of management's response, and the institution's resilience to those events. Review whether the reporting process includes a method of disseminating those reports to appropriate members of management.

2. Determine whether the risk monitoring and reporting process is regular and prompts action, when necessary, in a timely manner.

3. Determine whether program monitoring and reporting instigate appropriate changes that are effective in maintaining an acceptable level of risk.

[67] Refer to the *IT Handbook's* "Outsourcing Technology Services" booklet for the MSSP Examination Procedures.

4. Determine whether management develops and effectively uses metrics as part of the risk monitoring and reporting processes for the information security program. Review whether management does the following:

    a. Uses metrics that are timely, comprehensive, and actionable to improve the program's effectiveness and efficiency.
    b. Develops metrics that demonstrate the extent to which the information security program is implemented and whether the program is effective.
    c. Uses metrics to measure security policy implementation, the adequacy of security services delivery, and the impact of security events on business processes.
    d. Establishes metrics to measure conformance to the standards and procedures that are used to implement policies.
    e. Uses metrics to quantify and report risks in the information security program.

Objective 8: Determine whether management has security operations that encompass necessary security-related functions, are guided by defined processes, are integrated with lines of business and activities outsourced to third-party service providers, and have adequate resources (e.g., staff and technology).

1. Determine whether the institution's security operations activities include the following:

    a. Security software and device management (e.g., maintaining the signatures on signature-based devices and firewall rules).
    b. Forensics (e.g., analysis of potentially compromised systems).
    c. Vulnerability identification (e.g., operation or supervision of vulnerability scans, self-assessments, penetration tests, and analysis of audit results).
    d. Vulnerability cataloging and remediation tracking.
    e. Physical security management (e.g., CCTV, guards, and badge systems).
    f. Law enforcement interface (e.g., data retention and lawful intercepts).
    g. Third-party integration (e.g., managed security services and incident detection services).
    h. Monitoring of network, host, and application activity.
    i. Threat identification and assessment.
    j. Incident detection and management.
    k. Enforcement of access controls.

2. Determine whether management establishes defined processes and appropriate governance to facilitate the performance of security operations. Determine whether management coordinates security operations activities with the institution's lines of business and with the institution's third-party service providers.

3. Determine whether management has effective threat identification and assessment processes, including the following:

    a. Maintaining procedures for obtaining, monitoring, assessing, and responding to evolving threat and vulnerability information.

b. Identifying and assessing threats (e.g., threat information is often ad hoc, although some providers present threat information within a defined framework that readily lends itself to analytical operations).
c. Using tools to assist in the analysis of vulnerabilities (e.g., design of system, operation of the system, security procedures, business line controls, and implementation of the system and controls).
d. Using threat knowledge to drive risk assessment and response.
e. Designing policies to allow immediate and consequential threats to be dealt with expeditiously.
f. Developing appropriate processes to evaluate and respond to vulnerability information from external groups or individuals.

4. Determine whether management has effective threat monitoring processes, including the following:

   a. Defining threat monitoring policies that provide for both continual and ad hoc monitoring of communications and systems, effective incident detection and response, and the use of monitoring reports in subsequent legal proceedings.
   b. Establishing responsibility and accountability for security personnel and system administrators for monitoring.
   c. Appropriately reviewing and providing approval of the monitoring tools used.
   d. Monitoring of indicators, including vulnerabilities, attacks, compromised systems, and suspicious users.
   e. Monitoring both incoming and outgoing network traffic to identify malicious activity and data exfiltration.
   f. Establishing and documenting a process to independently monitor administrators and other users with higher privileges.

5. Determine whether management has effective incident identification and assessment processes to do the following:

   a. Identify indicators of compromise.
   b. Analyze the event associated with the indicators.
   c. Classify the event.
   d. Enable the use of response teams and responses depending on the type of event.
   e. Escalate the event consistent with the classification.
   f. Report internally and externally as appropriate.
   g. Identify personnel empowered to declare an incident.
   h. Develop procedures to test the incident escalation, response, and reporting processes.

6. Determine whether management has effective incident response processes, including the following:

   a. Protocols defined in the incident response policy to declare and respond to an incident once identified.

b. Procedures to minimize damage through the containment of the incident, restoration of systems, preservation of data and evidence, and notification, as appropriate, to customers and others as needed.
c. Appropriate balance of adequate people and technologies in the response.
d. A plan that is comprehensive, coordinated, integrated, and periodically tested with appropriate internal and external parties.
e. Policies and procedures to guide the response, assigning responsibilities to individuals; providing appropriate training; formalizing information flows; and selecting, installing, and understanding the tools used in the response effort.
f. Thresholds for reporting significant security incidents and processes to notify, as appropriate, the institution's regulators of those incidents that may affect the institution or the financial system.
g. Assignment of responsibilities, training, and testing.
h. Containment strategies.
i. Restoration and follow-up strategies.

Objective 9: Determine whether management has an effective information security program.

1. Determine whether the information security program is subject to periodic review and whether management provides for continual improvement in the program's effectiveness. Verify whether that review does the following:

    a. Addresses the program in its current environment.
    b. Demonstrates that lessons learned from experience, audit findings, and other opportunities for improvement are identified and applied.

Objective 10: Determine whether assurance activities provide sufficient confidence that the security program is operating as expected and reaching intended goals.

1. Review whether management ascertains assurance through the following:

    a. Testing and evaluations through a combination of self-assessments, penetration tests, vulnerability assessments, and audits with appropriate coverage, depth, and independence.
    b. Alignment of personnel skills and program needs.
    c. Reporting that is timely, complete, transparent, and relevant to management decisions.

2. Determine whether management considers the following key testing factors when developing and implementing independent tests:

    a. Scope.
    b. Personnel.
    c. Notifications.
    d. Confidentiality, integrity, and availability of the institution's information.
    e. Confidentiality of test plans and data.
    f. Frequency.

    g. Proxy testing.

3. Determine whether management uses the following types of tests and evaluations to determine the effectiveness of the information security program. Verify whether management ensures the following are done:

    a. Periodic self-assessments performed by the organizational unit being assessed.
    b. Penetration tests that subject a system to real-world attacks and identify weaknesses.
    c. Vulnerability assessments that define, identify, and classify the security holes found in the system.
    d. Audits performed by independent internal departments or third parties.

4. Determine whether management uses independent organizations to test aspects of its information security programs.

5. Determine whether management uses reporting of the results of self-assessments, penetration tests, vulnerability assessments, and audits to support management decision making.

6. Determine whether the annual information security report is timely and contains adequate information.

Objective 11: Discuss corrective action and communicate findings.

1. Review preliminary conclusions with the examiner-in-charge regarding the following:

    a. Violations of laws or regulations.
    b. Significant issues warranting inclusion as matters requiring attention or recommendations in the report of examination.
    c. The proposed Uniform Rating System for Information Technology management component rating and the potential impact of the conclusion on the composite or other component IT ratings.
    d. Potential impact of conclusions on the institution’s risk assessment.

2. Discuss findings with management and obtain proposed corrective action for significant deficiencies.

3. Document conclusions in a memo to the examiner-in-charge that provides report-ready comments for all relevant sections of the report of examination and guidance to future examiners.

4. Organize work papers to ensure clear support for significant findings by examination objective.

Appendix B: Glossary

Acceptable use policy: A document that establishes an agreement between users and the enterprise and defines for all parties the ranges of use that are approved before users can gain access to a network or the Internet.

Access: The ability to physically or logically enter or make use of an IT system or area (secured or unsecured). The process of interacting with a system.

Administrator privileges: Computer system access to resources that are unavailable to most users. Administrator privileges permit execution of actions that would otherwise be restricted.

Air-gapped environment: Security measure that isolates a secure network from unsecure networks physically, electrically, and electromagnetically.

Anomalous activity: Activity that deviates from normal. The result of the process of comparing definitions of what activity is considered normal against observed events to identify significant deviations.

Antivirus/anti-malware software: A program that monitors a computer or network to identify all types of malware and prevent or contain malware incidents.

Asset: In computer security, a major application, a general-support system, a high-impact program, a physical plant, a mission-critical system, personnel, equipment, or a logically related group of systems.

Attack signature: A specific sequence of events indicative of an unauthorized access attempt.

Authentication: The process of verifying the identity of an individual user, machine, software component, or any other entity.

Availability: Whether or how often a system is available for use by its intended users. Because downtime is usually costly, availability is an integral component of security.

Baseline configuration: A set of specifications for a system, or configuration item within a system, that has been formally reviewed and agreed on at a given point in time and that can be changed only through change control procedures. The baseline configuration is used as a basis for future builds, releases, or changes.

Black holing: A method typically used by ISPs to stop a distributed denial-of-service (DDoS) attack on one of its customers. This approach to blocking DDoS attacks makes the site in question completely inaccessible to all traffic, both malicious attack traffic and legitimate user traffic.

Border router: A device located at the organization's boundary to an external network.

Change management: The broad processes for managing organizational change. Change management encompasses planning, oversight or governance, project management, testing, and implementation.

Checksum: A mathematical value that is assigned to a file and used to “test” the file at a later date to verify that the data contained in the file has not been maliciously or erroneously changed.

Classification: Categorization (e.g., “confidential,” “sensitive,” or “public”) of the information processed by the service provider on behalf of the receiver company.

Cloud computing: Generally a migration from owned resources to shared resources in which client users receive IT services on demand from third-party service providers via the Internet “cloud.” In cloud environments, a client or customer relocates its resources—such as data, applications, and services—to computing facilities outside the corporate firewall, which the end user then accesses via the Internet.

Cloud storage: A model of data storage in which the digital data is stored in logical pools, the physical storage spans multiple servers (and often locations), and the physical environment is typically owned and managed by a hosting company.

Compensating control: A management, operational, and/or technical control (e.g., safeguard or countermeasure) employed by an organization in lieu of a recommended security control in the low, moderate, or high baselines that provides equivalent or comparable protection for an information system.

Computer security: Technological and managerial procedures applied to computer systems to ensure the availability, integrity, and confidentiality of information managed by the computer system.

Confidentiality: Assuring information will be kept secret, with access limited to appropriate persons.

Configuration management: The management of security features and assurances through control of changes made to a system’s hardware, software, firmware, documentation, testing, test fixtures, and test documentation throughout the development and operational life of the system.

Consumer information: For purposes of the Information Security Standards, “consumer information” means any record about an individual, whether in paper, electronic, or other form, that is a consumer report or is derived from a consumer report that is maintained by or on behalf of a financial institution for a business purpose, such as information that an institution obtains about a loan applicant or a prospective employee from a consumer report.

Control: The means of managing risk, including policies, procedures, guidelines, practices, or organizational structures, which can be of an administrative, technical, management, or legal nature.

Control requirements: Process used to document and/or track internal processes to determine that those established procedures and/or physical security policies are being followed.

Control self-assessment: A technique used to internally assess the effectiveness of risk management and control processes.

Corrective control: A mitigating technique designed to lessen the impact to the institution when adverse events occur.

Crisis management: The process of managing an institution's operations in response to an emergency or event that threatens business continuity. An institution's ability to communicate with employees, customers, and the media, using various communications devices and methods, is a key component of crisis management.

Critical system (infrastructure): The systems and assets, whether physical or virtual, that are so vital that the incapacity or destruction of them may have a debilitating impact.

Customer: For purposes of the Information Security Standards, "customer" means a consumer with whom a financial institution has a continuing relationship under which the institution provides one or more financial products or services to the consumer that are to be used primarily for personal, family, or household purposes. In the case of a credit union, a customer relationship will exist between a credit union and certain consumers that are not the credit union's members.

Customer information: A term used in the Information Security Standards to mean any record containing non-public personal information about a customer, whether in paper, electronic, or other form, that is maintained by or on behalf of a financial institution.

Customer information systems: For purposes of the Information Security Standards, "customer information systems" means any methods used to access, collect, store, use, transmit, protect, or dispose of customer information.

Cyber attack: An attempt to damage, disrupt, or gain unauthorized access to a computer, computer system, or electronic communications network. An attack, via cyberspace, targeting an institution for the purpose of disrupting, disabling, destroying, or maliciously controlling a computing environment/infrastructure; destroying the integrity of the data; or stealing controlled information.

Cyber event: A cybersecurity change or occurrence that may have an impact on organizational operations (including mission, capabilities, or reputation).

Cyber incident: Actions taken through the use of computer networks that result in an actual or potentially adverse effect on an information system or the information residing therein.

Cyber resilience: The ability of a system or domain to withstand cyber attacks or failures and, in such events, to reestablish itself quickly.

Cyber threat: An internal or external circumstance, event, action, occurrence, or person with the potential to exploit technology-based vulnerabilities and to adversely affect (create adverse consequences for) organizational operations, organizational assets (including information and information systems), individuals, other organizations, or society.

Cybersecurity: The process of protecting consumer and bank information by preventing, detecting, and responding to attacks.

Data classification program: A program that categorizes data to convey required safeguards for information confidentiality, integrity, and availability, and establishes required controls based on value and level of sensitivity.

Data corruption: Errors in computer data that occur during writing, reading, storage, transmission, or processing, which introduce unintended changes to the original data.

Data integrity: The property that data have not been destroyed or corrupted in an unauthorized manner; maintaining and assuring the accuracy and consistency of data over their entire life cycle.

Data loss prevention (DLP) program: A comprehensive approach (covering people, processes, and systems) of implementing policies and controls designed specifically to discover, monitor, and protect confidential data while it is stored, used, or in transit over the network and at the perimeter.

Database: A collection of data that is stored on any type of computer storage medium and may be used for more than one purpose.

Defense-in-depth: Information security strategy integrating people, technology, and operations capabilities to establish variable barriers across multiple layers and dimensions of the organization.

Demilitarized zone (DMZ): A computer or small subnetwork that sits between a trusted internal network, such as a corporate private LAN, and an untrusted external network, such as the public Internet.

Detection device: A device designed to recognize an event and alert management when events occur.

Detective control: A mitigating technique designed to recognize an event and alert management when events occur.

Device: A generic term for any machine or component that attaches to a computer or connects to a network.

Distributed denial of service (DDoS): A type of attack that makes a computer resource or resources unavailable to its intended users. Although the means to carry out, motives for, and targets of a DDoS attack may vary, it generally consists of the concerted efforts of a group that intends to affect an institution's reputation by preventing an Internet site, service, or application from functioning efficiently.

Due diligence for service provider selection: Technical, functional, and financial review to verify a third-party service provider's ability to deliver the requirements specified in its proposal. The intent is to verify that the service provider has a well-developed plan and adequate resources and experience to ensure acceptable service, controls, systems backup, availability, and continuity of service to its clients.

End-of-life: All software products have life cycles. End-of-life refers to the date when a software development company no longer provides automatic fixes, updates, or online technical assistance for the product.

End-point security: Refers to a methodology of protecting the corporate network when accessed with remote devices, such as laptops, or other wireless and mobile devices. Each device with a remote connection to the network creates a potential entry (or exit) point for security threats.

End-to-end process flow: Document that details the flow of the processes, considering automated and manual control points, hardware, databases, network protocols, and real-time versus periodic processing characteristics.

Enterprise-wide: Across an entire organization, rather than a single business department or function.

Exploit: A technique or code that uses a vulnerability to provide system access to the attacker. An exploit is an intentional attack to affect an operating system or application program.

External connections: An information system or component of an information system that is outside of the authorization boundary established by the organization and for which the organization typically has no direct control over the application of required security controls or the assessment of security control effectiveness.

File transfer protocol (FTP): A standard high-level protocol for transferring files from one computer to another, usually implemented as an application-level program.

Financial Services Information Sharing and Analysis Center (FS-ISAC): A nonprofit, information-sharing forum established by financial services industry participants to facilitate the public and private sectors' sharing of physical and cybersecurity threat and vulnerability information.

Firewall: A hardware or software link in a network that relays only data packets clearly intended and authorized to reach the other side.

Frame relay: A high-performance wide area network protocol that operates at the physical and data link layers of the Open Systems Interconnection reference model. Frame relay is an example of a packet-switched technology. Packet-switched networks enable end stations to dynamically share the network medium and the available bandwidth.

Governance: In computer security, governance means setting clear expectations for the conduct (behaviors and actions) of the entity being governed and directing, controlling, and strongly influencing the entity to achieve these expectations. Governance includes specifying a framework for decision making, with assigned decision rights and accountability, intended to consistently produce desired behaviors and actions.

Gramm–Leach–Bliley Act: The act, also known as the Financial Services Modernization Act of 1999 (Pub.L. 106-102, 113 Stat. 1338, enacted November 12, 1999), required the federal banking agencies to establish information security standards for financial institutions.

Hardening: The process of securing a computer's administrative functions or inactivating those features not needed for the computer's intended business purpose.

Hardware: The physical elements of a computer system; the computer equipment as opposed to the programs or information stored in a machine.

Hash: A fixed-length cryptographic output of variables, such as a message, being operated on by a formula or cryptographic algorithm.

Hijacking: An attacker's use of an authenticated user's communication session to communicate with system components.

Homing beacons: Devices that send messages to the institution when they connect to a network and that enable recovery of the device.

Host: A computer that is accessed by a user from a remote location.

Incident management: The process of identifying, analyzing, and correcting disruptions to operations and preventing future recurrences. The goal of incident management is to limit the disruption and restore operations as quickly as possible.

Incident response plan: A plan that defines the action steps, involved resources, and communication strategy upon identification of a threat or potential threat event, such as a breach in security protocol, power or telecommunications outage, severe weather, or workplace violence.

Information security: The process by which an organization protects the creation, collection, storage, use, transmission, and disposal of information.

Information systems: Electronic systems and physical components used to access, store, transmit, protect, and eventually dispose of information. Information systems can include networks (computer systems, connections to business partners and the Internet, and the interconnections between internal and external systems). Other examples are backup tapes, mobile devices, and other media.

Information technology (IT): Any services or equipment, or interconnected system(s) or subsystem(s) of equipment that compose the institution's IT architecture or infrastructure. IT can include computers; ancillary equipment (including imaging peripherals, input, output, and storage devices necessary for security and surveillance); peripheral equipment designed to be controlled by the central processing unit of a computer; software; firmware and similar procedures; services (including cloud computing and help-desk services or other professional services that support any point of the life cycle of the equipment or service); and related resources.

Infrastructure: Describes what has been implemented by IT architecture and often includes support facilities such as power, cooling, ventilation, server and data redundancy and resilience, and telecommunications lines. Specific architecture types may exist for the following: enterprise, data (information), technology, security, and application.

Integrity: Assurance that information is trustworthy and accurate; ensuring that information will not be accidentally or maliciously altered or destroyed (see "Data integrity").

Interconnectivity: The state or quality of being connected together. The interaction of a financial institution's internal and external systems and applications and the entities with which they are linked.

Interdependencies: When two or more departments, processes, functions, or third-party service providers support one another in some fashion.

Internal "trusted" zone: A channel in which the end points are known and data integrity is protected in transit. Depending on the communications protocol used, data privacy may be protected in transit. Examples include SSLIP security and a secure physical connection.

International Organization for Standardization (ISO): An independent, non-governmental, international organization that brings together experts to share knowledge and develop voluntary, consensus-based, market-relevant international standards.

Internet: The global system of interconnected computer networks that use the Internet protocol suite (TCP/IP) to link billions of devices worldwide.

Internet service provider (ISP): A company that provides its customers with access to the Internet (e.g., AT&T, Verizon, and CenturyLink).

Intrusion detection: Techniques that attempt to detect unauthorized entry or access into a computer or network by observation of actions, security logs, or audit data; detection of break-ins or attempts, either manually or via software expert systems that operate on logs or other information available on the network.

Intrusion detection system (IDS): Software or hardware product that detects and logs inappropriate, incorrect, or anomalous activity. It gathers and analyzes information from various areas within a computer or a network to identify possible security breaches, which include both intrusions (attacks from outside the organizations) and misuse (attacks from within the organizations). IDS are typically characterized based on the source of the data they monitor: host or network. A host-based IDS uses system log files and other electronic audit data to identify suspicious activity. A network-based IDS uses a sensor to monitor packets on the network to which it is attached.

Intrusion prevention system (IPS): A system that can detect an intrusive activity and can also attempt to stop the activity, ideally before it reaches its target.

IT system inventory: A list containing information about the information resources owned or operated by an organization.

Life-cycle process: The multistep process that starts with the initiation, analysis, design, and implementation, and continues through the maintenance and disposal of the system.

Log: A record of information or events in an organized system, usually sequenced in the order in which the events occurred.

Logical access: Ability to interact with computer resources granted using identification, authentication, and authorization.

Logical access controls: The policies, procedures, organizational structure, and electronic access controls designed to restrict access to computer software and data files.

Malware: Software designed to secretly access a computer system without the owner's informed consent. The expression is a general term (short for malicious software) used to mean a variety of forms of hostile, intrusive, or annoying software or program code. Malware includes computer viruses, worms, Trojan horses, spyware, dishonest adware, ransomware, crimeware, most rootkits, and other malicious and unwanted software or programs.

Media: Physical objects that store data, such as paper, hard disk drives, tapes, and compact disks.

Metric: A quantitative measurement.

Middleware: Software that connects two or more software components or applications. It is another term for an application programmer interface or API, and it allows programmers to access lower- or higher-level services by providing an intermediary layer that includes function calls to the services.

Mobile device: A portable computing and communications device with information-storage capability. Examples include notebook and laptop computers, cellular telephones and smart phones, tablets, digital cameras, and audio recording devices.

Multi-factor authentication: The process of using two or more factors to achieve authentication. Factors include something you know (e.g., password or personal identification number); something you have (e.g., cryptographic identification device or token); and something you are (e.g., biometric).

National Institute of Standards and Technology (NIST): An agency of the U.S. Department of Commerce that works to develop and apply technology, measurements, and standards. NIST developed a voluntary cybersecurity framework based on existing standards, guidelines, and practices for reducing cyber risks to critical infrastructures.

Network: Two or more computer systems grouped together to share information, software, and hardware.

Network activity baseline: A base for determining typical utilization patterns so that significant deviations can be detected.

Network administrator: The individual responsible for the installation, management, and control of a network.

Network diagram: A description of any kind of locality in terms of its physical layout. In the context of communication networks, a topology describes pictorially the configuration or arrangement of a network, including its nodes and connecting communication lines.

Network security: The protection of computer networks and their services from unauthorized entry, modification, destruction, or disclosure, and provision of assurance that the network performs its critical functions correctly and that there are no harmful side effects. Network security includes providing for data integrity.

Non-public personal information: For purposes of the Information Security Standards, non-public personal information means (i) "personally identifiable financial information"; and (ii) any list, description, or other grouping of consumers (and publicly available information pertaining to them) that is derived using any "personally identifiable financial information" that is not publicly available.

Non-repudiation: Ensuring that a transferred message has been sent and received by the parties claiming to have sent and received the message. Non-repudiation is a way to guarantee that the sender of a message cannot later deny having sent the message and that the recipient cannot deny having received the message.

Operating system: A system that supports and manages software applications. Operating systems allocate system resources, provide access and security controls, maintain file systems, and manage communications between end users and hardware devices.

Out-of-band: Activity outside of the primary means of interfacing with the customer. For example, if a user is performing activity online, he or she may be authenticated through a one-time password sent via text message.

Outsourcing: The practice of contracting with another entity to perform services that might otherwise be conducted in-house; a contractual relationship with a third party to provide services, systems, or support.

Packet: The data unit that is routed from source to destination in a packet-switched network.

Patch: Software code that replaces or updates other code. Patches frequently are used to correct security flaws.

Penetration test: The process of using approved, qualified personnel to conduct real-world attacks against a system to identify and correct security weaknesses before they are discovered and exploited by others.

Personally identifiable financial information: For purposes of the Information Security Standards, personally identifiable financial information means information (i) a consumer provides to a financial institution to obtain a financial product or service; (ii) about a consumer resulting from any transaction involving a financial product or service between the financial institution and a consumer; or (iii) that a financial institution otherwise obtains about a consumer in connection with providing a financial product or service, such as account balance information, payment history, overdraft history, and credit or debit card purchase information; or the fact that an individual is one of the financial institution's customers.

Phishing: A digital form of social engineering that uses authentic-looking—but bogus—e-mail to request information from users or direct them to fake websites that request information.

Policy: A document that records a high-level principle or an agreed-upon course of action; overall intention and direction as formally expressed by management.

Port: Either an end point to a logical connection or a physical connection to a computer.

Positive pay: A technique that can reduce check fraud by requesting businesses to send electronic files of information to the financial institution on all checks the business has issued.

Preventive control: A mitigating technique designed to prevent an event from occurring.

Principle of least privilege: The security objective of granting users only the access needed to perform official duties.

Privilege: The level of trust with which a system object is imbued.

Privileged access: Individuals with the ability to override system or application controls.

Protocol: A format for transmitting data between devices.

Real-time network monitoring: Immediate response to a penetration attempt that is detected and diagnosed in time to prevent access.

Remote access: The ability to obtain access to a computer or network from a remote location.

Remote deletions: Use of a technology to remove data from a portable device without touching the device.

Removable media: Portable electronic storage media, such as magnetic, optical, and solid-state devices that can be inserted into and removed from a computing device and that are used to store text, video, audio, and image information. Such devices have no independent processing capabilities. Examples include hard disks, floppy disks, zip drives, compact disks, thumb drives, pen drives, and similar storage devices.

Resource: Any enterprise asset that can help the organization achieve its objectives.

Retention requirement: Requirement established by a company or by regulation for the length of time and/or for the amount of information that should be retained.

Risk analysis: The process of identifying risks, determining their probability and impact, and identifying areas needing safeguards.

Risk assessment: A prioritization of potential business disruptions based on severity and likelihood of occurrence. The risk assessment includes an analysis of threats based on the impact to the institution, its customers, and financial markets, rather than the nature of the threat.

Rogue wireless access: An unauthorized wireless node on a network.

Routing: The process of moving information from its source to the destination.

Sandbox: A restricted, controlled execution environment that prevents potentially malicious software, such as mobile code, from accessing any system resources except those for which the software is authorized.

Scenario analysis: The process of analyzing possible future events by considering alternative possible outcomes.

Secure shell: Network protocol that uses cryptography to secure communication, remote command line log-in, and remote command execution between two networked computers.

Secure Sockets Layer (SSL): A protocol that is used to transmit private documents through the Internet.

Security architecture: A detailed description of all aspects of the system that relate to security, along with a set of principles to guide the design. A security architecture describes how the system is put together to satisfy the security requirements.

Security audit: An independent review and examination of system records and activities to test for adequacy of system controls, ensure compliance with established policy and operational procedures, and recommend any indicated changes in control, policy, and procedures.

Security breach: A security event that results in unauthorized access of data, applications, services, networks, or devices by bypassing underlying security mechanisms.

Security event: An event that potentially compromises the confidentiality, integrity, availability, or accountability of an information system.

Security log: A record that contains log-in and logout activity and other security-related events and that is used to track security-related information on a computer system.

Security posture: The security status of an enterprise's networks, information, and systems based on information security and assurance resources (e.g., people, hardware, software, and policies) and capabilities in place to manage the defense of the enterprise and to react as the situation changes.

Security violation: An instance in which a user or other person circumvents or defeats the controls of a system to obtain unauthorized access to information or system resources.

Sensitive customer information: A customer's name, address, or telephone number, in conjunction with the customer's social security number, driver's license number, account number, credit or debit card number, or personal identification number or password that would permit access to the customer's account. Sensitive customer information also includes any combination of components of customer information that would allow someone to log into or access the customer's account, such as user name and password or password and account number.

Server: A computer or other device that manages a network service. An example is a print server, which is a device that manages network printing.

Service level agreement (SLA): Formal documents between an institution and its third-party service provider that outline an institution's predetermined requirements for a service and establish incentives to meet, or penalties for failure to meet, the requirements. SLAs should specify and clarify performance expectations, establish accountability, and detail remedies or consequences if performance or service quality standards are not met.

Service provider: For purposes of the Information Security Standards, service provider means any person or entity that maintains, processes, or otherwise is permitted access to customer information or consumer information through its provision of services directly to a financial institution.

Shadow IT: A term used to describe IT systems or applications used inside institutions without explicit approval.

Sniffing: The passive interception of data transmissions.

Social engineering: A general term for trying to trick people into revealing confidential information or performing certain actions.

Spear phishing: An attack targeting a specific user or group of users, and attempts to deceive the user into performing an action that launches an attack, such as opening a document or clicking a link. Spear phishers rely on knowing some personal piece of information about their target, such as an event, interest, travel plans, or current issues. Sometimes this information is gathered by hacking into the targeted network.

Spoofing: A form of masquerading in which a trusted IP address is used instead of the true IP address as a means of gaining access to a computer system.

SQL Injection Attack: An exploit of target software that constructs structured query language (SQL) statements based on user input. An attacker crafts input strings so that when the target software constructs SQL statements based on the input, the resulting SQL statement performs actions other than those the application intended. SQL injection enables an attacker to talk directly to the database, thus bypassing the application completely. Successful injection can cause information disclosure as well as the ability to add or modify data in the database.

Stateful inspection: A firewall inspection technique that examines the claimed purpose of a communication for validity. For example, a communication claiming to respond to a request is compared to a table of outstanding requests.

System administration: The process of maintaining, configuring, and operating computer systems.

System resources: Capabilities that can be accessed by a user or program either on the user's machine or across the network. Capabilities can be services, such as file or print services, or devices, such as routers.

Third-party relationship: Any business arrangement between a financial institution and another entity, by contract or otherwise.

Third-party service provider: Any third party to whom a financial institution outsources activities that the institution itself is authorized to perform, including a technology service provider.

Threat intelligence: The acquisition and analysis of information to identify, track, and predict cyber capabilities, intentions, and activities that offer courses of action to enhance decision making.

Trojan horse: Malicious code hidden in software that has an apparently beneficial or harmless use.

Tunnel: The path that encapsulated packets follow in an Internet VPN.

U.S. Computer Emergency Readiness Team (US-CERT): US-CERT is part of the U.S. Department of Homeland Security's National Cybersecurity and Communications Integration Center in the Office of Cybersecurity and Communications. US-CERT is a partnership between the Department of Homeland Security and the public and private sectors, established to protect the nation's Internet infrastructure. US-CERT coordinates defense against and responses to cyber attacks across the nation.

User identification: The process, control, or information by which a user identifies himself or herself to the system as a valid user (as opposed to authentication).

Utility: A program used to configure or maintain systems, or to make changes to stored or transmitted data.

Virtual local area network (VLAN): Logical segmentation of a LAN into different broadcast domains.

Virtual machine: A software emulation of a physical computing environment.

Virtual private network (VPN): A computer network that uses public telecommunication infrastructure, such as the Internet, to provide remote offices or individual users with secure access to their organization's network.

Virus: Malicious code that replicates itself within a computer.

Vulnerability: A hardware, firmware, or software flaw that leaves an information system open to potential exploitation; a weakness in automated system security procedures, administrative controls, physical layout, internal controls, etc., that could be exploited to gain unauthorized access to information or to disrupt critical processing.

Vulnerability assessment: Systematic examination of systems to identify, quantify, and prioritize the security deficiencies of the systems.

Worm: A self-replicating malware computer program. It uses a computer network to send copies of itself to other nodes (computers on the network), possibly without any user intervention. This occurs primarily because of security vulnerabilities on the target computers.

Zero-day attack: An attack on a piece of software that has a vulnerability for which there is no known patch.

Appendix C: Laws, Regulations, and Guidance

Laws

12 USC 1861–1867, “Bank Service Company Act”
12 USC 1882, “Bank Protection Act”
15 USC 1681w, “Fair and Accurate Credit Transactions Act”
15 USC 6801 and 6805(b), “Gramm–Leach–Bliley Act”
18 USC 1030, “Fraud and Related Activity in Connection With Computers”

Consumer Financial Protection Bureau

Regulations

12 CFR 1005, “Electronic Fund Transfers (Regulation E)”
12 CFR 1016, “Privacy of Consumer Financial Information (Regulation P)”

Federal Deposit Insurance Corporation

Regulations

12 CFR 326, subpart A, “Minimum Security Procedures”
12 CFR 326, subpart B, “Procedures for Monitoring Bank Secrecy Act Compliance”
12 CFR 332, “Privacy of Consumer Financial Information”
12 CFR 353, “Suspicious Activity Reports”
12 CFR 364, appendix A, “Interagency Guidelines Establishing Standards for Safety and Soundness”
12 CFR 364, appendix B, “Interagency Guidelines Establishing Information Security Standards”

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FIL-13-2015, “FFIEC Joint Statements on Destructive Malware and Compromised Credentials” (March 30, 2015)
FIL-9-2015, “Business Continuity Planning Booklet Appendix J Update to FFIEC IT Examination Handbook Series” (February 23, 2015)
FIL-49-2014, “Technology Alert GNU Bourne-Again Shell (Bash) Vulnerability” (September 29, 2014)
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FIL-32-2007, “FDIC’s Supervisory Policy on Identity Theft” (April 11, 2007)
FIL-77-2006, “Authentication in an Internet Banking Environment Frequently Asked Questions” (August 21, 2006)
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FIL-66-2005, “Spyware—Guidance on Mitigating Risks From Spyware” (July 22, 2005)
FIL-64-2005, “Pharming”—Guidance on How Financial Institutions Can Protect Against Pharming Attacks” (July 18, 2005)
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FIL-27-2005, “Final Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice” (April 1, 2005)
FIL-7-2005, “Fair and Accurate Credit Transactions Act of 2003 Guidelines Requiring the Proper Disposal of Customer Information” (February 2, 2005)
FIL-132-2004, “Identity Theft Study on ‘Account Hijacking’ Identity Theft and Suggestions for Reducing Online Fraud” (December 14, 2004)
FIL-121-2004, “Computer Software Due Diligence—Guidance on Developing an Effective Software Evaluation Program to Assure Quality and Regulatory Compliance” (November 16, 2004)
FIL-114-2004, “Risk Management of Free and Open Source Software FFIEC Guidance” (October 21, 2004)
FIL-103-2004, “Interagency Informational Brochure on Internet ‘‘Phishing’ Scams” (September 13, 2004)
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FIL-62-2004, “Guidance on Developing an Effective Computer Virus Protection Program” (June 7, 2004)
FIL-27-2004, “Guidance on Safeguarding Customers Against E-Mail and Internet Related Fraud Schemes” (March 12, 2004)
FIL-63-2003, “Guidance on Identity Theft Response Programs” (August 13, 2003)
FIL-43-2003, “Guidance on Developing an Effective Software Patch Management Program” (May 29, 2003)
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FIL-67-2000, “Security Monitoring of Computer Networks” (October 3, 2000)
FIL-68-99, “Risk Assessment Tools and Practices” (July 7, 1999)
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FIL-82-96, “Risks Involving Client/Server Computer Systems” (October 8, 1996)

Federal Reserve

Regulations

12 CFR 208.61, “Minimum Security Devices and Procedures”
12 CFR 208.62, “Reports of Suspicious Activities”
12 CFR 208.63, “Procedures for Monitoring Bank Secrecy Act Compliance”
12 CFR 208, appendix D-1, “Interagency Guidelines Establishing Standards for Safety and Soundness”
12 CFR 208, appendix D-2, “Interagency Guidelines Establishing Information Security Standards”
12 CFR 211.5(l), “Interagency Guidelines Establishing Information Security Standards”
12 CFR 211.9, “Interagency Guidelines Establishing Standards for Safeguarding Customer Information”
12 CFR 211.24(i), “Interagency Guidelines Establishing Information Security Standards”
12 CFR 225, appendix F, “Interagency Guidelines Establishing Information Security Standards”

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SR Letter 15-9, “FFIEC Cybersecurity Assessment Tool for Chief Executive Officers and Boards of Directors”
SR Letter 05-19, “Interagency Guidance on Authentication in an Internet Banking Environment”
SR Letter 04-17, “FFIEC Guidance on the Use of Free and Open Source Software”
SR Letter 04-14, “FFIEC Brochure With Information on Internet ‘Phishing’”
SR Letter 02-18, “Section 312 of the USA Patriot Act—Due Diligence for Correspondent and Private Banking Accounts”
SR Letter 02-6, “Information Sharing Pursuant to Section 314(b) of the USA Patriot Act”
SR Letter 01-15, “Safeguarding Customer Information”
SR Letter 01-11, “Identity Theft and Pretext Calling”
SR Letter 00-17, “Guidance on the Risk Management of Outsourced Technology Services”
SR Letter 00-04, “Outsourcing of Information and Transaction Processing”
SR Letter 99-08, “Uniform Rating System for Information Technology”

SR Letter 97-32, “Sound Practices Guidance for Information Security for Networks”

National Credit Union Administration

Regulations

12 CFR 716, “Privacy of Consumer Financial Information & Appendix”
12 CFR 721, “Federal Credit Union Incidental Powers Activities”
12 CFR 741, “Requirements for Insurance”
12 CFR 748, “Security Program, Report of Crime and Catastrophic Act and Bank Secrecy Act Compliance & Appendices”

Guidance

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Office of the Comptroller of the Currency

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12 CFR 21, subpart A, “Minimum Security Devices and Procedures”
12 CFR 21, subpart B, “Reports of Suspicious Activities”
12 CFR 21, subpart C, “Procedures for Monitoring Bank Secrecy Act Compliance”
12 CFR 30, appendix A, “Interagency Guidelines Establishing Standards for Safety and Soundness”
12 CFR 30, appendix B, “Interagency Guidelines Establishing Information Security Standards”
12 CFR 41.83, “Proper Disposal of Records Containing Customer Information”

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FFIEC

Cybersecurity Assessment Tool

May 2017

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Additional Resources

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Appendix A: Mapping Baseline Statements to FFIEC IT Examination Handbook
Appendix B: Mapping Cybersecurity Assessment Tool to NIST Cybersecurity Framework
Appendix C: Glossary

User's Guide

Overview

In light of the increasing volume and sophistication of cyber threats, the Federal Financial Institutions Examination Council[1] (FFIEC) developed the Cybersecurity Assessment Tool (Assessment), on behalf of its members, to help institutions identify their risks and determine their cybersecurity maturity.

The content of the Assessment is consistent with the principles of the *FFIEC Information Technology Examination Handbook (IT Handbook)* and the National Institute of Standards and Technology (NIST) Cybersecurity Framework,[2] as well as industry accepted cybersecurity practices. The Assessment provides institutions with a repeatable and measureable process to inform management of their institution's risks and cybersecurity preparedness.

The Assessment consists of two parts: Inherent Risk Profile and Cybersecurity Maturity. The Inherent Risk Profile identifies the institution's inherent risk before implementing controls. The Cybersecurity Maturity includes domains, assessment factors, components, and individual declarative statements across five maturity levels to identify specific controls and practices that are in place. While management can determine the institution's maturity level in each domain, the Assessment is not designed to identify an overall cybersecurity maturity level.

To complete the Assessment, management first assesses the institution's inherent risk profile based on five categories:

- Technologies and Connection Types
- Delivery Channels
- Online/Mobile Products and Technology Services
- Organizational Characteristics
- External Threats

Management then evaluates the institution's Cybersecurity Maturity level for each of five domains:

- Cyber Risk Management and Oversight
- Threat Intelligence and Collaboration
- Cybersecurity Controls
- External Dependency Management
- Cyber Incident Management and Resilience

[1] The FFIEC comprises the principals of the following: The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Consumer Financial Protection Bureau, and State Liaison Committee.

[2] A mapping is available in Appendix B: Mapping Cybersecurity Assessment Tool to the NIST Cybersecurity Framework. NIST reviewed and provided input on the mapping to ensure consistency with Framework principles and to highlight the complementary nature of the two resources.

By reviewing both the institution's inherent risk profile and maturity levels across the domains, management can determine whether its maturity levels are appropriate in relation to its risk. If not, the institution may take action either to reduce the level of risk or to increase the levels of maturity. This process is intended to complement, not replace, an institution's risk management process and cybersecurity program.

Background

The Assessment is based on the cybersecurity assessment that the FFIEC members piloted in 2014, which was designed to evaluate community institutions' preparedness to mitigate cyber risks. NIST defines cybersecurity as "the process of protecting information by preventing, detecting, and responding to attacks." As part of cybersecurity, institutions should consider managing internal and external threats and vulnerabilities to protect infrastructure and information assets. The definition builds on information security as defined in FFIEC guidance.

Cyber incidents can have financial, operational, legal, and reputational impact. Recent high-profile cyber attacks demonstrate that cyber incidents can significantly affect capital and earnings. Costs may include forensic investigations, public relations campaigns, legal fees, consumer credit monitoring, and technology changes. As such, cybersecurity needs to be integrated throughout an institution as part of enterprise-wide governance processes, information security, business continuity, and third-party risk management. For example, an institution's cybersecurity policies may be incorporated within the information security program. In addition, cybersecurity roles and processes referred to in the Assessment may be separate roles within the security group (or outsourced) or may be part of broader roles across the institution.

Completing the Assessment

The Assessment is designed to provide a measurable and repeatable process to assess an institution's level of cybersecurity risk and preparedness. Part one of this Assessment is the Inherent Risk Profile, which identifies an institution's inherent risk relevant to cyber risks. Part two is the Cybersecurity Maturity, which determines an institution's current state of cybersecurity preparedness represented by maturity levels across five domains. For this Assessment to be an effective risk management tool, an institution may want to complete it periodically and as significant operational and technological changes occur.

Cyber risk programs build upon and align existing information security, business continuity, and disaster recovery programs. The Assessment is intended to be used primarily on an enterprise-wide basis and when introducing new products and services as follows:

- **Enterprise-wide.** Management may review the Inherent Risk Profile and the declarative statements to understand which policies, procedures, processes, and controls are in place enterprise-wide and where gaps may exist. Following this review, management can determine appropriate maturity levels for the institution in each domain or the target state for Cybersecurity Maturity. Management can then develop action plans for achieving the target state.
- **New products, services, or initiatives.** Using the Assessment before launching a new product, service, or initiative can help management understand how these might affect the institution's inherent risk profile and resulting desired maturity levels.

Part One: Inherent Risk Profile

Part one of the Assessment identifies the institution’s inherent risk. The Inherent Risk Profile identifies activities, services, and products organized in the following categories:

- **Technologies and Connection Types.** Certain types of connections and technologies may pose a higher inherent risk depending on the complexity and maturity, connections, and nature of the specific technology products or services. This category includes the number of Internet service provider (ISP) and third-party connections, whether systems are hosted internally or outsourced, the number of unsecured connections, the use of wireless access, volume of network devices, end-of-life systems, extent of cloud services, and use of personal devices.
- **Delivery Channels.** Various delivery channels for products and services may pose a higher inherent risk depending on the nature of the specific product or service offered. Inherent risk increases as the variety and number of delivery channels increases. This category addresses whether products and services are available through online and mobile delivery channels and the extent of automated teller machine (ATM) operations.
- **Online/Mobile Products and Technology Services.** Different products and technology services offered by institutions may pose a higher inherent risk depending on the nature of the specific product or service offered. This category includes various payment services, such as debit and credit cards, person-to-person payments, originating automated clearing house (ACH), retail wire transfers, wholesale payments, merchant remote deposit capture, treasury services and clients and trust services, global remittances, correspondent banking, and merchant acquiring activities. This category also includes consideration of whether the institution provides technology services to other organizations.
- **Organizational Characteristics**. This category considers organizational characteristics, such as mergers and acquisitions, number of direct employees and cybersecurity contractors, changes in security staffing, the number of users with privileged access, changes in information technology (IT) environment, locations of business presence, and locations of operations and data centers.
- **External Threats.** The volume and type of attacks (attempted or successful) affect an institution’s inherent risk exposure. This category considers the volume and sophistication of the attacks targeting the institution.

Risk Levels

Risk Levels incorporate the type, volume, and complexity of the institution’s operations and threats directed at the institution. Inherent risk does not include mitigating controls.

Select the most appropriate inherent risk level for each activity, service, or product within each category. The levels range from Least Inherent Risk to Most Inherent Risk (Figure 1) and incorporate a wide range of descriptions. The risk levels provide parameters for determining the inherent risk for each category. These parameters are not intended to be rigid but rather instructive to assist with assessing a risk level within each activity, service, or product. For situations where the risk level falls between two levels, management should select the higher risk level.

Figure 1: Inherent Risk Profile Layout

Risk Levels

Activity, Service, or Product

Category: Technologies and Connection Types	**Risk Levels**				
	Least	**Minimal**	**Moderate**	**Significant**	**Most**
Total number of Internet service provider (ISP) connections (including branch connections)	No connections	Minimal complexity (1–20 connections)	Moderate complexity (21–100 connections)	Significant complexity (101–200 connections)	Substantial complexity (>200 connections)
Unsecured external connections, number of connections not users (e.g., file transfer protocol (FTP), Telnet, rlogin)	None	Few instances of unsecured connections (1–5)	Several instances of unsecured connections (6–10)	Significant instances of unsecured connections (11–25)	Substantial instances of unsecured connections (>25)
Wireless network access	No wireless access	Separate access points for guest wireless and corporate wireless	Guest and corporate wireless network access are logically separated; limited number of users and access points (1–250 users; 1–25 access points)	Wireless corporate network access; significant number of users and access points (251–1,000 users; 26–100 access points)	Wireless corporate network access; all employees have access; substantial number of access points (>1,000 users; >100 access points)

Determine Inherent Risk Profile

Management can determine the institution’s overall Inherent Risk Profile based on the number of applicable statements in each risk level for all activities (Figure 2). For example, when a majority of activities, products, or services fall within the Moderate Risk Level, management may determine that the institution has a Moderate Inherent Risk Profile. Each category may, however, pose a different level of inherent risk. Therefore, in addition to evaluating the number of instances that an institution selects for a specific risk level, management may also consider evaluating whether the specific category poses additional risk.

Figure 2: Inherent Risk Summary

	Risk Levels				
	Least	**Minimal**	**Moderate**	**Significant**	**Most**
Number of Statements Selected in Each Risk Level					
Based on Individual Risk Levels Selected, Assign an Inherent Risk Profile	**Least**	**Minimal**	**Moderate**	**Significant**	**Most**

The following includes definitions of risk levels.

- **Least Inherent Risk.** An institution with a Least Inherent Risk Profile generally has very limited use of technology. It has few computers, applications, systems, and no connections. The variety of products and services are limited. The institution has a small geographic footprint and few employees.
- **Minimal Inherent Risk.** An institution with a Minimal Inherent Risk Profile generally has limited complexity in terms of the technology it uses. It offers a limited variety of less risky products and services. The institution’s mission-critical systems are outsourced. The institution primarily uses established technologies. It maintains a few types of connections to customers and third parties with limited complexity.
- **Moderate Inherent Risk.** An institution with a Moderate Inherent Risk Profile generally uses technology that may be somewhat complex in terms of volume and sophistication. The

institution may outsource mission-critical systems and applications and may support elements internally. There is a greater variety of products and services offered through diverse channels.

- **Significant Inherent Risk**. An institution with a Significant Inherent Risk Profile generally uses complex technology in terms of scope and sophistication. The institution offers high-risk products and services that may include emerging technologies. The institution may host a significant number of applications internally. The institution allows either a large number of personal devices or a large variety of device types. The institution maintains a substantial number of connections to customers and third parties. A variety of payment services are offered directly rather than through a third party and may reflect a significant level of transaction volume.
- **Most Inherent Risk.** An institution with a Most Inherent Risk Profile uses extremely complex technologies to deliver myriad products and services. Many of the products and services are at the highest level of risk, including those offered to other organizations. New and emerging technologies are utilized across multiple delivery channels. The institution may outsource some mission-critical systems or applications, but many are hosted internally. The institution maintains a large number of connection types to transfer data with customers and third parties.

Part Two: Cybersecurity Maturity

After determining the Inherent Risk Profile, the institution transitions to the Cybersecurity Maturity part of the Assessment to determine the institution's maturity level within each of the following five domains:

- **Domain 1:** Cyber Risk Management and Oversight
- **Domain 2:** Threat Intelligence and Collaboration
- **Domain 3:** Cybersecurity Controls
- **Domain 4:** External Dependency Management
- **Domain 5:** Cyber Incident Management and Resilience

Domains, Assessment Factors, Components, and Declarative Statements

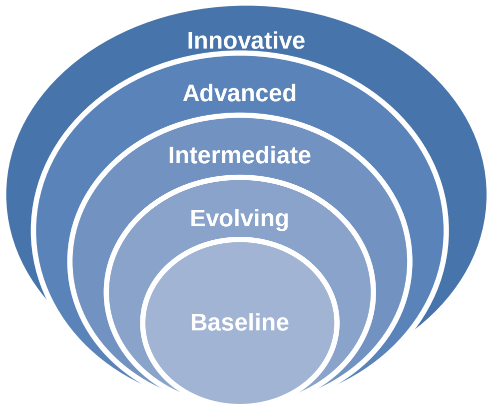
Within each domain are assessment factors and contributing components. Under each component, there are declarative statements describing an activity that supports the assessment factor at that level of maturity. Table 1 provides definitions for each domain and the underlying assessment factors.

Table 1: Domains and Assessment Factors Defined

Domains and Assessment Factors Defined	
Domain 1 **Cyber Risk Management and Oversight** Cyber risk management and oversight addresses the board of directors' (board's) oversight and management's development and implementation of an effective enterprise-wide cybersecurity program with comprehensive policies and procedures for establishing appropriate accountability and oversight.	
Assessment Factors	**Governance** includes oversight, strategies, policies, and IT asset management to implement an effective governance of the cybersecurity program. **Risk Management** includes a risk management program, risk assessment process, and audit function to effectively manage risk and assess the effectiveness of key controls. **Resources** include staffing, tools, and budgeting processes to ensure the institution's staff or external resources have knowledge and experience commensurate with the institution's risk profile. **Training and Culture** includes the employee training and customer awareness programs contributing to an organizational culture that emphasizes the mitigation of cybersecurity threats.
Domain 2 **Threat Intelligence and Collaboration** Threat intelligence and collaboration includes processes to effectively discover, analyze, and understand cyber threats, with the capability to share information internally and with appropriate third parties.	
Assessment Factors	**Threat Intelligence** refers to the acquisition and analysis of information to identify, track, and predict cyber capabilities, intentions, and activities that offer courses of action to enhance decision making. **Monitoring and Analyzing** refers to how an institution monitors threat sources and what analysis may be performed to identify threats that are specific to the institution or to resolve conflicts in the different threat intelligence streams. **Information Sharing** encompasses establishing relationships with peers and information-sharing forums and how threat information is communicated to those groups as well as internal stakeholders.
Domain 3 **Cybersecurity Controls** Cybersecurity controls are the practices and processes used to protect assets, infrastructure, and information by strengthening the institution's defensive posture through continuous, automated protection and monitoring.	
Assessment Factors	**Preventative Controls** deter and prevent cyber attacks and include infrastructure management, access management, device and end-point security, and secure coding. **Detective Controls** include threat and vulnerability detection, anomalous activity detection, and event detection, may alert the institution to network and system irregularities that indicate an incident has or may occur. **Corrective Controls** are utilized to resolve system and software vulnerabilities through patch management and remediation of issues identified during vulnerability scans and penetration testing.
Domain 4 **External Dependency Management** External dependency management involves establishing and maintaining a comprehensive program to oversee and manage external connections and third-party relationships with access to the institution's technology assets and information.	
Assessment Factors	**Connections** incorporate the identification, monitoring, and management of external connections and data flows to third parties. **Relationship Management** includes due diligence, contracts, and ongoing monitoring to help ensure controls complement the institution's cybersecurity program.

Domain 5	
Cyber Incident Management and Resilience Cyber incident management includes establishing, identifying, and analyzing cyber events; prioritizing the institution's containment or mitigation; and escalating information to appropriate stakeholders. Cyber resilience encompasses both planning and testing to maintain and recover ongoing operations during and following a cyber incident.	
Assessment Factors	**Incident Resilience Planning & Strategy** incorporates resilience planning and testing into existing business continuity and disaster recovery plans to minimize service disruptions and the destruction or corruption of data. **Detection, Response, & Mitigation** refers to the steps management takes to identify, prioritize, respond to, and mitigate the effects of internal and external threats and vulnerabilities. **Escalation & Reporting** ensures key stakeholders are informed about the impact of cyber incidents, and regulators, law enforcement, and customers are notified as required.

Figure 3: Cybersecurity Maturity Levels



Each maturity level includes a set of declarative statements that describe how the behaviors, practices, and processes of an institution can consistently produce the desired outcomes.

The Assessment starts at the Baseline maturity level and progresses to the highest maturity, the Innovative level (Figure 3). Table 2 provides definitions for each of the maturity levels, which are cumulative.

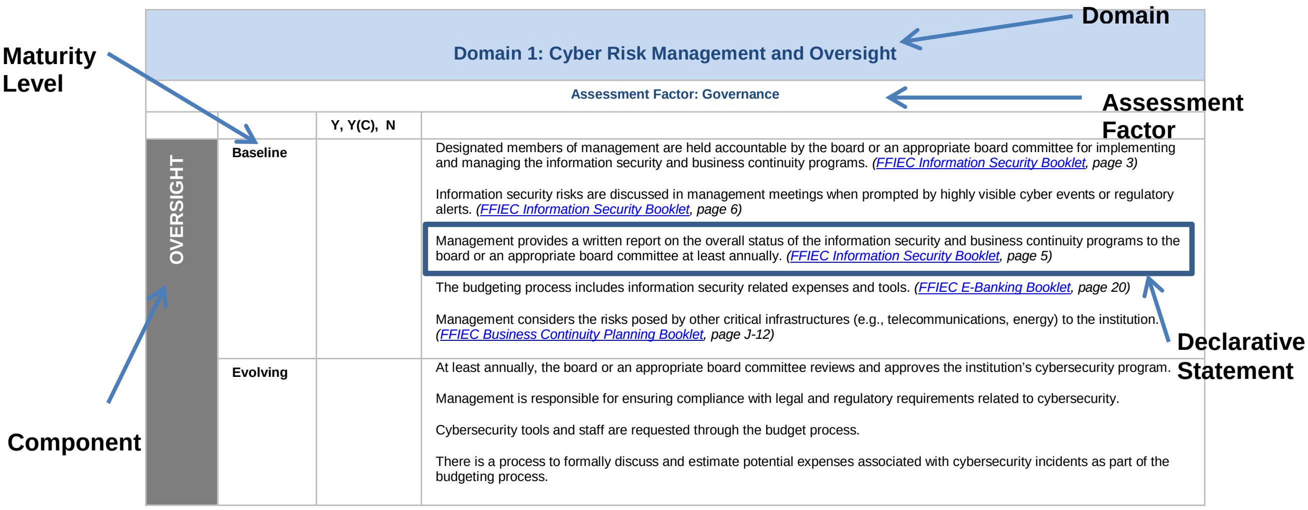
Table 2: Maturity Levels Defined

Maturity Levels Defined	
Baseline	Baseline maturity is characterized by minimum expectations required by law and regulations or recommended in supervisory guidance. This level includes compliance-driven objectives. Management has reviewed and evaluated guidance.
Evolving	Evolving maturity is characterized by additional formality of documented procedures and policies that are not already required. Risk-driven objectives are in place. Accountability for cybersecurity is formally assigned and broadened beyond protection of customer information to incorporate information assets and systems.
Intermediate	Intermediate maturity is characterized by detailed, formal processes. Controls are validated and consistent. Risk-management practices and analysis are integrated into business strategies.
Advanced	Advanced maturity is characterized by cybersecurity practices and analytics that are integrated across lines of business. Majority of risk-management processes are automated and include continuous process improvement. Accountability for risk decisions by frontline businesses is formally assigned.
Innovative	Innovative maturity is characterized by driving innovation in people, processes, and technology for the institution and the industry to manage cyber risks. This may entail developing new controls, new tools, or creating new information-sharing groups. Real-time, predictive analytics are tied to automated responses.

Completing the Cybersecurity Maturity

Each domain and maturity level has a set of declarative statements organized by assessment factor. To assist the institution's ability to follow common themes across maturity levels, statements are categorized by components. The components are groups of similar declarative statements to make the Assessment easier to use (Figure 4).

Figure 4: Cybersecurity Maturity



Management determines which declarative statements best fit the current practices of the institution. ***All declarative statements in each maturity level, and previous levels, must be attained and sustained to achieve that domain's maturity level.*** Attained and sustained requires affirmative answers to either "Yes" or "Yes with Compensating Controls"[3] for each of the declarative questions within a maturity level. While management can determine the institution's maturity level in each domain, the Assessment is not designed to identify an overall cybersecurity maturity level.

Management may determine that a declarative statement has been sufficiently sustained based on proven results. Certain declarative statements may not apply to all institutions if the product, service, or technology is not offered or used. Declarative statements that may not be applicable to all institutions are clearly designated and would not affect the determination of the specific maturity level.

Interpreting and Analyzing Assessment Results

Management can review the institution's Inherent Risk Profile in relation to its Cybersecurity Maturity results for each domain to understand whether they are aligned.

Table 3 depicts the relationship between an institution's Inherent Risk Profile and its domain Maturity Levels, as there is no single expected level for an institution. In general, as inherent risk

[3] Compensating control - A management, operational, and/or technical control (e.g., safeguard or countermeasure) employed by an organization in lieu of a recommended security control in the low, moderate, or high baselines that provides equivalent or comparable protection for an information system.

rises, an institution's maturity levels should increase. An institution's inherent risk profile and maturity levels will change over time as threats, vulnerabilities, and operational environments change. Thus, management should consider reevaluating its inherent risk profile and cybersecurity maturity periodically and when planned changes can affect its inherent risk profile (e.g., launching new products or services, new connections).

Table 3: Risk/Maturity Relationship

		Inherent Risk Levels				
		Least	**Minimal**	**Moderate**	**Significant**	**Most**
Cybersecurity Maturity Level for Each Domain	**Innovative**					
	Advanced					
	Intermediate					
	Evolving					
	Baseline					

If management determines that the institution's maturity levels are not appropriate in relation to the inherent risk profile, management should consider reducing inherent risk or developing a strategy to improve the maturity levels. This process includes

- determining target maturity levels.
- conducting a gap analysis.
- prioritizing and planning actions.
- implementing changes.
- reevaluating over time.
- communicating the results.

Management can set target maturity levels for each domain or across domains based on the institution's business objectives and risk appetite. Management can conduct a gap analysis between the current and target maturity levels and initiate improvements based on the gaps. Each declarative statement can represent a range of strategies and processes that have enterprise-wide impact. For example, declarative statements not yet attained provide insights for policies, processes, procedures, and controls that may improve risk management in relation to a specific risk or the institution's overall cybersecurity preparedness.

Using the maturity levels in each domain, management can identify potential actions that would increase the institution's overall cybersecurity preparedness. Management can review declarative statements at maturity levels beyond what the institution has achieved to determine the actions needed to reach the next level and implement changes to address gaps. Management's periodic reevaluations of the inherent risk profile and maturity levels may further assist the institution in maintaining an appropriate level of cybersecurity preparedness. In addition, management may also seek an independent validation, such as by the internal audit function, of the institution's Assessment process and findings.

The Assessment results should be communicated to the chief executive officer (CEO) and board. More information and questions to consider are contained in the "Overview for Chief Executive Officers and Boards of Directors."

Resources

In addition to the "Overview for Chief Executive Officers and Boards of Directors," the FFIEC has released the following documents to assist institutions with the Cybersecurity Assessment Tool.

- Appendix A: Mapping Baseline Statements to FFIEC IT Examination Handbook
- Appendix B: Mapping Cybersecurity Assessment Tool to NIST Cybersecurity Framework
- Appendix C: Glossary

Inherent Risk Profile

Category: Technologies and Connection Types	Risk Levels				
	Least	Minimal	Moderate	Significant	Most
Total number of Internet service provider (ISP) connections (including branch connections)	No connections	Minimal complexity (1–20 connections)	Moderate complexity (21–100 connections)	Significant complexity (101–200 connections)	Substantial complexity (>200 connections)
Unsecured external connections, number of connections not users (e.g., file transfer protocol (FTP), Telnet, rlogin)	None	Few instances of unsecured connections (1–5)	Several instances of unsecured connections (6–10)	Significant instances of unsecured connections (11–25)	Substantial instances of unsecured connections (>25)
Wireless network access	No wireless access	Separate access points for guest wireless and corporate wireless	Guest and corporate wireless network access are logically separated; limited number of users and access points (1–250 users; 1–25 access points)	Wireless corporate network access; significant number of users and access points (251–1,000 users; 26–100 access points)	Wireless corporate network access; all employees have access; substantial number of access points (>1,000 users; >100 access points)
Personal devices allowed to connect to the corporate network	None	Only one device type available; available to <5% of employees (staff, executives, managers); e-mail access only	Multiple device types used; available to <10% of employees (staff, executives, managers) and board; e-mail access only	Multiple device types used; available to <25% of authorized employees (staff, executives, managers) and board; e-mail and some applications accessed	Any device type used; available to >25% of employees (staff, executives, managers) and board; all applications accessed
Third parties, including number of organizations and number of individuals from vendors and subcontractors, with access to internal systems (e.g., virtual private network, modem, intranet, direct connection)	No third parties and no individuals from third parties with access to systems	Limited number of third parties (1–5) and limited number of individuals from third parties (<50) with access; low complexity in how they access systems	Moderate number of third parties (6–10) and moderate number of individuals from third parties (50–500) with access; some complexity in how they access systems	Significant number of third parties (11–25) and significant number of individuals from third parties (501–1,500) with access; high level of complexity in terms of how they access systems	Substantial number of third parties (>25) and substantial number of individuals from third parties (>1,500) with access; high complexity in how they access systems

Category: Technologies and Connection Types	Risk Levels				
	Least	**Minimal**	**Moderate**	**Significant**	**Most**
Wholesale customers with dedicated connections	None	Few dedicated connections (between 1–5)	Several dedicated connections (between 6–10)	Significant number of dedicated connections (between 11–25)	Substantial number of dedicated connections (>25)
Internally hosted and developed or modified vendor applications supporting critical activities	No applications	Few applications (between 1–5)	Several applications (between 6–10)	Significant number of applications (between 11–25)	Substantial number of applications and complexity (>25)
Internally hosted, vendor-developed applications supporting critical activities	Limited applications (0–5)	Few applications (6–30)	Several applications (31–75)	Significant number of applications (76–200)	Substantial number of applications and complexity (>200)
User-developed technologies and user computing that support critical activities (includes Microsoft Excel spreadsheets and Access databases or other user-developed tools)	No user-developed technologies	1–100 technologies	101–500 technologies	501–2,500 technologies	>2,500 technologies
End-of-life (EOL) systems	No systems (hardware or software) that are past EOL or at risk of nearing EOL within 2 years	Few systems that are at risk of EOL and none that support critical operations	Several systems that will reach EOL within 2 years and some that support critical operations	A large number of systems that support critical operations at EOL or are at risk of reaching EOL in 2 years	Majority of critical operations dependent on systems that have reached EOL or will reach EOL within the next 2 years or an unknown number of systems that have reached EOL
Open Source Software (OSS)	No OSS	Limited OSS and none that support critical operations	Several OSS that support critical operations	Large number of OSS that support critical operations	Majority of operations dependent on OSS
Network devices (e.g., servers, routers, and firewalls; include physical and virtual)	Limited or no network devices (<250)	Few devices (250–1,500)	Several devices (1,501–25,000)	Significant number of devices (25,001–50,000)	Substantial number of devices (>50,000)
Third-party service providers storing and/or processing information that support critical activities (Do not have access to internal systems, but the institution relies on their services)	No third parties that support critical activities	1–25 third parties that support critical activities	26–100 third parties that support critical activities	101–200 third parties that support critical activities; 1 or more are foreign-based	>200 third parties that support critical activities; 1 or more are foreign-based

Category: Technologies and Connection Types	Risk Levels				
	Least	Minimal	Moderate	Significant	Most
Cloud computing services hosted externally to support critical activities	No cloud providers	Few cloud providers; private cloud only (1–3)	Several cloud providers (4–7)	Significant number of cloud providers (8–10); cloud-provider locations used include international; use of public cloud	Substantial number of cloud providers (>10); cloud-provider locations used include international; use of public cloud

Category: Delivery Channels	Risk Levels				
	Least	Minimal	Moderate	Significant	Most
Online presence (customer)	No Web-facing applications or social media presence	Serves as an informational Web site or social media page (e.g., provides branch and ATM locations and marketing materials)	Serves as a delivery channel for retail online banking; may communicate to customers through social media	Serves as a delivery channel for wholesale customers; may include retail account origination	Internet applications serve as a channel to wholesale customers to manage large value assets
Mobile presence	None	SMS text alerts or notices only; browser-based access	Mobile banking application for retail customers (e.g., bill payment, mobile check capture, internal transfers only)	Mobile banking application includes external transfers (e.g., for corporate clients, recurring external transactions)	Full functionality, including originating new transactions (e.g., ACH, wire)
Automated Teller Machines (ATM) (Operation)	No ATM services	ATM services offered but no owned machines	ATM services managed by a third party; ATMs at local and regional branches; cash reload services outsourced	ATM services managed internally; ATMs at U.S. branches and retail locations; cash reload services outsourced	ATM services managed internally; ATM services provided to other financial institutions; ATMs at domestic and international branches and retail locations; cash reload services managed internally

Category: Online/Mobile Products and Technology Services	Risk Levels				
	Least	**Minimal**	**Moderate**	**Significant**	**Most**
Issue debit or credit cards	Do not issue debit or credit cards	Issue debit and/or credit cards through a third party; <10,000 cards outstanding	Issue debit or credit cards through a third party; between 10,000–50,000 cards outstanding	Issue debit or credit cards directly; between 50,000–100,000 cards outstanding	Issue debit or credit cards directly; >100,000 cards outstanding; issue cards on behalf of other financial institutions
Prepaid cards	Do not issue prepaid cards	Issue prepaid cards through a third party; <5,000 cards outstanding	Issue prepaid cards through a third party; 5,000–10,000 cards outstanding	Issue prepaid cards through a third party; 10,001–20,000 cards outstanding	Issue prepaid cards internally, through a third party, or on behalf of other financial institutions; >20,000 cards outstanding
Emerging payments technologies (e.g., digital wallets, mobile wallets)	Do not accept or use emerging payments technologies	Indirect acceptance or use of emerging payments technologies (customer use may affect deposit or credit account)	Direct acceptance or use of emerging payments technologies; partner or co-brand with non-bank providers; limited transaction volume	Direct acceptance or use of emerging payments technologies; small transaction volume; no foreign payments	Direct acceptance of emerging payments technologies; moderate transaction volume and/or foreign payments
Person-to-person payments (P2P)	Not offered	Customers allowed to originate payments; used by <1,000 customers or monthly transaction volume is <50,000	Customers allowed to originate payments; used by 1,000–5,000 customers or monthly transaction volume is between 50,000–100,000	Customers allowed to originate payments; used by 5,001–10,000 customers or monthly transaction volume is between 100,001–1 million	Customers allowed to request payment or to originate payment; used by >10,000 customers or monthly transaction volume >1 million
Originating ACH payments	No ACH origination	Originate ACH credits; daily volume <3% of total assets	Originate ACH debits and credits; daily volume is 3%–5% of total assets	Sponsor third-party payment processor; originate ACH debits and credits with daily volume 6%–25% of total assets	Sponsor nested third-party payment processors; originate debits and credits with daily volume that is >25% of total assets
Originating wholesale payments (e.g., CHIPS)	Do not originate wholesale payments	Daily originated wholesale payment volume <3% of total assets	Daily originated wholesale payment volume 3%–5% of total assets	Daily originated wholesale payment volume 6%–25% of total assets	Daily originated wholesale payment volume >25% of total assets

Category: Online/Mobile Products and Technology Services	Risk Levels				
	Least	**Minimal**	**Moderate**	**Significant**	**Most**
Wire transfers	Not offered	In person wire requests only; domestic wires only; daily wire volume <3% of total assets	In person, phone, and fax wire requests; domestic daily wire volume 3%–5% of total assets; international daily wire volume <3% of total assets	Multiple request channels (e.g., online, text, e-mail, fax, and phone); daily domestic wire volume 6%–25% of total assets; daily international wire volume 3%–10% of total assets	Multiple request channels (e.g., online, text, e-mail, fax, and phone); daily domestic wire volume >25% of total assets; daily international wire volume >10% of total assets
Merchant remote deposit capture (RDC)	Do not offer Merchant RDC	<100 merchant clients; daily volume of transactions is <3% of total assets	100–500 merchant clients; daily volume of transactions is 3%–5% of total assets	501–1,000 merchant clients; daily volume of transactions is 6%–25% of total assets	>1,000 merchant clients; daily volume of transactions is >25% of total assets
Global remittances	Do not offer global remittances	Gross daily transaction volume is <3% of total assets	Gross daily transaction volume is 3%–5% of total assets	Gross daily transaction volume is 6%–25% of total assets	Gross daily transaction volume is >25% of total assets
Treasury services and clients	No treasury management services are offered	Limited services offered; number of clients is <1,000	Services offered include lockbox, ACH origination, and remote deposit capture; number of clients is between 1,000–10,000	Services offered include accounts receivable solutions and liquidity management; number of clients is between 10,001–20,000	Multiple services offered including currency services, online investing, and investment sweep accounts; number of clients is >20,000
Trust services	Trust services are not offered	Trust services are offered through a third-party provider; assets under management total <$500 million	Trust services provided directly; portfolio of assets under management total $500 million–$999 million	Trust services provided directly; assets under management total $1 billion–$10 billion	Trust services provided directly; assets under management total >$10 billion
Act as a correspondent bank (Interbank transfers)	Do not act as a correspondent bank	Act as a correspondent bank for <100 institutions	Act as a correspondent bank for 100–250 institutions	Act as a correspondent bank for 251–500 institutions	Act as a correspondent bank for >500 institutions

Category: Online/Mobile Products and Technology Services	Risk Levels				
	Least	Minimal	Moderate	Significant	Most
Merchant acquirer (sponsor merchants or card processor activity into the payment system)	Do not act as a merchant acquirer	Act as a merchant acquirer; <1,000 merchants	Act as a merchant acquirer; outsource card payment processing; 1,000–10,000 merchants	Act as a merchant acquirer and card payment processor; 10,001–100,000 merchants	Act as a merchant acquirer and card payment processor; >100,000 merchants
Host IT services for other organizations (either through joint systems or administrative support)	Do not provide IT services for other organizations	Host or provide IT services for affiliated organizations	Host or provide IT services for up to 25 unaffiliated organizations	Host or provide IT services for 26–50 unaffiliated organizations	Host or provide IT services for >50 unaffiliated organizations

Category: Organizational Characteristics	Risk Levels				
	Least	Minimal	Moderate	Significant	Most
Mergers and acquisitions (including divestitures and joint ventures)	None planned	Open to initiating discussions or actively seeking a merger or acquisition	In discussions with at least 1 party	A sale or acquisition has been publicly announced within the past year, in negotiations with 1 or more parties	Multiple ongoing integrations of acquisitions are in process
Direct employees (including information technology and cybersecurity contractors)	Number of employees totals <50	Number of employees totals 50–2,000	Number of employees totals 2,001–10,000	Number of employees totals 10,001–50,000	Number of employees is >50,000
Changes in IT and information security staffing	Key positions filled; low or no turnover of personnel	Staff vacancies exist for non-critical roles	Some turnover in key or senior positions	Frequent turnover in key staff or senior positions	Vacancies in senior or key positions for long periods; high level of employee turnover in IT or information security
Privileged access (Administrators–network, database, applications, systems, etc.)	Limited number of administrators; limited or no external administrators	Level of turnover in administrators does not affect operations or activities; may utilize some external administrators	Level of turnover in administrators affects operations; number of administrators for individual systems or applications exceeds what is necessary	High reliance on external administrators; number of administrators is not sufficient to support level or pace of change	High employee turnover in network administrators; many or most administrators are external (contractors or vendors); experience in network administration is limited

Category: Organizational Characteristics	Risk Levels				
	Least	**Minimal**	**Moderate**	**Significant**	**Most**
Changes in IT environment (e.g., network, infrastructure, critical applications, technologies supporting new products or services)	Stable IT environment	Infrequent or minimal changes in the IT environment	Frequent adoption of new technologies	Volume of significant changes is high	Substantial change in outsourced provider(s) of critical IT services; large and complex changes to the environment occur frequently
Locations of branches/business presence	1 state	1 region	1 country	1–20 countries	>20 countries
Locations of operations/data centers	1 state	1 region	1 country	1–10 countries	>10 countries

Category: External Threats	Risk Levels				
	Least	**Minimal**	**Moderate**	**Significant**	**Most**
Attempted cyber attacks	No attempted attacks or reconnaissance	Few attempts monthly (<100); may have had generic phishing campaigns received by employees and customers	Several attempts monthly (100– 500); phishing campaigns targeting employees or customers at the institution or third parties supporting critical activities; may have experienced an attempted Distributed Denial of Service (DDoS) attack within the last year	Significant number of attempts monthly (501–100,000); spear phishing campaigns targeting high net worth customers and employees at the institution or third parties supporting critical activities; Institution specifically is named in threat reports; may have experienced multiple attempted DDoS attacks within the last year	Substantial number of attempts monthly (>100,000); persistent attempts to attack senior management and/or network administrators; frequently targeted for DDoS attacks

Total	Risk Levels				
	Least	**Minimal**	**Moderate**	**Significant**	**Most**
Number of Statements Selected in Each Risk Level					
Based on Individual Risk Levels Selected, Assign an Inherent Risk Profile	**Least**	**Minimal**	**Moderate**	**Significant**	**Most**

Cybersecurity Maturity

Domain 1: Cyber Risk Management and Oversight			
Assessment Factor: Governance			
		Y, Y(C), N	
OVERSIGHT	**Baseline**		Designated members of management are held accountable by the board or an appropriate board committee for implementing and managing the information security and business continuity programs. *(FFIEC Information Security Booklet, page 3)* Information security risks are discussed in management meetings when prompted by highly visible cyber events or regulatory alerts. *(FFIEC Information Security Booklet, page 6)* Management provides a written report on the overall status of the information security and business continuity programs to the board or an appropriate board committee at least annually. *(FFIEC Information Security Booklet, page 5)* The budgeting process includes information security related expenses and tools. *(FFIEC E-Banking Booklet, page 20)* Management considers the risks posed by other critical infrastructures (e.g., telecommunications, energy) to the institution. *(FFIEC Business Continuity Planning Booklet, page J-12)*
	Evolving		At least annually, the board or an appropriate board committee reviews and approves the institution's cybersecurity program. Management is responsible for ensuring compliance with legal and regulatory requirements related to cybersecurity. Cybersecurity tools and staff are requested through the budget process. There is a process to formally discuss and estimate potential expenses associated with cybersecurity incidents as part of the budgeting process.
	Intermediate		The board or an appropriate board committee has cybersecurity expertise or engages experts to assist with oversight responsibilities. The standard board meeting package includes reports and metrics that go beyond events and incidents to address threat intelligence trends and the institution's security posture. The institution has a cyber risk appetite statement approved by the board or an appropriate board committee. Cyber risks that exceed the risk appetite are escalated to management. The board or an appropriate board committee ensures management's

			annual cybersecurity self-assessment evaluates the institution's ability to meet its cyber risk management standards. The board or an appropriate board committee reviews and approves management's prioritization and resource allocation decisions based on the results of the cyber assessments. The board or an appropriate board committee ensures management takes appropriate actions to address changing cyber risks or significant cybersecurity issues. The budget process for requesting additional cybersecurity staff and tools is integrated into business units' budget processes.
	Advanced		The board or board committee approved cyber risk appetite statement is part of the enterprise-wide risk appetite statement. Management has a formal process to continuously improve cybersecurity oversight. The budget process for requesting additional cybersecurity staff and tools maps current resources and tools to the cybersecurity strategy. Management and the board or an appropriate board committee hold business units accountable for effectively managing all cyber risks associated with their activities. Management identifies root cause(s) when cyber attacks result in material loss. The board or an appropriate board committee ensures that management's actions consider the cyber risks that the institution poses to the financial sector.
	Innovative		The board or an appropriate board committee discusses ways for management to develop cybersecurity improvements that may be adopted sector-wide. The board or an appropriate board committee verifies that management's actions consider the cyber risks that the institution poses to other critical infrastructures (e.g., telecommunications, energy).

STRATEGY/ POLICIES			
	Baseline		The institution has an information security strategy that integrates technology, policies, procedures, and training to mitigate risk. *(FFIEC Information Security Booklet, page 3)* The institution has policies commensurate with its risk and complexity that address the concepts of information technology risk management. *(FFIEC Information Security Booklet, page, 16)* The institution has policies commensurate with its risk and complexity that address the concepts of threat information sharing. *(FFIEC E-Banking Booklet, page 28)* The institution has board-approved policies commensurate with its risk and complexity that address information security. *(FFIEC Information Security Booklet, page 16)* The institution has policies commensurate with its risk and complexity that address the concepts of external dependency or third-party management. *(FFIEC Outsourcing Booklet, page 2)* The institution has policies commensurate with its risk and complexity that address the concepts of incident response and resilience. (*FFIEC Information Security Booklet, page 83)* All elements of the information security program are coordinated enterprise-wide. *(FFIEC Information Security Booklet, page 7)*
	Evolving		The institution augmented its information security strategy to incorporate cybersecurity and resilience. The institution has a formal cybersecurity program that is based on technology and security industry standards or benchmarks. A formal process is in place to update policies as the institution's inherent risk profile changes.
	Intermediate		The institution has a comprehensive set of policies commensurate with its risk and complexity that address the concepts of threat intelligence. Management periodically reviews the cybersecurity strategy to address evolving cyber threats and changes to the institution's inherent risk profile. The cybersecurity strategy is incorporated into, or conceptually fits within, the institution's enterprise-wide risk management strategy. Management links strategic cybersecurity objectives to tactical goals. A formal process is in place to cross-reference and simultaneously update all policies related to cyber risks across business lines.

	Advanced		The cybersecurity strategy outlines the institution's future state of cybersecurity with short-term and long-term perspectives. Industry-recognized cybersecurity standards are used as sources during the analysis of cybersecurity program gaps. The cybersecurity strategy identifies and communicates the institution's role as a component of critical infrastructure in the financial services industry. The risk appetite is informed by the institution's role in critical infrastructure. Management is continuously improving the existing cybersecurity program to adapt as the desired cybersecurity target state changes.
	Innovative		The cybersecurity strategy identifies and communicates the institution's role as it relates to other critical infrastructures.
IT ASSET MANAGEMENT	**Baseline**		An inventory of organizational assets (e.g., hardware, software, data, and systems hosted externally) is maintained. *(FFIEC Information Security Booklet, page 9)* Organizational assets (e.g., hardware, systems, data, and applications) are prioritized for protection based on the data classification and business value. *(FFIEC Information Security Booklet, page 12)* Management assigns accountability for maintaining an inventory of organizational assets. *(FFIEC Information Security Booklet, page 9)* A change management process is in place to request and approve changes to systems configurations, hardware, software, applications, and security tools. *(FFIEC Information Security Booklet, page 56)*
	Evolving		The asset inventory, including identification of critical assets, is updated at least annually to address new, relocated, re-purposed, and sunset assets. The institution has a documented asset life-cycle process that considers whether assets to be acquired have appropriate security safeguards. The institution proactively manages system EOL (e.g., replacement) to limit security risks. Changes are formally approved by an individual or committee with appropriate authority and with separation of duties.
	Intermediate		Baseline configurations cannot be altered without a formal change request, documented approval, and an assessment of security implications. A formal IT change management process requires cybersecurity risk to be evaluated during the analysis, approval, testing, and reporting of changes.

	Advanced		Supply chain risk is reviewed before the acquisition of mission-critical information systems including system components. Automated tools enable tracking, updating, asset prioritizing, and custom reporting of the asset inventory. Automated processes are in place to detect and block unauthorized changes to software and hardware. The change management system uses thresholds to determine when a risk assessment of the impact of the change is required.
	Innovative		A formal change management function governs decentralized or highly distributed change requests and identifies and measures security risks that may cause increased exposure to cyber attack. Comprehensive automated enterprise tools are implemented to detect and block unauthorized changes to software and hardware.
Assessment Factor: Risk Management			
RISK MANAGEMENT PROGRAM	**Baseline**		An information security and business continuity risk management function(s) exists within the institution. *(FFIEC Information Security Booklet, page 68)*
	Evolving		The risk management program incorporates cyber risk identification, measurement, mitigation, monitoring, and reporting. Management reviews and uses the results of audits to improve existing cybersecurity policies, procedures, and controls. Management monitors moderate and high residual risk issues from the cybersecurity risk assessment until items are addressed.
	Intermediate		The cybersecurity function has a clear reporting line that does not present a conflict of interest. The risk management program specifically addresses cyber risks beyond the boundaries of the technological impacts (e.g., financial, strategic, regulatory, compliance). Benchmarks or target performance metrics have been established for showing improvements or regressions of the security posture over time. Management uses the results of independent audits and reviews to improve cybersecurity. There is a process to analyze and assign potential losses and related expenses, by cost center, associated with cybersecurity incidents.

	Advanced		Cybersecurity metrics are used to facilitate strategic decision-making and funding in areas of need. Independent risk management sets and monitors cyber-related risk limits for business units. Independent risk management staff escalates to management and the board or an appropriate board committee significant discrepancies from business unit's assessments of cyber-related risk. A process is in place to analyze the financial impact cyber incidents have on the institution's capital. The cyber risk data aggregation and real-time reporting capabilities support the institution's ongoing reporting needs, particularly during cyber incidents.
	Innovative		The risk management function identifies and analyzes commonalities in cyber events that occur both at the institution and across other sectors to enable more predictive risk management. A process is in place to analyze the financial impact that a cyber incident at the institution may have across the financial sector.
RISK ASSESSMENT	**Baseline**		A risk assessment focused on safeguarding customer information identifies reasonable and foreseeable internal and external threats, the likelihood and potential damage of threats, and the sufficiency of policies, procedures, and customer information systems. *(FFIEC Information Security Booklet, page 8)* The risk assessment identifies internet-based systems and high-risk transactions that warrant additional authentication controls. *(FFIEC Information Security Booklet, page 12)* The risk assessment is updated to address new technologies, products, services, and connections before deployment. *(FFIEC Information Security Booklet, page 13)*
	Evolving		Risk assessments are used to identify the cybersecurity risks stemming from new products, services, or relationships. The focus of the risk assessment has expanded beyond customer information to address all information assets. The risk assessment considers the risk of using EOL software and hardware components.
	Intermediate		The risk assessment is adjusted to consider widely known risks or risk management practices.

	Advanced		An enterprise-wide risk management function incorporates cyber threat analysis and specific risk exposure as part of the enterprise risk assessment.
	Innovative		The risk assessment is updated in real time as changes to the risk profile occur, new applicable standards are released or updated, and new exposures are anticipated. The institution uses information from risk assessments to predict threats and drive real-time responses. Advanced or automated analytics offer predictive information and real-time risk metrics.
AUDIT	**Baseline**		Independent audit or review evaluates policies, procedures, and controls across the institution for significant risks and control issues associated with the institution's operations, including risks in new products, emerging technologies, and information systems. *(FFIEC Audit Booklet, page 4)* The independent audit function validates controls related to the storage or transmission of confidential data. *(FFIEC Audit Booklet, page 1)* Logging practices are independently reviewed periodically to ensure appropriate log management (e.g., access controls, retention, and maintenance). *(FFIEC Operations Booklet, page 29)* Issues and corrective actions from internal audits and independent testing/assessments are formally tracked to ensure procedures and control lapses are resolved in a timely manner. *(FFIEC Information Security Booklet, page 6)*
	Evolving		The independent audit function validates that the risk management function is commensurate with the institution's risk and complexity. The independent audit function validates that the institution's threat information sharing is commensurate with the institution's risk and complexity. The independent audit function validates that the institution's cybersecurity controls function is commensurate with the institution's risk and complexity. The independent audit function validates that the institution's third-party relationship management is commensurate with the institution's risk and complexity. The independent audit function validates that the institution's incident response program and resilience are commensurate with the institution's risk and complexity.

	Intermediate		A formal process is in place for the independent audit function to update its procedures based on changes to the institution's inherent risk profile. The independent audit function validates that the institution's threat intelligence and collaboration are commensurate with the institution's risk and complexity. The independent audit function regularly reviews management's cyber risk appetite statement. Independent audits or reviews are used to identify gaps in existing security capabilities and expertise.
	Advanced		A formal process is in place for the independent audit function to update its procedures based on changes to the evolving threat landscape across the sector. The independent audit function regularly reviews the institution's cyber risk appetite statement in comparison to assessment results and incorporates gaps into the audit strategy. Independent audits or reviews are used to identify cybersecurity weaknesses, root causes, and the potential impact to business units.
	Innovative		A formal process is in place for the independent audit function to update its procedures based on changes to the evolving threat landscape across other sectors the institution depends upon. The independent audit function uses sophisticated data mining tools to perform continuous monitoring of cybersecurity processes or controls.
Assessment Factor: Resources			
STAFFING	**Baseline**		Information security roles and responsibilities have been identified. *(FFIEC Information Security Booklet, page 7)* Processes are in place to identify additional expertise needed to improve information security defenses. *(FFIEC Information Security Work Program, Objective I: 2-8)*

	Evolving		A formal process is used to identify cybersecurity tools and expertise that may be needed. Management with appropriate knowledge and experience leads the institution's cybersecurity efforts. Staff with cybersecurity responsibilities have the requisite qualifications to perform the necessary tasks of the position. Employment candidates, contractors, and third parties are subject to background verification proportional to the confidentiality of the data accessed, business requirements, and acceptable risk.
	Intermediate		The institution has a program for talent recruitment, retention, and succession planning for the cybersecurity and resilience staffs.
	Advanced		The institution benchmarks its cybersecurity staffing against peers to identify whether its recruitment, retention, and succession planning are commensurate. Dedicated cybersecurity staff develops, or contributes to developing, integrated enterprise-level security and cyber defense strategies.
	Innovative		The institution actively partners with industry associations and academia to inform curricula based on future cybersecurity staffing needs of the industry.
Assessment Factor: Training and Culture			
TRAINING	**Baseline**		Annual information security training is provided. *(FFIEC Information Security Booklet, page 66)* Annual information security training includes incident response, current cyber threats (e.g., phishing, spear phishing, social engineering, and mobile security), and emerging issues. *(FFIEC Information Security Booklet, page 66)* Situational awareness materials are made available to employees when prompted by highly visible cyber events or by regulatory alerts. *(FFIEC Information Security Booklet, page 7)* Customer awareness materials are readily available (e.g., DHS' Cybersecurity Awareness Month materials). *(FFIEC E-Banking Work Program, Objective 6-3)*

	Evolving		The institution has a program for continuing cybersecurity training and skill development for cybersecurity staff. Management is provided cybersecurity training relevant to their job responsibilities. Employees with privileged account permissions receive additional cybersecurity training commensurate with their levels of responsibility. Business units are provided cybersecurity training relevant to their particular business risks. The institution validates the effectiveness of training (e.g., social engineering or phishing tests).
	Intermediate		Management incorporates lessons learned from social engineering and phishing exercises to improve the employee awareness programs. Cybersecurity awareness information is provided to retail customers and commercial clients at least annually. Business units are provided cybersecurity training relevant to their particular business risks, over and above what is required of the institution as a whole. The institution routinely updates its training to security staff to adapt to new threats.
	Advanced		Independent directors are provided with cybersecurity training that addresses how complex products, services, and lines of business affect the institution's cyber risk.
	Innovative		Key performance indicators are used to determine whether training and awareness programs positively influence behavior.
CULTURE	**Baseline**		Management holds employees accountable for complying with the information security program. *(FFIEC Information Security Booklet, page 7)*
	Evolving		The institution has formal standards of conduct that hold all employees accountable for complying with cybersecurity policies and procedures. Cyber risks are actively discussed at business unit meetings. Employees have a clear understanding of how to identify and escalate potential cybersecurity issues.

	Intermediate		Management ensures performance plans are tied to compliance with cybersecurity policies and standards in order to hold employees accountable. The risk culture requires formal consideration of cyber risks in all business decisions. Cyber risk reporting is presented and discussed at the independent risk management meetings.
	Advanced		Management ensures continuous improvement of cyber risk cultural awareness.
	Innovative		The institution leads efforts to promote cybersecurity culture across the sector and to other sectors that they depend upon.

Domain 2: Threat Intelligence and Collaboration

Assessment Factor: Threat Intelligence

		Y, Y(C), N	
THREAT INTELLIGENCE AND INFORMATION	**Baseline**		The institution belongs or subscribes to a threat and vulnerability information sharing source(s) that provides information on threats (e.g., Financial Services Information Sharing and Analysis Center [FS-ISAC], U.S. Computer Emergency Readiness Team [US-CERT]). *(FFIEC E-Banking Work Program, page 28)* Threat information is used to monitor threats and vulnerabilities. *(FFIEC Information Security Booklet, page 83)* Threat information is used to enhance internal risk management and controls. *(FFIEC Information Security Booklet, page 4)*
	Evolving		Threat information received by the institution includes analysis of tactics, patterns, and risk mitigation recommendations.
	Intermediate		A formal threat intelligence program is implemented and includes subscription to threat feeds from external providers and internal sources. Protocols are implemented for collecting information from industry peers and government. A read-only, central repository of cyber threat intelligence is maintained.
	Advanced		A cyber intelligence model is used for gathering threat information. Threat intelligence is automatically received from multiple sources in real time. The institution’s threat intelligence includes information related to geopolitical events that could increase cybersecurity threat levels.
	Innovative		A threat analysis system automatically correlates threat data to specific risks and then takes risk-based automated actions while alerting management. The institution is investing in the development of new threat intelligence and collaboration mechanisms (e.g., technologies, business processes) that will transform how information is gathered and shared.

Assessment Factor: Monitoring and Analyzing			
MONITORING AND ANALYZING	**Baseline**		Audit log records and other security event logs are reviewed and retained in a secure manner. *(FFIEC Information Security Booklet, page 79)* Computer event logs are used for investigations once an event has occurred. *(FFIEC Information Security Booklet, page 83)*
	Evolving		A process is implemented to monitor threat information to discover emerging threats. The threat information and analysis process is assigned to a specific group or individual. Security processes and technology are centralized and coordinated in a Security Operations Center (SOC) or equivalent. Monitoring systems operate continuously with adequate support for efficient incident handling.
	Intermediate		A threat intelligence team is in place that evaluates threat intelligence from multiple sources for credibility, relevance, and exposure. A profile is created for each threat that identifies the likely intent, capability, and target of the threat. Threat information sources that address all components of the threat profile are prioritized and monitored. Threat intelligence is analyzed to develop cyber threat summaries including risks to the institution and specific actions for the institution to consider.
	Advanced		A dedicated cyber threat identification and analysis committee or team exists to centralize and coordinate initiatives and communications. Formal processes have been defined to resolve potential conflicts in information received from sharing and analysis centers or other sources. Emerging internal and external threat intelligence and correlated log analysis are used to predict future attacks. Threat intelligence is viewed within the context of the institution's risk profile and risk appetite to prioritize mitigating actions in anticipation of threats. Threat intelligence is used to update architecture and configuration standards.

	Innovative		The institution uses multiple sources of intelligence, correlated log analysis, alerts, internal traffic flows, and geopolitical events to predict potential future attacks and attack trends. Highest risk scenarios are used to predict threats against specific business targets. IT systems automatically detect configuration weaknesses based on threat intelligence and alert management so actions can be prioritized.
Assessment Factor: Information Sharing			
INFORMATION SHARING	**Baseline**		Information security threats are gathered and shared with applicable internal employees. *(FFIEC Information Security Booklet, page 83)* Contact information for law enforcement and the regulator(s) is maintained and updated regularly. *(FFIEC Business Continuity Planning Work Program, Objective I: 5-1)* Information about threats is shared with law enforcement and regulators when required or prompted. *(FFIEC Information Security Booklet, page 84)*
	Evolving		A formal and secure process is in place to share threat and vulnerability information with other entities. A representative from the institution participates in law enforcement or information-sharing organization meetings.
	Intermediate		A formal protocol is in place for sharing threat, vulnerability, and incident information to employees based on their specific job function. Information-sharing agreements are used as needed or required to facilitate sharing threat information with other financial sector organizations or third parties. Information is shared proactively with the industry, law enforcement, regulators, and information-sharing forums. A process is in place to communicate and collaborate with the public sector regarding cyber threats.
	Advanced		Management communicates threat intelligence with business risk context and specific risk management recommendations to the business units. Relationships exist with employees of peer institutions for sharing cyber threat intelligence. A network of trust relationships (formal and/or informal) has been established to evaluate information about cyber threats.

	Innovative		A mechanism is in place for sharing cyber threat intelligence with business units in real time including the potential financial and operational impact of inaction. A system automatically informs management of the level of business risk specific to the institution and the progress of recommended steps taken to mitigate the risks. The institution is leading efforts to create new sector-wide information-sharing channels to address gaps in external-facing information-sharing mechanisms.

Domain 3: Cybersecurity Controls

Assessment Factor: Preventative Controls

		Y, Y(C), N	
INFRASTRUCTURE MANAGEMENT	**Baseline**		Network perimeter defense tools (e.g., border router and firewall) are used. *(FFIEC Information Security Booklet, page 33)* Systems that are accessed from the Internet or by external parties are protected by firewalls or other similar devices. *(FFIEC Information Security Booklet, page 46)* All ports are monitored. *(FFIEC Information Security Booklet, page 50)* Up to date antivirus and anti-malware tools are used. *(FFIEC Information Security Booklet, page 78)* Systems configurations (for servers, desktops, routers, etc.) follow industry standards and are enforced. *(FFIEC Information Security Booklet, page 56)* Ports, functions, protocols and services are prohibited if no longer needed for business purposes. *(FFIEC Information Security Booklet, page 50)* Access to make changes to systems configurations (including virtual machines and hypervisors) is controlled and monitored. *(FFIEC Information Security Booklet, page 56)* Programs that can override system, object, network, virtual machine, and application controls are restricted. *(FFIEC Information Security Booklet, page 41)* System sessions are locked after a pre-defined period of inactivity and are terminated after pre-defined conditions are met. *(FFIEC Information Security Booklet, page 23)* Wireless network environments require security settings with strong encryption for authentication and transmission. (*N/A if there are no wireless networks.) *(FFIEC Information Security Booklet, page 40)*
	Evolving		There is a firewall at each Internet connection and between any Demilitarized Zone (DMZ) and internal network(s). Antivirus and intrusion detection/prevention systems (IDS/IPS) detect and block actual and attempted attacks or intrusions. Technical controls prevent unauthorized devices, including rogue wireless access devices and removable media, from connecting to the internal network(s). A risk-based solution is in place at the institution or Internet hosting

			provider to mitigate disruptive cyber attacks (e.g., DDoS attacks). Guest wireless networks are fully segregated from the internal network(s). (*N/A if there are no wireless networks.) Domain Name System Security Extensions (DNSSEC) is deployed across the enterprise. Critical systems supported by legacy technologies are regularly reviewed to identify for potential vulnerabilities, upgrade opportunities, or new defense layers. Controls for unsupported systems are implemented and tested.
	Intermediate		The enterprise network is segmented in multiple, separate trust/security zones with defense-in-depth strategies (e.g., logical network segmentation, hard backups, air-gapping) to mitigate attacks. Security controls are used for remote access to all administrative consoles, including restricted virtual systems. Wireless network environments have perimeter firewalls that are implemented and configured to restrict unauthorized traffic. (*N/A if there are no wireless networks.) Wireless networks use strong encryption with encryption keys that are changed frequently. (*N/A if there are no wireless networks.) The broadcast range of the wireless network(s) is confined to institution-controlled boundaries. (*N/A if there are no wireless networks.) Technical measures are in place to prevent the execution of unauthorized code on institution owned or managed devices, network infrastructure, and systems components.
	Advanced		Network environments and virtual instances are designed and configured to restrict and monitor traffic between trusted and untrusted zones. Only one primary function is permitted per server to prevent functions that require different security levels from co-existing on the same server. Anti-spoofing measures are in place to detect and block forged source IP addresses from entering the network.
	Innovative		The institution risk scores all of its infrastructure assets and updates in real time based on threats, vulnerabilities, or operational changes. Automated controls are put in place based on risk scores to infrastructure assets, including automatically disconnecting affected assets. The institution proactively seeks to identify control gaps that may be used as part of a zero-day attack.

			Public-facing servers are routinely rotated and restored to a known clean state to limit the window of time a system is exposed to potential threats.
ACCESS AND DATA MANAGEMENT	**Baseline**		Employee access is granted to systems and confidential data based on job responsibilities and the principles of least privilege. *(FFIEC Information Security Booklet, page 19)* Employee access to systems and confidential data provides for separation of duties. *(FFIEC Information Security Booklet, page 19)* Elevated privileges (e.g., administrator privileges) are limited and tightly controlled (e.g., assigned to individuals, not shared, and require stronger password controls). *(FFIEC Information Security Booklet, page 19)* User access reviews are performed periodically for all systems and applications based on the risk to the application or system. *(FFIEC Information Security Booklet, page 18)* Changes to physical and logical user access, including those that result from voluntary and involuntary terminations, are submitted to and approved by appropriate personnel. *(FFIEC Information Security Booklet, page 18)* Identification and authentication are required and managed for access to systems, applications, and hardware. *(FFIEC Information Security Booklet, page 21)* Access controls include password complexity and limits to password attempts and reuse. *(FFIEC Information Security Booklet, page 66)* All default passwords and unnecessary default accounts are changed before system implementation. *(FFIEC Information Security Booklet, page 61)* Customer access to Internet-based products or services requires authentication controls (e.g., layered controls, multifactor) that are commensurate with the risk. *(FFIEC Information Security Booklet, page 21)* Production and non-production environments are segregated to prevent unauthorized access or changes to information assets. (*N/A if no production environment exists at the institution or the institution's third party.) *(FFIEC Information Security Booklet, page 64)* Physical security controls are used to prevent unauthorized access to information systems and telecommunication systems. *(FFIEC Information Security Booklet, page 47)* All passwords are encrypted in storage and in transit. *(FFIEC Information Security Booklet, page 21)*

			Confidential data are encrypted when transmitted across public or untrusted networks (e.g., Internet). *(FFIEC Information Security Booklet, page 51)* Mobile devices (e.g., laptops, tablets, and removable media) are encrypted if used to store confidential data. (*N/A if mobile devices are not used.) *(FFIEC Information Security Booklet, page 51)* Remote access to critical systems by employees, contractors, and third parties uses encrypted connections and multifactor authentication. *(FFIEC Information Security Booklet, page 45)* Administrative, physical, or technical controls are in place to prevent users without administrative responsibilities from installing unauthorized software. *(FFIEC Information Security Booklet, page 25)* Customer service (e.g., the call center) utilizes formal procedures to authenticate customers commensurate with the risk of the transaction or request. *(FFIEC Information Security Booklet, page 19)* Data is disposed of or destroyed according to documented requirements and within expected time frames. *(FFIEC Information Security Booklet, page 66)*
	Evolving		Changes to user access permissions trigger automated notices to appropriate personnel. Administrators have two accounts: one for administrative use and one for general purpose, non-administrative tasks. Use of customer data in non-production environments complies with legal, regulatory, and internal policy requirements for concealing or removing of sensitive data elements. Physical access to high-risk or confidential systems is restricted, logged, and unauthorized access is blocked. Controls are in place to prevent unauthorized access to cryptographic keys.

	Intermediate		The institution has implemented tools to prevent unauthorized access to or exfiltration of confidential data. Controls are in place to prevent unauthorized escalation of user privileges. Access controls are in place for database administrators to prevent unauthorized downloading or transmission of confidential data. All physical and logical access is removed immediately upon notification of involuntary termination and within 24 hours of an employee's voluntary departure. Multifactor authentication and/or layered controls have been implemented to secure all third-party access to the institution's network and/or systems and applications. Multifactor authentication (e.g., tokens, digital certificates) techniques are used for employee access to high-risk systems as identified in the risk assessment(s). (*N/A if no high risk systems.) Confidential data are encrypted in transit across private connections (e.g., frame relay and T1) and within the institution's trusted zones. Controls are in place to prevent unauthorized access to collaborative computing devices and applications (e.g., networked white boards, cameras, microphones, online applications such as instant messaging and document sharing). (* N/A if collaborative computing devices are not used.)
	Advanced		Encryption of select data at rest is determined by the institution's data classification and risk assessment. Customer authentication for high-risk transactions includes methods to prevent malware and man-in-the-middle attacks (e.g., using visual transaction signing).

	Innovative		Adaptive access controls de-provision or isolate an employee, third-party, or customer credentials to minimize potential damage if malicious behavior is suspected. Unstructured confidential data are tracked and secured through an identity-aware, cross-platform storage system that protects against internal threats, monitors user access, and tracks changes. Tokenization is used to substitute unique values for confidential information (e.g., virtual credit card). The institution is leading efforts to create new technologies and processes for managing customer, employee, and third-party authentication and access. Real-time risk mitigation is taken based on automated risk scoring of user credentials.
DEVICE/END-POINT SECURITY	**Baseline**		Controls are in place to restrict the use of removable media to authorized personnel. *(FFIEC Information Security Work Program, Objective I: 4-1)*
	Evolving		Tools automatically block attempted access from unpatched employee and third-party devices. Tools automatically block attempted access by unregistered devices to internal networks. The institution has controls to prevent the unauthorized addition of new connections. Controls are in place to prevent unauthorized individuals from copying confidential data to removable media. Antivirus and anti-malware tools are deployed on end-point devices (e.g., workstations, laptops, and mobile devices). Mobile devices with access to the institution's data are centrally managed for antivirus and patch deployment. (*N/A if mobile devices are not used.) The institution wipes data remotely on mobile devices when a device is missing or stolen. (*N/A if mobile devices are not used.)
	Intermediate		Data loss prevention controls or devices are implemented for inbound and outbound communications (e.g., e-mail, FTP, Telnet, prevention of large file transfers). Mobile device management includes integrity scanning (e.g., jailbreak/rooted detection). (*N/A if mobile devices are not used.) Mobile devices connecting to the corporate network for storing and accessing company information allow for remote software version/patch validation. (*N/A if mobile devices are not used.)

	Advanced		Employees' and third parties' devices (including mobile) without the latest security patches are quarantined and patched before the device is granted access to the network. Confidential data and applications on mobile devices are only accessible via a secure, isolated sandbox or a secure container.
	Innovative		A centralized end-point management tool provides fully integrated patch, configuration, and vulnerability management, while also being able to detect malware upon arrival to prevent an exploit.
SECURE CODING	**Baseline**		Developers working for the institution follow secure program coding practices, as part of a system development life cycle (SDLC), that meet industry standards. *(FFIEC Information Security Booklet, page 56)* The security controls of internally developed software are periodically reviewed and tested. (*N/A if there is no software development.) *(FFIEC Information Security Booklet, page 59)* The security controls in internally developed software code are independently reviewed before migrating the code to production. (*N/A if there is no software development.) *(FFIEC Development and Acquisition Booklet, page 2)* Intellectual property and production code are held in escrow. (*N/A if there is no production code to hold in escrow.) *(FFIEC Development and Acquisition Booklet, page 39)*
	Evolving		Security testing occurs at all post-design phases of the SDLC for all applications, including mobile applications. (*N/A if there is no software development.)
	Intermediate		Processes are in place to mitigate vulnerabilities identified as part of the secure development of systems and applications. The security of applications, including Web-based applications connected to the Internet, is tested against known types of cyber attacks (e.g., SQL injection, cross-site scripting, buffer overflow) before implementation or following significant changes. Software code executables and scripts are digitally signed to confirm the software author and guarantee that the code has not been altered or corrupted. A risk-based, independent information assurance function evaluates the security of internal applications.
	Advanced		Vulnerabilities identified through a static code analysis are remediated before implementing newly developed or changed applications into production. All interdependencies between applications and services have been

			identified. Independent code reviews are completed on internally developed or vendor-provided custom applications to ensure there are no security gaps.
	Innovative		Software code is actively scanned by automated tools in the development environment so that security weaknesses can be resolved immediately during the design phase.
Assessment Factor: Detective Controls			
THREAT AND VULNERABILITY DETECTION	**Baseline**		Independent testing (including penetration testing and vulnerability scanning) is conducted according to the risk assessment for external-facing systems and the internal network. *(FFIEC Information Security Booklet, page 61)* Antivirus and anti-malware tools are used to detect attacks. *(FFIEC Information Security Booklet, page 55)* Firewall rules are audited or verified at least quarterly. *(FFIEC Information Security Booklet, page 82)* E-mail protection mechanisms are used to filter for common cyber threats (e.g., attached malware or malicious links). *(FFIEC Information Security Booklet, page 39)*
	Evolving		Independent penetration testing of network boundary and critical Web-facing applications is performed routinely to identify security control gaps. Independent penetration testing is performed on Internet-facing applications or systems before they are launched or undergo significant change. Antivirus and anti-malware tools are updated automatically. Firewall rules are updated routinely. Vulnerability scanning is conducted and analyzed before deployment/redeployment of new/existing devices. Processes are in place to monitor potential insider activity that could lead to data theft or destruction.
	Intermediate		Audit or risk management resources review the penetration testing scope and results to help determine the need for rotating companies based on the quality of the work. E-mails and attachments are automatically scanned to detect malware and are blocked when malware is present.

	Advanced		Weekly vulnerability scanning is rotated among environments to scan all environments throughout the year. Penetration tests include cyber attack simulations and/or real-world tactics and techniques such as red team testing to detect control gaps in employee behavior, security defenses, policies, and resources. Automated tool(s) proactively identifies high-risk behavior signaling an employee who may pose an insider threat.
	Innovative		User tasks and content (e.g., opening an e-mail attachment) are automatically isolated in a secure container or virtual environment so that malware can be analyzed but cannot access vital data, end-point operating systems, or applications on the institution's network. Vulnerability scanning is performed on a weekly basis across all environments.
ANOMALOUS ACTIVITY DETECTION	**Baseline**		The institution is able to detect anomalous activities through monitoring across the environment. *(FFIEC Information Security Booklet, page 32)* Customer transactions generating anomalous activity alerts are monitored and reviewed. *(FFIEC Wholesale Payments Booklet, page 12)* Logs of physical and/or logical access are reviewed following events. *(FFIEC Information Security Booklet, page 73)* Access to critical systems by third parties is monitored for unauthorized or unusual activity. *(FFIEC Outsourcing Booklet, page 26)* Elevated privileges are monitored. *(FFIEC Information Security Booklet, page 19)*
	Evolving		Systems are in place to detect anomalous behavior automatically during customer, employee, and third-party authentication. Security logs are reviewed regularly. Logs provide traceability for all system access by individual users. Thresholds have been established to determine activity within logs that would warrant management response.

	Intermediate		Online customer transactions are actively monitored for anomalous behavior. Tools to detect unauthorized data mining are used. Tools actively monitor security logs for anomalous behavior and alert within established parameters. Audit logs are backed up to a centralized log server or media that is difficult to alter. Thresholds for security logging are evaluated periodically. Anomalous activity and other network and system alerts are correlated across business units to detect and prevent multifaceted attacks (e.g., simultaneous account takeover and DDoS attack).
	Advanced		An automated tool triggers system and/or fraud alerts when customer logins occur within a short period of time but from physically distant IP locations. External transfers from customer accounts generate alerts and require review and authorization if anomalous behavior is detected. A system is in place to monitor and analyze employee behavior (network use patterns, work hours, and known devices) to alert on anomalous activities. An automated tool(s) is in place to detect and prevent data mining by insider threats. Tags on fictitious confidential data or files are used to provide advanced alerts of potential malicious activity when the data is accessed.
	Innovative		The institution has a mechanism for real-time automated risk scoring of threats. The institution is developing new technologies that will detect potential insider threats and block activity in real time.

EVENT DETECTION			
	Baseline		A normal network activity baseline is established. *(FFIEC Information Security Booklet, page 77)* Mechanisms (e.g., antivirus alerts, log event alerts) are in place to alert management to potential attacks. *(FFIEC Information Security Booklet, page 78)* Processes are in place to monitor for the presence of unauthorized users, devices, connections, and software. *(FFIEC Information Security Work Program, Objective II: M-9)* Responsibilities for monitoring and reporting suspicious systems activity have been assigned. *(FFIEC Information Security Booklet, page 83)* The physical environment is monitored to detect potential unauthorized access. *(FFIEC Information Security Booklet, page 47)*
	Evolving		A process is in place to correlate event information from multiple sources (e.g., network, application, or firewall).
	Intermediate		Controls or tools (e.g., data loss prevention) are in place to detect potential unauthorized or unintentional transmissions of confidential data. Event detection processes are proven reliable. Specialized security monitoring is used for critical assets throughout the infrastructure.
	Advanced		Automated tools detect unauthorized changes to critical system files, firewalls, IPS, IDS, or other security devices. Real-time network monitoring and detection is implemented and incorporates sector-wide event information. Real-time alerts are automatically sent when unauthorized software, hardware, or changes occur. Tools are in place to actively correlate event information from multiple sources and send alerts based on established parameters.
	Innovative		The institution is leading efforts to develop event detection systems that will correlate in real time when events are about to occur. The institution is leading the development effort to design new technologies that will detect potential insider threats and block activity in real time.

Assessment Factor: Corrective Controls			
PATCH MANAGEMENT	**Baseline**		A patch management program is implemented and ensures that software and firmware patches are applied in a timely manner. *(FFIEC Information Security Booklet, page 62)* Patches are tested before being applied to systems and/or software. *(FFIEC Operations Booklet, page 22)* Patch management reports are reviewed and reflect missing security patches. *(FFIEC Development and Acquisition Booklet, page 50)*
	Evolving		A formal process is in place to acquire, test, and deploy software patches based on criticality. Systems are configured to retrieve patches automatically. Operational impact is evaluated before deploying security patches. An automated tool(s) is used to identify missing security patches as well as the number of days since each patch became available. Missing patches across all environments are prioritized and tracked.
	Intermediate		Patches for high-risk vulnerabilities are tested and applied when released or the risk is accepted and accountability assigned.
	Advanced		Patch monitoring software is installed on all servers to identify any missing patches for the operating system software, middleware, database, and other key software. The institution monitors patch management reports to ensure security patches are tested and implemented within aggressive time frames (e.g., 0-30 days).
	Innovative		The institution develops security patches or bug fixes or contributes to open source code development for systems it uses. Segregated or separate systems are in place that mirror production systems allowing for rapid testing and implementation of patches and provide for rapid fallback when needed.

REMEDIATION			
	Baseline		Issues identified in assessments are prioritized and resolved based on criticality and within the time frames established in the response to the assessment report. *(FFIEC Information Security Booklet, page 87)*
	Evolving		Data is destroyed or wiped on hardware and portable/mobile media when a device is missing, stolen, or no longer needed. Formal processes are in place to resolve weaknesses identified during penetration testing.
	Intermediate		Remediation efforts are confirmed by conducting a follow-up vulnerability scan. Penetration testing is repeated to confirm that medium- and high-risk, exploitable vulnerabilities have been resolved. Security investigations, forensic analysis, and remediation are performed by qualified staff or third parties. Generally accepted and appropriate forensic procedures, including chain of custody, are used to gather and present evidence to support potential legal action. The maintenance and repair of organizational assets are performed by authorized individuals with approved and controlled tools. The maintenance and repair of organizational assets are logged in a timely manner.
	Advanced		All medium and high risk issues identified in penetration testing, vulnerability scanning, and other independent testing are escalated to the board or an appropriate board committee for risk acceptance if not resolved in a timely manner.
	Innovative		The institution is developing technologies that will remediate systems damaged by zero-day attacks to maintain current recovery time objectives.

Domain 4: External Dependency Management			
Assessment Factor: Connections			
		Y, Y(C), N	
CONNECTIONS	**Baseline**		The critical business processes that are dependent on external connectivity have been identified. *(FFIEC Information Security Booklet, page 9)* The institution ensures that third-party connections are authorized. *(FFIEC Information Security Booklet, page 17)* A network diagram is in place and identifies all external connections. *(FFIEC Information Security Booklet, page 9)* Data flow diagrams are in place and document information flow to external parties. *(FFIEC Information Security Booklet, page 10)*
	Evolving		Critical business processes have been mapped to the supporting external connections. The network diagram is updated when connections with third parties change or at least annually. Network and systems diagrams are stored in a secure manner with proper restrictions on access. Controls for primary and backup third-party connections are monitored and tested on a regular basis.
	Intermediate		A validated asset inventory is used to create comprehensive diagrams depicting data repositories, data flow, infrastructure, and connectivity. Security controls are designed and verified to detect and prevent intrusions from third-party connections. Monitoring controls cover all external connections (e.g., third-party service providers, business partners, customers). Monitoring controls cover all internal network-to-network connections.
	Advanced		The security architecture is validated and documented before network connection infrastructure changes. The institution works closely with third-party service providers to maintain and improve the security of external connections.

	Innovative		Diagram(s) of external connections is interactive, shows real-time changes to the network connection infrastructure, new connections, and volume fluctuations, and alerts when risks arise. The institution's connections can be segmented or severed instantaneously to prevent contagion from cyber attacks.
Assessment Factor: Relationship Management			
DUE DILIGENCE	**Baseline**		Risk-based due diligence is performed on prospective third parties before contracts are signed, including reviews of their background, reputation, financial condition, stability, and security controls. *(FFIEC Information Security Booklet, page 69)* A list of third-party service providers is maintained. *(FFIEC Outsourcing Booklet, page 19)* A risk assessment is conducted to identify criticality of service providers. *(FFIEC Outsourcing Booklet, page 6)*
	Evolving		A formal process exists to analyze assessments of third-party cybersecurity controls. The board or an appropriate board committee reviews a summary of due diligence results including management's recommendations to use third parties that will affect the institution's inherent risk profile.
	Intermediate		A process is in place to confirm that the institution's third-party service providers conduct due diligence of their third parties (e.g., subcontractors). Pre-contract, physical site visits of high-risk vendors are conducted by the institution or by a qualified third party.
	Advanced		A continuous process improvement program is in place for third-party due diligence activity. Audits of high-risk vendors are conducted on an annual basis.
	Innovative		The institution promotes sector-wide efforts to build due diligence mechanisms that lead to in-depth and efficient security and resilience reviews. The institution is leading efforts to develop new auditable processes and for conducting due diligence and ongoing monitoring of cybersecurity risks posed by third parties.

CONTRACTS			
	Baseline		Formal contracts that address relevant security and privacy requirements are in place for all third parties that process, store, or transmit confidential data or provide critical services. *(FFIEC Information Security Booklet, page 7)* Contracts acknowledge that the third party is responsible for the security of the institution's confidential data that it possesses, stores, processes, or transmits. *(FFIEC Information Security Booklet, page 12)* Contracts stipulate that the third-party security controls are regularly reviewed and validated by an independent party. *(FFIEC Information Security Booklet, page 12)* Contracts identify the recourse available to the institution should the third party fail to meet defined security requirements. *(FFIEC Outsourcing Booklet, page 12)* Contracts establish responsibilities for responding to security incidents. *(FFIEC E-Banking Booklet, page 22)* Contracts specify the security requirements for the return or destruction of data upon contract termination. *(FFIEC Outsourcing Booklet, page 15)*
	Evolving		Responsibilities for managing devices (e.g., firewalls, routers) that secure connections with third parties are formally documented in the contract. Responsibility for notification of direct and indirect security incidents and vulnerabilities is documented in contracts or service-level agreements (SLAs). Contracts stipulate geographic limits on where data can be stored or transmitted.
	Intermediate		Third-party SLAs or similar means are in place that require timely notification of security events.
	Advanced		Contracts require third-party service provider's security policies meet or exceed those of the institution. A third-party termination/exit strategy has been established and validated with management.
	Innovative		The institution promotes a sector-wide effort to influence contractual requirements for critical third parties to the industry.

ONGOING MONITORING	**Baseline**		The third-party risk assessment is updated regularly. *(FFIEC Outsourcing Booklet, page 3)* Audits, assessments, and operational performance reports are obtained and reviewed regularly validating security controls for critical third parties. *(FFIEC Information Security Booklet, page 86)* Ongoing monitoring practices include reviewing critical third-parties' resilience plans. *(FFIEC Outsourcing Booklet, page 19)*
	Evolving		A process to identify new third-party relationships is in place, including identifying new relationships that were established without formal approval. A formal program assigns responsibility for ongoing oversight of third-party access. Monitoring of third parties is scaled, in terms of depth and frequency, according to the risk of the third parties. Automated reminders or ticklers are in place to identify when required third-party information needs to be obtained or analyzed.
	Intermediate		Third-party employee access to the institution's confidential data are tracked actively based on the principles of least privilege. Periodic on-site assessments of high-risk vendors are conducted to ensure appropriate security controls are in place.
	Advanced		Third-party employee access to confidential data on third-party hosted systems is tracked actively via automated reports and alerts.
	Innovative		The institution is leading efforts to develop new auditable processes for ongoing monitoring of cybersecurity risks posed by third parties.

Domain 5: Cyber Incident Management and Resilience			
Assessment Factor: Incident Resilience Planning and Strategy			
		Y, Y(C), N	
PLANNING	**Baseline**		The institution has documented how it will react and respond to cyber incidents. *(FFIEC Business Continuity Planning Booklet, page 4)* Communication channels exist to provide employees a means for reporting information security events in a timely manner. *(FFIEC Information Security Booklet, page 83)* Roles and responsibilities for incident response team members are defined. *(FFIEC Information Security Booklet, page 84)* The response team includes individuals with a wide range of backgrounds and expertise, from many different areas within the institution (e.g., management, legal, public relations, as well as information technology). *(FFIEC Information Security Booklet, page 84)* A formal backup and recovery plan exists for all critical business lines. *(FFIEC Business Continuity Planning Booklet, page 4)* The institution plans to use business continuity, disaster recovery, and data backup programs to recover operations following an incident. *(FFIEC Information Security Booklet, page 71)*
	Evolving		The remediation plan and process outlines the mitigating actions, resources, and time parameters. The corporate disaster recovery, business continuity, and crisis management plans have integrated consideration of cyber incidents. Alternative processes have been established to continue critical activity within a reasonable time period. Business impact analyses have been updated to include cybersecurity. Due diligence has been performed on technical sources, consultants, or forensic service firms that could be called to assist the institution during or following an incident.

	Intermediate		A strategy is in place to coordinate and communicate with internal and external stakeholders during or following a cyber attack. Plans are in place to re-route or substitute critical functions and/or services that may be affected by a successful attack on Internet-facing systems. A direct cooperative or contractual agreement(s) is in place with an incident response organization(s) or provider(s) to assist rapidly with mitigation efforts. Lessons learned from real-life cyber incidents and attacks on the institution and other organizations are used to improve the institution's risk mitigation capabilities and response plan.
	Advanced		Methods for responding to and recovering from cyber incidents are tightly woven throughout the business units' disaster recovery, business continuity, and crisis management plans. Multiple systems, programs, or processes are implemented into a comprehensive cyber resilience program to sustain, minimize, and recover operations from an array of potentially disruptive and destructive cyber incidents. A process is in place to continuously improve the resilience plan.
	Innovative		The incident response plan is designed to ensure recovery from disruption of services, assurance of data integrity, and recovery of lost or corrupted data following a cybersecurity incident. The incident response process includes detailed actions and rule-based triggers for automated response.
TESTING	**Baseline**		Scenarios are used to improve incident detection and response. *(FFIEC Information Security Booklet, page 71)* Business continuity testing involves collaboration with critical third parties. *(FFIEC Business Continuity Planning Booklet, page J-6)* Systems, applications, and data recovery is tested at least annually. *(FFIEC Business Continuity Planning Booklet, page J-7)*
	Evolving		Recovery scenarios include plans to recover from data destruction and impacts to data integrity, data loss, and system and data availability. Widely reported events are used to evaluate and improve the institution's response. Information backups are tested periodically to verify they are accessible and readable.

	Intermediate		Cyber-attack scenarios are analyzed to determine potential impact to critical business processes. The institution participates in sector-specific cyber exercises or scenarios (e.g., FS-ISAC Cyber Attack (against) Payment Processors (CAPP)). Resilience testing is based on analysis and identification of realistic and highly likely threats as well as new and emerging threats facing the institution. The critical online systems and processes are tested to withstand stresses for extended periods (e.g., DDoS). The results of cyber event exercises are used to improve the incident response plan and automated triggers.
	Advanced		Resilience testing is comprehensive and coordinated across all critical business functions. The institution validates that it is able to recover from cyber events similar to by known sophisticated attacks at other organizations. Incident response testing evaluates the institution from an attacker's perspective to determine how the institution or its assets at critical third parties may be targeted. The institution corrects root causes for problems discovered during cybersecurity resilience testing. Cybersecurity incident scenarios involving significant financial loss are used to stress test the institution's risk management.
	Innovative		The institution tests the ability to shift business processes or functions between different processing centers or technology systems for cyber incidents without interruption to business or loss of productivity or data. The institution has validated that it is able to remediate systems damaged by zero-day attacks to maintain current recovery time objectives. The institution is leading the development of more realistic test environments. Cyber incident scenarios are used to stress test potential financial losses across the sector.

Assessment Factor: Detection, Response, and Mitigation			
DETECTION	**Baseline**		Alert parameters are set for detecting information security incidents that prompt mitigating actions. *(FFIEC Information Security Booklet, page 43)* System performance reports contain information that can be used as a risk indicator to detect information security incidents. *(FFIEC Information Security Booklet, page 86)* Tools and processes are in place to detect, alert, and trigger the incident response program. *(FFIEC Information Security Booklet, page 84)*
	Evolving		The institution has processes to detect and alert the incident response team when potential insider activity manifests that could lead to data theft or destruction.
	Intermediate		The incident response program is triggered when anomalous behaviors and attack patterns or signatures are detected. The institution has the ability to discover infiltration, before the attacker traverses across systems, establishes a foothold, steals information, or causes damage to data and systems. Incidents are detected in real time through automated processes that include instant alerts to appropriate personnel who can respond. Network and system alerts are correlated across business units to better detect and prevent multifaceted attacks (e.g., simultaneous DDoS attack and account takeover). Incident detection processes are capable of correlating events across the enterprise.
	Advanced		Sophisticated and adaptive technologies are deployed that can detect and alert the incident response team of specific tasks when threat indicators across the enterprise indicate potential external and internal threats. Automated tools are implemented to provide specialized security monitoring based on the risk of the assets to detect and alert incident response teams in real time.
	Innovative		The institution is able to detect and block zero-day attempts and inform management and the incident response team in real time.

RESPONSE AND MITIGATION			
	Baseline		Appropriate steps are taken to contain and control an incident to prevent further unauthorized access to or use of customer information. *(FFIEC Information Security Booklet, page 84)*
	Evolving		The incident response plan is designed to prioritize incidents, enabling a rapid response for significant cybersecurity incidents or vulnerabilities. A process is in place to help contain incidents and restore operations with minimal service disruption. Containment and mitigation strategies are developed for multiple incident types (e.g., DDoS, malware). Procedures include containment strategies and notifying potentially impacted third parties. Processes are in place to trigger the incident response program when an incident occurs at a third party. Records are generated to support incident investigation and mitigation. The institution calls upon third parties, as needed, to provide mitigation services. Analysis of events is used to improve the institution's security measures and policies.
	Intermediate		Analysis of security incidents is performed in the early stages of an intrusion to minimize the impact of the incident. Any changes to systems/applications or to access entitlements necessary for incident management are reviewed by management for formal approval before implementation. Processes are in place to ensure assets affected by a security incident that cannot be returned to operational status are quarantined, removed, disposed of, and/or replaced. Processes are in place to ensure that restored assets are appropriately reconfigured and thoroughly tested before being placed back into operation.
	Advanced		The incident management function collaborates effectively with the cyber threat intelligence function during an incident. Links between threat intelligence, network operations, and incident response allow for proactive response to potential incidents. Technical measures apply defense-in-depth techniques such as deep-packet inspection and black holing for detection and timely response to network-based attacks associated with anomalous ingress or egress traffic patterns and/or DDoS attacks.

	Innovative		The institution's risk management of significant cyber incidents results in limited to no disruptions to critical services. The technology infrastructure has been engineered to limit the effects of a cyber attack on the production environment from migrating to the backup environment (e.g., air-gapped environment and processes).
Assessment Factor: Escalation and Reporting			
ESCALATION AND REPORTING	**Baseline**		A process exists to contact personnel who are responsible for analyzing and responding to an incident. *(FFIEC Information Security Booklet, page 83)* Procedures exist to notify customers, regulators, and law enforcement as required or necessary when the institution becomes aware of an incident involving the unauthorized access to or use of sensitive customer information. *(FFIEC Information Security Booklet, page 84)* The institution prepares an annual report of security incidents or violations for the board or an appropriate board committee. *(FFIEC Information Security Booklet, page 5)* Incidents are classified, logged, and tracked. *(FFIEC Operations Booklet, page 28)*
	Evolving		Criteria have been established for escalating cyber incidents or vulnerabilities to the board and senior management based on the potential impact and criticality of the risk. Regulators, law enforcement, and service providers, as appropriate, are notified when the institution is aware of any unauthorized access to systems or a cyber incident occurs that could result in degradation of services. Tracked cyber incidents are correlated for trend analysis and reporting.
	Intermediate		Employees that are essential to mitigate the risk (e.g., fraud, business resilience) know their role in incident escalation. A communication plan is used to notify other organizations, including third parties, of incidents that may affect them or their customers. An external communication plan is used for notifying media regarding incidents when applicable.
	Advanced		The institution has established quantitative and qualitative metrics for the cybersecurity incident response process. Detailed metrics, dashboards, and/or scorecards outlining cyber incidents and events are provided to management and are part of the board meeting package.

	Innovative		A mechanism is in place to provide instantaneous notification of incidents to management and essential employees through multiple communication channels with tracking and verification of receipt.

Florida Office of Financial Regulation

Administrative Policies & Procedures

TITLE:	**Ethics and Professional Responsibility**
NUMBER:	**OFR AP&P 1-2**[1]
EFFECTIVE DATE:	**May 30, 2013**
REVISED DATE:	**May 2, 2018**
REISSUE DATE:	**May 29, 2019**
APPROVED BY:	**Chief of Staff**

I. PURPOSE

The Office of Financial Regulation (OFR) is committed to building public trust and confidence in the State's financial services industry. To do so, the industry's regulators must work in an ethical, professional, and open manner.

The OFR adopts and follows the Department of Financial Services (DFS): AP&P 1-15, Department of Financial Services Code of Ethics. References to "department" in DFS AP&P 1-15 shall include OFR unless otherwise specified in this memorandum. This memorandum details additional ethical guidelines, procedures and principles that are required of all OFR staff.

OFR has adopted an "appearance of impropriety" standard for evaluating employee conduct. This standard applies to both professional and personal conduct. For purposes of this document, the phrase "appearance of impropriety" means conduct that would create in reasonable minds a perception that the employee's ability to carry out the duties and responsibilities of the OFR with integrity, impartiality and competence is impaired. In some cases, this may result in a stricter standard than imposed by DFS AP&P 1-15. In the event there is a conflict between DFS AP&P 1-15 and this memorandum, the OFR standard shall apply.

It is essential that all employees of OFR conduct themselves in an ethical and professional manner to effectively regulate and maintain the trust of the regulated industries.

[1] Previously titled OFR Guideline Memo – 006

II. SCOPE

This memorandum is applicable to all Office of Financial Regulation staff.

III. REFERENCES

A. Department of Financial Services (DFS): AP&P 1-15, Department of Financial Services Code of Ethics
B. Florida Statutes: Chapter 112, Part III
C. Florida Administrative Code: Rule 60L-36.003
D. Florida Administrative Code: Rule 69U-100.956

IV. DEFINITIONS

A. Annual Statement of Independence, Form OFR-AA-02 - completed annually by all employees of the OFR to report his or her business relationships with OFR regulated entities.
B. Immediate Family Member as used in Annual Statement of Independence, Form OFR-AA-02, means a parent, sibling, spouse, child, or person who is engaged to be married to the employee or who otherwise holds himself or herself out as or is generally known as the person with whom the employee intends to form a household.
C. Lobbying - influencing or attempting to influence legislative action or nonaction through oral or written communication or an attempt to obtain the goodwill of a member or employee of the Legislature.
D. OFR Ethics Officer - the General Counsel of the OFR.
E. Personal Interest as used in Annual Statement of Independence, Form OFR-AA-02, means having a business relationship with a person or entity. Examples of personal interests include but are not limited to: being an owner or co-owner of a business, having an account or joint-account, loan or co-signer on a loan, and ownership or joint ownership of a credit card or line of credit with a business.
F. Recuse - to disqualify or remove oneself from participation in an action.

V. GENERAL GUIDELINES AND PROCEDURES

A. Prohibited Practices
   1. No OFR employee may accept or solicit any gift from a business or person regulated by OFR, DFS, or the Office of Insurance Regulation (OIR), regardless of value.
   2. No OFR employee may hold an active license or registration issued by OFR, DFS, or OIR.
   3. OFR employees may not lobby the legislature on behalf of OFR unless they are designated by OFR to do so and registered with the Lobbyist Registration Office. The following positions are designated to lobby on behalf of OFR: Commissioner, Chief of

Staff, Director of Communications, Legislative Affairs Director, General Counsel, and the Budget Director.

B. Ethics Officer
1. Ensure that OFR employees are familiar with applicable ethics rules.
2. Advise OFR employees on questions of ethics and professional responsibility.

C. Employee Responsibility
1. Comply with the DFS Code of Ethics and the OFR Ethics and Professional Responsibilities policies.
2. Sign the Employee Pledge upon employment.
3. Complete and submit an Annual Statement of Independence, Form OFR-AA-02 within five (5) working days of employment.
4. Complete an Annual Statement of Independence, Form OFR-AA-02, before July 1 each year.
    - Tallahassee staff shall submit original, signed forms directly to their Division Director.
    - Field staff shall submit original signed forms to the Area Financial Manager, who will forward them to the Division Director.
5. Notify their supervisor and submit an Interim Notification on Form OFR-AA-02 within five (5) working days of the change or learning of a previously unknown relationship.
6. Recuse themselves from any direct regulation, examination, investigation, legal casework, or licensing review of entities disclosed on the Annual Statement of Independence:
    - Licensing staff are not required to recuse themselves from processing applications for individuals employed by an entity listed on the Annual Statement of Independence unless the review involves matters requiring a subjective decision and the employee is involved in the decision-making process.
    - Recusal should be accomplished by contacting the supervisor and notifying them in writing of the relationship.
7. Complete Ethics Training upon onboarding and thereafter, on a biennial basis.
8. Report all suspected workplace ethical violations to the OFR Inspector General.
9. Read and comply with Florida Administrative Code: Rule 69U-100.956, for employees within the Division of Financial Institutions.

D. Management Responsibility
1. Comply with the guidelines above.
2. Ensure employees under their supervision sign the Employee Pledge.

3. Ensure employees under their supervision sign an Annual Statement of Independence. Area Financial Managers shall maintain copies of the statements and interim notifications of employees in their geographic area. The Division Director shall maintain all original statements and interim notifications. **NOTE:** The record retention schedule for the Annual Statement of Independence requires retention for ten (10) fiscal years from the date filed with agency. See OFR Individual Retention Schedule (000181-0001a).
4. Ensure that employees do not perform any direct regulation, examination, investigation, legal casework, or licensing review of entities disclosed on their Annual Statement of Independence except as allowed in this policy.
5. Ensure employees complete Ethics Training upon onboarding and thereafter, on a biennial basis.

E. Conflict of Interest – Solicitations or Offers of Employment

1. If an employee applies for or is offered any relationship with an entity regulated by or doing business with OFR, DFS, or OIR, the employee shall notify his or her supervisor within three (3) days of application or receipt of the job offer.
2. Following the submission of an application or an offer of employment from an entity regulated by or doing business with the OFR, DFS, or OIR, the OFR may assess the risk associated with the employee's intended relationship with the entity. If the objectivity of the employee is deemed to be impaired due to the submission of an application for employment or receipt of an offer of employment, the employee shall be reassigned and not permitted to continue to maintain access to information available through the OFR.
3. It remains the responsibility of the employee to avoid any conduct that would violate the DFS Code of Ethics or this policy.

F. Disclosure of Financial Interests

Specified management level employees are required to annually file a Statement of Financial Interests, Form 1, as required by the Florida Commission on Ethics (FCE). Employees required to file a Form 1 with the FCE will do so in a timely manner. Employees who are required to file a Form 1 will be notified by DFS Human Resources.

I. TITLE:

Department of Financial Services Code of Ethics

II. AUTHORITY AND REFERENCES:

Florida Statutes: Chapter 112. Part III
Florida Administrative Code: Chapters 60L-36.003

III. PURPOSE:

All employees of the Department of Financial Services must adhere to the highest ethical standards. Acting ethically requires employees to do more than comply with the law. The Department of Financial Services (the "Department") recognizes the importance of maintaining the highest ethical standards among its employees. The public expects its government officials to conduct the State's business in an ethical, honest, and open manner. Employees are expected to know and comply with the Department's Code of Ethics in addition to all state laws regarding ethics, including the statutory Code of Ethics found in Chapter 112, Part III, Florida Statutes, and the provisions in the Rule Chapter 60L-36.003, Florida Administrative Code.

IV. DEFINITIONS:

A. "Business entity" means any corporation, partnership, limited partnership, proprietorship, firm, enterprise, franchise, association, self-employed individual, or trust, whether fictitiously named or not, doing business in this state.

B. "Commission" means the Commission on Ethics created by Section 112.320, Florida Statutes, or any successor to which its duties are transferred.

C. "Committee of Continuous Existence" means any group, organization, association, or other such entity which is certified pursuant to the provisions of Section 106.04, Florida Statutes, in making contributions to candidates, political committees, or political parties.

D. "Conflict" or "conflict of interest" means a situation in which regard for a private interest tends to lead to disregard of a public duty or interest.

E. "Department" means the Department of Financial Services.

F. “Ethics Officer” means the General Counsel to the Chief Financial Officer (CFO) and is appointed to consult with Department employees on questions of ethics and compliance with the provisions of this policy.

G. “Gift” means anything accepted by a person or on that person’s behalf, whether directly or indirectly, for that person’s benefit, and for which no payment is made in advance. A “gift” can include the following:

1. Real property.

2. The use of real property.

3. Tangible or intangible personal property.

4. The use of tangible or intangible personal property.

5. A preferential rate or terms on a debt, loan, goods, or services, which rate is below the customary rate and is not either a government rate available to all other similarly situated government employees or officials or a rate which is available to similarly situated members of the public by virtue of occupation, affiliation, age, religion, sex, or national origin.

6. Forgiveness of indebtedness.

7. Transportation, other than that provided to a public officer or employee by an agency in relation to officially approved governmental business, lodging, or parking.

8. Food or beverage.

9. Membership dues.

10. Entrance fees, admission fees, or tickets to events, performances, or facilities.

11. Plants, flowers, or floral arrangements.

12. Services provided by persons pursuant to a professional license or certificate.

13. Other personal services for which a fee is normally charged by the person providing the services.

14. Any other similar service or thing having an attributable value not already provided for in this section.

H. "Lobbyist" means any person who, for salary, fee, or other compensation, seeks, or sought during the preceding 12 months, to influence the governmental decision-making of a reporting individual or procurement employee or his or her agency or seeks, or sought during the preceding 12 months, to encourage the passage, defeat, or modification of any proposal or recommendation by the reporting individual or procurement employee or his or her agency.

I. "Political Committee" means any two or more individuals, or a person other than an individual, that, in an aggregate amount in excess of $500 during a single calendar year:

1. accepts contributions for the purposes of making contributions to any candidate, political committee, committee of continuous existence, or political party;

2. accepts contributions for the purpose of expressly advocating the election or defeat of a candidate or the passage or defeat of an issue;

3. makes expenditures that expressly advocate the election or defeat of a candidate or the passage or defeat of an issue; or

4. makes contributions to a common fund, other than a joint checking account between spouses, from which contributions are made to any candidate, political committee, committee of continuous existence, or political party.

J. "Relative" means an individual who is related to a public officer or employee as father, mother, son, daughter, brother, sister, uncle, aunt, first cousin, nephew, niece, husband, wife, father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, sister-in-law, stepfather, stepmother, stepson, stepdaughter, stepbrother, stepsister, half brother, half sister, grandparent, great grandparent, grandchild, great grandchild, step grandparent, step great grandparent, step grandchild, step great grandchild, person who is engaged to be married to the public officer or employee or who otherwise holds himself out as or is generally known as the person whom the public officer or employee intends to form a household, or any other natural person having the same legal residence as the public officer or employee.

K. “State Building” means any building owned or leased by the state in which state business is conducted.

V. ETHICAL GUIDELINES:

A. General Principles

1. Every employee of the Department is expected to treat colleagues and members of the public with courtesy and respect.

2. Department employees shall ensure that all disclosures made in accordance with the Code of Ethics laws are truthful, fair and accurate. Employees shall record information honestly, completely and accurately.

B. Conflict of Interest

1. A Department employee shall not maintain a personal or financial interest in a matter pending before the Department. Circumstances that do not constitute a conflict of interest are limited to:
   (a) An employee seeking a license of some type with the Department.
   (b) An employee who has filed a consumer complaint with the Department.
   (c) An employee who has filed a claim for unclaimed property.

2. An employee shall, within twenty-four (24) hours of knowledge of a matter, notify his or her supervisor if an employee’s relative, or a business in which the employee’s relative retains a financial interest, has regulatory or contractual business pending before the Department. Circumstances that do not constitute a conflict of interest are limited to:
   (a) A relative seeking a license of some type with the Department.
   (b) A relative who has filed a consumer complaint with the Department.
   (c) A relative who has filed a claim for unclaimed property.

3. A Department employee shall not maintain employment or a contractual relationship with any business entity or any agency which is regulated by the Department, or is doing business with the Department, except that the employee may purchase goods or services from a business entity which is subject to the

regulation of the Department if the price and terms of the transaction are available to members of the general public.

4. A Department employee shall not maintain any employment or contractual relationship that will create a conflict between the employee's private interests and the performance of his or her public duties.

5. If a Department employee applies for or is offered employment, the employee shall within three (3) days notify his or her supervisor of the employment application or job offer. If a Department employee is seeking or upon an entity offering any contractual relationship with an entity regulated by or doing business with the Department, the employee shall, prior to the seeking of the contractual relationship, or within three (3) days upon an entity offering the contractual relationship, notify his or her supervisor.

C. Abuse of Position of Public Trust

1. Department employees shall not use their official position, or the powers of their office, to benefit their own personal interests. This provision will be interpreted broadly to ensure that employees will not abuse the powers of their office for their own personal interests or gain. Examples of prohibited conduct are:

a. Accepting a discount on goods or services (not provided to the general public) from a vendor doing business with the Department.
b. Using a Department vehicle for personal purposes, except as may be permitted for law enforcement personnel.
c. Asking a vendor or contractor doing business with the Department to hire an employee's spouse, child, or other family member.
d. Using Department facilities, equipment, resources for political campaigns, or other political purposes.

D. Charitable Fundraising

1. The Department encourages employees to volunteer their personal time and resources to benefit not-for-profit charities and organizations. Department employees shall not solicit contributions to charitable entities from individuals or entities which are regulated by or do business with the Department. Such fundraising would be a violation of Section C of this Code of Ethics. Department employees may participate in the Florida State Employees Charitable Campaign

(FSECC) during normal business hours to the extent authorized by the CFO. Pursuant to Section 110.181 (1) (a), F.S., FSECC is the only authorized charitable fundraising drive directed toward state employees within work areas during work hours. Division Directors, in consultation with the Ethics Officer, must approve solicitations related to charitable fundraising in the workplace.

E. Political Campaigns and Fundraising

1. Department employees have the right to participate in political campaigns during their personal time. Employees who participate in political campaigns or political activities during normal business hours should do so only when they have received prior approval to take annual leave. Employees are permitted to express their opinions on political subjects and candidates, take an active part in political campaigns outside of working hours, including the wearing of badges or buttons, and displaying bumper stickers and posters.

2. A Department employee who qualifies as a political candidate must notify the Chief of Human Resource Management and his immediate supervisor of his or her candidacy within three (3) days upon qualification.

3. No employee is permitted to make, solicit, or accept contributions for any political campaign in a state building. If a person attempts to deliver a contribution in a state building, the contribution should be refused and the person tendering the contribution should be informed that it is illegal to accept a contribution in a state building. The employee should also notify the Inspector General of the incident. Contributions received by mail at a state building must be returned to the sender.

F. Disclosure of Information Exempt from Public Release

1. Department employees may be privy to information which is exempt from public disclosure under Florida's public records law. Employees are prohibited from disclosing this information or using it for their own personal benefit.

G. Restrictions Upon Leaving the Department

1. A Senior Management Service (SMS) or Selected Exempt Service (SES) employee cannot personally represent another person or entity for compensation

before the Department for a period of two (2) years following termination or retirement.

2. A former employee is prohibited from having any employment or contractual relationship for two (2) years with any business entity (other than a public agency) in connection with a contract for services which was within his or her responsibility while serving as a Department employee.

H. Restrictions Regarding Relatives

1. Employees with knowledge of applicants who possess characteristics particularly suitable to vacancies in the Department should feel welcome to refer those applicants to the Chief of Human Resource Management. However, employees are prohibited from influencing the hiring of relatives for positions within the Department by directly contacting the hiring manager. Anytime an employee recommends a relative for a position within the Department, the employee should first consult with the Department's Ethics Officer prior to making the recommendation.

2. An employee may not appoint, employ, promote, or advance for appointment, employment, promotion, or advancement, in or to a position, over which the employee exercises jurisdiction or control, any individual who is a relative of the employee.

3. Employees shall not procure contractual services for the Department from a business in which a relative is an officer, partner, director or owner.

I. Disclosure Requirements

1. Florida law requires certain employees to file a full and public disclosure of their financial interests with the Florida Commission on Ethics. This disclosure is designed to assure the public that employees' decisions are made impartially and in the public interest, and not for personal gain. Employees shall review and follow the applicable financial disclosure requirements found in Section 112.3145, Florida Statutes.

J. The Receipt and Reporting of Gifts

1. The gift restrictions in this Code apply broadly to all Department employees.

2. An employee is prohibited from soliciting any gift from a political committee or committee of continuous existence, from a vendor doing business with the employee's agency, from a lobbyist who lobbies the Department, from the partner, firm, employer or principal of such lobbyist, or from a person or entity doing business with the Department.

3. An employee is prohibited from accepting any gift, directly or indirectly, from a political committee or committee of continuous existence, from a vendor doing business with the employee's agency, from a lobbyist who lobbies the Department, from the partner, firm, employer, or principal of such lobbyist, or from a person or entity doing business with the Department, unless the following limited exceptions apply:

   (a) Gifts can be accepted from relatives, unless the relative is a lobbyist or a principal of a lobbyist, in which case the general prohibition on receipt of gifts from lobbyists applies. Employees who are married to or involved in a personal relationship with a lobbyist or the principal of a lobbyist shall consult with the Department's Ethics Officer on how to address this situation.

   (b) Gifts can be accepted from personal friends in the ordinary course of friendship, provided that the personal friend is not:

      (i) a lobbyist; or
      (ii) a partner, firm, member, employer, employee or principal of a lobbyist; or
      (iii) a person having a regulatory or contractual interest (either individually or through a corporation or organization) in a matter pending before the Department; or
      (iv) a person who (either individually or through a corporation or organization) provides goods or services to the Department under contract or agreement; or
      (v) a person (either individually or through a corporation or organization) seeking such business from the Department.

   (c) On-site consumption of food or refreshment at receptions and/or other events (even if valued at over $25.00) is permissible provided that the employee's attendance at such event is an appropriate exercise of the employee's official duties. The consumption of food or refreshment at such events, that is provided by or paid for by a lobbyist, principal of a lobbyist, a vendor doing business or seeking to do business with the Department, or an entity regulated by the Department is prohibited. However, if the reception and/or event is part of a sponsored conference, meeting, or other function for which the Department has paid a registration fee or cost for the employee's attendance, and the registration fee or cost includes food or refreshment as part of the printed agenda or other registration materials, the food or refreshment is not a gift and is therefore allowable for on-site consumption.

4. If an employee receives an unsolicited gift which is prohibited under this Code of Ethics, the employee should notify his supervisor and return the gift to the sender. If an employee receives a perishable gift, such as a fruit basket, the employee should donate the gift to a charitable organization. The employee should then write the donor and explain that while appreciated, Department employees are prohibited from receiving gifts under this Code of Ethics.

5. An employee is prohibited from soliciting or knowingly accepting an honorarium from a political committee or committee of continuous existence, from a vendor doing business with the employee's agency, from a lobbyist who lobbies the employee's agency, or from the employer, principal, partner, or firm of such a lobbyist.

K. If an employee has any questions regarding this Code of Ethics, or needs practical advice regarding the ethics of a particular situation, the Ethics Officer to the Department is available to discuss these concerns.

Title 31: Money and Finance: Treasury
PART 561—IRANIAN FINANCIAL SANCTIONS REGULATIONS

Subpart B—Prohibitions

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§561.201 CISADA-based sanctions on certain foreign financial institutions.

Upon a finding by the Secretary of the Treasury that a foreign financial institution knowingly engages in one or more of the activities described in paragraphs (a)(1) through (a)(6) of this section, attempts or conspires to facilitate or participate in one or more of such activities, or is owned or controlled by a foreign financial institution that the Secretary finds knowingly engages in one or more of such activities, consistent with the Secretary of the Treasury's authorities under the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (Pub. L. 111-195) (22 U.S.C. 8501-8551) ("CISADA"), as amended by the Iran Threat Reduction and Syria Human Rights Act of 2012 (Pub. L. 112-158), either the Secretary of the Treasury will impose one or more strict conditions, as set forth in paragraph (b) of this section, on the opening or maintaining of a correspondent account or a payable-through account in the United States for that foreign financial institution, or, as set forth in paragraph (c) of this section, the Secretary of the Treasury will prohibit a U.S. financial institution from opening or maintaining a correspondent account or a payable-through account in the United States for that foreign financial institution. The name of the foreign financial institution and the relevant prohibition or strict condition(s) will be added to the List of Foreign Financial Institutions Subject to Correspondent Account or Payable-Through Account Sanctions (CAPTA List) on the Office of Foreign Assets Control's Web site (*www.treasury.gov/ofac*) and published in the FEDERAL REGISTER.

(a) A foreign financial institution engages in an activity described in this paragraph if, in any location or currency, the foreign financial institution knowingly:

(1) Facilitates the efforts of the Government of Iran (including efforts of Iran's Islamic Revolutionary Guard Corps or any of its agents or affiliates)—

(i) To acquire or develop weapons of mass destruction or delivery systems for weapons of mass destruction; or

(ii) To provide support for organizations designated as foreign terrorist organizations under section 219(a) of the Immigration and Nationality Act (8 U.S.C. 1189(a)) or support for acts of international terrorism, as defined in §561.312 of this part;

(2) Facilitates the activities of—

(i) A person subject to financial sanctions pursuant to United Nations Security Council Resolutions 1737, 1747, 1803, or 1929, or any other resolution adopted by the Security Council that imposes sanctions with respect to Iran; or

(ii) A person acting on behalf of or at the direction of, or owned or controlled by, a person described in paragraph (a)(2)(i) of this section;

NOTE TO PARAGRAPH (a)(2) OF §561.201: Persons subject to financial sanctions pursuant to the United Nations Security Council resolutions listed in §561.201(a)(2) include individuals and entities listed in the Annex to UNSC Resolution 1737, Annex I of UNSC Resolution 1747, Annexes I and III of UNSC Resolution 1803, and Annexes I, II, and III of UNSC Resolution 1929; and individuals and entities designated by the Security Council or by the Committee established pursuant to UNSC Resolution 1737 (the “Committee”) as being engaged in, directly associated with or providing support for Iran's proliferation sensitive nuclear activities, or the development of nuclear weapon delivery systems; and individuals and entities acting on behalf of or at the direction of those so listed or designated; and entities owned or controlled by those so listed or designated; and individuals and entities determined by the Security Council or the Committee to have assisted listed or designated individuals or entities in evading sanctions of, or in violating the provisions of, UNSC Resolutions 1737, 1747, 1803, or 1929.

(3) Engages in money laundering to carry out an activity described in paragraphs (a)(1) or (2) of this section;

(4) Facilitates efforts by the Central Bank of Iran or any other Iranian financial institution to carry out an activity described in paragraphs (a)(1) or (a)(2) of this section;

(5) Facilitates a significant transaction or transactions or provides significant financial services for—

(i) Iran's Islamic Revolutionary Guard Corps or any of its agents or affiliates whose property and interests in property are blocked pursuant to the International Emergency Economic Powers Act (50 U.S.C. 1701 *et seq.*) (“IEEPA”); or

(ii) A person whose property and interests in property are blocked pursuant to parts 544 or 594 of this chapter in connection with Iran's proliferation of weapons of mass destruction or delivery systems for weapons of mass destruction or Iran's support for international terrorism; or

Note to paragraph (a)(5) of §561.201: The names of persons whose property and interests in property are blocked pursuant to IEEPA are published in the Federal Register and incorporated into the Office of Foreign Assets Control's Specially Designated Nationals and Blocked Persons List (the “SDN List”). The SDN List is accessible through the following page on the Office of Foreign Assets Control's Web site: *www.treasury.gov/sdn.* Additional information pertaining to the SDN List can be found in appendix A to this chapter. Agents or affiliates of Iran's Islamic Revolutionary Guard Corps (“IRGC”) whose property and interests in property are blocked pursuant to IEEPA are identified by a special reference to the “IRGC” at the end of their entries on the SDN List, in addition to the reference to the regulatory part of this chapter pursuant to which their property and interests in property are blocked. For example, an affiliate of the IRGC whose property and interests in property are blocked pursuant to the Weapons of Mass Destruction Proliferators Sanctions Regulations, 31 CFR part 544, will have the tags “[NPWMD][IRGC]” at the end of its entry on the SDN List. Persons whose property and interests in property are blocked pursuant to parts 544 or 594 of this chapter in connection with Iran's proliferation of weapons of mass destruction or delivery systems for weapons of mass destruction or Iran's support for international terrorism also are identified by the tag “[IFSR]” in addition to the tag referencing part 544 or part 594, as the case may be, located at the end of their entries on the SDN List (e.g., [NPWMD][IFSR] or [SDGT][IFSR]). In addition, see §561.405 concerning entities that may not be listed on the SDN List but whose property and interests in property are nevertheless blocked.

(6) Facilitates, or participates or assists in, an activity described in paragraphs (a)(1) through (a)(5) of this section, including by acting on behalf of, at the direction of, or as an intermediary for, or otherwise assisting, another person with respect to the activity.

the activity.

(b) The Secretary of the Treasury may impose one or more strict conditions on the opening or maintaining by a U.S. financial institution of a correspondent account or a payable-through account in the United States for a foreign financial institution that the Secretary finds engages in one or more of the activities described in paragraph (a) of this section. Except as otherwise authorized pursuant to this part, a U.S. financial institution shall not open or maintain a correspondent account or payable-through account in the United States in a manner that is inconsistent with any strict condition imposed and in effect pursuant to this paragraph. Such conditions may include, but are not limited to, the following:

(1) Prohibiting or restricting any provision of trade finance through the correspondent account or payable-through account of the foreign financial institution;

(2) Restricting the transactions that may be processed through the correspondent account or payable-through account of the foreign financial institution to certain types of transactions, such as personal remittances;

(3) Placing monetary limits on, or limiting the volume of, the transactions that may be processed through the correspondent account or payable-through account of the foreign financial institution;

(4) Requiring pre-approval from the U.S. financial institution for all transactions processed through the correspondent account or payable-through account of the foreign financial institution; or

(5) Prohibiting or restricting the processing of foreign exchange transactions through the correspondent account or payable-through account of the foreign financial institution.

NOTE TO PARAGRAPH (b) OF §561.201: The name of the foreign financial institution, together with the actual strict condition or conditions to be imposed, will be added to the CAPTA List on the Office of Foreign Assets Control's Web site (*www.treasury.gov/ofac*), and published in the FEDERAL REGISTER.

(c) If the Secretary of the Treasury does not impose one or more strict conditions, pursuant to paragraph (b) of this section, on the opening or maintaining of a correspondent account or a payable-through account in the United States for a foreign financial institution that the Secretary finds engages in one or more of the activities described in paragraph (a) of this section, the Secretary, consistent with CISADA, will prohibit the opening or maintaining by a U.S. financial institution of a correspondent account or a payable-through account in the United States for that foreign financial institution. Except as otherwise authorized pursuant to this part, a U.S. financial institution shall not open or maintain a correspondent account or a payable-through account in the United States for a foreign financial institution for which the opening or maintaining of such an account is prohibited pursuant to this paragraph.

NOTE TO PARAGRAPH (c) OF §561.201: The names of foreign financial institutions for which the opening or maintaining of a correspondent account or a payable-through account in the United States is prohibited will be listed on the CAPTA List on the Office of Foreign Assets Control's Web site (*www.treasury.gov/ofac*), and published in the FEDERAL REGISTER.

NOTE TO §561.201: The CAPTA List will specify whether U.S. financial institutions are required to:

(1) Impose strict conditions on the opening or maintaining of a correspondent account or a payable-through account for a particular foreign financial institution pursuant to paragraph (b) of this section;

(2) Prohibit the opening or maintaining of a correspondent account or a payable-through account for a particular foreign financial institution pursuant to paragraph (c) of this section;

(3) Prohibit the opening or maintaining of a correspondent account or a payable-through account for a particular foreign financial institution pursuant to §561.203(a)(1) and (a)(2)(i); or

(4) Prohibit the opening of a correspondent account or a payable-through account and impose strict conditions on maintaining a preexisting correspondent account or a payable-through account for a particular foreign financial institution pursuant to §561.203(a)(1) and (a)(2)(ii). Where applicable, the CAPTA List also will specify the strict condition or conditions to be imposed on the correspondent account or the payable-through account.

[77 FR 11726, Feb. 27, 2012, as amended at 77 FR 66919, Nov. 8, 2012; 84 FR 9457, Mar. 15, 2019]

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§561.202 Prohibitions on persons owned or controlled by U.S. financial institutions.

Except as otherwise authorized pursuant to this part, any person that is owned or controlled by a U.S. financial institution is prohibited from knowingly engaging in any transaction with or benefitting Iran's Islamic Revolutionary Guard Corps or any of its agents or affiliates whose property and interests in property are blocked pursuant to the International Emergency Economic Powers Act (50 U.S.C. 1701 *et seq.*) (“IEEPA”).

NOTE 1 TO §561.202: The names of persons whose property and interests in property are blocked pursuant to IEEPA are published in the FEDERAL REGISTER and incorporated into the Office of Foreign Assets Control's Specially Designated Nationals and Blocked Persons List (the “SDN List”). The SDN List is accessible through the following page on the Office of Foreign Assets Control's Web site: *www.treasury.gov/sdn.* Additional information pertaining to the SDN List can be found in appendix A to this chapter. Agents or affiliates of Iran's Islamic Revolutionary Guard Corps (“IRGC”) whose property and interests in property are blocked pursuant to IEEPA are identified by a special reference to the “IRGC” at the end of their entries on the SDN List, in addition to the reference to the regulatory part of this chapter pursuant to which their property and interests in property are blocked. For example, an affiliate of the IRGC whose property and interests in property are blocked pursuant to the Weapons of Mass Destruction Proliferators Sanctions Regulations, 31 CFR part 544, will have the tag “[NPWMD] [IRGC]” at the end of its entry on the SDN List. In addition, see §561.405 concerning entities that may not be listed on the SDN List but whose property and interests in property are nevertheless blocked.

NOTE 2 TO §561.202: A U.S. financial institution is subject to the civil penalties provided for in section 206(b) of IEEPA if any person that it owns or controls violates the prohibition set forth in this section and the U.S. financial institution knew or should have known of such violation. *See* §561.701(a)(2).

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§561.203 NDAA-based sanctions on certain foreign financial institutions.

(a) *Imposition of sanctions.* Subject to the limitations, exceptions, and conditions set forth in paragraphs (d) through (k) of this section, upon a determination by the Secretary of the Treasury that a foreign financial institution has knowingly conducted or facilitated any significant financial transaction with the Central Bank of Iran or a designated Iranian financial institution, consistent with section 1245 of the National Defense Authorization Act for Fiscal Year 2012 (Pub. L. 112-81) (22 U.S.C. 8513a) (the “2012 NDAA”), as amended by the Iran Threat Reduction and Syria Human Rights Act of 2012 (Pub. L. 112-158) (22 U.S.C. 8701-8795) (the “TRA”), the Secretary of the Treasury:

(1) Will prohibit U.S. financial institutions from opening a correspondent account or a payable-through account in the United States for the foreign financial institution with respect to which the determination has been made; and either

(2)(i) Will prohibit U.S. financial institutions from maintaining a correspondent account or a payable-through account in the United States for the foreign financial institution with respect to which the determination has been made; or

(ii) Will impose one or more strict conditions on the maintaining of any correspondent account or payable-through account that had been opened in the United States for the foreign financial institution prior to the Secretary of the Treasury's determination with respect to the foreign financial institution.

Note 1 to paragraph (a) of §561.203: The names of *designated Iranian financial institutions* are identified on the Specially Designated Nationals and Blocked Persons List (the “SDN List”) on the Office of Foreign Assets Control's Web site with the tag “[NDAA]” at the end of their entries, in addition to the reference to the regulatory part of this chapter pursuant to which their property and interests in property are blocked. The SDN List is accessible through the following page on the Office of Foreign Assets Control's Web site: *www.treasury.gov/sdn.*

Note 2 to paragraph (a) of §561.203: The name of any foreign financial institution with respect to which a determination has been made pursuant to this paragraph (a), along with the relevant sanctions to be imposed (prohibition(s) and/or strict condition(s)), will be added to the List of Foreign Financial Institutions Subject to Correspondent Account or Payable-Through Account Sanctions (CAPTA List), which is maintained on the Office of Foreign Assets Control's Web site (*www.treasury.gov/ofac*), and published in the Federal Register.

(b) *Strict conditions.* The strict conditions that might be imposed on the maintaining of a pre-existing correspondent account or payable-through account for a foreign financial institution pursuant to paragraph (a)(2)(ii) of this section include, but are not limited to, the following:

(1) Prohibiting or restricting any provision of trade finance through the correspondent account or payable-through account of the foreign financial institution;

(2) Restricting the transactions that may be processed through the correspondent account or payable-through account of the foreign financial institution to certain types of transactions, such as personal remittances;

(3) Placing monetary limits on, or limiting the volume of, the transactions that may be processed through the correspondent account or payable-through account of the foreign financial institution;

(4) Requiring pre-approval from the U.S. financial institution for all transactions processed through the correspondent account or payable-through account of the foreign financial institution; or

(5) Prohibiting or restricting the processing of foreign exchange transactions through the correspondent account or payable-through account of the foreign

financial institution.

(c) *Prohibitions.* (1) Except as otherwise authorized pursuant to this part, a U.S. financial institution shall not open a correspondent account or payable-through account in the United States for a foreign financial institution for which the opening of such an account is prohibited pursuant to paragraph (a)(1) of this section.

(2) Except as otherwise authorized pursuant to this part, a U.S. financial institution shall not maintain a correspondent account or payable-through account in the United States for a foreign financial institution for which the maintaining of such an account is prohibited pursuant to paragraph (a)(2)(i) of this section.

(3) Except as otherwise authorized pursuant to this part, a U.S. financial institution shall not maintain a correspondent account or payable-through account in the United States for a foreign financial institution in a manner that is inconsistent with any strict condition imposed and in effect pursuant to paragraph (a)(2)(ii) of this section.

(d) *Privately owned foreign financial institutions.* (1) Subject to the exceptions set forth in paragraphs (g) and (i) through (k) of this section, sanctions may be imposed pursuant to paragraph (a) of this section beginning on February 29, 2012, with respect to any significant financial transaction conducted or facilitated by a privately owned foreign financial institution that is not for the purchase of petroleum or petroleum products from Iran.

(2) Subject to the exceptions and conditions set forth in paragraphs (h) through (k) of this section, sanctions may be imposed pursuant to paragraph (a) of this section with respect to any significant financial transaction conducted or facilitated by a privately owned foreign financial institution on or after June 28, 2012, for the purchase of petroleum or petroleum products from Iran.

(e) *Government-owned or -controlled foreign financial institutions, excluding foreign central banks.* (1) Subject to the exceptions and conditions set forth in paragraphs (h) through (k) of this section, sanctions may be imposed pursuant to paragraph (a) of this section with respect to any significant financial transaction conducted or facilitated by a foreign financial institution owned or controlled by the government of a foreign country, excluding a central bank of a foreign country, on or after June 28, 2012, for the sale or purchase of petroleum or petroleum products to or from Iran.

(2) Subject to the exceptions and conditions set forth in paragraphs (g) and (i) through (k) of this section, sanctions may be imposed pursuant to paragraph (a) of

this section with respect to any significant financial transaction conducted or facilitated by a foreign financial institution owned or controlled by the government of a foreign country, excluding a central bank of a foreign country, on or after February 6, 2013, that is not for the sale or purchase of petroleum or petroleum products to or from Iran.

(f) *Foreign central banks.* Subject to the exceptions and conditions set forth in paragraphs (h) through (k) of this section, sanctions may be imposed pursuant to paragraph (a) of this section on a central bank of a foreign country only insofar as it engages in a financial transaction for the sale or purchase of petroleum or petroleum products to or from Iran conducted or facilitated on or after June 28, 2012.

(g) Sanctions will not be imposed under paragraph (a) of this section with respect to any foreign financial institution for conducting or facilitating a transaction for the sale of agricultural commodities, food, medicine, or medical devices to Iran.

(h) The Secretary of the Treasury may impose sanctions pursuant to paragraph (a) of this section with respect to any significant financial transaction conducted or facilitated by a foreign financial institution on or after June 28, 2012, for the purchase of petroleum or petroleum products from Iran only if the President determines, not later than March 30, 2012, and every 180 days thereafter, that there is a sufficient supply of petroleum and petroleum products from countries other than Iran to permit a significant reduction in petroleum and petroleum products purchased from Iran by or through foreign financial institutions. Such successive sufficiency determinations by the President shall render subject to sanctions under paragraph (a) of this section those financial transactions conducted or facilitated by a foreign financial institution for the purchase of petroleum or petroleum products from Iran during each successive 180-day period beginning 90 days after the President's determination.

NOTE TO PARAGRAPH (h) OF §561.203: Under Section 1245(d)(4)(B) of the 2012 NDAA, the President is to make a determination, not later than March 30, 2012, and every 180 days thereafter, of whether the price and supply of petroleum and petroleum products produced in countries other than Iran is sufficient to permit purchasers of petroleum and petroleum products from Iran to reduce significantly their purchases from Iran. This determination is to be based on reports on the availability and price of petroleum and petroleum products produced in countries other than Iran that, pursuant to section 1245(d)(4)(A) of the 2012 NDAA, the Administrator of the Energy Information Administration, in consultation with the Secretary of the Treasury, the Secretary of State, and the Director of National Intelligence, was to submit to Congress beginning not later than February 29, 2012, and every 60 days thereafter. Beginning September 1, 2012, pursuant to section 1245(d)(4)(A) of the 2012 NDAA, as amended by section 503(b) of the TRA, the report of the Administrator of the Energy Information Administration is to be submitted to Congress not later than October 25, 2012, and the last Thursday of every other month thereafter.

(i) Sanctions will not be imposed under paragraph (a) of this section with respect to a financial transaction described in paragraph (j) of this section that is conducted or facilitated by a foreign financial institution if, for the 180-day period during which the financial transaction is conducted or facilitated, the Secretary of State has determined and reported to Congress:

(1) That the country with primary jurisdiction over the foreign financial institution has significantly reduced its crude oil purchases from Iran, thus qualifying for a "significant reduction exception" for the 180-day period during which the financial transaction is conducted or facilitated; or

(2) That the country with primary jurisdiction over the foreign financial institution has received a significant reduction exception described in this paragraph in a previous period and, after receiving the exception, has reduced its crude oil purchases from Iran to zero during a subsequent 180-day reporting period.

NOTE TO PARAGRAPH (i) OF §561.203: The Secretary of State is to determine whether a country qualifies for the "significant reduction exception" and report such determination to Congress not later than 90 days after the date on which the President makes the initial determination referenced in paragraph (h) of this section, and every 180 days thereafter. Accordingly, a significant reduction exception covers a period of 180 days.

(j) A financial transaction conducted or facilitated by a foreign financial institution is described in this paragraph (j) if:

(1) The financial transaction is only for trade in goods or services that either originate in the country with primary jurisdiction over the foreign financial institution and are exported and sold directly to Iran or originate in Iran and are exported and sold directly to the country with primary jurisdiction over the foreign financial institution;

(2) Any funds owed to the country with primary jurisdiction over the foreign financial institution as a result of such trade are paid to:

(i) Individuals who are citizens, nationals, or permanent residents of the country with primary jurisdiction over the foreign financial institution; or

(ii) Entities organized under the laws of the country with primary jurisdiction over the foreign financial institution that are not the Government of Iran, as defined in §561.321;

(3) Any funds owed to Iran as a result of such trade are subject to the terms and conditions set forth in paragraph (k) of this section; and

(4) Funds owed as a result of such trade are not credited to an account held at any financial institution whose name appears on the List of Foreign Financial Institutions Subject to Correspondent Account or Payable-Through Account Sanctions (CAPTA List), which is maintained on the Office of Foreign Assets Control's Web site (*www.treasury.gov/ofac*).

(k) In order for a transaction to qualify for the significant reduction exception from the sanctions imposed under paragraph (a) of this section described in paragraph (i), all funds owed to Iran as a result of a trade transaction described in paragraph (j)(1) of this section must be subject to the following conditions and restrictions:

(1) The funds must be credited to an account held at a foreign financial institution that conducted or facilitated the trade transaction described in paragraph (j)(1) of this section;

(2) The funds must be credited to an account held in the country with primary jurisdiction over that foreign financial institution;

(3) The funds must be credited to an account held in the name of the Central Bank of Iran, the Iranian party to the trade transaction, or an Iranian financial institution that is not a designated Iranian financial institution;

(4) Payments from the funds may be made only in the manner and to the persons specified in paragraph (k)(5) of this section for amounts owed to such persons for the direct exportation and sale to Iran of goods or services originating in the country with primary jurisdiction over the foreign financial institution holding the funds (*but see* Note 2 to §561.203);

(5) Payments from the funds for the goods or services exported and sold to Iran, as described in paragraph (k)(4) of this section, may be made only by check payable to or to the order of, or by transfer to an account at a foreign financial institution in the country with primary jurisdiction over the foreign financial institution holding the funds that is held in the name of:

(i) Individuals who are citizens, nationals, or permanent residents of the country with primary jurisdiction over the foreign financial institution holding the funds; or

(ii) Entities that are organized under the laws of that country;

(6) The funds may not be withdrawn in cash, remitted to Iran or paid to anyone that is the *Government of Iran,* as defined in §561.321, or credited to an account held at a financial institution whose name appears on the CAPTA List (see paragraph (j)(4) of this section); and

(7) Other than in payment for goods or services exported and sold to Iran as set forth in paragraphs (k)(4) through (k)(6) of this section, the funds may be transferred from the initial account described in paragraphs (k)(1) through (k)(3) of this section only to another account that is held at the same foreign financial institution, located in the country with primary jurisdiction over that foreign financial institution, and subject to the following conditions and restrictions:

(i) The account must be a separate, special purpose account holding only funds owed to Iran as a result of trade transactions that qualify for the significant reduction exception described in paragraph (i) of this section and that are conducted or facilitated by the foreign financial institution holding the account; and

(ii) The conditions and restrictions on the funds owed to Iran set forth in paragraphs (k)(1) through (k)(6) of this section apply in full to the account described in this paragraph, except that the account must be held only in the name of the Central Bank of Iran or an Iranian financial institution that is not a designated Iranian financial institution.

NOTE TO PARAGRAPHS (j) AND (k) OF §561.203: *See* §561.408 for a provision interpreting the phrases goods or services originating in the country with primary jurisdiction over the foreign financial institution and goods or services originating in Iran.

NOTE 1 TO §561.203: The sanctions regime described in §561.203 is separate from the sanctions regimes described in §§561.201 and 561.204 and applies in addition to, and independently of, the sanctions regimes imposed under §§561.201 and 561.204.

NOTE 2 TO §561.203: Paragraph (g) of this section excepts transactions for the sale of agricultural commodities, food, medicine, or medical devices to Iran from the imposition of sanctions under paragraph (a) of this section. Therefore, funds owed to Iran as a result of a trade transaction described in paragraph (j)(1) of this section may be used for the purchase and export to Iran of agricultural commodities, food, medicine, or medical devices regardless of the country from which such goods are purchased and regardless of where such goods originate, and payment from the funds for such goods may be made to exporters in countries other than the country with primary jurisdiction over the foreign financial institution holding the funds.

[77 FR 11726, Feb. 27, 2012, as amended at 78 FR 16405, Mar. 15, 2013; 84 FR 9457, Mar. 15, 2019]

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§561.204 Additional petroleum-related sanctions on certain foreign financial institutions.

(a) *Imposition of sanctions.* Subject to the limitations, exceptions, and conditions set forth in paragraphs (d) through (f) of this section, upon a determination by the Secretary of the Treasury that a foreign financial institution has knowingly engaged in one or more of the activities described in paragraph (b) of this section, the Secretary of the Treasury may:

(1) Prohibit U.S. financial institutions from opening a correspondent account or a payable-through account in the United States for the foreign financial institution with respect to which the determination has been made; and either

(2)(i) Prohibit U.S. financial institutions from maintaining a correspondent account or a payable-through account in the United States for the foreign financial institution with respect to which the determination has been made; or

(ii) Impose one or more strict conditions on the maintaining of any correspondent account or payable-through account that had been opened in the United States for the foreign financial institution prior to the Secretary of the Treasury's determination with respect to the foreign financial institution.

NOTE 1 TO PARAGRAPH (a) OF §561.204: The name of any foreign financial institution with respect to which a determination has been made pursuant to this paragraph (a), along with the relevant sanctions to be imposed (prohibition(s) and/or strict condition(s)), will be added to the List of Foreign Financial Institutions Subject to Correspondent Account or Payable-Through Account Sanctions (CAPTA List), which is maintained on the Office of Foreign Assets Control's Web site (*www.treasury.gov/ofac*), and published in the FEDERAL REGISTER.

NOTE 2 TO PARAGRAPH (a) OF §561.204: *See* §561.203(b) for examples of strict conditions that might be imposed, pursuant to paragraph (a)(2)(ii) of this section, on the maintaining of a pre-existing correspondent account or payable-through account for a foreign financial institution with respect to which the Secretary of the Treasury's determination has been made.

(b) *Sanctionable activity.* A foreign financial institution engages in an activity described in this paragraph if it knowingly conducts or facilitates any significant financial transaction:

(1) With the National Iranian Oil Company ("NIOC"), the Naftiran Intertrade Company ("NICO"), or any entity owned or controlled by, or operating for or on behalf of, NIOC or NICO, except for a sale or provision to any of the foregoing of the products described in section 5(a)(3)(A)(i) of the Iran Sanctions Act of 1996 (Pub. L.

104-172) (50 U.S.C. 1701 note), as amended, provided that the fair market value of such products is lower than the applicable dollar threshold specified in that provision;

NOTE TO PARAGRAPH (b)(1) OF §561.204: As of March 15, 2013, the products described in section 5(a)(3)(A)(i) of the Iran Sanctions Act of 1996 (Pub. L. 104-172) (50 U.S.C. 1701 note), as amended, are refined petroleum products, and for the fair market value of such products to be lower than the applicable dollar threshold specified in that provision the products sold or provided to NIOC, NICO, or any entity owned or controlled by, or operating for or on behalf of, NIOC or NICO, must have a fair market value of less than $1,000,000, and, during a 12-month period, an aggregate fair market value of less than $5,000,000.

(2) For the purchase or acquisition of petroleum or petroleum products from Iran; or

(3) For the purchase or acquisition of petrochemical products from Iran.

(c) *Prohibitions.* (1) A U.S. financial institution shall not open a correspondent account or payable-through account in the United States for a foreign financial institution for which the opening of such an account is prohibited pursuant to paragraph (a)(1) of this section.

(2) A U.S. financial institution shall not maintain a correspondent account or payable-through account in the United States for a foreign financial institution for which the maintaining of such an account is prohibited pursuant to paragraph (a)(2)(i) of this section.

(3) A U.S. financial institution shall not maintain a correspondent account or payable-through account in the United States for a foreign financial institution in a manner that is inconsistent with any strict condition imposed and in effect pursuant to paragraph (a)(2)(ii) of this section.

(4) The prohibitions in paragraphs (c)(1) through (c)(3) of this section apply except to the extent transactions are authorized by regulations, orders, directives, or licenses that may be issued pursuant to this part, and notwithstanding any contracts entered into or any license or permit granted prior to the effective date of the prohibition.

(d) *Exempt activity.* Sanctions will not be imposed under paragraph (a) of this section with respect to any foreign financial institution for:

(1) Conducting or facilitating a transaction for the sale of agricultural commodities, food, medicine, or medical devices to Iran or when the underlying transaction has been authorized by the Office of Foreign Assets Control pursuant to any part of this chapter V; or

(2) Conducting or facilitating a transaction involving a natural gas development and pipeline project initiated prior to July 31, 2012, to bring gas from Azerbaijan to Europe and Turkey in furtherance of a production sharing agreement or license awarded by a sovereign government other than the Government of Iran before July 31, 2012.

Note to paragraph (d)(2) of §561.204: The natural gas development and pipeline project referred to in this paragraph is the project to develop the Shah Deniz natural gas field in Azerbaijan's sector of the Caspian Sea and related pipeline projects to bring the gas from Azerbaijan to Europe and Turkey.

(e) The Secretary of the Treasury may impose sanctions pursuant to paragraph (a) of this section with respect to any significant financial transaction described in paragraphs (b)(1) and (b)(2) of this section only if the President makes the successive determinations that there is a sufficient supply of petroleum and petroleum products from countries other than Iran described in paragraph (h) of §561.203.

(f) Sanctions will not be imposed under paragraph (a) of this section with respect to any significant financial transaction described in paragraphs (b)(1) and (b)(2) of this section that is conducted or facilitated by a foreign financial institution if:

(1) For the 180-day period during which the financial transaction is conducted or facilitated, the Secretary of State has determined and reported to Congress:

(i) That the country with primary jurisdiction over the foreign financial institution has significantly reduced its crude oil purchases from Iran, thus qualifying for the “significant reduction exception” for the 180-day period during which the financial transaction is conducted or facilitated; or

(ii) That the country with primary jurisdiction over the foreign financial institution has received a significant reduction exception described in this paragraph in a previous period, and, after receiving the exception, has reduced its crude oil purchases from Iran to zero during a subsequent 180-day reporting period; and

(2) The transaction satisfies the conditions and restrictions set forth in paragraphs (j) and (k) of §561.203.

NOTE TO PARAGRAPH (f) OF §561.204: The Secretary of State is to determine whether a country qualifies for the "significant reduction exception" and report such determination to Congress not later than 90 days after the date on which the President makes the initial determination referenced in paragraph (h) of this section, and every 180 days thereafter. Accordingly, a significant reduction exception covers a period of 180 days.

NOTE TO §561.204: The sanctions regime described in this section is separate from the sanctions regimes described in §§561.201 and 561.203 and applies in addition to, and independently of, the sanctions regimes imposed under §§561.201 and 561.203.

[78 FR 16407, Mar. 15, 2013, as amended at 84 FR 9457, Mar. 15, 2019]

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§561.205 Metals-related sanctions on certain foreign financial institutions.

(a) *Imposition of sanctions.* Subject to the exemptions set forth in paragraph (d) of this section, upon a determination by the Secretary of the Treasury, in consultation with the Secretary of State, that a foreign financial institution has, on or after May 8, 2019, knowingly engaged in one or more of the activities described in paragraph (b) of this section, the Secretary of the Treasury may:

(1) Prohibit U.S. financial institutions from opening a correspondent account or a payable-through account in the United States for the foreign financial institution with respect to which the determination has been made; and either

(2)(i) Prohibit U.S. financial institutions from maintaining a correspondent account or a payable-through account in the United States for the foreign financial institution with respect to which the determination has been made; or

(ii) Impose one or more strict conditions on the maintaining of a correspondent account or payable-through account in the United States for the foreign financial institution with respect to which the determination has been made.

NOTE 1 TO PARAGRAPH (a): The name of any foreign financial institution with respect to which a determination has been made pursuant to this paragraph (a), along with the relevant sanctions to be imposed (prohibition(s) and/or strict condition(s)), will be added to the List of Foreign Financial Institutions Subject to Correspondent Account or Payable-Through Account Sanctions (CAPTA List), which is maintained on the Office of Foreign Assets Control's website (*www.treasury.gov/ofac*), and published in the FEDERAL REGISTER.

NOTE 2 TO PARAGRAPH (a): *See* §561.203(b) for examples of strict conditions that might be imposed, pursuant to paragraph (a)(2)(ii) of this section, on the maintaining of a correspondent account or payable-through account for a foreign financial institution with respect to which the Secretary of the Treasury's determination has been made.

(b) *Sanctionable activity.* A foreign financial institution has engaged in an activity described in this paragraph if it knowingly conducted or facilitated, on or after May 8, 2019, any significant financial transaction:

(1) For the sale, supply, or transfer to Iran of significant goods or services used in connection with the iron, steel, aluminum, or copper sectors of Iran;

(2) For the purchase, acquisition, sale, transport, or marketing of iron, iron products, aluminum, aluminum products, steel, steel products, copper, or copper products from Iran; or

(3) For or on behalf of any person whose property and interests in property are blocked pursuant to Executive Order 13871.

(c) *Prohibitions.* (1) A U.S. financial institution shall not open a correspondent account or payable-through account in the United States for a foreign financial institution for which the opening of such an account is prohibited pursuant to paragraph (a)(1) of this section.

(2) A U.S. financial institution shall not maintain a correspondent account or payable-through account in the United States for a foreign financial institution for which the maintaining of such an account is prohibited pursuant to paragraph (a)(2)(i) of this section.

(3) A U.S. financial institution shall not maintain a correspondent account or payable-through account in the United States for a foreign financial institution in a manner that is inconsistent with any strict condition imposed and in effect pursuant to paragraph (a)(2)(ii) of this section.

(4) The prohibitions in paragraphs (c)(1) through (c)(3) of this section apply except to the extent provided by regulations, orders, directives, or licenses that may be issued pursuant to this part, and notwithstanding any contract entered into or any license or permit granted prior to the effective date.

(d) *Exempt activity.* Nothing in this section shall apply to transactions for the conduct of the official business of the Federal Government or the United Nations (including its specialized agencies, programmes, funds, and related organizations) by employees, grantees, or contractors thereof.

[84 FR 38547, Aug. 7, 2019]

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§561.220 Evasions; attempts; causing violations; conspiracies.

(a) Any transaction on or after the effective date that evades or avoids, has the purpose of evading or avoiding, causes a violation of, or attempts to violate any of the prohibitions set forth in this part is prohibited.

(b) Any conspiracy formed to violate any of the prohibitions set forth in this part is prohibited.

[78 FR 16408, Mar. 15, 2013. Redesignated at 84 FR 38547, Aug. 7, 2019]

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Title 31: Money and Finance: Treasury
PART 561—IRANIAN FINANCIAL SANCTIONS REGULATIONS

Subpart C—General Definitions

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§561.301 Effective date.

(a) The effective date of a prohibition or condition imposed pursuant to §§561.201, 561.203, 561.204, or 561.205 on the opening or maintaining of a correspondent account or a payable-through account in the United States by a U.S. financial institution for a particular foreign financial institution is the earlier of the date the U.S. financial institution receives actual or constructive notice of such prohibition or condition.

(b) The effective date of the prohibition contained in §561.202 with respect to Iran's Islamic Revolutionary Guard Corps and any of its agents or affiliates whose property and interests in property are blocked as of August 16, 2010, is August 16, 2010.

(c) The effective date of the prohibition contained in §561.202 with respect to an agent or affiliate of Iran's Islamic Revolutionary Guard Corps whose property and interests in property become blocked after August 16, 2010, is the earlier of the date of actual or constructive notice that such person's property and interests in property are blocked.

(d) For the purposes of this section, *constructive notice* is the date that notice of the blocking of the relevant person's property and interests in property is published in the FEDERAL REGISTER.

[77 FR 11726, Feb. 27, 2012, as amended at 78 FR 16408, Mar. 15, 2013; 84 FR 38547, Aug. 7, 2019]

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§561.302 UNSC Resolution 1737.

The term *UNSC Resolution 1737* means United Nations Security Council Resolution 1737, adopted December 23, 2006.

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§561.303 UNSC Resolution 1747.

The term *UNSC Resolution 1747* means United Nations Security Council Resolution 1747, adopted March 24, 2007.

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§561.304 UNSC Resolution 1803.

The term *UNSC Resolution 1803* means United Nations Security Council Resolution 1803, adopted March 3, 2008.

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§561.305 UNSC Resolution 1929.

The term *UNSC Resolution 1929* means United Nations Security Council Resolution 1929, adopted June 9, 2010.

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§561.306 Correspondent account.

The term *correspondent account* means an account established by a U.S. financial institution for a foreign financial institution to receive deposits from, or to make payments on behalf of, the foreign financial institution, or to handle other financial transactions related to such foreign financial institution.

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§561.307 Payable-through account.

The term *payable-through account* means a correspondent account maintained by a U.S. financial institution for a foreign financial institution by means of which the foreign financial institution permits its customers to engage, either directly or through foreign financial institution permits its customers to engage, either directly or through a subaccount, in banking activities usual in connection with the business of banking in the United States.

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§561.308 Foreign financial institution.

The term *foreign financial institution* means any foreign entity that is engaged in the business of accepting deposits, making, granting, transferring, holding, or brokering loans or credits, or purchasing or selling foreign exchange, securities, commodity futures or options, or procuring purchasers and sellers thereof, as principal or agent. It includes but is not limited to depository institutions, banks, savings banks, money service businesses, trust companies, securities brokers and dealers, commodity futures and options brokers and dealers, forward contract and foreign exchange merchants, securities and commodities exchanges, clearing corporations, investment companies, employee benefit plans, dealers in precious metals, stones, or jewels, and holding companies, affiliates, or subsidiaries of any of the foregoing. The term does not include the international financial institutions identified in 22 U.S.C. 262r(c)(2), the International Fund for Agricultural Development, the North American Development Bank, or any other international financial institution so notified by the Office of Foreign Assets Control.

[77 FR 66920, Nov. 8, 2012]

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§561.309 U.S. financial institution.

The term *U.S. financial institution* means any U.S. entity that is engaged in the business of accepting deposits, making, granting, transferring, holding, or brokering loans or credits, or purchasing or selling foreign exchange, securities, commodity futures or options, or procuring purchasers and sellers thereof, as principal or agent. It includes but is not limited to depository institutions, banks, savings banks, money service businesses, trust companies, insurance companies, securities brokers and dealers, commodity futures and options brokers and dealers, forward contract and foreign exchange merchants, securities and commodities exchanges, clearing corporations, investment companies, employee benefit plans, and U.S. holding companies, U.S. affiliates, or U.S. subsidiaries of any of the foregoing. This term includes those branches, offices, and agencies of foreign financial institutions that are located in the United States, but not such institutions' foreign branches, offices, or agencies.

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§561.310 Money laundering.

The term *money laundering* means engaging in deceptive practices to obscure the nature of transactions involving the movement of illicit cash or illicit cash equivalent proceeds into, out of, or through a country, or into, out of, or through a financial institution, such that the transactions are made to appear legitimate.

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§561.311 Agent.

The term *agent* includes an entity established by a person for purposes of conducting transactions on behalf of the person in order to conceal the identity of the person.

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§561.312 Act of international terrorism.

The term *act of international terrorism* has the same definition as that provided under section 14 of the Iran Sanctions Act of 1996 (50 U.S.C. 1701 note). As of February 27, 2012, the term *act of international terrorism* means an act which is violent or dangerous to human life and that is a violation of the criminal laws of the United States or of any state or that would be a criminal violation if committed within the jurisdiction of the United States or any state and which appears to be intended to intimidate or coerce a civilian population; to influence the policy of a government by intimidation or coercion; or to affect the conduct of a government by assassination or kidnapping.

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§561.313 Financial services.

The term *financial services* includes loans, transfers, accounts, insurance, investments, securities, guarantees, foreign exchange, letters of credit, and commodity futures or options.

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§561.314 Knowingly.

The term *knowingly,* with respect to conduct, a circumstance, or a result, means that a person has actual knowledge, or should have known, of the conduct, the circumstance, or the result.

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§561.315 Person.

The term *person* means an individual or entity.

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§561.316 Entity.

The term *entity* means a partnership, association, trust, joint venture, corporation, or other organization.

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§561.317 Money service businesses.

The term *money service businesses* means any agent, agency, branch, or office of any person doing business, whether or not on a regular basis or as an organized business concern, in one or more of the capacities listed in 31 CFR 103.11(uu)(1) through (5). The term does not include a bank or a person registered with, and regulated or examined by, the Securities and Exchange Commission or the Commodity Futures Trading Commission.

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§561.318 Petroleum.

The term *petroleum* (also known as crude oil) means a mixture of hydrocarbons that exists in liquid phase in natural underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities.

[78 FR 16408, Mar. 15, 2013]

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§561.319 Petroleum products.

The term *petroleum products* includes unfinished oils, liquefied petroleum gases, pentanes plus, aviation gasoline, motor gasoline, naphtha-type jet fuel gases, pentanes plus, aviation gasoline, motor gasoline, naphtha-type jet fuel, kerosene-type jet fuel, kerosene, distillate fuel oil, residual fuel oil, petrochemical feedstocks, special naphthas, lubricants, waxes, petroleum coke, asphalt, road oil, still gas, and miscellaneous products obtained from the processing of crude oil (including lease condensate), natural gas, and other hydrocarbon compounds. The term does not include natural gas, liquefied natural gas, biofuels, methanol, and other non-petroleum fuels.

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§561.320 Iranian financial institution.

The term *Iranian financial institution* means any entity (including foreign branches), wherever located, organized under the laws of Iran or any jurisdiction within Iran, or owned or controlled by the Government of Iran, or in Iran, or owned or controlled by any of the foregoing, that is engaged in the business of accepting deposits, making, granting, transferring, holding, or brokering loans or credits, or purchasing or selling foreign exchange, securities, commodity futures or options, or procuring purchasers and sellers thereof, as principal or agent. It includes but is not limited to depository institutions, banks, savings banks, money service businesses, trust companies, insurance companies, securities brokers and dealers, commodity futures and options brokers and dealers, forward contract and foreign exchange merchants, securities and commodities exchanges, clearing corporations, investment companies, employee benefit plans, dealers in precious metals, stones, or jewels, and holding companies, affiliates, or subsidiaries of any of the foregoing.

[77 FR 66920, Nov. 8, 2012]

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§561.321 Government of Iran.

The term *Government of Iran* includes:

(a) The state and the Government of Iran, as well as any political subdivision, agency, or instrumentality thereof;

(b) Any entity owned or controlled directly or indirectly by the foregoing;

(c) Any person to the extent that such person is, or has been, or to the extent that there is reasonable cause to believe that such person is, or has been, acting or purporting to act directly or indirectly on behalf of any of the foregoing; and

(d) Any person or entity identified by the Secretary of the Treasury to be the Government of Iran under 31 CFR part 560.

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§561.322 Entity owned or controlled by the Government of Iran.

The phrase *entity owned or controlled by the Government of Iran* means any entity, including a financial institution, in which the Government of Iran owns a 50 percent or greater interest or a controlling interest, and any entity, including a financial institution, which is otherwise controlled by that government.

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§561.323 Foreign financial institution owned or controlled by the government of a foreign country.

The phrase *foreign financial institution owned or controlled by the government of a foreign country* means any foreign financial institution, including a central bank of a foreign country, in which a government of a foreign country owns a 50 percent or greater interest and any foreign financial institution which is otherwise controlled by a government of a foreign country.

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§561.324 Designated Iranian financial institution.

The term *designated Iranian financial institution* means any Iranian financial institution whose property and interests in property are blocked by the Department of the Treasury pursuant to any part of this chapter or any Executive order issued pursuant to the International Emergency Economic Powers Act (50 U.S.C. 1701 *et seq.*) and whose name is listed on the Specially Designated Nationals and Blocked Persons List on the Office of Foreign Assets Control's Web site, except for any Iranian financial institution whose property and interests in property are blocked solely pursuant to Executive Order 13599 of February 5, 2012.

Note to §561.324: Facilitating significant transactions or providing significant financial services for a financial institution whose property and interests in property are blocked pursuant to parts 544 or 594 of this chapter in connection with Iran's proliferation of weapons of mass destruction or delivery systems for weapons of mass destruction or Iran's support for international terrorism has, since the enactment of CISADA on July 1, 2010, constituted an activity that could subject a foreign financial institution to prohibitions or strict conditions on correspondent accounts or payable-through accounts in the United States. See §561.201.

See §561.201.

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§561.325 Financial transaction.

The term *financial transaction* means any transfer of value involving a financial institution.

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§561.326 Privately owned foreign financial institution.

The phrase *privately owned foreign financial institution* means any foreign financial institution that is not owned or controlled by the government of a foreign country.

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§561.327 Agricultural commodities, food, medicine, and medical devices.

(a) The term *agricultural commodities* means:

(1) Products not listed on the Commerce Control List in the Export Administration Regulations, 15 CFR part 774, supplement no. 1, that fall within the term "agricultural commodity" as defined in section 102 of the Agricultural Trade Act of 1978 (7 U.S.C. 5602); and

(2) Products not listed on the Commerce Control List in the Export Administration Regulations, 15 CFR part 774, supplement no. 1, that are intended for ultimate use in Iran as:

(i) Food for humans (including raw, processed, and packaged foods; live animals; vitamins and minerals; food additives or supplements; and bottled drinking water) or animals (including animal feeds);

(ii) Seeds for food crops;

(iii) Fertilizers or organic fertilizers; or

(iv) Reproductive materials (such as live animals, fertilized eggs, embryos, and semen) for the production of food animals.

(b) The term *food* means items that are intended to be consumed by and provide nutrition to humans or animals in Iran, including vitamins and minerals, food additives and supplements, and bottled drinking water, and seeds that germinate into items that are intended to be consumed by and provide nutrition to humans or animals in Iran. For purposes of this definition, the term *food* does not include:

(1) Alcoholic beverages, cigarettes, gum, or fertilizer; and

(2) The following excluded food items: castor beans, castor bean seeds, raw eggs, fertilized eggs (other than fish and shrimp roe), dried egg albumin, live animals, Rosary/Jequirity peas, non-food-grade gelatin powder, and peptones and their derivatives.

(c) The term *medicine* has the same meaning given the term “drug” in section 201 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 321) but does not include any item listed on the Commerce Control List in the Export Administration Regulations, 15 CFR part 774, supplement no. 1 (excluding items classified as EAR 99).

(d) The term *medical devices* has the meaning given the term “device” in section 201 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 321) but does not include any item listed on the Commerce Control List in the Export Administration Regulations, 15 CFR part 774, supplement no. 1 (excluding items classified as EAR 99).

[77 FR 11726, Feb. 27, 2012, as amended at 78 FR 16408, Mar. 15, 2013]

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§561.328 Reduce significantly, significantly reduced, and significant reduction.

The terms *reduce significantly, significantly reduced,* and *significant reduction,* used with respect to purchases from Iran of petroleum and petroleum products, include a reduction in such purchases in terms of price or volume toward a complete cessation of such purchases.

[78 FR 16408, Mar. 15, 2013]

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§561.329 Iran.

The term *Iran* means the Government of Iran and the territory of Iran and any other territory or marine area, including the exclusive economic zone and continental shelf, over which the Government of Iran claims sovereignty, sovereign rights, or jurisdiction, provided that the Government of Iran exercises partial or total de facto control over the area or derives a benefit from economic activity in the area pursuant to international arrangements.

[78 FR 16408, Mar. 15, 2013]

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§561.330 Petrochemical products.

The term *petrochemical products* includes any aromatic, olefin, and synthesis gas, and any of their derivatives, including ethylene, propylene, butadiene, benzene, toluene, xylene, ammonia, methanol, and urea.

[78 FR 16409, Mar. 15, 2013]

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§561.331 Aluminum, aluminum products.

The terms *aluminum* and *aluminum products* mean any raw, semi-fabricated, fabricated, or finished form of aluminum or aluminum alloy of all grades, sizes, and thicknesses, including in the following forms: Ores and concentrates (*e.g.,* bauxite and alumina); unwrought aluminum including ingots, slabs, and billets; powders and flakes; wrought aluminum including bars, rods, profiles, plates, sheets, strip, foil, tubes, and pipes; tube or pipe fittings; reservoirs, tanks, vats, and similar containers; wire, stranded wire, ropes, cables, and plaited band; castings, stampings, and forgings; waste and scrap, including slag, and any aluminum and aluminum products produced from the melting or recycling of aluminum scrap.

[84 FR 38547, Aug. 7, 2019]

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§561.332 Aluminum sector of Iran.

The term *aluminum sector of Iran* means the mining, refining, processing, or manufacturing of aluminum or aluminum products in Iran.

[84 FR 38547, Aug. 7, 2019]

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§561.333 Copper, copper products.

The terms *copper* and *copper products* mean any raw, semi-fabricated, fabricated, or finished form of copper or copper alloy of all grades, sizes, and thicknesses, including in the following forms: Ores and concentrates; copper mattes, cement copper (precipitated copper); refined, unrefined, wrought, or unwrought copper; billets; cathodes; bars, rods, profiles, plates, sheets, strips, foil, tubes, and pipes; tube and pipe fittings; powders and flakes; reservoirs, tanks, vats, and similar containers; wire, stranded wire, ropes, cables, and plaited band; castings, stampings, and forgings; and waste and scrap, including slag.

[84 FR 38547, Aug. 7, 2019]

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§561.334 Copper sector of Iran.

The term *copper sector of Iran* means the mining, refining, processing, or manufacturing of copper or copper products in Iran.

[84 FR 38547, Aug. 7, 2019]

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§561.335 Iron, iron products, steel, steel products.

The terms *iron, iron products, steel,* and *steel products* mean any raw, semi-fabricated, fabricated, or finished form of iron, iron alloy, alloy steel, non-alloy steel, ferroalloys, pig iron, and spiegeleisen of all grades, sizes, and thicknesses, whether or not clad, plated, or coated, including in the following forms: Iron ores and concentrates including roasted iron pyrites; pigs and blocks; ferrous products obtained by direct reduction of iron ore and other spongy ferrous products, in lumps or pellets; granules and powders; ingots, blooms billets, slabs, and beam blanks; flat-rolled products (plates, sheets, strips, and foils) either cut-to-length or in coils; bars, and rods; structural profiles (beams, channels, angles, and other shapes); sheet piling; railway or tramway track construction materials; tubes, pipes, and hollow profiles; tube or pipe fittings; reservoirs, tanks, vats, and similar containers; wire, stranded wire, ropes, cables, and plaited band; castings, stampings, and forgings; and ferrous waste and scrap, including slag.

[84 FR 38547, Aug. 7, 2019]

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§561.336 Iron sector of Iran.

The term *iron sector of Iran* means the mining, refining, processing, or manufacturing of iron or iron products in Iran.

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§561.337 Steel sector of Iran.

The term *steel sector of Iran* means the iron-ore smelting, ferrous-scrap melting, refining, processing, or manufacturing of steel or steel products in Iran.

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Title 31: Money and Finance: Treasury
PART 561—IRANIAN FINANCIAL SANCTIONS REGULATIONS

Subpart D—Interpretations

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§561.401 Reference to amended sections.

Except as otherwise specified, reference to any provision in or appendix to this part or chapter or to any regulation, ruling, order, instruction, directive, or license issued pursuant to this part refers to the same as currently amended.

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§561.402 Effect of amendment.

Unless otherwise specifically provided, any amendment, modification, or revocation of any provision in or appendix to this part or chapter or of any order revocation of any provision in or appendix to this part or chapter or of any order, regulation, ruling, instruction, or license issued by the Office of Foreign Assets Control does not affect any act done or omitted, or any civil or criminal proceeding commenced or pending, prior to such amendment, modification, or revocation. All penalties, forfeitures, and liabilities under any such order, regulation, ruling, instruction, or license continue and may be enforced as if such amendment, modification, or revocation had not been made.

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§561.403 Facilitation of certain efforts, activities, or transactions by foreign financial institutions.

For purposes of §§561.201, 561.203, 561.204, and 561.205, the term *facilitate* or *facilitated* used with respect to certain efforts, activities, or transactions refers to the provision of assistance by a foreign financial institution for those efforts, activities, or transactions, including the provision of currency, financial instruments, securities, or any other transmission of value; purchasing; selling; transporting; swapping; brokering; financing; approving; guaranteeing; or the provision of other services of any kind; or the provision of personnel; or the provision of software, technology, or goods of any kind.

[84 FR 38548, Aug. 7, 2019]

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§561.404 Significant transaction or transactions; significant financial services; significant financial transaction.

In determining, for purposes of paragraph (a)(5) of §561.201, whether a transaction is significant, whether transactions are significant, or whether financial services are significant, or, for purposes of paragraph (a) of §561.203, paragraph (b) of §561.204, and paragraph (b) of §561.205 whether a financial transaction is significant, the Secretary of the Treasury may consider the totality of the facts and circumstances. As a general matter, the Secretary may consider some or all of the following factors:

(a) *Size, number, and frequency.* The size, number, and frequency of transactions, financial services, or financial transactions performed over a period of time, including whether the transactions, financial services, or financial transactions are increasing or decreasing over time and the rate of increase or decrease.

(b) *Nature.* The nature of the transaction(s), financial services, or financial transaction, including the type, complexity, and commercial purpose of the transaction(s), financial services, or financial transaction.

(c) *Level of Awareness; Pattern of Conduct.* (1) Whether the transaction(s), financial services, or financial transaction is performed with the involvement or approval of management or only by clerical personnel; and (2) Whether the transaction(s), financial services, or financial transaction is part of a pattern of conduct or the result of a business development strategy.

(d) *Nexus.* The proximity between the foreign financial institution engaging in the transaction(s) or providing the financial services and a blocked person described in paragraph (a)(5) of §561.201, or between the foreign financial institution conducting or facilitating the financial transaction described in paragraph (a) of §561.203 and the Central Bank of Iran or a designated Iranian financial institution, as defined in §561.324, or between the foreign financial institution conducting or facilitating the financial transaction described in paragraph (b) of §561.204 and the National Iranian Oil Company ("NIOC"), the Naftiran Intertrade Company ("NICO"), any entity owned or controlled by, or operating for or on behalf of, NIOC or NICO, or the activities described in paragraphs (b)(2) and (b)(3) of that section. For example, a transaction or financial service in which a foreign financial institution provides brokerage or clearing services to, or maintains an account or makes payments for, a blocked person described in paragraph (a)(5) of §561.201, the Central Bank of Iran, a designated Iranian financial institution, NIOC, or NICO in a direct customer relationship generally would be of greater significance than a transaction or financial service a foreign financial institution conducts for or provides to a blocked person described in paragraph (a)(5) of §561.201, the Central Bank of Iran, a designated Iranian financial institution, NIOC, or NICO indirectly or in a tertiary relationship.

(e) *Impact.* The impact of the transaction(s) or financial services on the objectives of the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010, as amended by the Iran Threat Reduction and Syria Human Rights Act of 2012 ("TRA"), or of the financial transaction on the objectives of the National Defense Authorization Act for Fiscal Year 2012, as amended by TRA, or of the financial transaction on the objectives of Executive Order 13622 of July 30, 2012, including:

(1) The economic or other benefit conferred or attempted to be conferred on a blocked person described in paragraph (a)(5) of §561.201, on the Central Bank of Iran or a designated Iranian financial institution, or on NIOC, NICO, any entity owned or controlled by, or operating for or on behalf of, NIOC or NICO, or any

person engaged in the activities described in paragraphs (b)(2) and (b)(3) of §561.204;

(2) Whether and how the transaction(s), financial services, or financial transaction contributes to the proliferation of weapons of mass destruction or delivery systems for such weapons, to support for international terrorism, to the suppression of human rights, to an increase in Iran's crude oil revenues, or to connecting the Central Bank of Iran or a designated Iranian financial institution to the international financial system; and

(3) Whether the transaction(s), financial services, or financial transaction supports humanitarian activity or involves the payment of basic expenses as specified in and authorized pursuant to UNSC Resolution 1737 or the payment of extraordinary expenses that have been authorized by the Sanctions Committee established pursuant to UNSC Resolution 1737, or the payment for the sale of food, medicine, or medical devices to Iran.

(f) *Deceptive practices:* Whether the transaction(s), financial services, or financial transaction involves an attempt to obscure or conceal the actual parties or true nature of the transaction(s), financial services, or financial transaction or to evade sanctions; for example, whether the transaction enabled the Central Bank of Iran to facilitate the evasion of sanctions by a blocked person described in §561.201(a)(5) or a designated Iranian financial institution, as defined in §561.324.

(g) *Central Bank of Iran Reserves, Settlement Services, Foreign Currency Exchanges, and Official Development Assistance Repayment:* Other factors involved in making a determination of whether a transaction(s), financial service, or financial transaction is significant are whether the transaction solely involves the passive holding of Central Bank of Iran reserves by a foreign financial institution; whether the Central Bank of Iran's role is limited to providing settlement services or foreign currency exchanges in transactions between a non-designated Iranian financial institution and a foreign financial institution; and whether the transaction involves only the repayment of official development assistance by the Central Bank of Iran or the transfer of funds required as a condition of Iran's membership in an international financial institution.

(h) *Other relevant factors.* Such other factors that the Secretary deems relevant on a case-by-case basis in determining the significance of a transaction(s), financial services, or financial transaction.

[77 FR 11726, Feb. 27, 2012, as amended at 78 FR 16409, Mar. 15, 2013; 84 FR 38548, Aug. 7, 2019]

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§561.405 Entities owned by a person whose property and interests in property are blocked.

A person whose property and interests in property are blocked pursuant to the International Emergency Economic Powers Act (50 U.S.C. 1701 *et seq.*) has an interest in all property and interests in property of an entity in which it owns, directly or indirectly, a 50 percent or greater interest. The property and interests in property of such an entity, therefore, are blocked, and such an entity is a person whose property and interests in property are blocked pursuant to the International Emergency Economic Powers Act (50 U.S.C. 1701 *et seq.*), regardless of whether the entity itself is listed on the Office of Foreign Assets Control's Specially Designated Nationals and Blocked Persons List.

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§561.406 Country with primary jurisdiction over the foreign financial institution.

For purposes of §561.203(i) and §561.204(f), a country includes any jurisdiction that has its own central bank or contains a separate financial sector authority, and a foreign financial institution (including its foreign branches outside of the United States) is under a country's primary jurisdiction if the foreign financial institution is organized under the laws of the country or any jurisdiction within that country.

[78 FR 16409, Mar. 15, 2013]

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§561.407 Conducting or facilitating a financial transaction with the Central Bank of Iran or a designated Iranian financial institution.

A foreign financial institution conducts or facilitates a financial transaction with the Central Bank of Iran or a designated Iranian financial institution if it maintains an account for such entities or engages in a financial transaction directly or indirectly with such entities.

NOTE TO §561.407: See §561.404 for factors that may be considered in determining whether a financial transaction is significant, as required for the imposition of certain sanctions pursuant to this part.

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§561.408 Goods or services originating in a country.

(a) Goods originating in a country are goods that have been grown, produced, manufactured, extracted, or processed, and goods that have been substantially transformed, in the country.

(b) Services originating in a country are services performed in that country or services performed in the country to which the services are being exported by a citizen, national, or permanent resident of the country from which the services originate who is ordinarily resident in that country.

(c) For purposes of this part, services originating in a country do not include the brokering of transactions for the sale and exportation of goods or services not originating in that country.

[78 FR 16409, Mar. 15, 2013]

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FEDERAL DEPOSIT INSURANCE CORPORATION
RMS MANUAL OF EXAMINATION POLICIES

WITH UPDATES THROUGH 08/2020

Incorporated by Reference in
Florida Office of Financial Regulation
Rule 69U-100.045, Florida Administrative Code (F.A.C.)
(effective __/____)

Risk Management Manual of Examination Policies

Complete Manual - ZIP (10MB)

Current Year Updates:

January 2020 Updates Only - ZIP
February 2020 Updates Only - ZIP
March 2020 Updates Only - ZIP
May 2020 Updates Only - ZIP
August 2020 Updates Only - ZIP

Prior Year Updates:

December 2019 Updates Only - ZIP
October 2019 Updates Only - ZIP
September 2019 Updates Only - ZIP
August 2019 Updates Only - ZIP
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PDF Help
ZIP Help

Part I: Basic Examination Concepts and Guidelines

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1.1	Basic Examination Concepts and Guidelines	PDF	Audio	02:14	1/2020

Part II: CAMELS

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2.1	Capital	PDF	Audio	01:20	4/2015
3.1	Asset Quality	PDF	Audio	00:07	3/2012
3.2	Loans	PDF	Audio - Part 1 Audio - Part 2 Audio - Part 3 Audio - Part 4	01:51 02:15 01:23 01:17	9/2019
3.3	Securities and Derivatives	PDF	Audio	02:00	4/2005

Section	Title	PDF	Audio (Note 1)	Run Time (Hrs/Mins)	Last Updated
3.4	Cash and Due from Banks	PDF	Audio	00:25	3/2012
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3.8	Off-Balance Sheet Activities	PDF	Audio	30:45	6/2019
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4.2	Internal Routine and Controls	PDF	Audio	02:08	3/2015
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4.4	Fidelity and Other Indemnity Protection	PDF	Audio	00:37	4/2005
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4.6	Miscellaneous Banking Activities	PDF	Audio	00:09	4/2005
5.1	Earnings	PDF	Audio	0:41	7/2018
6.1	Liquidity and Funds Management	PDF	Audio	01:53	10/2019
7.1	Sensitivity to Market Risk	PDF	Audio	02:04	7/2018

Part III: Other Examination Issues

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8.1	Bank Secrecy Act, Anti-Money Laundering and Office of Foreign Assets Control	PDF	Audio	04:44	4/2005
9.1	Bank Fraud and Insider Abuse	PDF	Audio	01:18	4/1998
10.1	Suspicious Activity and Criminal Violations	PDF	Audio	00:47	11/2017
11.1	International Banking	PDF	Audio	04:04	1/2018
12.1	Applications	PDF	Audio	02:16	4/2005

Part IV: Administrative and Enforcement Actions

Section	Title	PDF	Audio (Note 1)	Run Time (Hrs/Mins)	Last Updated
13.1	Informal Actions	PDF	Audio	00:11	4/2016
14.1	Civil Money Penalties	PDF	Audio	00:31	4/2005
15.1	Formal Administrative Actions	PDF	Audio	01:00	7/2016

Part V: Examination Reports

Section	Title	PDF	Audio (Note 1)	Run Time (Hrs/Mins)	Last Updated
16.1	Report of Examination Instructions	PDF	Audio unavailable	N/A	5/2020
16.2	Report of Examination Instructions - International	PDF	Audio	00:51	1/2018
17.1	Bank of Anytown	PDF	Audio unavailable	N/A	3/2020
17.2	Bank of Anytown - International	PDF	Audio	00:37	1/2018
18.1	Report of Investigation Instructions	PDF	Audio	01:11	4/2005
19.1	Bank of Anytown - Report of Investigation	PDF	Audio	00:01	4/2005

Part VI: Appendix - Examination Processes and Tools

Section	Title	PDF	Audio (Note 1)	Run Time (Hrs/Mins)	Last Updated
20.1	Risk-Focused, Forward-Looking Safety and Soundness Supervision	PDF	Audio	00:32	2/2020
21.1	Examination Planning	PDF	Audio unavailable	N/A	5/2020
22.1	Examination Documentation Modules	HTML	Audio unavailable	N/A	8/2020
23.1	*Reserved for Future Documents*	N/A	N/A	N/A	N/A

(Note 1) The MP3 files may not be complete copies of the PDF files due to the exclusion of charts and tables that do not convert well to audio presentations. Therefore, the content in the PDF version takes precedence over the content in the Audio version.

RATIONALE OF BANK EXAMINATIONS

The Federal Deposit Insurance Corporation conducts bank examinations to ensure public confidence in the banking system and to protect the Deposit Insurance Fund. Maintaining public confidence in the banking system is essential because customer deposits are a primary funding source that depository institutions use to meet fundamental objectives such as providing financial services. Safeguarding the integrity of the Deposit Insurance Fund is necessary to protect customers' deposits and resolve failed banks.

Onsite examinations help ensure the stability of insured depository institutions by identifying undue risks and weak risk management practices. Examination activities center on evaluating an institution's capital, assets, management, earnings, liquidity, and sensitivity to market risk. Evaluating a bank's adherence to laws and regulations is also an important part of bank examinations and is given high priority by Congress and bank supervisors.

Finally, bank examinations play a key role in the supervisory process by helping the FDIC identify the cause and severity of problems at individual banks and emerging risks in the financial-services industry. The accurate identification of existing and emerging risks helps the FDIC develop effective corrective measures for individual institutions and broader supervisory strategies for the industry.

CONDUCT OF EXAMINATIONS

Given the fundamental reasons for conducting examinations, regulatory personnel must have access to all records and employees of a bank during an examination.

Sections 10(b) and (c) of the Federal Deposit Insurance Act (FDI Act) empower examiners to make a thorough examination of a bank's affairs. Examiners should contact their regional office for guidance if faced with serious impediments to an examination, including uncooperative executive officers, or restricted access to bank employees or records. The regional office will determine an appropriate solution to enable examiners to obtain the information needed to complete the examination. In such cases, examiners should document all significant examination obstacles and the regional office's resolution of the situation.

Prohibition Against Political Communication

FDIC employees should avoid any form of political communication with insured depository institutions that could be perceived as suggesting the examination process is influenced by political considerations, or that the bank should take a particular position on legislative issues. Examinations must be kept free from political considerations, or the appearance of being influenced by political considerations, in order to maintain the integrity and effectiveness of the examination process. FDIC employees should promptly inform their regional office of any situation they feel compromised this policy.

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RATING SYSTEM

Introduction

The Uniform Financial Institutions Rating System (UFIRS) was adopted by the Federal Financial Institutions Examination Council (FFIEC) on November 13, 1979, and updated in December 1996. Over the years, the UFIRS proved to be an effective supervisory tool for evaluating financial institutions on a uniform basis and for identifying institutions requiring special attention. Changes in the banking industry and regulatory policies prompted a revision of the 1979 rating system. The 1996 revisions to the UFIRS include the addition of a sixth component addressing sensitivity to market risk, the explicit reference to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating descriptions.

The UFIRS takes into consideration certain financial, managerial, and compliance factors that are common to all institutions. Under this system, the supervisory agencies endeavor to ensure all financial institutions are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on institutions exhibiting financial and operational weaknesses or adverse trends.

The UFIRS also serves as a useful vehicle for identifying institutions with deficiencies in particular component areas. Further, the rating system assists Congress in assessing the aggregate strength of the financial industry and following risk management trends. As such, the UFIRS assists regulatory agencies in fulfilling their mission of maintaining stability and public confidence in the nation's financial system.

UFIRS Overview

Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation of six financial and operational components, which are also rated. The component ratings reflect an institution's capital adequacy, asset quality, management capabilities, earnings sufficiency, liquidity position, and sensitivity to market risk (commonly referred to as CAMELS ratings). When assigning ratings, examiners consider an institution's size and sophistication, the nature and complexity of its activities, and its general risk profile.

Composite and component ratings are assigned based on a numerical scale from 1 to 5, with 1 indicating the highest rating, strongest performance and risk management practices, and least degree of supervisory concern. A 5 rating indicates the lowest rating, weakest performance and risk management practices, and highest degree of supervisory concern.

A bank's composite rating generally bears a close relationship to its component ratings. However, the composite rating is not derived by averaging the component ratings. Each component rating is based on a qualitative analysis of the factors composing that component and its interrelationship with other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at an institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition of the financial institution. Composite and component ratings are disclosed to an institution's board of directors and senior management. However, banks cannot, except in very limited circumstances, disclose the ratings or any part of a report of examination (ROE) without the prior written consent of their primary federal regulator.

Management's ability to respond to changing circumstances and address risks that result from new business conditions, activities, or products is an important factor in determining an institution's risk profile and the level of supervisory concern. For this reason, the management component is given special consideration when assigning a composite rating.

The ability of management to identify and control the risks of its operations is also taken into account when assigning each component rating. All institutions should properly manage their risks; however, appropriate management practices vary considerably among financial institutions depending on their size, complexity, and risk profile. Less complex institutions that are engaged solely in traditional banking activities and whose directors and senior managers are actively involved in the oversight and management of day-to-day operations may use relatively basic risk assessment, risk management, and internal control systems. Institutions that are more complex need formal, multifaceted systems and internal controls to provide the information managers and directors need to monitor and direct higher risk activities.

Consumer Compliance, Community Reinvestment Act, and specialty examination findings and ratings are also taken into consideration, as appropriate, when assigning component and composite ratings under the UFIRS. Specialty examination areas include: Bank Secrecy Act, Information Technology (IT), Trust, Government Security Dealers, Municipal Security Dealers, and Registered Transfer Agent.

An addendum at the end of this section contains definitions and descriptions of the UFIRS composite and component ratings.

Disclosure of Ratings

The FDIC believes it is appropriate to disclose the UFIRS component and composite ratings to bank management. Disclosure of the UFIRS ratings helps ensure banks implement appropriate risk management practices by allowing a more open and complete discussion of examination findings and recommendations.

Additionally, open discussion of the CAMELS ratings provides institutions with a better understanding of how ratings are derived and enables management to better address weaknesses in specific areas.

Discussions with Management

Generally, the examiner-in-charge (EIC) should discuss the recommended component and composite ratings with senior management and, when appropriate, the board of directors, near the conclusion of the examination. Examiners should clearly explain that their ratings are tentative and subject to the review and final approval by the regional director or designee. Examiners should follow regional guidance regarding the disclosure of component and composite ratings of 3 or worse. Generally, in these situations, examiners should contact the regional office overseeing the institution and discuss the proposed ratings with the case manager or assistant regional director prior to disclosing the ratings to management or the board.

Examiners should discuss the key factors they considered when assigning component and composite ratings with management and the board. Examiners should also explain that the composite rating is not based on a numerical average but rather a qualitative evaluation of an institution's overall managerial, operational, and financial performance.

The management component rating may be particularly sensitive and important. The quality of management is often the single most important element in the successful operation of an insured institution. It is usually the factor most indicative of how well risk is identified and controlled. For this reason, examiners should thoroughly review and explain the factors considered when assigning the management rating. Written comments in support of the management rating should include an assessment of the effectiveness of existing policies and procedures in identifying and managing risks.

Examiners should remind management that all examination findings, including the composite and component ratings whether disclosed verbally or in the written ROE, are subject to the confidentiality rules imposed by Part 309 of the FDIC Rules and Regulations.

The regional office should inform management if there are material processing delays or substantive changes to the ROE that modify the preliminary examination findings or recommendations disclosed at examination exit meetings.

Examination Letters

The FDIC's expectations for troubled institutions should be clearly communicated to bank management between the close of an examination and the issuance of an enforcement action. An examination letter should be delivered by FDIC field supervisors to chief executive officers/presidents during examination exit meetings, or earlier, for any bank newly assigned a CAMELS composite 3 rating or worse.

Examination letters should notify management that the institution's composite rating was tentatively downgraded and convey the expectation that management stabilize the institution's risk profile and strengthen its financial condition. The letter should notify management that actions taken to materially expand the institution's balance sheet or risk profile are inconsistent with supervisory expectations. The letter should also inform management they are required to obtain a non-objection from the regional director before engaging in any transactions that would materially change the institution's balance sheet composition, such as significantly increasing total assets or volatile funding sources. If practical, state banking departments should be included as a joint issuer of examination letters relating to FDIC-supervised examinations. Furthermore, an examination letter should be arranged if a downgrade is anticipated due to a state examination.

Immediate corrective measures, including the issuance of a temporary order requiring an institution to cease and desist, may be appropriate in higher-risk situations. If examiners believe such action should be considered, they should discuss the situation with the field supervisor and regional case manager without delay.

EXAMINATION FREQUENCY

The first priority of the Division of Risk Management Supervision (RMS) is the effective oversight of banks requiring special attention. The identification and supervision of banks requiring special attention is best accomplished through the examination process.

Section 337.12 of the FDIC Rules and Regulationsimplements Section 10(d) of the FDI Act and governs the frequency of examinations for insured state nonmember banks and state savings associations. Section 347.211 governs the examination frequency of branches of foreign banks.

Section 337.12 requires a full-scope, onsite examination of every insured state nonmember bank and state savings association at least once during each 12-month period. Annual examination intervals may be extended to 18 months under the following conditions:

- The bank has total assets of less than $3 billion;
- The bank is well capitalized as defined in Section 324.403(b)(1) of the FDIC Rules and Regulations;
- The bank was assigned a management component rating of 1 or 2 at the most recent FDIC or applicable state examination;
- The bank was assigned a composite rating of 1 or 2 at the most recent FDIC or applicable state examination;
- The bank currently is not subject to a formal enforcement proceeding or order by the FDIC, OCC, or Federal Reserve System; and
- No person acquired control of the bank during the preceding 12-month period in which a full-scope, onsite examination would have been required but for the above noted exceptions.

These rules apply similarly to U.S. branches or agencies of a foreign bank with total assets less than $3 billion if the office received a composite Federal Reserve ROCA[1] rating of 1 or 2 at its most recent examination. In all cases, the FDIC reserves the right to examine more frequently if the agency deems it necessary.

The FDIC strives to conduct risk management and specialty examinations of all state nonmember banks within prescribed intervals. If examination frequency requirements, other than a few nominal and non-recurring exceptions, cannot be met, regional directors should prepare and submit a memorandum to the Director of RMS. The memorandum should include a description of the nature and cause of the situation and a description of any needed, planned, or implemented corrective measures designed to maintain an adequate supervision program.

Alternate Examinations

Examinations may be conducted in alternate 12- or 18-month periods if the FDIC determines that a full-scope, onsite examination completed by the appropriate state supervisory authority during the interim period is acceptable. However, such alternate examinations should be accepted only for the following institutions: composite 1- or 2-rated institutions, and stable and improving composite 3-rated institutions if the composite rating is confirmed by an offsite review and no adverse trends are noted from other available information. The length of time between the end of one examination and the start of the next (whether one or both of the examinations are conducted by a state supervisory agency or the FDIC) should not exceed 12- or 18-months.

For purposes of monitoring compliance with examination frequency schedules, the end of the examination is defined as the earlier of the date the EIC submits the report for review, or 60 calendar days from the examination start date as defined in the Report of Examination Instructions.

Specialty Examination Intervals

The statutory requirements in Section 10(d) of the FDI Act do not apply to specialty examinations. Thus, specialty examinations are governed by internal RMS policy. Specialty examinations should generally be conducted concurrently with risk management examinations, except when the size or arrangement of a department makes it impractical or inefficient to do so. Although there will be some differences, specialty examinations are generally subject to the same examination intervals, including appropriate extensions, as risk management examinations.

In situations where rating differences or alternate state examinations result in examination intervals that are not conducive to scheduling concurrent examinations, regional directors can make reasonable adjustments to specialty examination intervals to accommodate concurrent examinations. Reasonable adjustments include extending the examination cycle for 1- and 2-rated specialty areas. Although not permitted by statute for safety and soundness examinations, internal policy allows regional directors to extend the examination cycle for 3-rated specialty areas. Specialty areas rated 4 or 5 should normally not be extended beyond a one-year interval. Additionally, since Municipal Securities Dealers are subject to a two-year examination cycle under Municipal Securities Rulemaking Board rules, any adjustment in this area should not exceed the two-year requirement. The possibility of conducting specialty examinations with state authorities should be explored if reasonable adjustments can be made.

When the state supervisory authority has responsibility for conducting the safety and soundness examination, the FDIC is not required to conduct any specialty examinations that the state authority does not conduct, with the exception of Bank Secrecy Act (BSA) examinations. The FDIC is required to conduct a BSA examination if the state does not conduct a BSA examination.

Insured Branches of Foreign Banks

Insured branches of foreign banks must be examined every 12 months under Section 10(d) of the FDI Act. However, Section 347.211 of the FDIC Rules and Regulations specifies that domestic branches of foreign banks may be considered for an 18-month examination cycle when certain criteria are met and no other factors suggest more frequent examinations are necessary. To be eligible for an extended 18-month examination cycle, a U.S. branch of a foreign bank must:

- Have total assets of less than $3 billion;
- Have a composite ROCA supervisory rating of 1 or 2 at its most recent examination;
- Not be subject to a formal enforcement action;
- Not have undergone a change in control during the preceding 12 months; and
- Have Tier 1 and total risk-based capital ratios (at the foreign bank) of at least 6 percent and 10 percent, respectively, when reported on a consolidated basis; or

1 The ROCA components are: Risk management, Operational controls, Compliance, and Asset quality.

- Have maintained on a daily basis (over the previous three quarters) eligible assets in an amount not less than 108 percent of the preceding quarter's average third-party liabilities, and have sufficient liquidity currently available to meet its obligations to third parties.

Additional factors may also be considered in determining examination frequency, including certain discretionary standards outlined in Section 347.211.

EXAMINATION TYPES

Risk-Focused Supervision

Effective risk management is central to safe and sound banking. The objective of a risk-focused examination is to efficiently evaluate the safety and soundness of a bank. Examiners should focus their resources on a bank's high-risk areas when assessing risk management programs, financial conditions, internal controls, etc. The exercise of examiner judgment to determine the scope and depth of review in each functional area is crucial to the success of the risk-focused supervisory process. Examiners should make risk-scoping decisions on a case-by-case basis in consultation with their supervisory examiner, field supervisor, or the bank's case manager.

The most effective examination approach focuses examiner resources on assessing management's ability to identify and control risks. Internal and external audits, loan reviews, and other control activities are integral considerations in an assessment of a bank's risk profile. Refer to the Internal Routine and Controls section of this Manual for an in-depth discussion of this area.

Examiners should consider the adequacy of audit and control practices in determining a bank's risk profile and, when appropriate, try to reduce regulatory burdens by testing rather than duplicating the work of a bank's audit and control functions. Transaction testing remains a reliable and essential examination technique for use in the assessment of a bank's condition. However, the amount of transaction testing necessary to evaluate activities generally depends on the quality of the bank's risk management processes. Once the integrity of the bank's risk management system is verified through testing, conclusions regarding the extent of risks within an activity can often be based on the results of internal reports rather than in-depth, onsite assessments.

The FDIC's long-standing philosophy and methods for examining institutions are fully described within this manual in Section 20.1 Risk-Focused, Forward-Looking Safety and Soundness Supervision. Examiners are expected to conduct examination activities consistent with Section 20.1.

Full-Scope Examinations

The minimum requirements of a full-scope examination are defined as the procedures necessary to complete the mandatory pages of the uniform ROE and evaluate all components (Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) of the UFIRS rating system. The completion of additional steps and pages may also be appropriate.

In a full-scope examination, all examination activities are considered in the overall assessment of the institution. These activities include the Risk Management, IT, BSA/Anti-Money Laundering (AML)/ Office of Foreign Assets Control, Trust, Registered Transfer Agent, Municipal Securities Dealer, and Government Securities Dealer examination programs. Examination ratings (when assigned) and summary comments should be included in the risk management ROE. Compliance and Community Reinvestment Act examination activities are included in the overall supervision program with separate reports and examination cycles.

Limited-Scope Examinations and Visitations

The terms *limited-scope examination* and *visitation* are interchangeable and may be defined as any review that does not meet the minimum requirements of a full-scope examination. Because the reviews are not full-scope examinations, they do not satisfy the requirements of Section 10(d) of the FDI Act. Examiners may conduct the reviews for a variety of reasons, such as to assess changes in an institution's risk profile or to monitor compliance with corrective programs. Examiners may also conduct the reviews to investigate adverse or unusual situations, to determine progress in correcting deficiencies, or to assess compliance with supervisory requirements established through an order.

Limited-scope reviews may address the overall condition of the institution, material changes since the previous examination, or areas that exhibit more than normal risk. Depending on the scope, purpose, and sufficiency of the reviews, examiners can assign composite ratings and component ratings. Component ratings for areas that were not sufficiently reviewed should be brought forward from the previous examination.

Examiners are not required to complete standard ROE schedules when completing limited-scope reviews. However, they may include applicable schedules in their report to clarify findings or recommendations. Results should generally be conveyed in a memorandum from the EIC to the regional director. The results of a review, if sent to the institution, can be in any appropriate format.

Institutions Subject to Corrective Actions

Supervisory strategies for institutions operating under an enforcement action, particularly formal actions, should generally include limited-scope reviews. The onsite reviews should include an evaluation of management's understanding of, and adherence to, the provisions of the corrective program. Limited-scope reviews should be scheduled within six months after an enforcement action is issued to evaluate an institution's progress in implementing the corrective program. Particular attention should be focused on the primary cause of the institution's problems and the principal objectives of corrective programs. If a decision is made to forego or delay an interim onsite review, the reasons should be documented in regional office files.

Newly Chartered Insured Institutions

Adverse economic conditions and other factors often affect newly chartered institutions more than established institutions, and the failure rates of de novo institutions exceed those of established institutions. Therefore, unseasoned institutions pose a material risk to the Deposit Insurance Fund (DIF) and warrant close regulatory oversight.

Among noted concerns, de novo institutions that deviate from approved business plans, especially with respect to real estate and development loans, are of particular concern to supervisory personnel. Other, common risk factors observed at troubled or failed de novo institutions during their first three years of operation include:

- Non-compliance with orders approving deposit insurance,
- Inadequate risk management controls,
- Rapid growth,
- Concentrations in higher risk assets,
- Over reliance on volatile funding sources,
- Problematic third-party relationships,
- Weak compliance management systems, and
- Unseasoned loan portfolios.

In all cases, major deviations from, or material changes to, approved business plans by newly insured institutions warrant in-depth analysis to assess risks to the institution and the DIF. In order to better identify risks and strengthen supervisory responses to identified risks, supervisory personnel should:

- Employ appropriate onsite and offsite supervisory practices;
- Carefully coordinate risk management, compliance, and interagency activities;
- Monitor activities, at least quarterly, for changes to, or deviations from, established business plans; and
- Clearly define expectations to management regarding the timing, type, and documentation required to satisfy supervisory monitoring activities.

Orders granting federal deposit insurance require bank management to seek prior approval for any major deviation, or material change, from the institution's approved business plan. To ensure that this requirement is met, the board should monitor the institution's performance for early signs that correction is needed or that a request for a change in business plan is necessary.

If a major deviation or material change to approved business plans is identified by the FDIC during an examination or other review, the case manager or examiner-in-charge should document the deviation/change in a memorandum to the regional director and include an assessment of the riskiness of the deviation/change. In such circumstances, prompt communication to bank management is necessary, and proactive, supervisory action is appropriate.

Examination and Visitation Cycles

If a newly chartered and insured institution is a subsidiary of a multi-bank holding company that is in satisfactory condition, normal examination cycles should be followed at the regional director's discretion; otherwise, a limited-scope examination should be conducted within the first six months of operation and a full-scope examination within the first twelve months of operation. Subsequent to the first examination and through the third year of operation, at least one examination should be performed each year. Extended examination intervals should not be applied in the first three years of operation. After the initial full-scope examination, examinations may be alternated with the state supervisory authority.

Monitoring Activities

During the three-year de novo period, examiners should emphasize the need for management to seek prior approval for any proposed material change(s) from the approved business plans. Regional offices have a responsibility to monitor de novo institutions' activities, review compliance with any conditions of deposit insurance orders, and track performance in relation to approved business plans. Significant changes to business plans must be submitted to the appropriate regional office for approval. Examiners assist in monitoring activities by:

- Conducting general visitation and examination procedures,
- Assessing institutions' overall risk profiles and management capabilities,
- Reviewing institutions' conformity with business plans,
- Evaluating compliance with any outstanding conditions, and
- Documenting their findings in reports of examination.

Changes in Business Plans

There is a significant degree of judgment involved in determining a major deviation or material change in a business plan. Such changes may be evidenced by shifts in asset or liability mix; variances in loan, deposit, or total asset volumes from original projections; or the introduction or deletion of a specific business strategy (such as the initiation of subprime lending or the gathering of brokered deposits). Business plans generally address a number of factors that include, but are not limited to:

- Geographic markets;
- Loan products and services;
- Investment strategies and levels;
- Deposit products and services;
- Other services, such as private banking or trust services;
- Liquidity strategies and funding sources;
- Delivery channels, particularly through third-party relationships;
- Fixed assets (e.g., branches/loan production offices);
- Other activities (on- or off-balance sheet), including fee-for-service activities;
- Customer categories (such as money services businesses or foreign financial institutions); and
- Relationships with parent organizations and affiliates.

State nonmember banks requesting deposit insurance must agree to obtain the prior approval of the FDIC for any material change to their business plan. Any significant change in the items listed above should generally be viewed as a material change in business plan. Such changes may be evidenced by significant (+/- 25 percent) deviation in asset growth projections; changes in the asset/liability mix or products and services offered; or the introduction of new business strategies such as an unplanned establishment of loan production offices or use of third parties to broker, underwrite, or originate credit on behalf of the institution.

Converting to Insured Nonmember Status

A full-scope examination should be conducted within twelve months of the last examination prior to conversion for national, state member, and thrift institutions. For noninsured institutions converting to insured status, a full-scope examination should be conducted within twelve months of the last examination prior to conversion. If the last examination was conducted by the state authority, the regional director has the discretion to accept it. However, such an examination should be accepted only for institutions rated composite 1 or 2.

Change of Ownership Control

A full-scope examination should be conducted within twelve months after a change of control. Thereafter, standard examination intervals apply.

COORDINATING EXAMINATION SCHEDULES

State Authorities

Every effort should be made to coordinate examination schedules with state authorities to take advantage of state resources, to minimize duplications of effort, and to lessen business disruptions to institutions. A representative of the regional office should meet with representatives from each state banking authority to determine examination responsibilities for the upcoming year. Responsibilities may be defined by ratings, size, or location of institutions, or assigned by specific institutions as deemed appropriate. Such agreements should contain flexibility to allow either party to alter schedules with minimal notice. While state examination requirements should be considered in the coordination process, state requirements should not be the determining factor in the final agreement.

Holding Company Inspections and Subsidiary Institution Examinations

Examinations of holding company subsidiaries should be coordinated with other federal agencies whenever possible. Particular emphasis for coordinating examinations should be placed on banking organizations with over $10 billion in consolidated assets and those banking organizations (generally with assets in excess of $1 billion) that exhibit financial weaknesses.

Examinations and inspections of insured subsidiary banks and bank holding companies that do not meet the foregoing criteria should be coordinated to the extent practical. Regional directors (or designees) should meet periodically with representatives from other federal agencies to develop coordinated schedules that will maximize the use of available resources and enhance the efficiency of bank examinations and bank holding company inspections. The coordination of examination and inspection activities should, when possible, focus on the use of common financial statement dates and allow for joint discussions with management. However, absolute concurrence, common as-of dates, and simultaneous starting dates are not required. Appropriate state regulatory agencies should be kept informed and encouraged to participate in the coordinated federal efforts affecting state-chartered institutions.

Examinations of nonbank affiliates may be conducted at the discretion of the regional director, but independent examinations of holding companies supervised by the Federal Reserve may not be conducted without prior approval of the Washington Office.

Interstate Banking and Chain Banks

A coordinated supervisory strategy for interstate banking organizations (both intra- and inter-regional) should be developed. The supervisory strategy developed should combine traditional supervision of individual units with an appropriate top-down approach to assess risks and to monitor and coordinate supervisory actions. For these organizations, the regional director has discretion to omit, delay, or modify existing examination frequencies if the financial condition of the holding company and lead bank is considered satisfactory; the condition of the subsidiary units is believed to be satisfactory; control over all insured banks in the organization is effectively centralized; and management is favorably regarded.

Regional directors are responsible for designating a lead region to design an appropriate supervisory strategy for interstate banking organizations and for ensuring pertinent information is conveyed in a timely manner to other regions and to appropriate federal and state agencies.

Chain banking organizations generally involve a group of financial institutions or holding companies that are controlled by one individual or company. Regional directors are responsible for maintaining a record system for chain banking organizations and for developing an overall supervisory strategy for these organizations. RMS policy is to supervise banks that are part of a chain banking organization in a manner that considers the financial impact of the consolidated chain on the individual institutions within that chain. Refer to Section 4.3, Related Organizations for additional details on, and a full description of, chain banking organizations.

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SCHEDULING GUIDELINES

Periodic onsite examinations are critical to the supervisory process and are an integral part of the examination program. Diversified risks in the industry and the volatile performance and financial condition of individual institutions necessitate emphasis on more frequent and less-structured supervision. Investigations, phone calls, emails, limited-scope examinations, correspondence, and other forms of customized contact should be made as necessary. The purpose is to identify and obtain corrections in an institution's policies and procedures before serious financial problems develop.

Examination planning activities should include efforts to determine the activities and condition of nonbank subsidiaries. If not determinable in advance, this information should be obtained early in the examination in order to assess the necessity for, and depth of, subsidiary examinations.

A major component of the risk-focused supervisory approach is the flexibility to conduct examination activities at various times during the examination cycle based on risk or staffing considerations. However, it is anticipated that most examination activities will be conducted as of a single point-in-time near the end of the risk management examination cycle, particularly in well-rated institutions.

Forward-Looking Supervision

Risk-focused supervision employs a forward-looking supervisory approach where control weaknesses or other risk management conditions or problems are assessed early, and when necessary, corrected, in order to prevent or mitigate serious problems to an institution's financial condition in the future.

To address minor issues identified during an examination, examiners may present suggestions to management during discussions. For more significant problems, examiners should discuss the deficiencies with management and the board of directors during the examination and at subsequent exit meetings, and address the problems in the ROE. Such discussions and written commentary should clearly convey the issue that is cause for concern and explain the risks to the institution's operations or financial performance if not addressed in a timely manner. Significant issues that require immediate attention should be identified as Matters Requiring Board Attention in the ROE. If circumstances warrant and after discussing with appropriate FDIC regional management, examiners should make recommendations for informal or formal agreements or actions if they identify unacceptable risk levels or risk management practices, even in 1 or 2 rated institutions.

A forward-looking supervisory approach that identifies and seeks to correct objectionable conditions requires serious thought and a balanced response by examiners. Critical comments must be well supported and based on facts, logic, and prudent supervisory standards. Although examiners cannot predict future events, they should consider the likelihood that identified weaknesses will cause material problems in the future, and consider the severity of damage to an institution if conditions deteriorate. In circumstances where formal action is considered, examiners should consult with the regional office while the examination is in progress regarding the material needed to support a potential action.

Scheduling Considerations

The success of a risk-focused examination program depends largely on the effectiveness of examination planning efforts and assignment scheduling. The objective of a risk-focused examination process is to identify problems early and devise solutions in the quickest, most efficient manner possible. In some instances, evidence of objectionable practices or conditions may indicate the need for an accelerated examination or visitation. In less severe situations, the information is retained and factored into the scheduling of future examinations.

In order for examiners to proactively assess potential deficiencies, it is critical for field supervisors and other personnel to be aware of, and have access to, pertinent documentation. Regional directors should ensure copies of relevant correspondence and other information that may affect scheduling decisions is documented and made available to scheduling personnel.

The following lists include sources of information that may influence examination schedules or activities. In some instances, the information may identify concerns that lead to immediate examinations. In less severe situations, the information may help identify risks that require follow-up or impact the scheduling of future examinations. The lists, while not all-inclusive, highlight the need for forward-looking supervision.

Offsite Analysis and Monitoring

- Statistical CAMELS Offsite Rating System
- Comprehensive Analytical Reports
- Interim Financial Reports
- Growth Monitoring System
- UBPR Analysis
- Press Releases

Other Financial Indicators

- Unusually high or fluctuating profit levels
- Significant operating losses
- Significant provision expenses to the allowance for loan and lease losses (ALLL) or allowance for credit losses (ACL), as applicable
- Significant levels of delinquent loans
- Significant changes in balance sheet composition
- Unusually elevated or rapidly growing asset concentrations
- High reliance on brokered funds
- Excessive trading
- Excessive dividends
- Unusually high or low ratios or numbers

Applications or Other Bank-Provided Data

- Merger activity
- Large defalcation
- Change of control
- Adverse audit report findings
- Newly insured institution
- Change in external auditor
- New subsidiaries or business lines
- Cancellation of blanket bond insurance
- Exercise of a new power or profit center
- Acquiring party in an FDIC-assisted transactions
- Large paydown/payoff of previously classified loans
- Affiliation with a problem institution/holding company

Known Characteristics

- Unusually high or low salaries
- Compensation linked to financial-performance metrics
- Significant litigation
- Infighting among officers or directors
- Officers or directors with past due loans
- Dominating or self-serving management
- Operating at the margin of laws and regulations
- Inexperienced or questionable management
- Substantial outside business interests of a key officer

- Conducting business with questionable firms
- Lack of diversity in business lines
- Higher-risk business strategies
- Refinancing poor quality loans
- Advertising above-market interest rates
- Large blocks of bank stock pledged as collateral
- Numerous or unusual affiliated loan participations
- Improper handling of correspondent bank accounts
- Sacrificing price or quality to increase loan volumes
- Hiring of a dismissed, unethical, or marginal officer

Other Bank Regulators

- Improper handling of correspondent bank accounts
- Increased or unusual loan participations among affiliated or closely-held institutions
- Large blocks of stock pledged as collateral
- Affiliation with an institution or holding company rated 3, 4, or 5
- Large defalcation
- Banker with past due loans at another institution
- Loans classified at other institutions

Media

- New chief executive officer or chief lending officer
- Adverse publicity
- Annual or interim period losses
- Adverse economic event in a community
- Natural disaster such as a flood, fire, or earthquake
- Large defalcation
- Large financial commitment as sponsor or lead bank in a major project or development
- Banker death or disappearance
- Announcement of major new activity or department

Observations/Other

- Change in external auditor
- High or sudden employee turnover
- Significant litigation against the institution or insiders
- Unusual activity in stock of the institution (price movement up or down, or heavy trading volume)
- Institution advertising above-market rates
- Significant change in asset/liability compositions
- Questionable loans being booked
- Relationships with borrowers of questionable character
- Confidential or anonymous tips

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RELYING ON STATE EXAMINATIONS

Section 10(d)(9) of the FDI Act requires the FFIEC to issue guidelines establishing standards for the purpose of determining the acceptability of state reports of examination. Under Section 10(d)(3-4), a federal banking agency may conduct an annual, onsite examination of an insured depository institution in alternate 12- or 18-month periods if the agency determines that a state examination conducted during the intervening period is adequate. The standards issued by the FFIEC are to be used at the discretion of the appropriate federal banking agency.

The FDIC and the Federal Reserve Board of Governors have a history of coordinating examination activities with state banking departments. This close cooperation improves the supervisory process by promoting a safe and sound banking system, maximizing examination efficiencies, and reducing the regulatory burden on state-chartered, depository institutions.

The federal and state banking agencies have worked together in the following areas:

- Conducting alternate, joint, and concurrent examinations of insured depository institutions, and of the branches and agencies of foreign banks that have been chartered by the states;
- Processing safety and soundness examination reports and applications on a timely basis;
- Using common examination report and application forms;
- Developing and issuing informal (e.g., board resolutions, memoranda of understanding or other similar agreements) and formal enforcement actions;
- Exchanging supervisory information;
- Offering federal agency training programs to state examiners; and
- Providing access to the federal agency databases.

The FDIC intends to continue these cooperative efforts to the maximum extent possible. It is recognized, however, that the adequacy of state budgeting, examiner staffing, and training are important factors to enhancing federal and state coordination. The FDIC has entered into formal and informal arrangements with most state banking departments. These arrangements or working agreements generally address the following areas:

- The number of state-chartered, insured institutions to be examined on an alternating basis by the state banking department and by the FDIC;
- The frequency of safety and soundness examinations;

- The type of examinations to be conducted (independent, joint, or concurrent) by each agency;
- The examination procedures to be performed;
- The responsibilities of each agency for processing reports of examination;
- The responsibilities of each agency for conducting specialty examinations;
- The procedures for coordinating informal and formal enforcement actions;
- The procedures for processing joint applications; and
- The procedures for sharing supervisory information.

These arrangements are structured to permit federal and state agencies flexibility in conducting independent examinations, subject only to notification to the other party. The flexibility allows the agencies to tailor activities based on the particulars of each state and the individual banks within a state. Generally, only institutions rated 1 or 2 are examined on an alternating basis allowing for a reasonable interval between examinations.

The FDIC will accept and rely on state reports of examination in all cases in which it is determined that state examinations enable the FDIC to effectively carry out its supervisory responsibilities. The following criteria may be considered, in whole or in part, when determining the acceptability of a state report of examination under Section 10(d) of the FDI Act:

- The completeness of the state examination report. The state report of examination should contain sufficient information to permit a reviewer to make an independent determination on the overall condition of the institution as well as each component factor and composite rating assigned under the UFIRS and commonly referred to as the CAMELS rating system, or the ROCA rating system used for branches and agencies of foreign banks.
- The adequacy of documentation maintained by state examiners to support observations made in examination reports.
- The ability over time of a state banking department to achieve examination objectives. At a minimum, the FDIC will consider the adequacy of state budgets; examiner staffing and training; and examination reports, reviews, and follow-up procedures. Accreditation of a state banking department by the Conference of State Bank Supervisors will also be considered.
- The adequacy of any formal or informal arrangement or working agreement between a state banking department and the FDIC.

The FDIC, as part of its routine review of state examination reports, will assess the quality and scope of the reports to determine whether they continue to meet the general criteria noted above. The FDIC retains the option to conduct a follow-up examination in cases in which a state examination report appears insufficient or the condition of an insured institution appears to be seriously deteriorating.

If a state and the FDIC have cooperative examination programs, regional directors may involve FDIC examiners in state examinations if an institution's condition is deteriorating, or areas of concern are identified.

The FDIC will work with state banking departments to resolve any concerns regarding the acceptability of each other's work, the operation of cooperative programs, or any other issues of mutual interest.

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COMMUNICATION BETWEEN EXAMINATIONS

Interim contact with bank management is a critical form of communication and should be conducted within 30 days of the midpoint between risk management examinations (FDIC or state). Interim contacts provide a way to monitor the institution's financial condition and gather insight into trends regarding the nature, scope, and risk of an institution's activities. Interim contacts also help supervisory staff (including examiners) establish an appropriate examination scope and identify resources required for the next examination.

The objective of an interim contact is to build and maintain effective communication with the institution. The contacts provide an opportunity for management to discuss financial trends, strategic initiatives, developing risks, and regulatory changes that may affect the institution. The contacts also help identify changes in the bank's risk profile that may require an alteration in supervisory strategies. Supervisory staff can conduct interim contacts by phone or in person, depending on the matters to be discussed and travel proximity.

Information derived from interim contacts and supervisory activities can be used as part of the risk-focused examination process. The process seeks to strike an appropriate balance between evaluating the condition of an institution at a certain point in time and evaluating the soundness of the institution's risk management processes in all phases of the economic cycle. Given the purpose of this communication, the staff conducting the interim contact should coordinate with state supervisory counterparts who may also have interim contact procedures. Staff is also encouraged to share information with state banking departments if significant items are identified during contacts.

Because case managers and other supervisory staff contact institutions that are under a supervisory action periodically between examinations, only institutions with Risk Management and specialty examination composite ratings of 1 or 2 require an "interim" contact. Regional directors have the discretion to designate regional- or field-office staff to be responsible for contacting bank management. A brief file memorandum summarizing the contact should be prepared and entered into the correspondence file as an *Interim Bank Contact*. The memo is an important, formal record of the Corporation's supervisory efforts; comments should be brief and factual. Case managers should review the contact memorandum if they are responsible for oversight of the institution and did not perform the contact themselves.

Topics discussed during interim contacts generally focus on the nature of the institution's operations and risks. The following topics are provided for illustrative purposes.

- Significant changes in bank products or services;
- Changes in bank management or key personnel;
- Changes in the strategic plan, business plan, or operations;
- Significant trends or changes in the local economy or business conditions as detailed in publicly available information, Division of Insurance and Research data, or other means;
- Purchase, acquisition, or merger strategies;
- Changes in technology, including operational systems, or plans for new products/activities that involve new technologies;
- Financial performance and trends, particularly unfavorable factors identified during off-site analysis;
- Progress in addressing any outstanding matters requiring board attention, violations, or enforcement actions;
- Recent Financial Institution Letters, laws, rules, and regulations that may affect the institution's operations;
- Any matters that may be of interest to regulators, including significant audit or security incidents; and
- Institution management's concerns about the bank or FDIC supervisory activities.

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Other contacts with an institution that occur near the midpoint of examinations, such as a visitation or other direct communication with institution management, may serve as the interim contact. In such cases, the system of record should be updated by case managers to indicate that an interim contact was completed via alternate means.

EXAMINATION PLANNING ACTIVITIES

Thorough examination planning is critical to the efficient completion of an examination. Effective planning helps support risk-scoping decisions in terms of work performed and areas to receive special attention. It can also help determine staffing needs in regard to the number and expertise of personnel required. Finally, it can enhance examination efficiencies and reduce disruptions at institutions.

Examiners should consider the need for branch examinations when planning examinations. The FDIC examines branch offices on an as-needed basis only, and the regional director is responsible for deciding if a branch examination is necessary. The decision to conduct a branch examination may be delegated to the field supervisor or EIC of a particular examination.

In general, examinations should reflect a comprehensive and coordinated effort between risk management and specialty examiners to assess an institution's overall risk profile. Information request letters from various functions scheduled for the upcoming examination (for example, Risk Management, Information Technology (IT), Bank Secrecy Act (BSA), and Trust examinations) should be coordinated and combined whenever practical. Examiners should take special care to tailor information request letters to the unique risk profile and business model of the institution, and remove unnecessary and redundant information from request lists.

As a general rule, field supervisors (FS) or supervisory examiners (SE) must call institution management at least 90 days ahead of the projected start date of the examination to inform them of the upcoming safety and soundness examination. The FS or SE will provide notice that profile scripts for general safety and soundness, which includes BSA, Trust (when applicable), and IT, will be sent to the institution. Exceptions to this general policy (such as no-notice examinations, which require regional director approval) may include problem institutions, situations where management and ownership of the institution are identical, or in situations where conditions appear to be deteriorating rapidly.

Supervisors should be mindful of an institution's space and personnel limitations and schedule the number of examiners working on bank premises accordingly. Additionally, throughout the examination, examiners should make every effort to conduct as many examination activities as reasonably possible offsite in order to minimize disruptions to an institution's normal business activities.

The following items, while not all-inclusive, are well suited for offsite review when the related information is available.

- Policies and procedures
- Audit plan
- Audit reports and responses
- Strategic plan
- Board and committee minutes/reports
- Financial data
- Asset-related reports and documents

An examination procedures module titled Risk Scoping Activities is included in the Examination Documentation Modules. This module identifies and lists several activities that may be completed by examiners during the examination planning process.

Reviewing External Audit Workpapers

An external audit workpaper review is intended to provide information relating to an institution's internal control environment and its financial reporting practices. Thus, a workpaper review assists examiners in determining the scope of the examination and the procedures to be applied to different areas of operations.

Examiners should review the workpapers of the independent public accountant or other auditor performing the institution's external auditing program when an FDIC-supervised institution has undergone a financial statement or balance sheet audit, and:

- Significant concerns exist regarding matters that would fall within the scope of the work performed by the institution's external auditors, or
- The institution has been, or is expected to be, assigned a UFIRS composite rating of 4 or 5.

However, when considering how best to use examination resources, examiners should exercise reasonable judgment with respect to performing an external audit workpaper review for these institutions. For example, it would be appropriate to conduct an external audit workpaper review for FDIC-supervised institutions when significant matters exist and the review is reasonably expected to provide an examination benefit. If examiners determine that a benefit would not be derived from performing an external audit workpaper review for an FDIC-supervised institution, examiners must document, and include in the examination workpapers, the reasons for not conducting the review.

Shared-Loss Agreements

A shared-loss agreement (SLA) is a contract between the FDIC and institutions that acquire failed bank assets. Under the agreements, the FDIC agrees to absorb a portion of the losses, if incurred, on specific assets (usually loans), purchased by an institution. If an institution makes recoveries on covered assets, they must reimburse the FDIC for part of the recoveries. Shared-loss agreements cover specific timeframes and are often written so the FDIC absorbs 80 percent of incurred losses (up to a stated threshold), and receives 80 percent of recoveries. To maintain loss coverage, institutions must adhere to the terms of the agreement and make good faith efforts to collect loans.

Note: The FDIC's reimbursement for losses on assets covered by an SLA is measured in relation to an asset's book value on the records of the failed institution on the date of its failure, not in relation to the acquisition-date fair value at which covered assets must be booked by an acquiring bank.

The FDIC uses different types of agreements for commercial loans and residential mortgages. Both types cover credit losses and certain related expenses. However, for commercial assets, SLAs generally cover losses for five years and recoveries for eight years. For residential mortgages, SLAs generally cover losses and recoveries for ten years. At the inception of either type of agreement, the acquiring institution records an indemnification asset to reflect the expected FDIC loss reimbursement under the life of the SLA.

Shared-loss agreements are designed to keep assets in the private sector, place failed bank assets with local acquirers, and preserve asset values while reducing resolution costs. Banks should not allow shared-loss considerations to unduly impact foreclosure decisions. Banks should only foreclose on properties after exhausting other loss-mitigation and workout options. To avoid unnecessary home foreclosures, most residential SLAs specifically require institutions to engage in loss-mitigation efforts in accordance with the FDIC's Mortgage Loan Modification Program or the national Home Affordable Modification Program.

Examination Considerations

Regional and field office personnel should regularly communicate with the Division of Resolutions and Receiverships (DRR) to coordinate activities and share SLA information. Pre-examination communication between examiners and DRR allows examiners to determine the type and extent of SLAs and the existence of any issues that might affect an institution's safety and soundness. If any of a bank's assets are covered by an SLA, examiners should review the agreement and consider its implications when:

- Performing asset reviews,
- Assessing accounting entries,
- Assigning asset classifications, and
- Determining CAMELS ratings.

Risk management examiners should include a sample of SLA-related commercial assets in their loan scope. The number of loans sampled should be sufficient to allow examiners to assess whether the assets are administered in a manner consistent with commercial assets not covered by SLAs. Examiners may determine it is unnecessary to include SLA-related residential mortgages in their loan scope; however, SLA coverage should be considered when assigning adverse classifications to residential credits covered by SLAs.

In most cases, the portion of an asset covered by an SLA should not be subject to adverse classification because loss sharing represents a conditional guarantee from the FDIC. Generally, the amount that would otherwise be adversely classified (Substandard, Doubtful, or Loss) should be reduced by the applicable coverage rate (often 80 or 95 percent).

Risk management examiners should review management's plans and efforts to ensure that the indemnification asset has a zero balance when the period for loss protection under an SLA expires. Examiners should discuss any potential SLA concerns with a regional SLA subject matter expert.

Risk management examiners are not expected to evaluate an institution's compliance with SLAs. Personnel from DRR evaluate compliance with SLAs; assess SLA-related accounting, reporting, and recordkeeping systems; and review loss-claim certificates. However, risk management examiners should notify their regional SLA subject matter expert and DRR staff if they identify potential problems or nonconformance with an agreement.

Other Examination Considerations

As noted above, if any of a bank's assets are covered by an SLA, examiners should review the agreement and consider its implications during examinations or visitations. The following scheduling considerations apply to FDIC-supervised institutions that received FDIC assistance, or were involved in purchase and assumption or deposit transfer transactions. Acquiring institutions with total assets in excess of ten times the deposits acquired, which are rated composite 2 or better are exempt from the following requirements.

A visitation or limited-scope examination should be conducted at state nonmember institutions within 30 days of the transaction date to determine how funds from the FDIC are being used and whether the bank is in compliance with any applicable assistance agreement. A second visitation or limited-scope examination should be conducted within six months of the transaction. A full-scope examination should be conducted within twelve months of the transaction. Thereafter, standard examination frequency schedules apply.

A cooperative program should be established with the appropriate federal agency for national, state member, and thrift institutions to ensure that all institutions receiving FDIC funds are properly monitored and that the FDIC regional director is informed of important developments.

MEETINGS WITH BANK PERSONNEL

Open dialogue with institution management is critical to forward-looking, risk-focused supervision. Open communication helps ensure examination requests are met and disruptions to an institution's daily activities are minimized. The EIC should extend an invitation (through senior management or directly to a board member if they meet a director during the examination) for directors to participate in regularly scheduled meetings with examiners or to schedule individual meetings with the EIC.

Director attendance at examination meetings increases their knowledge of the examination process and provides directors with an opportunity to discuss their views on bank-related matters with examiners. The meetings also allow examiners to gain insight into the experience levels and leadership qualities of bank management. While encouraging participation in examination meetings, the EIC should emphasize that director attendance is voluntary and that a lack of participation will not be viewed negatively.

Examiners should promote open communication at board meetings and encourage director participation in future examination meetings. Other ways to inform bankers and promote open communication includes references in the ROE transmittal letter and discussions during interim contacts and outreach events, such as Directors' Colleges.

Meetings with Management

Prior to the onsite examination, the EIC should communicate with management to coordinate examination activities. Such communication should address information requests (including the names of contact individuals), workspace plans, and the general scope of the examination. Other informal meetings should be held as needed throughout the examination to discuss various topics, gain management's perspective on local economic conditions and bank-specific issues, and to keep management informed regarding the progress of the examination. Prior to the conclusion of the examination, examiners should thoroughly discuss their findings and recommendations with senior management. Such meetings are critical in communicating examination findings to the bank and providing management an opportunity to respond. Exit meetings should fully apprise bank management of all deficiencies and supervisory recommendations that will be cited in the ROE.

The following examples represent situations that will prompt meetings and encourage dialogue between examiners and management during the course of an examination. The circumstances of each examination will determine the type and number of meetings necessary, as well as the degree of formality required to schedule and conduct the meetings.

Examination Planning The EIC should contact institution management approximately six to eight weeks ahead of the examination. The purpose of this contact is to discuss the preliminary description of the institution's business model, risk profile, and complexity, and to describe how those definitions are being used to determine the planned examination scope and request list content. The meeting provides an opportunity to get management's perspective on economic conditions, key challenges/risks, significant audit findings since the prior examination, and key risk-management processes. Primary topics of conversation should generally include current financial conditions; significant changes (planned or completed) to bank policies, personnel, or strategic direction; and any other significant changes since the previous examination.
The EIC should also discuss how and when information requests will be sent to the bank (electronic or hard copies), and the method and timing for any requested information to be delivered to examiners (FDIC*connect*, external media, or hard copies). Importantly, the EIC should facilitate the secure exchange of information between institution management and examiners, by ensuring that the delivery method(s) used meet the security measures discussed in the FDIC's e-Exam policies for the exchange, use, and storage of electronic information.

Finally, the EIC should conduct an onsite meeting with bank management, or conduct a telephone conversation with management if an onsite meeting is not feasible, in advance of the examination after reviewing the requested materials provided by management. The discussion should focus on examination logistics, including the size of the examination team; and plans for work to be completed off-site and on-site.

First Day Generally, the EIC and examination team should meet with senior management and staff during the first day of the examination for introductions, to request additional information, to discuss the areas that will be reviewed during the examination, and to cover other general examination requirements. Such meetings provide an opportunity to establish open lines of communication.

Follow-up on Prior Examination Issues Early in the examination, it is useful for the EIC to meet with senior management and discuss the bank's progress in responding to prior supervisory recommendations, as well as outstanding internal and external audit recommendations. This is also a good opportunity for examiners to gain management's perspectives on other bank-specific concerns.

Strategic Planning and Budget The EIC and management should discuss asset and/or capital growth plans, new business or business products, and other strategic and budget issues during the course of the examination.

Loan Discussion Management should participate in loan discussions and the initial review of adverse classifications, as appropriate, considering the size and condition of the institution and loan portfolio.

Material Preliminary Findings Normally, the EIC should notify senior management of major findings and possible recommendations before the final management meeting. This is to ensure that management has the opportunity to provide any additional information or clarification for examiner consideration before the conclusion of the examination.

Management Meetings The EIC is expected to communicate with institution management regularly during the examination to inform management of the examination progress and findings. Further, all major examination issues should be discussed with senior management as soon as practical during an examination. Additionally, all significant issues should be discussed again at the end of the examination, prior to meeting with the board of directors.

As noted in the Examination Letters for Troubled Institutions section above, the FDIC's expectations for troubled institutions should be clearly communicated to bank management between the close of an examination and the issuance of an enforcement action.

Regardless of the number or type of meetings held, it is critical that examiners ensure on-going two-way communication with management. Such communication enhances the effectiveness of the examination process by allowing all parties to freely exchange information.

Meetings with Directors

The policies in this section have been established for meetings with boards of directors. These policies are designed to encourage director involvement in, and enhance director awareness of, FDIC supervisory efforts and to increase the effectiveness of such efforts. The bank's composite rating is the most important variable in deciding if and when these meetings should be held.

Banks Assigned a Composite Rating of 4 or 5

The EIC and the regional director or designee should meet with the board of directors (with the required quorum in attendance) during or subsequent to the examination. Additional meetings or contacts with the board of directors or appropriate board committee may be scheduled at the regional director's discretion.

Banks Assigned a Composite Rating of 3

The EIC should meet with the board (with the required quorum in attendance) during or subsequent to the examination. Regional office representation is at the discretion of the regional director. Additional meetings or other contacts with the board of directors or appropriate board committee may be scheduled at the discretion of the regional director or designee.

Banks Assigned a Composite Rating of 1 or 2

The EIC will meet with the board or a board committee during or subsequent to the examination when 36 months or more have elapsed since the last such meeting; the management component of the CAMELS rating is 3, 4 or 5; any other CAMELS performance rating is 4 or 5; or any two performance ratings are 3, 4 or 5. It is important to note that meeting with a board committee (in lieu of the entire board) in conjunction with an examination is permissible only when the committee is influential as to policy, meets regularly, contains reasonable outside director representation, and reports regularly to the entire board. Other factors that may be relevant to the decision of holding a board meeting include recent changes in control, ownership, or top management; adverse economic conditions; requests by management or the board for a meeting; or any unique conditions or trends pertinent to the institution. Regional office participation in meetings with banks rated composite 1 or 2 is at the regional director's discretion.

Matters Requiring Board Attention (MRBA)

The EIC will meet with the board of directors, or a board committee, during or subsequent to the examination whenever the EIC recommends including a MRBA in the ROE. To assist directors in prioritizing their efforts to address MRBA, discussions should cover the reasons for the MRBA, highlight the benefits and importance of addressing issues and the possible consequences of not taking action.

Other Considerations

When a meeting is held in conjunction with an examination, reference should be made on the Examination Conclusions and Comments (ECC) schedule as to the committee or board members, bank managers or personnel, and regulators in attendance. A clear but concise presentation of the items covered at the meeting, including corrective commitments and/or reactions of management, should also be included. If a meeting is held, but not in conjunction with an examination, a summary of the meeting, including the items noted above, should be prepared and a copy mailed to the institution, via certified mail, for consideration by the board and inclusion in the official minutes of the directorate's next meeting.

When it is concluded that a meeting with a board committee rather than the full board is appropriate, selection of the committee must be based on the group's actual responsibilities and functions rather than its title. In all cases, the committee chosen should include an acceptable representation of board members who are not full-time officers.

The success of a board meeting is highly dependent upon the examiner's preparation. The EIC should notify bank management as soon as possible of any plans to meet with the board to present overall examination findings. A written agenda that lists all areas to be discussed and provides supporting documents or schedules generally enhances examiners' explanations of findings and recommendations. Failure to adequately prepare for a meeting can substantially diminish the supervisory value of an examination. Both the written agenda, and the EIC discussions at the meeting, should be clear regarding items that senior management and the board are expected to address.

To encourage awareness and participation, examiners should inform bank management that the examination report (or copies thereof) should be made available to each director for thorough and timely review, and that a signature page is included in the examination report to be signed by each director after review of the report. Management should also be reminded that the report is confidential, remains the property of the FDIC, and that utmost care should be exercised in its reproduction and distribution. The bank should be advised to retrieve, destroy, and record the fact of destruction of any reproduced copies after they have served their purpose.

OTHER SOURCES OF INFORMATION

The primary purpose of this Manual is to provide instructions to the field examiner that should be applied in the risk management examination process. Other policy manuals or other instructional materials pertaining to additional areas of examination interest, such as trust department operations, IT activities, transfer agent, and consumer compliance have also been developed. Those areas were not addressed significantly in this Manual in order to enhance the organization of the primary risk management material and to keep the document reasonable in length. However, exclusion of these topics in no way implies that these activities do not impact a safety and soundness examination. To the contrary, deficiencies in other aspects of a bank's operations can have a major impact on an institution's overall condition. Therefore, it is critical for examiners to be aware of the existence and understand the significance of deficiencies in other areas.

Specialty examination findings should be addressed in the ECC section of the risk management ROE. The placement and length of related comments should be commensurate with the significance of the findings and the impact on the UFIRS ratings. Inclusion of specific specialty examination pages in the ROE in support of findings in the ECC section is addressed in Manual Section 16.1 – Report of Examination Instructions.

If a specialty examination is conducted at a date substantially removed from other examination activities, examiners may communicate their findings through a visitation report and letter to the institution if warranted. However, summary comments should also be included in the risk management ROE and factored into the UFIRS ratings.

In some situations, it may be necessary for examiners to conduct specialty examinations separately from the Risk Management examination. In these rare cases, a separate specialty examination report may be prepared, consistent with regional guidance and outstanding report preparation instructions.

To emphasize and illustrate how weaknesses in these ancillary activities can adversely affect the whole bank, a brief overview of trust, IT, BSA, and consumer protection activities is provided.

Trust Department

A bank's trust department acts in a fiduciary capacity when the assets it manages are not the bank's, but belong to and are for the benefit of others. This type of relationship necessitates a great deal of confidence on the part of customers and demands a high degree of good faith and responsibility on a bank's part. The primary objective of a trust department examination is to determine whether its operations or the administration of its accounts have given rise to possible or contingent liabilities, or direct liabilities (estimated losses), which could reduce the bank's capital accounts. If the terms of trust instruments are violated, if relevant laws and regulations are not complied with, or if generally accepted fiduciary standards are not adhered to, the department, and hence the bank, may become liable and suffer losses. If the magnitude of these losses is very high, the viability of the bank may be threatened. To aid examiners in evaluating a trust department, the Uniform Interagency Trust Rating System was devised. Composite ratings of 1 (best performance) through 5 (worst performance) are assigned based on analysis of five critical areas of a trust department's administration and operations. These include Management; Operations, Internal Controls and Audits; Earnings; Compliance; and Asset Management.

Information Technology

Information technology services apply to virtually all recordkeeping and operational areas in banks. These IT services may be managed internally on a bank's own in-house computer system, or outsourced, wholly or in part, to an independent data center that performs IT functions. Although some or all IT services may be outsourced, management and the board retain oversight responsibilities.

The potential consequences of receiving faulty data or suffering an interruption of services are serious and warrant comprehensive IT policies and procedures and thorough IT examinations. A primary objective of an IT examination is to determine the confidentiality, integrity, and availability of records produced by automated systems. Examination priorities include an evaluation of management's ability to identify risks and maintain appropriate compensating controls.

IT operations are rated in accordance with the Uniform Rating System for Information Technology (URSIT), which is based on an evaluation of four critical components: audit; management; development and acquisition; and support and delivery. The composite IT rating is influenced by the performance of the four component functions and reflects the effectiveness of a bank's IT risk management and information security programs and practices. A scale of 1 through 5 is used, wherein 1 indicates strong performance and 5 denotes critically deficient operating performance.

Most IT examinations should be embedded in risk management ROEs. The URSIT composite and component ratings should be assigned at each IT examination and included in the ROE in accordance with Section 16.1 of the RMS Manual.

Bank Secrecy Act

The Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act of 1970 is often referred to as the Bank Secrecy Act. The purpose of the BSA is to ensure U.S. financial institutions maintain appropriate records and file certain reports involving currency transactions and customer relationships. Several acts and regulations that strengthen the scope and enforcement of BSA, anti-money laundering (AML), and counter-terrorist-financing measures have been signed into law. Some of these include:

- Money Laundering Control Act-1986
- Annuzio-Wylie Anti-Money Laundering Act-1992
- Money Laundering Suppression Act-1994
- Money Laundering & Financial Crimes Strategy Act-1998
- USA PATRIOT Act-2001

Findings from BSA examinations are generally included within the risk management report; however, separate BSA examinations can be conducted. Although a separate rating system for BSA does not exist, BSA findings can affect both the management rating and the overall composite rating of the institution. Refer to the BSA section of this Manual for additional information.

Consumer Protection

The principal objective of consumer protection examinations is to determine a bank's compliance with various consumer and civil rights laws and regulations. Consumer protection statutes include, but are not limited to, Truth in Lending, Truth in Savings, Community Reinvestment Act, and Fair Housing regulations. Noncompliance with these regulatory restrictions and standards may result in an injustice to affected individual(s) and reflects adversely on an institution's management and reputation. Moreover, violations of consumer laws can result in civil or criminal liabilities, and consequently, financial penalties. If significant in amount, such losses could have an adverse financial impact on a bank. As is the case for IT and trust operations, an interagency rating system for consumer compliance has been designed. It provides a general framework for evaluating an institution's conformance with consumer protection and civil rights laws and regulations. A numbering scale of 1 through 5 is used with 1 signifying the strongest performance and 5 the worst performance. A separate examination rating is assigned to each institution based on its performance in the area of community reinvestment. The four ratings are outstanding, satisfactory, needs to improve, and substantial noncompliance.

Summary

Risk management examiners must have a general knowledge of the key principles, policies, and practices relating to IT, BSA, consumer protection, trust, and other specialty examinations. Additionally, examiners should be knowledgeable of state laws and regulations that apply to the banks they examine; the rules, regulations, statements of policy and various banking-related statutes contained in the FDIC Rules and Regulations; and the instructions for completing Consolidated Reports of Condition and Income.

DISCLOSING REPORTS OF EXAMINATION

The ROE is highly confidential. Although a copy is provided to a bank, that copy remains the property of the FDIC. Without the FDIC's prior authorization, directors, officers, employees, and agents of a bank are not permitted to disclose the contents of a report. Under specified circumstances, FDIC regulations permit disclosures by a bank to its parent holding company or majority shareholder.

Standard FDIC regulations do not prohibit employees or agents of a bank from reviewing the ROE if it is necessary for purposes of their employment. Accountants and attorneys acting in their capacities as bank employees or agents may review an examination report without prior FDIC approval, but only insofar as it relates to their scope of employment. The FDIC believes the definition of agent includes an accountant or accounting firm that performs an audit of the bank.

Reports of Examination are routinely provided to a bank's chartering authority. Therefore, state bank examiners may review the bank's copy of an FDIC examination during a state examination.

EXAMINATION WORKPAPERS

Introduction

Examiners should document their findings through a combination of brief summaries, source documents, report comments, and other workpapers that clearly describe financial conditions, management practices, and examination conclusions. Documentation should generally describe:

- Key audit/risk-scoping decisions,
- Source documents reviewed, and
- General examination procedures performed.

Documentation should include summary statements. Summary statements can take many forms, including notations on copies of source documents, separate hand-written notes, and electronic or hard-copy memorandums. At a minimum, summary comments should:

- Detail examination findings and recommendations,
- Describe supporting facts and logic, and
- Record management responses and completion dates for promised corrective actions.

Although examination documentation may be maintained in various ways, examiners must securely retain appropriate supporting records of all major examination conclusions, recommendations, and assertions detailed in the ROE.

Safeguarding Examination Information

Examination information may contain non-public customer information as defined in Section 501(b) of the Gramm-Leach-Bliley Act. Therefore, examiners must carefully safeguard information and follow established procedures for accessing, transporting, storing, and disposing of electronic and paper information. The procedures, which may involve Washington-, regional-, and field-office practices, should include technical, physical, and administrative safeguards and an incident response program.

Examiners must protect FDIC property and data and respond quickly to any security breech. Examiners should:

- Protect computer equipment and data in transit,
- Track data in transit, and
- Secure unattended equipment and data.

Examiners must report unauthorized access to data and equipment on a timely basis. Examiners should contact the FDIC's Help Desk within one hour after discovery; their supervisor as soon as possible; and in instances where theft of equipment is involved, the local police.

Examination Documentation (ED) Modules

Examination procedures have been developed jointly by the FDIC, the Federal Reserve, and various state agencies to provide examiners with tools to scope examination activities, evaluate financial conditions and risk-management practices, and document examination findings. The use of these modules is discretionary. When not used, examination findings should be documented as discussed above.

The ED modules incorporate questions and points of consideration into examination procedures that specifically address a bank's risk management strategies for each of its major business activities. The modules direct examiners to evaluate areas of risk and associated risk-control practices, thereby facilitating an effective supervisory program. The ED module examination procedures are generally separated into three distinct tiers: Core Analysis, Expanded Analysis, and Impact Analysis. The extent to which an examiner works through each of these levels of analysis depends upon the conclusions reached regarding the presence of significant concerns or deficiencies.

Where significant deficiencies or weaknesses are noted in the Core Analysis review, the examiner should complete the Expanded Analysis section, but only for the decision factors that present the greatest degree of risk to the bank.

On the other hand, if risks are properly managed, examiners can conclude their review after documenting conclusions concerning the Core Analysis Decision Factors and carrying forward any applicable comments to the ROE. The Expanded Analysis section provides guidance to examiners to help determine if weaknesses are material to a bank's condition or if an activity is inadequately managed.

The use of the modules should be tailored to the characteristics of each bank based on its size, complexity, and risk profile. As a result, the extent to which each module is completed will vary. Individual procedures presented for each level are meant only to serve as a guide for answering the decision factors. Each procedure does not require an individual response.

Substance of Workpapers

Appropriate documentation should be prepared and retained in the workpapers for each significant job task performed. A checklist of examination procedures performed may be used to document completed tasks and included as part of the examination workpapers. The checklist may also be used as the final documentation of lower-risk areas if findings are not material.

Examiners should use standardized loan line sheets except in special situations where alternative forms, such as institution-generated line sheets, provide a clear and substantial time savings and the same general loan information. Line sheets must contain sufficient, albeit sometimes brief, supporting data to substantiate a pass designation or adverse classification.

For BSA examinations, examiners should document preliminary, core, and expanded procedures as needed, in accordance with current guidance relating to BSA/AML workprograms for examination procedures.

Workpaper forms are available in ETS to supplement report pages for certain areas of review, such as risk-weighted assets and cash flow projections. When warranted, supplemental workpapers may be included in the ROE to the extent that they provide material support for significant findings.

Filing of Workpapers

Historically examiners maintained paper copies of documents to support examination findings. Generally, information can now be obtained electronically, or be captured electronically, using portable scanners. Examiners should scan documents that support examination findings unless technical or other issues require hard copies. Examiners should scan documents in a secure location within a reasonable time after receiving or developing them. Scanners should be turned off when not in use to clear the scanner's memory of previously scanned information. Examiners should return hardcopy documents to their source or destroy them in a secure manner (onsite when possible) after completing the scanning process.

Electronic documentation must be appropriately secured throughout the supervisory process to prevent disclosure of confidential or sensitive information to unauthorized individuals. Examiners should manage and store general examination documents using the Electronic Workpapers Module in the Regional Automated Document Distribution and Imaging System (RADD).

Examiners must exercise sound judgment in determining which electronic workpapers to retain. Examiners should only retain final documents that support examination or other supervisory findings (not multiple versions of a document) and delete all other documents. The examiner-in-charge is responsible for ensuring that only appropriate electronic workpapers are retained and that the workpapers are retained in accordance with existing policies and procedures.

At the conclusion of an examination or visitation, examiners should generally delete a bank's electronic workpapers from their laptops. However, electronic workpapers can be retained for longer periods if the information is needed to support ongoing business needs. In such instances, examiners should delete the electronic workpapers as soon as practical.

Note: Non-FDIC issued laptops, desktops, or other electronic devices may not be used to store institution-provided information or examination workpapers.

If hardcopy documents are maintained, the documents should be appropriately stored and secured. Each folder, envelope, or binder should be labeled with the institution's name and location, the date of examination, and a list of documents that were prepared for each category. At its discretion, each region and field office may designate the major documentation categories and supplemental lists for their respective office(s). The EIC is responsible for ensuring outdated workpapers are appropriately purged and current workpapers are properly organized and filed.

If hardcopy documents are physically transported to another location, examiners must follow existing procedures to create logs of hardcopy documents that contain personally identifiable information.

BSA workpapers must be retained for five years and should be maintained separately from the workpapers of the risk management examination. The separate retention of BSA workpapers will expedite their submission to the Treasury Department in the event they are requested.

Retention of Workpapers

Line sheets should generally be retained for one examination cycle, after which they may be purged from the active loan deck. Risk Management and Trust Officer's Questionnaires should be retained for a minimum of ten years from the examination start date. Officer's Questionnaires should be retained indefinitely when irregularities are discovered or suspected, especially if the signed questionnaire may provide evidence of these irregularities. The examiner may submit a copy of the Officer's Questionnaire with the ROE if circumstances warrant, such as when the examiner suspects that an officer knowingly provided incorrect information on the document.

Retention of other workpapers beyond one examination should generally be confined to those banks with existing or pending administrative actions, special documents relating to past insider abuse, documents that are the subject of previous criminal referral letters, or other such sensitive documents. While the retention of workpapers beyond one examination cycle is generally discouraged, major schedules and other pertinent workpapers can be retained if deemed useful. Additionally, if a bank's composite rating is 3 or worse, most workpapers should be maintained until the bank returns to a satisfactory condition.

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ADDENDUM TO SECTION 1.1

UFIRS RATINGS DEFINITIONS

Composite Ratings

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are capital adequacy, asset quality, management capability, earnings quantity and quality, liquidity adequacy, and sensitivity to market risk. The composite ratings are defined as follows:

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile, and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institution's size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and failure is highly probable.

Component Ratings

Each of the component rating descriptions are divided into an introductory paragraph, a list of principal evaluation factors, and a brief description of each numerical rating. Some of the evaluation factors are reiterated under one or more of the other components to reinforce the interrelationship between components. The evaluation factors for each component rating are in no particular order of importance.

Capital Adequacy

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital.

The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of capital and the overall financial condition of the institution;
- The ability of management to address emerging needs for additional capital;
- The nature, trend, and volume of problem assets, and the adequacy of the allowance for loan and lease losses and other valuation reserves;
- Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities;
- Risk exposure represented by off-balance sheet activities;
- The quality and strength of earnings, and the reasonableness of dividends;
- Prospects and plans for growth, as well as past experience in managing growth; and
- Access to capital markets and other sources of capital including support provided by a parent holding company.

Ratings

A rating of 1 indicates a strong capital level relative to the institution's risk profile.

A rating of 2 indicates a satisfactory capital level relative to the financial institution's risk profile.

A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

Asset Quality

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the exposure to counter-party, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered.

The asset quality of a financial institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices;
- The level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions;
- The adequacy of the allowance for loan and lease losses and other asset valuation reserves;

- The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit;
- The diversification and quality of the loan and investment portfolios;
- The extent of securities underwriting activities and exposure to counter-parties in trading activities;
- The existence of asset concentrations;
- The adequacy of loan and investment policies, procedures, and practices;
- The ability of management to properly administer its assets, including the timely identification and collection of problem assets;
- The adequacy of internal controls and management information systems; and
- The volume and nature of credit-documentation exceptions.

Ratings

A rating of 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset quality in such institutions is of minimal supervisory concern.

A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

A rating of 4 is assigned to financial institutions with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

Management

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of oversight and support of all institution activities by the board of directors and management;
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products;
- The adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities;
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile;
- The adequacy of audits and internal controls to promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure

compliance with laws, regulations, and internal policies;
- Compliance with laws and regulations;
- Responsiveness to recommendations from auditors and supervisory authorities;
- Management depth and succession;
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority;
- Reasonableness of compensation policies and avoidance of self-dealing;
- Demonstrated willingness to serve the legitimate banking needs of the community; and
- The overall performance of the institution and its risk profile.

Ratings

A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

Earnings

This rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the ALLL, or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The rating of an institution's earnings is based upon, but not limited to, an assessment of the following evaluation factors:

- The level of earnings, including trends and stability;
- The ability to provide for adequate capital through retained earnings;
- The quality and sources of earnings;
- The level of expenses in relation to operations;
- The adequacy of the budgeting systems, forecasting processes, and management information systems in general;
- The adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts; and
- The earnings exposure to market risk such as interest rate, foreign exchange, and price risks.

Ratings

A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

Liquidity

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition;
- The availability of assets readily convertible to cash without undue loss;
- Access to money markets and other sources of funding;
- The level of diversification of funding sources, both on- and off-balance sheet;
- The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer-term assets;
- The trend and stability of deposits;
- The ability to securitize and sell certain pools of assets; and
- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

Ratings

A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

A rating of 2 indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.

A rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.

A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

A rating of 5 indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Sensitivity to Market Risk

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, consideration should be given to management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to its level of market risk exposure.

For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates. In some larger institutions, foreign operations can be a significant source of market risk. For some institutions, trading activities are a major source of market risk.

Market risk is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices, or equity prices;
- The ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile;
- The nature and complexity of interest rate risk exposure arising from nontrading positions; and
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

Ratings

A rating of 1 indicates that market risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

A rating of 2 indicates that market risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

A rating of 3 indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

A rating of 4 indicates that control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

A rating of 5 indicates that control of market risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

INTRODUCTION

Purpose of Capital

Bank capital performs several very important functions. It absorbs losses, promotes public confidence, helps restrict excessive asset growth, and provides protection to depositors and the deposit insurance funds.

Absorbs Losses

Capital allows institutions to continue operating as going concerns during periods when operating losses or other adverse financial results are experienced.

Promotes Public Confidence

Capital provides a measure of assurance to the public that an institution will continue to provide financial services even when losses have been incurred, thereby helping to maintain confidence in the banking system and minimize liquidity concerns.

Restricts Excessive Asset Growth

Capital, along with minimum capital ratio standards, restrains unjustified asset expansion by requiring that asset growth be funded by a commensurate amount of additional capital.

Protects Depositors and the Deposit Insurance Fund

Placing owners at significant risk of loss, should the institution fail, helps to minimize the potential for moral hazard, and promotes safe and sound banking practices.

The FDIC, as the primary insuring agency, has a responsibility to protect depositors and the deposit insurance fund. Consequently, the FDIC focuses attention on the adequacy of capital during bank examinations and in supervisory programs. For example, examiners carefully review asset and liability accounts to determine adjusted equity levels, as compared to simply identifying book capital. Similarly, examiners identify higher-risk assets, such as adversely classified loans, and assets listed for special mention or as concentrations, because the assets may contribute to losses or weaken capital in the future. Additionally, examiners review bank policies and procedures, and management's qualifications and performance, to identify weaknesses that could hinder earnings or reduce capital. And finally, to assess the potential effect on capital, examiners review bank's earnings, capital-distribution plans, and contingent liabilities that may arise from banking relationships, trust activities, or litigation.

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REGULATORY CAPITAL REQUIREMENTS

Regulatory capital requirements have evolved as innovations in financial instruments and investment activities introduced greater complexity to the banking industry. To ensure regulatory requirements keep pace with these changes, federal banking agencies revised the rules governing qualifying capital instruments and minimum capital levels. Capital rules in the U.S. generally follow a framework of rules adopted by the Basel Committee on Banking Supervision (BCBS), an international standard-setting body that deals with various aspects of bank supervision. The FDIC is a member of the BCBS and works with the Board of Governors of the Federal Reserve System (FRB) and the Office of the Comptroller of the Currency (OCC) to establish domestic capital regulations.

In 2013, the FDIC, FRB, and OCC issued regulations for insured depository institutions in the U.S. that align with Basel III capital standards (Basel III). The standards and regulations are designed to strengthen the quality and quantity of bank capital and promote a stronger financial industry that is more resilient to economic stress. Basel III capital standards emphasize common equity tier 1 capital as the predominant form of bank capital. Common equity tier 1 capital is widely recognized as the most loss-absorbing form of capital, as it is permanent and places shareholders' funds at risk of loss in the event of insolvency. Moreover, Basel III strengthens minimum capital ratio requirements and risk-weighting definitions, increases Prompt Corrective Action (PCA) thresholds, establishes a capital conservation buffer, and provides a mechanism to mandate counter-cyclical capital buffers.

Basel III standards apply to all insured depository institutions. For FDIC-supervised institutions, the capital rules are contained in Part 324 of the FDIC Rules and Regulations. Part 324 defines capital elements, establishes risk-weighting guidelines for determining capital requirements under the standardized and advanced approaches, and sets PCA standards that prescribe supervisory action for institutions that are not adequately capitalized. Part 324 also establishes requirements to maintain a capital conservation buffer that affects capital distributions and discretionary payments. The phase-in of Part 324 began on January 1, 2014 for advanced approach institutions[1] and January 1, 2015 for community banks and

[1] Generally, an advanced approaches institution is an institution that has consolidated total assets of $250 billion or more or has on-balance sheet foreign exposure of $10 billion or more. Refer to Section 324.100.

other non-advanced approaches institutions. Full implementation of the rules for all institutions begins on January 1, 2019.

This chapter provides an overview of the rule; however examiners should refer to Part 324 for specific rule text.

Other Regulatory Requirements

Examiners should be aware of other regulatory requirements that address capital requirements, such as:

Topic	Rule
Risk-Based Insurance Premiums	Part 327 of the FDIC Rules and Regulations
Brokered Deposits	Section 337.6 of the FDIC Rules and Regulations
Limits on Extensions of Credit to Insiders	Section 337.3 of the FDIC Rules and Regulations and FRB Regulation O
Activities and Investments Insured State Nonmember	Part 362 of the FDIC Rules and Regulations
Limitations on Interbank Liabilities	Part 206 of FRB Regulations
Limitations on Federal Reserve Discount Window Advances	Section 10B of the Federal Reserve Act
Grounds for Appointing of Conservator or Receiver	Section 11(c)(5) of the Federal Deposit Insurance Act (FDI Act)

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COMPONENTS OF CAPITAL

Part 324 establishes three components of regulatory capital: common equity tier 1 capital, additional tier 1 capital, and tier 2 capital. Tier 1 capital is the sum of common equity tier 1 capital and additional tier 1 capital. Total capital is the sum of tier 1 and tier 2 capital. Common equity tier 1 capital, tier 1 capital, and total capital serve as the numerators for calculating regulatory capital ratios. An institution's risk-weighted assets, as defined by Part 324, serve as the denominator for these ratios. Average total assets with certain adjustments serve as the denominator for the tier 1 leverage capital ratio.

Common Equity Tier 1 Capital

Common equity tier 1 capital is the most loss-absorbing form of capital. It includes qualifying common stock and related surplus net of treasury stock; retained earnings; certain accumulated other comprehensive income (AOCI) elements if the institution does not make an AOCI opt-out election (refer to opt-out election discussion in next paragraph), plus or minus regulatory deductions or adjustments as appropriate; and qualifying common equity tier 1 minority interests. It is important to note that the federal banking agencies expect the majority of common equity tier 1 capital to be in the form of common voting shares.

Part 324 allows all non-advanced approach institutions to make a permanent, one-time opt-out election, enabling them to calculate regulatory capital without AOCI. Such an election neutralizes the impact of unrealized gains or losses on available-for-sale bond portfolios in the context of regulatory capital levels. To opt-out, institutions must make a one-time permanent election on the March 31, 2015 Call Report. For institutions that do not or cannot opt-out, the AOCI adjustment to common equity tier 1 capital could have a significant impact on regulatory capital ratios if significant bond portfolio appreciation or depreciation occurs.

Part 324 requires that several items be fully deducted from common equity tier 1 capital such as goodwill, deferred tax assets that arise from net operating loss and tax credit carry-forwards, other intangible assets (except for mortgage servicing assets), gains on sale of securitization exposures, and certain investments in another financial institution's capital instruments. Additionally, banks must adjust for unrealized gains or losses on certain cash flow hedges. Finally, banks must consider threshold deductions for three specific types of assets: mortgage servicing assets, deferred tax assets related to temporary timing differences, and significant investments in another unconsolidated financial institution's common stock. Generally, banks must deduct the amount of exposure to these types of assets, by category, that exceeds 10 percent of a base common equity tier 1 capital calculation. In addition, there is a 15 percent aggregate limit on these three threshold deduction items. The amounts of threshold items not deducted will be assigned a 250 percent risk weight when Part 324 is fully phased in.

Additional Tier 1 Capital

Additional tier 1 capital includes qualifying noncumulative perpetual preferred stock, bank-issued Small Business Lending Fund and Troubled Asset Relief Program instruments that previously qualified for tier 1 capital, and qualifying tier 1 minority interests, less certain investments in other unconsolidated financial institutions' instruments that would otherwise qualify as additional tier 1 capital.

Tier 2 Capital

Tier 2 capital includes the allowance for loan and lease losses up to 1.25 percent of risk-weighted assets, qualifying preferred stock, subordinated debt, and qualifying tier 2 minority interests, less any deductions in the tier 2 instruments of an unconsolidated financial institution. Part 324 eliminates previous limits on term subordinated debt, limited-life preferred stock, and the amount of tier 2 capital includable in total capital.

Deductions and Limits

Investments in the capital instruments of another financial institution, such as common stock, preferred stock, subordinated debt, and trust preferred securities might need to be deducted from each tier of capital. Investments must be analyzed to determine whether they are significant or non-significant, which depends on the percentage of common stock that a bank owns in the other financial institution. If the bank owns 10 percent or less of the other institution's common shares, then all of that investment is non-significant. If a bank owns more than 10 percent, then all of the investment in that company is significant. Part 324 contains separate deduction requirements for significant and non-significant investments.

In many cases, deductions will be made from the tier of capital for which an investment would otherwise be eligible. To illustrate, if a bank's investment is an instrument that qualifies as tier 2 capital, it is deducted from tier 2 capital. If it qualifies as an additional tier 1 capital instrument, it is deducted from additional tier 1 capital. If it qualifies as a common equity tier 1 capital instrument, it is deducted from common equity tier 1 capital. If the bank does not have sufficient tier 2 capital to absorb a deduction, then the excess amount is deducted from additional tier 1 capital or from common equity tier 1 capital if there is insufficient additional tier 1 capital.

Part 324 limits the amount of minority interest in a subsidiary that may be included in each tier of capital. To be included in capital, the instrument that gives rise to minority interest must qualify for a particular tier of capital.

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RISK-WEIGHTED ASSETS

Part 324 prescribes two approaches to risk weighting assets. The standardized approach is generally designed for community banks, while the advanced approach is used by larger, more complex institutions.

Standardized Approach

A bank's balance sheet assets and credit equivalent amounts of off-balance sheet items are generally assigned to one of four risk categories (0, 20, 50, and 100 percent) according to the obligor, or if relevant, the guarantor or the nature of the collateral. Part 324, Subpart D (Risk-weighted Assets-Standardized Approach) sets forth the criteria for categorizing non-advanced approach institutions' assets and off-balance sheet exposures for risk-weighting purposes.

Since the risk-weighting system was first introduced in the U.S. in the early 1990s, the general process of risk weighting assets has not changed. However, several changes implemented by the standardized approach involve risk weights other than the 0, 20, 50, and 100 percent categories. These changes are individually outlined below and include high volatility commercial real estate loans; past due asset exposures; securitizations or structured investments; equity exposures; and collateralized and guaranteed exposures.

High Volatility Commercial Real Estate Loans (HVCRE)

Loans designated as HVCRE loans generally refer to a subset of acquisition, development, and construction (ADC) loans that are assigned a risk-weighting of 150 percent. HVCRE loans do not include 1-4 family residential ADC projects, loans to finance agricultural properties, or community development projects. HVCRE loans also exclude ADC projects where:

- The loan-to-value is at or below supervisory maximums,
- The borrower contributed at least 15 percent of the as-completed value in cash or unencumbered marketable assets, and
- The contributed capital is contractually required to remain throughout the project life.

Past-Due Asset Risk Weights

The standardized approach requires financial institutions to transition assets that are 90 days or more past due or on nonaccrual from their original risk weight to 150 percent. For example, if the bank held a revenue bond that was on nonaccrual, Part 324 requires the bond to be risk weighted at 150 percent compared to its original 50 percent risk weight. This treatment could potentially apply to commercial, agricultural, multi-family, and consumer loans as well as fixed income securities. However, this requirement does not apply to past due 1-4 family residential real estate loans (which would be risk weighted at 100 percent), HVCRE (risk weighted at 150 percent), and the portion of loan balances with eligible guarantees or collateral where the risk weight can vary.

Structured Securities and Securitizations

Part 324 establishes risk weight approaches for securitization exposures and structured security exposures that are retained on- or off-balance sheet. Typical examples of securitization exposures include private label collateralized mortgage obligations (CMOs), trust preferred collateralized debt obligations, and asset-backed securities, provided there is tranching of credit risk. Generally, pass-through and government agency CMOs are excluded from the securitization exposure risk weight approaches. In general, Part 324 requires FDIC-supervised institutions to calculate the risk weight of securitization exposures using either the *gross-up approach* or the *Simplified Supervisory Formula Approach* (SSFA) consistently across all securitization exposures, except in certain cases. For instance, the bank can, at any time, risk-weight a securitization exposure at 1,250 percent.

The gross-up approach is similar to earlier risk-based capital rules, where capital is required on the credit exposure of the bank's investment in the subordinate tranche, as well as its pro rata share of the more senior tranches it supports. It calculates a capital requirement based on the weighted-average risk weights of the underlying exposures in the securitization pool.

The SSFA is designed to assign a lower risk weight to more senior-class securities and higher risk weights to support tranches. The SSFA is both risk-sensitive and forward-looking. The formula adjusts the risk weight for a security's underlying collateral based on key risk factors such as incurred losses, nonperforming loans, and the ability of subordinate tranches to absorb losses. In any case, a securitization is assigned at least a minimum risk weight of 20 percent.

Securitization Due Diligence

Section 324.41(c) implements due diligence requirements for securitization exposures. The analysis must be commensurate with the complexity of the securitization exposure and the materiality of the exposure in relation to capital.

Under these requirements, management must demonstrate a comprehensive understanding of the features of a securitization exposure that would materially affect its performance. The due diligence analysis should be conducted prior to acquisition and at least quarterly as long as the instrument is in the institution's portfolio.

When conducting analysis of a securitization exposure, the bank should consider structural features such as:

- Credit enhancements,
- Performance of servicing organizations,
- Deal-specific definitions of default, and
- Any other features that could materially impact the performance of the exposure.

The analysis should also assess relevant performance information of the underlying credit exposures such as:

- Past due payments;
- Prepayment rates;
- Property types;
- Average loan-to-value ratios;
- Geographic and industry diversification;
- Relevant market data information, such as bid-ask spreads;
- Recent sale prices;
- Trading volumes;
- Historic price volatility;
- Implied market volatility; and the
- Size, depth, and concentration level of the market for the securitization.

For re-securitization exposures, the analysis should assess the performance on underlying securitization exposures.

If management is not able to demonstrate sufficient understanding of a securitization exposure, regulators may require the bank to assign the exposure a 1,250 percent risk weight.

Equity Risk Weights

Part 324 assigns various risk weights for equity investments. Significant investments in the common shares of an unconsolidated financial institution that are not deducted from common equity tier 1 capital, are assigned a 250 percent risk weight when Basel III is fully phased in. For banks that are allowed to hold publicly traded equities, the risk weight for these assets ranges from 100 to 300 percent. A risk weight of 400 percent is assigned to non-publicly traded equity exposures. A risk weight of 600 percent is assigned to investments in a hedge fund or investment fund that has greater than immaterial leverage. To the extent that the aggregate adjusted carrying value of certain equity exposures does not exceed 10 percent of the bank's total capital, a 100 percent risk weight may be applied.

Part 324 also contains various look-through approaches for equity exposures to investment funds. For example, if a bank has an equity investment in a mutual fund that invests in various types of bonds, the regulation directs how to assign proportional risk weights based on the underlying investments. In addition, there is special treatment for a few classes of equity securities. Risk weights for Federal

Reserve Bank stock is 0 percent, Federal Home Loan Bank stock receives a 20 percent risk weight, and community development exposures, including Community Development Financial Institutions, are assigned 100 percent risk weights. Examiners should refer to Sections 324.51, 324.52, and 324.53 for additional information regarding risk weights for equity exposures.

Collateralized Transactions

In certain circumstances, an institution has the option to recognize the risk-mitigating effects of financial collateral to reduce the risk-based capital requirements associated with a collateralized transaction. Financial collateral includes cash on deposit (or held for the bank by a third party trustee), gold bullion, certain investment grade[2] securities, publicly traded equity securities, publicly traded convertible bonds, and certain money market fund shares.

Part 324 permits two general approaches to recognize financial collateral for risk weighting purposes. The simple approach generally allows substituting the risk weight of the financial collateral for the risk weight of any exposure. In order to use the simple approach, the collateral must be subject to a collateral agreement for at least the life of the exposure, the collateral must be revalued at least every 6 months, and the collateral (other than gold) and the exposure must be denominated in the same currency. The second approach, the collateral haircut (discount) approach, allows a bank to calculate the exposure for repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions using a mathematical formula and supervisory haircut factors. Refer to Section 324.37 for additional details.

Most institutions are expected to use the simple approach; however, regardless of the approach chosen, it must be applied consistently for similar exposures or transactions.

The following are examples under the simple approach. A bank may assign a zero percent risk weight to the collateralized portion of an exposure where the financial collateral is cash on deposit. A bank may also assign a zero percent risk weight if the financial collateral is an exposure to a sovereign[3] that qualifies for a zero percent risk weight and the bank has discounted the market value of the collateral by 20 percent. Transactions collateralized by debt securities of government sponsored entities receive a 20 percent risk weight, while risk weights for transactions collateralized by money market funds will vary according to the funds' investments. Finally, for transactions collateralized by investment grade securities, such as general obligation municipal, revenue, and corporate bonds, banks may use collateral risk weights of 20, 50, and 100 percent, respectively.

Treatment of Guarantees

Under Part 324, banks have the option to substitute the risk weight of an eligible guarantee or guarantor for the risk weight of the underlying exposure. For example, if the bank has a loan guaranteed by an eligible guarantor, the bank can use the risk weight of the guarantor. Eligible guarantors include entities such as depository institutions and holding companies, the International Monetary Fund, Federal Home Loan Banks, the Federal Agricultural Mortgage Corporation, entities with investment grade debt, sovereign entities, and foreign banks. An eligible guarantee must be written, be either unconditional or a contingent obligation of the U.S. government or its agencies, cover all or a pro rata share of all contractual payments, give the beneficiary a direct claim against the protection provider, and meet other requirements outlined in the definition of eligible guarantees under Section 324.2.

Off-Balance Sheet Exposures

The risk-weighted amounts for all off-balance sheet items are determined by a two-step process. First, the "credit equivalent amount" is determined by multiplying the face value or notional amount of the off-balance sheet item by a credit conversion factor. Second, the credit equivalent amount is assigned to the appropriate risk category, like any other balance sheet asset.

Advanced Approaches

An institution that has consolidated total assets equal to $250 billion or more; that has consolidated total on-balance sheet foreign exposures equal to $10 billion or more; is a subsidiary of a depository institution or holding company that uses the advanced approaches; or elects to use the advanced approaches is generally subject to the advanced approaches which are described in Part 324, Subpart E (Risk-weighted Assets - Internal Ratings-Based and Advanced Measurement Approaches) and Subpart F (Risk-weighted Assets - Market Risk). These subparts outline requirements for risk weighting a complex institution's assets and other exposures, including trading accounts. The advanced approaches are not described in this Manual. Please refer to Part 324 and other pertinent materials for detailed information.

[2] *Investment grade* means that the issuer has adequate capacity to meet financial commitments for the projected life of the asset or exposure.

[3] *Sovereign* means a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government.

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MINIMUM REGULATORY CAPITAL RATIOS

As defined by Section 324.10(a), FDIC-supervised institutions must maintain the following minimum capital ratios. These requirements are identical to those for national and state member banks.

- Common equity tier 1 capital to total risk-weighted assets ratio of 4.5 percent,
- Tier 1 capital to total risk-weighted assets ratio of 6 percent,
- Total capital to total risk-weighted assets ratio of 8 percent, and
- Tier 1 capital to average total assets ratio (tier 1 leverage ratio) of 4 percent.

Section 324.4(b) indicates that any insured institution which has less than its minimum leverage capital requirement may be deemed to be engaged in an unsafe and unsound practice pursuant to Section 8 of the FDI Act, unless the institution has entered into and is in compliance with a written agreement or has submitted and is in compliance with a plan approved by the FDIC to increase its leverage capital ratio and take other action as may be necessary. Section 324.4(c) indicates that any insured depository institution with a tier 1 capital to total assets ratio of less than 2 percent may be deemed to be operating in an unsafe and unsound condition.

Notwithstanding the minimum capital requirements, an FDIC-supervised institution must maintain capital commensurate with the level and nature of all risks to which the institution is exposed. Furthermore, an FDIC-supervised institution must have a process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining an appropriate level of capital. The FDIC is not precluded from taking formal enforcement actions against an insured depository institution with capital above the minimum requirement if the specific circumstances indicate such action appropriate.

Additionally, FDIC-supervised institutions that fail to maintain capital at or above minimum leverage capital requirements may be issued a capital directive by the FDIC. Capital directives generally require an institution to restore its capital to the minimum leverage requirement within a specified time period. Refer to Section 15.1 – Formal Administrative Actions for further discussion on capital directives.

Supplementary Leverage Ratio

For advanced approach institutions, a supplementary leverage ratio of 3 percent will be required as of January 1, 2018. This supplemental ratio is not related to the four minimum capital ratios applicable to all insured institutions. The supplemental ratio is a stand-alone ratio that must be calculated by dividing tier 1 capital by total leverage exposure. Total leverage exposure consists of on-balance sheet items, less amounts deducted from tier 1 capital, plus:

- Potential future credit exposure related to derivatives contracts;
- Cash collateral for derivative transactions not meeting certain criteria;
- Effective notional amounts of sold credit derivatives;
- Gross value of receivables of repo-style transactions not meeting certain criteria;
- Ten percent of the notional amount of unconditionally cancellable commitments; and
- The notional amount of all other off-balance sheet exposures multiplied by standardized credit conversion factors, excluding securities lending and borrowing transactions, reverse repurchase agreements, and derivatives.

The supplemental leverage ratio is derived by calculating the arithmetic mean of this measure for the last day of each month in the reporting period.

In addition, the largest banking organizations will be subject to an enhanced supplementary leverage ratio beginning January 1, 2018. To avoid restrictions on capital distributions and discretionary bonus payments, bank holding companies (BHCs) with more than $700 billion in consolidated total assets or more than $10 trillion in assets under custody must maintain a leverage buffer greater than 2 percentage points above the minimum supplementary leverage ratio requirement of 3 percent, for a total of more than 5 percent. Insured depository institution subsidiaries of such BHCs must maintain at least a 6 percent supplementary leverage ratio to be considered well capitalized under the PCA framework.

Capital Conservation Buffer

The capital conservation buffer is designed to strengthen an institution's financial resilience during economic cycles. Beginning January 1, 2016, financial institutions will be required to maintain a capital conservation buffer as shown in the table below in order to avoid restrictions on capital distributions and other payments.

Year	CET1 Capital Conservation Buffer
2016	0.625%
2017	1.25%
2018	1.875%
2019	2.50%

If a bank's capital conservation buffer falls below the amount listed in the table above, its maximum payout amount for capital distributions and discretionary payments declines to a set percentage of eligible retained income based on the size of the bank's buffer. The following table reflects the maximum payout ratio for the fully phased in capital conservation buffer beginning January 1, 2019. For the maximum payout ratios during the transition period (January 1, 2016 through December 1, 2018), refer to Section 32.400(a)(2).

Capital Conservation Buffer (% of RWA)	Maximum Payout Ratio (% of Eligible Retained Income)
Greater than 2.5%	No payout limitation
Less than or equal to 2.5% and greater than 1.875%	60%
Less than or equal to 1.875% and greater than 1.25%	40%
Less than or equal to 1.25% and greater than 0.625%	20%
Less than or equal to 0.625%	0%

The types of payments subject to the restrictions include dividends, share buybacks, discretionary payments on tier 1 instruments, and discretionary bonus payments. It is important to note that the FDIC maintains the authority to impose further restrictions and require capital to be commensurate with the bank's risk profile.

A bank cannot make capital distributions or certain discretionary bonus payments during the current calendar quarter if its eligible retained income is negative and its capital conservation buffer was less than 2.50 percent as of the end of the previous quarter. Eligible retained income is a bank's net income as reported in its Call Reports for the four calendar quarters preceding the current quarter, net of any capital distributions, and certain discretionary bonus payments that were made during those four quarters.

To calculate the capital conservation buffer for a given quarter, each minimum risk-based capital requirement in Part 324 is subtracted from the institution's corresponding capital ratios. The following ratios would be subtracted from the institution's corresponding ratio to derive the buffer amount:

- Common equity tier 1 risk-based capital ratio minus 4.5 percent;
- Tier 1 risk-based capital ratio minus 6 percent; and
- Total risk-based capital ratio minus 8 percent.

The lowest of the three measures would represent the institution's capital conservation buffer and is used to determine its maximum payout for the current quarter. To the extent a bank's capital conservation buffer is 2.50 percent or less of risk-weighted assets, the bank's maximum payout amount for capital distributions and discretionary payments would decline.

The FDIC may permit an FDIC-supervised institution that is otherwise limited from making distributions and discretionary bonus payments to make a distribution or discretionary bonus payment upon an institution's request, if the FDIC determines that the distribution or discretionary bonus payment would not be contrary to the purposes of this section, or to the safety and soundness of the FDIC-supervised institution.

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PROMPT CORRECTIVE ACTION

Part 324, Subpart H (Prompt Corrective Action) was issued by the FDIC pursuant to Section 38 of the FDI Act. Its purpose is to establish the capital measures and levels that are used to determine supervisory actions authorized under Section 38 of the FDI Act. Subpart H also outlines the procedures for the submission and review of capital restoration plans and other directives pursuant to Section 38. Notably, neither Subpart H nor Section 38 limits the FDIC's authority to take supervisory actions to address unsafe or unsound practices or conditions, deficient capital levels, or violations of law. Actions under this Subpart and Section 38 may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the FDIC.

The following table summarizes the PCA categories.

PCA Category	Total RBC Ratio	Tier 1 RBC Ratio	CET1 RBC Ratio	Tier 1 Leverage Ratio
Well Capitalized	10%	8%	6.5%	5%
Adequately Capitalized	8%	6%	4.5%	4%
Undercapitalized	< 8%	< 6%	< 4.5%	< 4%
Significantly Undercapitalized	< 6%	< 4%	< 3%	< 3%
Critically Undercapitalized	Tangible Equity/Total Assets ≤ 2%			

Any bank that does not meet the minimum PCA requirements may be deemed to be in violation of Part 324, and engaged in an unsafe or unsound practice unless the bank has entered into and is in compliance with a written plan approved by the FDIC. In addition, under Subpart H, the FDIC may reclassify a well-capitalized FDIC-supervised institution as adequately capitalized, or require an adequately capitalized or undercapitalized FDIC-supervised institution to comply with certain mandatory or discretionary supervisory actions as if the institution were in the next lower PCA category. Refer to Part 324, Subpart H for further details.

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EXAMINATION-IDENTIFIED DEDUCTIONS FROM COMMON EQUITY CAPITAL

Identified Losses and Inadequate Reserves

Part 324 provides that, on a case-by-case basis and in conjunction with supervisory examinations of an FDIC-supervised institution, deductions from capital may be required. The definition of common equity tier 1 capital specifically provides for the deduction of identified losses, such as items classified Loss, any provision expenses that are necessary to replenish the Allowance for Loan and Lease Losses (ALLL) to an adequate level, estimated losses in contingent liabilities, differences in accounts which represent shortages, and liabilities not shown on books. Losses attributed to a criminal violation may also need to be deducted from capital; refer to Section 16.1 – Report of Examination Instructions for the Capital Calculations page instructions. Also, for the calculation of capital ratios, assets may need to be adjusted for certain identified losses; refer to the instructions for the Capital Calculations page for details.

When it is deemed appropriate during an examination to adjust capital for items classified Loss or for an inadequate ALLL, the following method should be used by examiners. This method avoids adjustments that may otherwise result in a double deduction (e.g., for loans classified Loss), particularly when common equity tier 1 capital already has been effectively reduced through provision expenses recorded in the ALLL. Additionally, the following method addresses situations where an institution overstated the amount of common equity tier 1 capital by failing to take necessary provision expenses to establish and maintain an adequate ALLL.

- Deduct the amount of Loss for items other than held-for-investment loans and leases in the calculation of common equity tier 1 capital. If other real estate (ORE) general reserves exist, refer to the discussion of Other Real Estate Reserves below.
- Deduct the amount of Loss for held-for-investment loans and leases from the ALLL in the calculation of tier 2 capital.
- If the ALLL is considered inadequate, an estimate of the provision expense needed for an adequate ALLL should be made. The estimate is made after identified losses have been deducted from the ALLL. Loans and leases classified Doubtful should not be directly deducted from capital. Rather, they should be included in the evaluation of the ALLL and, if appropriate, accounted for by the inadequate ALLL adjustment. An adjustment from common equity tier 1 capital to tier 2 capital for the provision expenses necessary to replenish the ALLL to an adequate level should be made when the amount is significant.

Other Real Estate Reserves

Other real estate reserves, whether considered general or specific reserves, are not recognized as a component of regulatory capital. However, these reserves should be considered when accounting for ORE that is classified Loss. Examiners should consider the existence of any general ORE reserves when deducting ORE classified Loss. To the extent ORE reserves adequately cover the risks inherent in the ORE portfolio as a whole, including any individual ORE properties classified Loss, there would not be a deduction from common equity tier 1 capital. The ORE Loss in excess of ORE reserves should be deducted from common equity tier 1 capital under Assets Other Than Held-for-Investment Loans and Leases Classified Loss.

Liabilities Not Shown on Books

Non-book liabilities have a direct bearing on capital adjustments. These definite and direct, but unbooked liabilities (contingent liabilities are treated differently) should be carefully verified and supported by factual comments. Examiners should recommend that bank records be adjusted so that all liabilities are properly reflected. Deficiencies in a bank's accrual accounting system, which are of such magnitude that the institution's capital accounts are significantly overstated constitutes an example of non-book liabilities for which an adjustment should be made in the examination capital analysis. Similarly, an adjustment to capital should be made for material, deferred tax liabilities or for a significant amount of unpaid bills that are not reflected on the bank’s books.

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CAPITAL ADEQUACY

The FDIC's authority to enforce capital standards in financial institutions includes the use of written agreements, capital directives, and discretionary actions. A discussion on the use of these powers is included in Section 15.1 - Formal Administrative Actions, of this manual. Specific recommendations regarding capital adequacy should not be made solely on the examiner's initiative. Coordination between the examiner and the regional office is essential in this area. If the level or trend of the bank's capital position is adverse, the matter should be discussed with management with a comment included in the examination report. It is particularly important that management's plans to correct the capital deficiency be accurately determined and noted in the report, along with the examiner's assessment of the feasibility and sufficiency of those plans.

Supervisory assessments of capital adequacy will generally be based on the following factors.

Less Than Adequately Capitalized Institutions

Banks that fail to meet minimum capital ratios are often subject to capital directives or other formal enforcement action by the FDIC to increase capital. Moreover, such institutions may have any application submitted to the FDIC denied if such application requires the FDIC to evaluate the adequacy of the institution's capital structure.

Fundamentally Sound and Well-Managed Banks

Minimum capital ratios are generally viewed as the minimum acceptable standards for banks whose overall financial condition is fundamentally sound, which are well-managed, and which have no material or significant financial weaknesses. While the FDIC will make this determination based on each bank's own condition and specific circumstances, the definition generally applies to those banks evidencing a level of risk, which is no greater than that normally associated with a Composite rating of 1 or 2. Banks meeting this definition, which are in compliance with the minimum capital requirements, will not generally be required by the FDIC to raise new capital from external sources.

Problem Banks

Banks evidencing a level of risk at least as great as that normally associated with a Composite rating of 3, 4, or 5 will be required to maintain capital higher than the minimum regulatory requirement and at a level deemed appropriate in relation to the degree of risk within the institution. These higher capital levels should normally be addressed through informal actions, such as Memoranda of Understanding, between the FDIC and the bank or, in cases of more pronounced risk, through the use of formal enforcement actions under Section 8 of the FDI Act.

Capital Requirements of Primary Regulator

All insured depository institutions are expected to meet any capital requirements established by their primary state or federal regulator that exceed the minimum capital requirement set forth by regulation. The FDIC will consult with the bank's primary state or federal regulator when establishing capital requirements higher than the minimum set forth by regulation.

Capital Plans

Banks with insufficient capital in relation to their risk profile are often required to submit a capital plan to the FDIC in conjunction with a formal enforcement action or other directive. The development of a capital plan is frequently recommended by the FDIC to help boards of directors formulate a plan for restoring capital adequacy. Capital plans may be requested informally through the supervisory process, a Memorandum of Understanding, or other mandatory or discretionary supervisory action. Examiners should consider the necessity of recommending a capital plan if the adequacy of the capital position is in question. If a capital plan is in place, examiners should assess compliance with the plan and whether the outstanding capital plan remains appropriate and, if necessary, recommend revisions to the regional office.

Disallowing the Use of Bankruptcy

Section 2522(c) of the Crime Control Act of 1990 amended the Bankruptcy Code to require that in Chapter 11 bankruptcy cases the trustee shall seek to immediately cure any deficit under any commitment by a debtor to maintain the capital of an insured depository institution. Chapter 11 cases are those in which a debtor company seeks to reorganize its debt. In addition, Section 2522(d) provides an eighth priority in distribution for such commitments. These provisions place the FDIC in a strong, preferred position with respect to a debtor if a commitment to maintain capital is present and the institution is inadequately capitalized.

This provision will only be useful to the FDIC if commitments to maintain capital can be obtained from owners of institutions such as holding companies, or other corporations or financial conglomerates. Examples of situations where opportunities might exist include situations where a prospective owner might be attempting to mitigate a factor such as potential future risk to the insurance funds or when the FDIC is providing assistance to an acquirer. In addition, in accordance with the PCA provisions in Part 324, undercapitalized FDIC-supervised institutions are required to file a capital plan with the FDIC and, before such a capital plan can be accepted, any company having control over the institution would need to guarantee the bank's compliance with the plan. However, in any case, a commitment to maintain capital should be considered only as an additional enhancement and not as a substitute for actual capital.

Increasing Capital in Operating Banks

To raise capital ratios, management of an institution must increase capital levels or reduce asset growth to the point that the capital formation rate exceeds asset growth. The following sections describe alternatives to increasing the capital level in banks.

Increased Earnings Retention

Management may attempt to increase earnings retention through a combination of higher earnings or lower cash dividend rates. Earnings may be improved, for example, by tighter controls over certain expense outlays; repricing of loans, fees, or service charges; upgrading credit standards and administration to reduce loan or investment losses, or through various other adjustments. An increase in retained earnings will improve capital ratios assuming the increase exceeds asset growth.

Sale of Additional Capital Stock

Sometimes increased earnings retention is insufficient to address capital requirements and the sale of new equity must be pursued. One adverse effect of this option is shareholder dilution. If the sale of additional stock is a consideration, examiners should indicate in the examination report the sources from which such funds might be obtained. This notation will be helpful as background data for preliminary discussions with the state banking supervisor and serves to inform the regional director as to the practical possibilities of new stock sales. The following information could be incorporated into the report, at the examiner's discretion:

- A complete list of present shareholders, indicating amounts of stock held and their financial worth. Small holdings may be aggregated if a complete listing is impractical.
- Information concerning individual directors relative to their capacity and willingness to purchase stock.
- A list of prominent customers and depositors who are not shareholders, but who might be interested in acquiring stock.
- A list of other individuals or possible sources of support in the community who, because of known wealth or other reasons, might desire to subscribe to new stock.

Any other data bearing upon the issue of raising new capital, along with the examiner's opinions regarding the most likely prospects for the sale of new equity, should be included in the confidential section of the examination report.

Reduce Asset Growth

Bank management may also increase capital ratios by reducing asset growth to a level below that of capital formation. Some institutions will respond to supervisory concerns regarding the bank's capitalization level by attempting to reduce the institution's total assets. Sometimes this intentional asset shrinkage will be accomplished by disposing of short-term, marketable assets and allowing volatile liabilities to run off. This reduction may result in a relatively higher capital-to-assets ratio, but it may leave the bank with a strained liquidity posture. Therefore, it is a strategy that can have adverse consequences from a safety and soundness perspective and examiners should be alert to the possible impact this strategy could have in banks that are experiencing capital adequacy problems.

Contingent Liabilities

Contingent liabilities reflect potential claims on bank assets. Any actual or direct liability that is contingent upon a future event or circumstance may be considered a contingent liability. Contingent liabilities are divided into two general categories. Category I contingent liabilities result in a concomitant increase in bank assets if the contingencies convert to actual liabilities. These contingencies usually result from off-balance sheet lending activities such as loan commitments and letters of credit. For example, when a bank funds an existing loan commitment or honors a draft drawn on a letter of credit, it generally originates a loan for the amount of liability incurred.

Category II contingent liabilities include those in which a claim on assets arises without an equivalent increase in assets. For example, pending litigation in which the bank is defendant or claims arising from trust operations could reduce an institution’s cash or other assets.

Examination Policies

Examination interest in contingent liabilities is predicated upon an evaluation of the impact contingencies may have on a bank's condition. Contingent liabilities that are significant in amount or have a high probability of becoming direct liabilities must be considered when the bank's component ratings are assigned. For example, the amount of contingent liabilities and the extent to which they may be funded must be considered in the analysis of liquidity. Determination of the management component may appropriately include consideration of contingencies, particularly off-balance sheet lending practices. Contingent liabilities arising from off-balance sheet fee producing activities may enhance earnings. In rating earnings, the impact of present and future fee income should be analyzed.

The extent to which contingent liabilities may ultimately result in charges against capital accounts is always part of the examination process and an important consideration in rating capital. Examiners should consider the degree of off-balance sheet risk in their analysis of the bank's overall capital adequacy and the determination of compliance with Part 324 of the FDIC Rules and Regulations.

Potential and Estimated Losses

As described above, Category I contingent liabilities are defined as those that will give rise to a concomitant increase in bank assets if the contingencies convert into actual liabilities. Such contingencies should be evaluated for credit risk and, if appropriate, listed for Special Mention or subjected to adverse classification. If a Category I contingent liability is classified Loss, it would be included in the *Other Adjustments to and Deductions from Common Equity Tier 1 Capital* category on the Capital Calculations page if an allowance has not been established for the classified exposure. To the extent the off-balance sheet credit exposure classified Loss has an associated allowance, the Loss is deducted from the allowance for credit losses on off-balance sheet credit exposures, not Common Equity Tier 1 Capital.

A bank's exposure to Category II contingent liabilities normally depends solely on the probability of the contingencies becoming direct liabilities. To reflect the degree of likelihood that a contingency may result in a charge to the capital accounts, the terms potential loss and estimated loss are used. A loss contingency is an existing condition, situation, or set of circumstances that involves uncertainty as to possible loss that will be resolved when one or more future events occur or fail to occur. Potential loss refers to contingent liabilities in which there is substantial and material risk of loss to the bank. An estimated loss from a loss contingency (for example, pending or threatened litigation) should be recognized if it is probable that an asset has been impaired or a liability incurred as of the examination date and the amount of the loss can be reasonably estimated.

For further information, examiners should refer to the Statement of Financial Accounting Standards Codification (ASC) 450 Contingencies.

The memorandum section of the Capital Calculations page of the Report of Examination includes two contingent liability items. The first item, Contingent Liabilities, refers to Category I contingent liabilities. The second item, Potential Loss, refers only to Category II contingent liabilities. Estimated losses related to Category II contingent liabilities are reflected in the Other Adjustments to and Deductions from Common Equity Tier 1 Capital line item. Contingent liability losses are not included as adjustments to assets.

Common Forms of Contingent Liabilities

Common types and characteristics of contingent liabilities encountered in bank examinations are discussed below. In all cases, the examiner's fundamental objectives are to ascertain the likelihood that such contingencies may result in losses to the bank and assess the pending impact on its financial condition.

Litigation

If the bank is involved in a lawsuit where the outcome may affect the bank’s financial condition, the examiner should include the facts in the examination report. Comments should address the essential points upon which the suit is based, the total dollar amount of the plaintiff's claim, the basis of the bank's defense, the status of any negotiations toward a compromise settlement, and the opinion of bank management or counsel relative to the probability of a successful defense. In addition, corroboration of information and opinions provided by bank management regarding significant lawsuits should be obtained from the bank's legal counsel. At the examiner's discretion, reference to suits that are small or otherwise of limited consequence may be omitted from the examination report.

Determination of potential or estimated losses in connection with lawsuits is often difficult. There may be occasions where damages sought are of such magnitude that, if the bank is unsuccessful in its defense, it could be rendered insolvent. In such instances, examiners should consult their regional office for guidance. All potential and estimated losses must be substantiated by comments detailing the specific reasons leading to the conclusion.

Trust Activities

Contingent liabilities may develop within the trust department due to actions or inactions of the bank acting in its fiduciary capacity. These contingencies may arise from failure to abide by governing instruments, court orders, generally accepted fiduciary standards, or controlling statutes and regulations. Deficiencies in administration by the trust department can lead to lawsuits, surcharges, or other penalties that must be absorbed by the bank's capital accounts. Therefore, the dollar volume and severity of such contingencies must be analyzed during the safety and soundness examination.

Consigned Items and Nonledger Control Accounts

Banks sometimes provide customer services that do not result in transactions entered on the general ledger. These customer services include safekeeping, rental of safe deposit box facilities, purchase and sale of investments for customers, sale of traveler's checks, and collection department services. It is management's responsibility to ensure that collateral and other nonledger items are properly recorded and protected by effective custodial controls. Proper insurance protection must be obtained to protect against claims arising from mishandling, negligence, or other unforeseen occurrences. Failure to take protective steps may lead to contingent liabilities. The following is a brief description of customer service activities involving consigned items.

Customer Safekeeping

Safe Deposit Boxes - The bank and its customers enter into a contract whereby the bank receives a fee for renting safe deposit boxes and assumes responsibility of exercising reasonable care against loss of the box's contents. When a loss does occur, unless the bank can demonstrate that it employed reasonably prudent care, it could be held liable. Safe deposit box access should be granted only after verifying the lessee's signature at each visit. The bank generally cannot gain access to a customer's safe deposit box except as allowed under certain statutes or court orders.

Safekeeping - In addition to items held as collateral for loans, banks occasionally hold customers' valuables. To limit potential liabilities, banks should attempt to discourage this practice by emphasizing the benefits of a safe deposit box, but when not possible or practical to do so, the same procedures employed in handling loan collateral must be followed.

Custodial Accounts - Banks may act as custodian for customers' investments such as stocks, bonds, or gold. When serving as custodian, the bank has only the duties of safekeeping the property involved and performing ministerial acts as directed by the principal. As a rule, no management or advisory duties are exercised. Before providing such services, the bank should seek advice of legal counsel concerning applicable state and federal laws governing this type of relationship. In addition, use of signed agreements or contracts, which clearly define the bank's duties and responsibilities is an important part in limiting potential liability.

Collection Items

The collection department may act as an agent for others in receiving, collecting, and liquidating items. In consideration for this service, a fee is generally received. An audit trail must be in place to substantiate proper handling of all items to reduce the bank's potential liability.

Consigned Items

Consigned items typically include traveler's checks. Banks share a fee with the consignor of traveler's checks. A working supply is generally maintained at the selling station(s) and the reserve supply should be maintained under dual control in the bank's vault.

Reserve Premium Accounts

The American Bankers Association (ABA) sponsored the creation of the American Bankers Professional and Fidelity Insurance Company Ltd. (ABPFIC). The ABPFIC is a mutual insurance company that reinsures a portion of Progressive Company's directors and officers liability and fidelity bond insurance programs, which are available to banks that are ABA members. Banks that obtain insurance coverage from Progressive become members of ABPFIC. As a mutual reinsurance company, ABPFIC established a mechanism (a Reserve Premium Account) by which its members are required to provide additional funds to ABPFIC to cover losses.

The Reserve Premium Account Agreement between the bank and the ABPFIC provides for the bank to deposit into the Account an amount equal to the insurance premiums quoted by Progressive for the bank's first year combined Director and Officer Liability insurance, Financial Institution Bond, and such other coverages written by Progressive. No funds are actually placed with or transferred to ABPFIC when a Reserve Premium Account is established. Rather, a bank can satisfy this deposit requirement by pledging or otherwise earmarking specific bank assets for this purpose.

Unless ABPFIC makes a demand for payment from Reserve Premium Accounts to cover losses, the assets in such accounts remain bank assets and any associated earnings are the banks'. Any demand for payment would reportedly be made on a pro rata basis to all banks that must maintain a Reserve Premium Account. Establishing a Reserve Premium Account results in a Category II contingent liability equal to the bank's deposit into the account.

Under ASC 450 a bank would accrue an estimated loss from the contingent liability resulting from having entered into a Reserve Premium Account Agreement with ABPFIC when and if available information indicates that (1) it is probable that ABPFIC will make a demand for payment from the account and (2) the amount of the payment can be reasonably estimated.

The asset used to satisfy the Reserve Premium Account requirement should be shown in the proper balance sheet category and considered a pledged asset. If a bank pledged or otherwise earmarked any short term and marketable assets (e.g., securities) for its Reserve Premium Account, the amount of the bank's contingent liability should be reflected in management's internal liquidity analysis since the assets used to satisfy Reserve requirement are not available to meet liquidity needs.

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EVALUATING CAPITAL ADEQUACY

Banks are expected to meet any capital requirements properly established by its primary state or federal regulator, which exceed the minimum capital requirement set forth in the regulation. Once these minimum capital requirements are met, the evaluation of capital adequacy extends to factors that require a combination of analysis and judgment. Banks are too dissimilar to permit use of standards based on one or only a few criteria. Generally, a financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks.

It is important to note that what is adequate capital for safety and soundness purposes may differ significantly from the minimum leverage and risk-based standards and the *Well Capitalized* and *Adequately Capitalized* definitions that are used in the PCA regulations and certain other capital-based rules. The minimums set forth in the leverage and risk-based capital standards apply to sound, well-run institutions.

In all cases, a financial institution is expected to maintain capital commensurate with the risks to which it is exposed, especially the volume and severity of adversely classified assets.

After determining that an institution meets the minimum capital requirements, examiners should use judgment and financial analysis to assess the overall adequacy of an institution's capital. The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following factors.

Financial Condition of the Institution

The institution's overall financial condition and risk management practices are important considerations when assessing capital adequacy. For example, asset quality problems can cause losses that deplete capital, and poor earnings can hinder capital formation. Additionally, institutions with weak policies, procedures, or management teams may be unable to address financial risks. Furthermore, risk may not always be reflected in the current financial condition. Therefore, examiners should not rely solely on an institution's current financial condition when determining capital adequacy and must assess management's ability to identify, measure, monitor, and control all material risks that may affect capital.

Quality of Capital

The composition of and quality of capital are important considerations when assessing capital adequacy. Higher-quality capital that is available to absorb losses on a going-concern basis enhances the institution's resiliency. For instance, all things being equal, voting common equity is higher quality than hybrid capital instruments because voting common equity is available to absorb losses as they occur while hybrid capital instruments have debt-like features that may limit its ability to absorb losses.

Emerging Needs for Additional Capital

Management's ability to address emerging needs for additional capital depends on many factors. A few of these factors include earnings performance and growth plans, the financial capacity of the directorate, and the strength of a holding company. A combination of ratio analysis and examiner judgment is required to evaluate these types of issues. As part of assessing capital adequacy, the impact of growth and strategic objectives should be considered.

Problem Assets

The nature, trend, and volume of problem assets and the adequacy of the ALLL are vital factors in determining capital adequacy. Items to consider include:

- The type and level of problem assets,
- Loan-origination and portfolio-administration activities,
- The level of the ALLL, and
- The institution's methodology for establishing the ALLL level.

Examiners should consider current, and when applicable prior, examination findings when assessing capital adequacy. Examiners should also review Uniform Bank Performance Reports and perform appropriate level and trend analysis. In assessing the ALLL adequacy, examiners should review the institution's ALLL methodology in accordance with outstanding regulatory and accounting pronouncements.

Balance Sheet Composition

The quality, type, and diversification of on- and off-balance sheet items must be considered when reviewing the adequacy of an institution's capital. Risk-weighted capital guidelines and ratios can help examiners determine the adequacy of capital protection, but examiner judgment is required to assess overall capital adequacy. For example, a portfolio of 150 percent risk-weighted HVCRE loans at two different institutions may have different risk characteristics. Additionally, regulatory capital ratios alone do not account for concentration risk, market risk, or risks associated with nontraditional banking activities. Examiner judgment is therefore an integral part of assessing an institution's level of risk and management's ability to adequately manage such risks.

Off-Balance Sheet Risk Exposures

Examiners should consider the risks associated with off-balance sheet activities when evaluating capital. For example, an institution's capital needs can be significantly affected by the volume and nature of activities conducted in a fiduciary capacity. Fiduciary activities, or other nontraditional-banking initiatives, can expose the bank to losses that could affect capital. Similarly, lawsuits against the bank, or other contingent liabilities such as off-balance sheet lending, may indicate a need for greater capital protection and must be carefully reviewed.

Earnings and Dividends

A bank's current and historical earnings record is one of the key elements to consider when assessing capital adequacy. Good earnings performance enables a bank to fund asset growth and remain competitive in the marketplace while at the same time retaining sufficient equity to maintain a strong capital position. The institution's dividend policy is also of importance. Excessive dividends can negate strong earnings performance and result in a weakened capital position, while excessively low dividends may lower the attractiveness of the stock to investors, which can be a detriment should the bank need to raise additional equity. Generally, earnings should first be applied to the elimination of losses and the establishment of necessary reserves and prudent capital levels. Thereafter, dividends can be disbursed in reasonable amounts. Consideration should be given to the extent affiliates rely on or require dividends and other support and the potential impact to the institution's capital position, including in periods of stress.

Asset Growth

Management's ability to adequately plan for and manage growth is important with respect to assessing capital adequacy. A review of past performance and future prospects is a good starting point for this review. The examiner may want to compare asset growth to capital formation during recent periods. The examiner should review the current budget and strategic plan to review growth plans and potential impact to capital adequacy.

Access to Capital Sources

Management's access to capital sources, including existing shareholders and holding company support, is a vital factor in analyzing capital. If management has ample access to capital on reasonable terms, the institution may be able to operate with less capital than an institution without such access. Also, the financial capacity of existing shareholders and strength of a holding company will factor into capital access. If a holding company previously borrowed funds to purchase newly issued stock of a subsidiary bank (a process referred to as double leverage), the holding company may be less able to provide additional capital. The examiner would need to extend beyond standard ratio analysis of the bank to assess management's access to capital sources. For example, examiners can consider current market conditions when assessing the institution's ability to raise capital.

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RATING THE CAPITAL FACTOR

The adequacy of an institution's capital is one of the elements that examiners must determine to arrive at a composite rating in accordance with the Uniform Financial Institutions Rating System. This determination is a judgmental process that requires examiners to consider all of the subjective and objective variables, concepts, and guidelines that have been discussed throughout this section. Ratings are based on a scale of 1 through 5, with a rating of 1 indicating the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile; and the level of least supervisory concern. A 5 rating indicates the most critically deficient level of performance; inadequate risk management practices relative to the institution's size, complexity, and risk profile; and the greatest supervisory concern.

Uniform Financial Institution Rating System

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital. The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of capital and the overall financial condition of the institution.
- The ability of management to address emerging needs for additional capital.
- The nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves.
- Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities.
- Risk exposure represented by off-balance sheet activities.
- The quality and strength of earnings, and the reasonableness of dividends.
- Prospects and plans for growth, as well as past experience in managing growth.
- Access to capital markets and other sources of capital, including support provided by a parent holding company.

Ratings

A rating of 1 indicates a strong capital level relative to the institution's risk profile.

A rating of 2 indicates a satisfactory capital level relative to the financial institution's risk profile.

A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

INTRODUCTION

Asset quality is one of the most critical areas in determining the overall condition of a bank. The primary factor affecting overall asset quality is the quality of the loan portfolio and the credit administration program. Loans typically comprise a majority of a bank's assets and carry the greatest amount of risk to their capital. Securities may also comprise a large portion of the assets and also contain significant risks. Other items which can impact asset quality are other real estate, other assets, off-balance sheet items and, to a lesser extent, cash and due from accounts, and premises and fixed assets.

Management often expends significant time, energy, and resources administering their assets, particularly the loan portfolio. Problems within this portfolio can detract from their ability to successfully and profitably manage other areas of the institution. Examiners should be diligent and focused when reviewing a bank's assets, as they can significantly impact most other facets of bank operations.

EVALUATION OF ASSET QUALITY

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify and manage credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the Allowance for Loan and Lease Losses (ALLL) and weigh the exposure to counter-party, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered.

Prior to assigning an asset quality rating, several factors should be considered. The factors should be reviewed within the context of any local and regional conditions that might impact bank performance. Also, any systemic weaknesses, as opposed to isolated problems, should be given appropriate consideration. The following is not a complete list of all possible factors that may influence an examiner's assessment; however, all assessments should consider the following:

- The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices.
- The level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions.
- The adequacy of the ALLL and other asset valuation reserves.
- The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit.
- The diversification and quality of the loan and investment portfolios.
- The extent of securities underwriting activities and exposure to counter-parties in trading activities.
- The existence of asset concentrations.
- The adequacy of loan and investment policies, procedures, and practices.
- The ability of management to properly administer its assets, including the timely identification and collection of problem assets.
- The adequacy of internal controls and management information systems.
- The volume and nature of credit documentation exceptions.

When assigning component ratings, the above factors, among others, should be evaluated not only according to current adverse classification levels and risk management practices, but also considering any ongoing trends. The same classification levels and management practices might be looked on more or less favorably depending on any improving or deteriorating trends in one or more factors. The examiner should never look at things in a vacuum, instead, noting how the current level or status of each factor relates to previous and expected performance and the performance of other similar institutions.

RATING THE ASSET QUALITY FACTOR

The asset quality rating definitions are applied following a thorough evaluation of existing and potential risks and the mitigation of those risks. The definitions of each rating follow.

A rating of 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset quality in such institutions is of minimal supervisory concern.

A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

A rating of 4 is assigned to financial institutions with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

INTRODUCTION

Section 39 of the Federal Deposit Insurance Act, *Standards for Safety and Soundness,* requires each federal banking agency to establish safety and soundness standards for all insured depository institutions. Appendix A to Part 364 of the FDIC Rules and Regulations, *Interagency Guidelines Establishing Standards for Safety and Soundness,* sets standards that institutions are required to follow/adopt. Operational and managerial standards pertaining to an institution's loan portfolio address areas such as asset quality, internal controls, credit underwriting, and loan documentation. The standards are designed to identify potential safety and soundness concerns and to ensure that action is taken to address those concerns before they pose a risk to the Deposit Insurance Fund.

The examiner's evaluation of an institution's lending policies, credit administration, and the quality of the loan portfolio is among the most important aspects of the examination process. To a great extent, the quality of an institution's loan portfolio determines the risk to depositors and to the FDIC's insurance fund. Conclusions regarding the institution's condition and the quality of its management are weighted heavily by the examiner's findings with regard to lending practices. Emphasis on review and evaluation of the loan portfolio and its administration by institution management during examinations recognizes that loans comprise a major portion of most institutions' assets; and, that it is the asset category which ordinarily presents the greatest credit risk and potential loss exposure to banks. Moreover, pressure for increased profitability, liquidity considerations, and a more complex society produce great innovations in credit instruments and approaches to lending. Loans have consequently become more complex. Examiners therefore find it necessary to devote a large portion of time and attention to loan portfolio examination.

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LOAN ADMINISTRATION

Lending Policies

The examiner's evaluation of the loan portfolio involves much more than merely appraising individual loans. Prudent management and administration of the overall loan account, including establishment of sound lending and collection policies, are of vital importance if the institution is to be continuously operated in an acceptable manner.

Lending policies should be clearly defined and set forth in such a manner as to provide effective supervision by the directors and senior officers. The board of directors of every institution has the legal responsibility to formulate lending policies and to supervise their implementation. Therefore examiners should encourage establishment and maintenance of written, up-to-date lending policies which have been approved by the board of directors. A lending policy should not be a static document, but must be reviewed periodically and revised in light of changing circumstances surrounding the borrowing needs of the institution's customers as well as changes that may occur within the institution itself. To a large extent, the economy of the community served by the institution dictates the composition of the loan portfolio. The widely divergent circumstances of regional economies and the considerable variance in characteristics of individual loans preclude establishment of standard or universal lending policies. There are, however, certain broad areas of consideration and concern that are typically addressed in the lending policies of all banks regardless of size or location. These include the following:

- General fields of lending in which the institution will engage and the kinds or types of loans within each general field;
- Lending authority of each loan officer;
- Lending authority of a loan or executive committee, if any;
- Responsibility of the board of directors in reviewing, ratifying, or approving loans;
- Guidelines under which unsecured loans will be granted;
- Guidelines for rates of interest and the terms of repayment for secured and unsecured loans;
- Limitations on the amount advanced in relation to the value of the collateral and the documentation required by the institution for each type of secured loan;
- Guidelines for obtaining and reviewing real estate appraisals as well as for ordering reappraisals, when needed;
- Maintenance and review of complete and current credit files on each borrower;
- Appropriate collection procedures including, but not limited to, actions to be taken against borrowers who fail to make timely payments;
- Limitations on the maximum volume of loans in relation to total assets;
- Limitations on the extension of credit through overdrafts;
- Description of the institution's normal trade area and circumstances under which the institution may extend credit outside of such area;
- Guidelines that address the goals for portfolio mix and risk diversification and cover the institution's plans for monitoring and taking appropriate corrective action, if deemed necessary, on any concentrations that may exist;

- Guidelines addressing the institution's loan review and grading system ("Watch list");
- Guidelines addressing the institution's review of the Allowance for Loan and Lease Losses (ALLL); and
- Guidelines for adequate safeguards to minimize potential environmental liability.

The above are only guidelines for areas that should be considered during the loan policy evaluation. Examiners should also encourage management to develop specific guidelines for each lending department or function. As with overall lending policies, it is not the FDIC's intent to suggest universal or standard loan policies for specific types of credit. The establishment of these policies is the responsibility of each institution's Board and management. Therefore, the following discussion of basic principles applicable to various types of credit will not include or allude to acceptable ratios, levels, comparisons or terms. These matters should, however, be addressed in each institution's lending policy, and it will be the examiner's responsibility to determine whether the policies are realistic and being followed.

Much of the rest of this section of the Manual discusses areas that should be considered in the institution's lending policies. Guidelines for their consideration are discussed under the appropriate areas.

Loan Review Systems

The terms *loan review system* or *credit risk review system* refer to the responsibilities assigned to various areas such as credit underwriting, loan administration, problem loan workout, or other areas. Responsibilities may include assigning initial credit grades, ensuring grade changes are made when needed, or compiling information necessary to assess the appropriateness of the ALLL.

The complexity and scope of a loan review system will vary based upon an institution's size, type of operations, and management practices. Systems may include components that are independent of the lending function, or may place some reliance on loan officers. Although smaller institutions are not expected to maintain separate loan review departments, it is essential that all institutions have an effective loan review system. Regardless of its complexity, an effective loan review system is generally designed to address the following objectives:

- To promptly identify loans with well-defined credit weaknesses so that timely action can be taken to minimize credit loss;
- To provide essential information for determining the appropriateness of the ALLL;
- To identify relevant trends affecting the collectibility of the loan portfolio and isolate potential problem areas;
- To evaluate the activities of lending personnel;
- To assess the adequacy of, and adherence to, loan policies and procedures, and to monitor compliance with relevant laws and regulations;
- To provide the board of directors and senior management with an objective assessment of the overall portfolio quality; and
- To provide management with information related to credit quality that can be used for financial and regulatory reporting purposes.

Credit Risk Rating or Grading Systems

Accurate and timely credit grading is a primary component of an effective loan review system. Credit grading involves an assessment of credit quality, the identification of problem loans, and the assignment of risk ratings. An effective system provides information for use in establishing an allowance for specific credits and for the determination of an overall ALLL level.

Credit grading systems often place primary reliance on loan officers for identifying emerging credit problems. However, given the importance and subjective nature of credit grading, a loan officer's judgement regarding the assignment of a particular credit grade should generally be subject to review. Reviews may be performed by peers, superiors, loan committee(s), or other internal or external credit review specialists. Credit grading reviews performed by individuals independent of the lending function are preferred because they can often provide a more objective assessment of credit quality. A loan review system typically includes the following:

- A formal credit grading system that can be reconciled with the framework used by Federal regulatory agencies;
- An identification of loans or loan pools that warrant special attention;
- A mechanism for reporting identified loans, and any corrective action taken, to senior management and the board of directors; and
- Documentation of an institution's credit loss experience for various components of the loan and lease portfolio.

Loan Review System Elements

Loan review policies are typically reviewed and approved at least annually by the board of directors. Policy guidelines include a written description of the overall credit grading process, and establish responsibilities for the various loan review functions. The policy generally addresses the following items:

- Qualifications of loan review personnel;
- Independence of loan review personnel;
- Frequency of reviews;
- Scope of reviews;
- Depth of reviews;
- Review of findings and follow-up; and
- Workpaper and report distribution.

Qualifications of Loan Review Personnel

Personnel to involve in the loan review function are qualified based on level of education, experience, and extent of formal training. They are knowledgeable of both sound lending practices and their own institution's specific lending guidelines. In addition, they are knowledgeable of pertinent laws and regulations that affect lending activities.

Loan Review Personnel Independence

Loan officers are generally responsible for ongoing credit analysis and the prompt identification of emerging problems. Because of their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid over reliance upon loan officers. To avoid conflicts of interest, management typically ensures that, when feasible, all significant loans are reviewed by individuals that are not part of, or influenced by anyone associated with, the loan approval process.

Larger institutions typically establish separate loan review departments staffed by independent credit analysts. Cost and volume considerations may not justify such a system in smaller institutions. Often, members of senior management that are independent of the credit administration process, a committee of outside directors, or an outside loan review consultant fill this role. Regardless of the method used, loan review personnel should report their findings directly to the board of directors or a board committee.

Frequency of Reviews

The loan review function provides feedback on the effectiveness of the lending process in identifying emerging problems. Reviews of significant credits are generally performed annually, upon renewal, or more frequently when factors indicate a potential for deteriorating credit quality. A system of periodic reviews is particularly important to the ALLL determination process.

Scope of Reviews

Reviews typically cover all loans that are considered significant. In addition to loans over a predetermined size, management will normally review smaller loans that present elevated risk characteristics such as credits that are delinquent, on nonaccrual status, restructured as a troubled debt, previously classified, or designated as Special Mention. Additionally, management may wish to periodically review insider loans, recently renewed credits, or loans affected by common repayment factors. The percentage of the portfolio selected for review should provide reasonable assurance that all major credit risks have been identified.

Depth of Reviews

Loan reviews typically analyze a number of important credit factors, including:

- Credit quality;
- Sufficiency of credit and collateral documentation;
- Proper lien perfection;
- Proper loan approval;
- Adherence to loan covenants;
- Compliance with internal policies and procedures, and applicable laws and regulations; and
- The accuracy and timeliness of credit grades assigned by loan officers.

Review of Findings and Follow-up

Loan review findings should be reviewed with appropriate loan officers, department managers, and members of senior management. Typically, any existing or planned corrective action (including estimated timeframes) is obtained for all noted deficiencies, with those deficiencies that remain unresolved reported to senior management and the board of directors.

Workpaper and Report Distribution

A list of the loans reviewed, including the review date, and documentation supporting assigned ratings is commonly prepared. A report that summarizes the results of the review is typically submitted to the board at least quarterly. Findings usually address adherence to internal policies and procedures, and applicable laws and regulations, so that deficiencies can be remedied in a timely manner. Examiners should review the written response from management in response to any substantive criticisms or recommendations and assess corrective actions taken.

Allowance for Loan and Lease Losses (ALLL)

Each institution must maintain an ALLL that is appropriate to absorb estimated credit losses associated with the held for investment loan and lease portfolio, i.e., loans and leases that the institution has the intent and ability to hold for the foreseeable future or until maturity or payoff. Each institution should also maintain, as a separate liability account, an allowance sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as loan commitments, standby letters of credit, and guarantees. This separate liability account for estimated credit losses on off-balance sheet credit exposures should not be reported as part of the ALLL on an institution's balance sheet. Loans and leases held for sale are carried on the balance sheet at the lower of cost or fair value, with a separate valuation allowance. This separate valuation allowance should not be included as part of the ALLL and accordingly regulatory capital.

The term "estimated credit losses" means an estimate of the current amount of the loan and lease portfolio (net of unearned income) that is not likely to be collected; that is, net charge-offs that are likely to be realized for a loan, or pool of loans. The estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in generally accepted accounting principles (U.S. GAAP). When available information confirms specific loans and leases, or portions thereof, to be uncollectible, these amounts should be promptly charged-off against the ALLL.

Estimated credit losses should reflect consideration of all significant factors that affect repayment as of the evaluation date. Estimated losses on loan pools should reflect historical net charge-off levels for similar loans, adjusted for changes in current conditions or other relevant factors. Calculation of historical charge-off rates can range from a simple average of net charge-offs over a relevant period, to more complex techniques, such as migration analysis.

Portions of the ALLL can be attributed to, or based upon the risks associated with, individual loans or groups of loans. However, the ALLL is available to absorb credit losses that arise from the entire portfolio. It is not segregated for any particular loan, or group of loans.

Responsibility of the Board and Management

It is the responsibility of the board of directors and management to maintain the ALLL at an appropriate level. The allowance should be evaluated, and appropriate provisions made, at least quarterly. In carrying out their responsibilities, the board and management are expected to:

- Establish and maintain a loan review system that identifies, monitors, and addresses asset quality problems in a timely manner.
- Ensure the prompt charge-off of loans, or portions of loans, deemed uncollectible.
- Ensure that the process for determining an appropriate allowance level is based on comprehensive, adequately documented, and consistently applied analysis.

For purposes of Reports of Condition and Income (Call Reports) an appropriate ALLL for loans held for investment should consist of the following items:

- The amount of allowance related to loans individually evaluated and determined to be impaired under ASC (Accounting Standards Codification) Subtopic 310-10, *Receivables - Overall*.
- The amount of allowance related to loans that were individually evaluated for impairment and determined not to be impaired, as well as other loans collectively evaluated under ASC Subtopic 450-20, *Contingencies – Loss Contingencies*.
- The amount of allowance related to loans evaluated under ASC Subtopic 310-30, *Receivables –Loans and Debt Securities Acquired with Deteriorated Credit Quality*.
- The amount of allowance related to international transfer risk associated with its cross-border lending exposure.

Furthermore, management's analysis of an appropriate allowance level requires significant judgement in determining estimates of credit losses. An institution may support its estimate through qualitative factors that adjust historical loss rates or an unallocated portion that can be supported through a similar analysis.

When determining an appropriate allowance, primary reliance should normally be placed on analysis of the various components of a portfolio, including all significant credits reviewed on an individual basis. Examiners should refer to ASC Subtopic 310-10 for guidance in establishing an allowance for individually evaluated loans determined to be impaired and measured under that standard. When analyzing the appropriateness of an allowance, portfolios evaluated collectively should group loans with similar characteristics, such as risk classification, past due status, type of loan, industry, or collateral. A depository institution may, for example, analyze the following groups of loans and provide for them in the ALLL:

- Significant credits reviewed on an individual basis (i.e., impaired loans);

- Loans and leases that are not reviewed individually, but which present elevated risk characteristics, such as delinquency, adverse classification, or Special Mention designation;
- Homogenous loans that are not reviewed individually, and do not present elevated risk characteristics; and
- All other loans that have not been considered or provided for elsewhere.

In addition to estimated credit losses, the losses that arise from the transfer risk associated with an institution's cross-border lending activities require special consideration. Over and above any minimum amount that is required by the Interagency Country Exposure Review Committee to be provided in the Allocated Transfer Reserve (or charged to the ALLL), an institution must determine if their ALLL is appropriate to absorb estimated losses from transfer risk associated with its cross-border lending exposure.

Factors to Consider in Estimating Credit Losses

Estimated credit losses should reflect consideration of all significant factors that affect the portfolio's collectibility as of the evaluation date. While historical loss experience provides a reasonable starting point, historical losses, or even recent trends in losses, are not by themselves, a sufficient basis to determine an appropriate ALLL level. Management should also consider any relevant qualitative factors that are likely to cause estimated losses to differ from historical loss experience such as:

- Changes in lending policies and procedures, including underwriting, collection, charge-off and recovery practices;
- Changes in local and national economic and business conditions;
- Changes in the volume or type of credit extended;
- Changes in the experience, ability, and depth of lending management;
- Changes in the volume and severity of past due, nonaccrual, troubled debt restructurings, or classified loans;
- Changes in the quality of an institution's loan review system or the degree of oversight by the board of directors; and,
- The existence of, or changes in the level of, any concentrations of credit.

Institutions are also encouraged to use ratio analysis as a supplemental check for evaluating the overall reasonableness of an ALLL. Ratio analysis can be useful in identifying trends in the relationship of the ALLL to classified and nonclassified credits, to past due and nonaccrual loans, to total loans and leases and binding commitments, and to historical charge-off levels. However, while such comparisons can be helpful as a supplemental check of the reasonableness of management's assumptions and analysis, they are not, by themselves, a sufficient basis for determining an appropriate ALLL. Such comparisons do not eliminate the need for a comprehensive analysis and documentation of the loan and lease portfolio and the factors affecting its collectibility.

Examiner Responsibilities

Generally, following the quality assessment of the loan and lease portfolio, the loan review system, and the lending policies, examiners are responsible for assessing the appropriateness of the ALLL. Examiners should consider all significant factors that affect the collectibility of the portfolio. Examination procedures for reviewing the appropriateness of the ALLL are included in the Examination Documentation (ED) Modules.

In assessing the overall appropriateness of an ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of judgement. Credit loss estimates will not be precise due to the wide range of factors that must be considered. Furthermore, the ability to estimate credit losses on specific loans and categories of loans should improve over time. Therefore, examiners will generally accept management's estimates of credit losses in their assessment of the overall appropriateness of the ALLL when management has:

- Maintained effective systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner;
- Analyzed all significant factors that affect the collectibility of the portfolio; and
- Established an acceptable ALLL evaluation process that meets the objectives for an appropriate ALLL.

If, after the completion of all aspects of the ALLL review described in this section, the examiner does not concur that the reported ALLL level is appropriate, or the ALLL evaluation process is deficient, recommendations for correcting these problems, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the Report of Examination.

Regulatory Reporting of the ALLL

An ALLL established in accordance with the guidelines provided above should fall within a range of acceptable estimates. When an ALLL is not deemed at an appropriate level, management will be required to increase the provision for loan and lease loss expense sufficiently to restore the ALLL reported in its Call Report to an appropriate level.

Accounting and Reporting Treatment

ASC Subtopic 450-20 provides the basic guidance for recognition of a loss from a contingency that should be accrued through a charge to income (i.e., a provision expense) when available information indicates that it is probable the asset has been impaired and the amount is reasonably estimated. ASC Subtopic 310-10 provides specific guidance about the measurement and disclosure for loans individually evaluated and determined to be impaired. Loans are considered to be impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement. This would generally include all loans restructured as a troubled debt and nonaccrual loans.

For individually impaired loans, ASC Subtopic 310-10 provides guidance on the acceptable methods to measure impairment. Specifically, this standard states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price. However, the Call Report instructions require an institution to use the fair value of the collateral in its determination of impairment for all impaired collateral dependent loans. When developing the estimate of expected future cash flows for a loan, an institution should consider all available information reflecting past events and current conditions, including the effect of existing qualitative factors.

Large groups of smaller-balance homogenous loans are *not* included in the scope of ASC Subtopic 310-10, unless the loan is a troubled debt restructuring. Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. Examiners should refer to ASC Subtopic 450-20 for loans collectively evaluated for impairment, as well as individual loans that are identified for evaluation on an individual basis and determined not to be impaired.

Institutions should not layer their loan loss allowances. Layering is the inappropriate practice of recording estimates in the ALLL for the same loan under the different accounting standards. Layering can happen when an institution measures impairment on an individually impaired loan and includes that same loan in its estimate of loan losses on a collective basis, thereby estimating the loan loss for the same loan twice.

While different institutions may use different methods, there are certain common elements that should be included in any ALLL methodology. Generally, an institution's methodology should:

- Include a detailed loan portfolio analysis, performed regularly;
- Consider all loans (whether on an individual or group basis);
- Identify loans to be evaluated for impairment on an individual basis under ASC Subtopic 310-10; loans evaluated under ASC Subtopic 310-30; and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under ASC Subtopic 450-20;
- Consider all known relevant internal and external factors that may affect loan collectibility;
- Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
- Consider the particular risks inherent in different kinds of lending;
- Consider current collateral values (less costs to sell), where applicable;
- Require that analyses, estimates, reviews and other ALLL methodology functions be performed by competent and well-trained personnel;
- Be based on current and reliable data;
- Be well-documented, in writing, with clear explanations of the supporting analyses and rationale; and,
- Include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with U.S. GAAP.

A systematic methodology that is properly designed and implemented should result in an institution's best estimate of the ALLL. Accordingly, institutions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.

Examiners are encouraged, with the acknowledgement of management, to communicate with an institution's external auditors and request an explanation of their rationale and findings, when differences in judgment concerning the appropriateness of the institution's ALLL exist. In case of controversy, an institution and its auditor may be reminded when an institution's supervisory agency's interpretation on how U.S. GAAP should be applied to a specified event or transaction (or series of related events or transactions) differs from the institution's interpretation, the supervisory agency may require the institution to reflect the event(s) or transaction(s) in its Call Report in accordance with the agency's interpretation and to amend previously submitted reports.

Additional information on the documentation of the ALLL, including its methodology, and the establishment of loan review systems is provided in the Interagency Statement of Policy on the Allowance for Loan and Lease Losses, (including frequently asked questions) dated December 13, 2006, and the Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations, dated July 2, 2001.

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PORTFOLIO COMPOSITION

Commercial Loans

General

Loans to business enterprises for commercial or industrial purposes, whether proprietorships, partnerships or corporations, are commonly described as commercial loans. In asset distribution, commercial or business loans frequently comprise one of the most important assets of an institution. They may be secured or unsecured and have short or long-term maturities. Such loans include working capital advances, term loans and loans to individuals for business purposes.

Short-term working capital and seasonal loans provide temporary capital in excess of normal needs. They are used to finance seasonal requirements and are repaid at the end of the cycle by converting inventory and accounts receivable into cash. Such loans may be unsecured; however, many working capital loans are advanced with accounts receivable and/or inventory as collateral. Firms engaged in manufacturing, distribution, retailing and service-oriented businesses use short-term working capital loans.

Term business loans have assumed increasing importance. Such loans normally are granted for the purpose of acquiring capital assets, such as plant and equipment. Term loans may involve a greater risk than do short-term advances, because of the length of time the credit is outstanding. Because of the potential for greater risk, term loans are usually secured and generally require regular amortization. Loan agreements on such credits may contain restrictive covenants during the life of the loan. In some instances, term loans may be used as a means of liquidating, over a period of time, the accumulated and unpaid balance of credits originally advanced for seasonal needs. While such loans may reflect a borrower's past operational problems, they may well prove to be the most viable means of salvaging a problem situation and effecting orderly debt collection.

Commercial lending policies generally address acquisition of credit information, such as property, operating and cash flow statements; factors that might determine the need for collateral acquisition; acceptable collateral margins; perfecting liens on collateral; lending terms, and charge-offs.

Accounts Receivable Financing

Accounts receivable financing is a specialized area of commercial lending in which borrowers assign their interests in accounts receivable to the lender as collateral. Typical characteristics of accounts receivable borrowers are those businesses that are growing rapidly and need year-round financing in amounts too large to justify unsecured credit, those that are nonseasonal and need year-round financing because working capital and profits are insufficient to permit periodic cleanups, those whose working capital is inadequate for the volume of sales and type of operation, and those whose previous unsecured borrowings are no longer warranted because of various credit factors.

Several advantages of accounts receivable financing from the borrower's viewpoint are: it is an efficient way to finance an expanding operation because borrowing capacity expands as sales increase; it permits the borrower to take advantage of purchase discounts because the company receives immediate cash on its sales and is able to pay trade creditors on a satisfactory basis; it insures a revolving, expanding line of credit; and actual interest paid may be no more than that for a fixed amount unsecured loan.

Advantages from the institution's viewpoint are: it generates a relatively high yield loan, new business, and a depository relationship; permits continuing banking relationships with long-standing customers whose financial conditions no longer warrant unsecured credit; and minimizes potential loss when the loan is geared to a percentage of the accounts receivable collateral. Although accounts receivable loans are collateralized, it is important to analyze the borrower's financial statements. Even if the collateral is of good quality and in excess of the loan, the borrower must demonstrate financial progress. Full repayment through collateral liquidation is normally a solution of last resort.

Institutions use two basic methods to make accounts receivable advances. First, blanket assignment, wherein the borrower periodically informs the institution of the amount of receivables outstanding on its books. Based on this information, the institution advances the agreed percentage of the outstanding receivables. The receivables are usually pledged on a non-notification basis and payments on receivables are made directly to the borrower who then remits them to the institution. The institution applies all or a portion of such funds to the borrower's loan. Second, ledgering the accounts, wherein the lender receives duplicate copies of the invoices together with the shipping documents and/or delivery receipts. Upon receipt of satisfactory information, the institution advances the agreed percentage of the outstanding receivables. The receivables are usually pledged on a notification basis. Under this method, the institution maintains complete control of the funds paid on all accounts pledged by requiring the borrower's customer to remit directly to the institution.

In the area of accounts receivable financing, an institution's lending policy typically addresses the acquisition of credit information such as property, operating and cash flow statements. It also typically addresses maintenance of an accounts receivable loan agreement that establishes a percentage advance against acceptable receivables, a maximum dollar amount due from any one account debtor, financial strength of debtor accounts, insurance that "acceptable receivables" are defined in light of the turnover of receivables pledged, aging of accounts receivable, and concentrations of debtor accounts.

Leveraged Lending

The Federal institution regulatory agencies initially issued guidance on April 9, 2001, concerning sound risk management practices for institutions engaged in leveraged financing. In light of the developments and experience gained since the initial guidance was issued, the Federal institution regulatory agencies issued new Interagency Guidance on Leveraged Lending on May 21, 2013, to update and replace the 2001 guidance. Examiners should also review the related Frequently Asked Questions (FAQ) issued on November 7, 2014.

Applicability

A financial institution’s risk management practices should be consistent with the size and risk profile of its leveraged activities relative to its assets, earnings, liquidity, and capital. Institutions that originate or sponsor leveraged transactions can refer to the guidance for suggestions about sound risk management principles.

The agencies do not intend for a financial institution that originates a small number of less complex, leveraged loans to have policies and procedures commensurate with a larger, more complex leveraged loan origination business. However, any financial institution that participates in leveraged lending transactions may refer to and consider supervisory guidance provided in the “Participations Purchased” section of the guidance.

General

Leveraged lending is an important type of financing for national and global economies, and the U.S. financial industry plays an integral role in making credit available and syndicating that credit to investors. In particular, financial institutions should ensure they do not unnecessarily heighten risks by originating poorly underwritten loans. For example, a poorly underwritten leveraged loan that is pooled with other loans or is participated with other institutions may generate risks for the financial system.

Numerous definitions of leveraged lending exist throughout the financial services industry and commonly contain some combination of the following:

- Proceeds used for buyouts, acquisitions, or capital distributions.
- Transactions where the borrower’s Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt divided by EBITDA exceed 4.0X EBITDA or 3.0X EBITDA, respectively, or other defined levels appropriate to the industry or sector.
- A borrower recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio.
- Transactions when the borrower’s post-financing leverage, as measured by its leverage ratios (for example, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors), significantly exceeds industry norms or historical levels.

A financial institution engaging in leveraged lending typically defines the activity within its policies and procedures in a manner sufficiently detailed to ensure consistent application across all business lines. An appropriate definition describes clearly the purposes and financial characteristics common to these transactions, and covers risk from both direct exposure and indirect exposure via limited recourse financing secured by leveraged loans, or financing extended to financial intermediaries (such as conduits and special purpose entities (SPEs)) that hold leveraged loans.

In general, supervisory expectations for sound risk management of leveraged lending activities places importance on institutions developing and maintaining the following:

- Transactions structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with supportable performance projections, these elements of a safe-and-sound loan structure should clearly support a borrower's capacity to repay and to de-lever to a sustainable level over a reasonable period, whether underwritten to hold or distribute;
- A definition of leveraged lending that facilitates consistent application across all business lines;
- Well-defined underwriting standards that, among other things, define acceptable leverage levels and describe amortization expectations for senior and subordinate debt;
- A credit limit and concentration framework consistent with the institution's risk appetite;
- Sound Management Information Systems (MIS) that enable management to identify, aggregate, and monitor leveraged exposures and comply with policy across all business lines;
- Strong pipeline management policies and procedures that, among other things, provide for real-time information on exposures and limits, and exceptions to the timing of expected distributions and approved hold levels; and,
- Guidelines for conducting periodic portfolio and pipeline stress tests to quantify the potential impact of economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.

Risk Management Framework

Given the high-risk profile of leveraged transactions, prudent financial institutions engaged in leveraged lending adopt a risk management framework that has an intensive and frequent review and monitoring process. The framework has as its foundation written risk objectives, risk acceptance criteria, and risk controls. A lack of robust risk management processes and controls at a financial institution with significant leveraged lending activities could contribute to supervisory findings that the financial institution is engaged in unsafe-and-unsound banking practices.

General Policy Expectations

A financial institution's credit policies and procedures for leveraged lending generally address the following:

- Identification of the financial institution's risk appetite including clearly defined amounts of leveraged lending that the institution is willing to underwrite (for example, pipeline limits) and is willing to retain (for example, transaction and aggregate hold levels). The designated risk appetite is commonly supported by an analysis of the potential effect on earnings, capital, liquidity, and other risks that result from these positions, and is approved by the board of directors;
- A limit framework that includes limits or guidelines for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure, and industry and geographic concentrations. This limit framework identifies the related management approval authorities and exception tracking provisions. In addition to notional pipeline limits, financial institutions with significant leveraged transactions implement underwriting limit frameworks that assess stress losses, flex terms, economic capital usage, and earnings at risk or that otherwise provide a more nuanced view of potential risk;
- Procedures for ensuring the risks of leveraged lending activities are appropriately reflected in an institution's allowance for loan and lease losses (ALLL) and capital adequacy analyses;
- Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms;
- Guidelines for appropriate oversight by senior management, including adequate and timely reporting to the board of directors;
- Expected risk-adjusted returns for leveraged transactions;
- Minimum underwriting standards (see "Underwriting Standards" section below); and,
- Effective underwriting practices for primary loan origination and secondary loan acquisition.

Participations Purchased

Financial institutions purchasing participations and assignments in leveraged lending transactions should make a thorough, independent evaluation of the transaction and the risks involved before committing any funds. They should apply the same standards of prudence, credit assessment and approval criteria, and in-house limits that would be employed if the purchasing organization were originating the loan. Policies typically include requirements for:

- Obtaining and independently analyzing full credit information both before the participation is purchased and on a timely basis thereafter;
- Obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, Uniform Commercial Code (UCC) searches, and other relevant documents;
- Carefully monitoring the borrower's performance throughout the life of the loan; and,

- Establishing appropriate risk management guidelines as described in this document.

Underwriting Standards

A financial institution's underwriting standards should be clear, written and measurable, and should accurately reflect the institution's risk appetite for leveraged lending transactions. A financial institution should have clear underwriting limits regarding leveraged transactions, including the size that the institution will arrange both individually and in the aggregate for distribution. The originating institution should be mindful of reputational risks associated with poorly underwritten transactions, as these risks may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy. An institution's underwriting standards typically consider the following:

- Whether the business premise for each transaction is sound and the borrower's capital structure is sustainable regardless of whether the transaction is underwritten for the institution's own portfolio or with the intent to distribute.
- A borrower's capacity to repay and ability to de-lever to a sustainable level over a reasonable period.
- Expectations for the depth and breadth of due diligence on leveraged transactions.
- Standards for evaluating expected risk-adjusted returns.
- The degree of reliance on enterprise value and other intangible assets for loan repayment, along with acceptable valuation methodologies, and guidelines for the frequency of periodic reviews of those values;
- Expectations for the degree of support provided by the sponsor (if any), taking into consideration the sponsor's financial capacity, the extent of its capital contribution at inception, and other motivating factors.
- Whether credit agreement terms allow for the material dilution, sale, or exchange of collateral or cash flow-producing assets without lender approval;
- Credit agreement covenant protections, including financial performance (such as debt-to-cash flow, interest coverage, or fixed charge coverage), reporting requirements, and compliance monitoring.
- Collateral requirements in credit agreements that specify acceptable collateral and risk-appropriate measures and controls, including acceptable collateral types, loan-to-value guidelines, and appropriate collateral valuation methodologies. Standards for asset-based loans that are part of the entire debt structure also should outline expectations for the use of collateral controls (for example, inspections, independent valuations, and payment lockbox), other types of collateral and account maintenance agreements, and periodic reporting requirements; and,
- Whether loan agreements provide for distribution of ongoing financial and other relevant credit information to all participants and investors.

Credit Analysis

Effective underwriting and management of leveraged lending risk is highly dependent on the quality of analysis employed during the approval process as well as ongoing monitoring. An institution's analysis of leveraged lending transactions typically ensures that:

- Cash flow analyses do not rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;
- Liquidity analyses include performance metrics appropriate for the borrower's industry; predictability of the borrower's cash flow; measurement of the borrower's operating cash needs; and ability to meet debt maturities;
- Projections exhibit an adequate margin for unanticipated merger-related integration costs;
- Projections are stress tested for one or two downside scenarios, including a covenant breach;
- Transactions are reviewed at least quarterly to determine variance from plan, the related risk implications, and the accuracy of risk ratings and accrual status;
- Enterprise and collateral valuations are independently derived or validated outside of the origination function, are timely, and consider potential value erosion;
- Collateral liquidation and asset sale estimates are based on current market conditions and trends;
- Potential collateral shortfalls are identified and factored into risk rating and accrual decisions;
- Contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or the issuance of new equity; and
- The borrower is adequately protected from interest rate and foreign exchange risk.

Valuation Standards

Institutions often rely on enterprise value and other intangibles when (1) evaluating the feasibility of a loan request; (2) determining the debt reduction potential of planned asset sales; (3) assessing a borrower's ability to access the capital markets; and, (4) estimating the strength of a secondary source of repayment. Institutions may also view enterprise value as a useful benchmark for assessing a sponsor's economic incentive to provide financial support. Given the specialized knowledge needed for the development of a credible enterprise valuation and the importance of enterprise valuations in the underwriting and ongoing risk assessment processes, enterprise valuations should be performed by qualified persons independent of an institution's origination function.

There are several methods used for valuing businesses. The most common valuation methods are assets, income, and market. Asset valuation methods consider an enterprise's underlying assets in terms of its net going-concern or liquidation value. Income valuation methods consider an enterprise's ongoing cash flows or earnings and apply appropriate capitalization or discounting techniques. Market valuation methods derive value multiples from comparable company data or sales transactions. However, final value estimates should be based on the method or methods that give supportable and credible results. In many cases, the income method is generally considered the most reliable.

There are two common approaches employed when using the income method. The "capitalized cash flow" method determines the value of a company as the present value of all future cash flows the business can generate in perpetuity. An appropriate cash flow is determined and then divided by a risk-adjusted capitalization rate, most commonly the weighted average cost of capital. This method is most appropriate when cash flows are predictable and stable. The "discounted cash flow" method is a multiple-period valuation model that converts a future series of cash flows into current value by discounting those cash flows at a rate of return (referred to as the "discount rate") that reflects the risk inherent therein. This method is most appropriate when future cash flows are cyclical or variable over time. Both income methods involve numerous assumptions, and therefore, supporting documentation should fully explain the evaluator's reasoning and conclusions.

When a borrower is experiencing a financial downturn or facing adverse market conditions, a prudent lender will reflect those adverse conditions in its assumptions for key variables such as cash flow, earnings, and sales multiples when assessing enterprise value as a potential source of repayment. Changes in the value of a borrower's assets are typically tested under a range of stress scenarios, including business conditions more adverse than the base case scenario. Stress tests of enterprise values and their underlying assumptions are generally conducted and documented at origination of the transaction and periodically thereafter, incorporating the actual performance of the borrower and any adjustments to projections. Prudent institutions perform their own discounted cash flow analysis to validate the enterprise value implied by proxy measures such as multiples of cash flow, earnings, or sales.

Enterprise value estimates derived from even the most rigorous procedures are imprecise and ultimately may not be realized. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral typically have policies that provide for appropriate loan-to-value ratios, discount rates, and collateral margins. Based on the nature of an institution's leveraged lending activities, the prudent institution establishes limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value. Regardless of the methodology used, the assumptions underlying enterprise-value estimates typically are clearly documented, well supported, and understood by the institution's appropriate decision-makers and risk oversight units. Further, an institution's valuation methods are appropriate for the borrower's industry and condition.

Risk Rating Leveraged Loans

The risk rating of leveraged loans involves the use of realistic repayment assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period of time. For example, supervisors commonly assume that the ability to fully amortize senior secured debt or the ability to repay at least 50 percent of total debt over a five-to-seven year period provides evidence of adequate repayment capacity. If the projected capacity to pay down debt from cash flow is nominal with refinancing the only viable option, the credit will usually be adversely rated even if it has been recently underwritten. In cases when leveraged loan transactions have no reasonable or realistic prospects to de-lever, a Substandard rating is likely. Furthermore, when assessing debt service capacity, extensions and restructures should be scrutinized to ensure that the institution is not merely masking repayment capacity problems by extending or restructuring the loan.

If the primary source of repayment becomes inadequate, it would generally be inappropriate for an institution to consider enterprise value as a secondary source of repayment unless that value is well supported. Evidence of well-supported value may include binding purchase and sale agreements with qualified third parties or thorough asset valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, when a portion of the loan may not be protected by pledged assets or a well-supported enterprise value, examiners generally will rate that portion Doubtful or Loss and place the loan on nonaccrual status.

Risks in leveraged lending activities are considered in the ALLL and capital adequacy analysis. For allowance purposes, leverage exposures should be taken into account either through analysis of the estimated credit losses from the discrete portfolio or as part of an overall analysis of the portfolio utilizing the institution's internal risk grades or other factors. At the transaction level, exposures heavily reliant on enterprise value as a secondary source of repayment should be scrutinized to determine the need for and adequacy of specific allocations.

Problem Credit Management

Individual action plans are typically formulated by management when working with borrowers experiencing diminished operating cash flows, depreciated collateral values, or other significant plan variances. Weak initial underwriting of transactions, coupled with poor structure and limited covenants, may make problem credit discussions and eventual restructurings more difficult for an institution as well as result in less favorable outcomes.

A financial institution generally formulates credit policies that define expectations for the management of adversely rated and other high-risk borrowers whose performance departs significantly from planned cash flows, asset sales, collateral values, or other important targets. These policies should stress the need for workout plans that contain quantifiable objectives and measureable time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale of the credit in the secondary market, or liquidation of collateral. Problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

Reporting and Analytics

Diligent financial institutions regularly monitor higher risk credits, including leveraged loans. Monitoring includes management's review of comprehensive reports about the characteristics and trends in such exposures at least quarterly, with summaries provided to the board of directors. Policies and procedures typically identify the fields to be populated and captured by a financial institution's MIS, which then yields accurate and timely reporting to management and the board of directors that may include the following:

- Individual and portfolio exposures within and across all business lines and legal vehicles, including the pipeline;
- Risk rating distribution and migration analysis, including maintenance of a list of those borrowers who have been removed from the leveraged portfolio due to improvements in their financial characteristics and overall risk profile;
- Industry mix and maturity profile;
- Metrics derived from probabilities of default and loss given default;
- Portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, non-performing amounts, and charge-offs;
- Amount of impaired assets and the nature of impairment, and the amount of the ALLL attributable to leveraged lending;
- The aggregate level of policy exceptions and the performance of that portfolio;
- Exposures by collateral type, including unsecured transactions and those where enterprise value will be the source of repayment for leveraged loans. Reporting should also consider the implications of defaults that trigger pari passu treatment for all lenders and, thus, dilute the secondary support from the sale of collateral;
- Secondary market pricing data and trading volume, when available;
- Exposures and performance by deal sponsors. Deals introduced by sponsors may, in some cases, be considered exposure to related borrowers. An institution should identify, aggregate, and monitor potential related exposures;
- Gross and net exposures, hedge counterparty concentrations, and policy exceptions;
- Actual versus projected distribution of the syndicated pipeline, with regular reports of excess levels over the hold targets for the syndication inventory. Pipeline definitions should clearly identify the type of exposure. This includes committed exposures that have not been accepted by the borrower, commitments accepted but not closed, and funded and unfunded commitments that have closed but have not been distributed;
- Total and segmented leveraged lending exposures, including subordinated debt and equity holdings, alongside established limits. Reports should provide a detailed and comprehensive view of global exposures, including situations when an institution has indirect exposure to an obligor or is holding a previously sold position as collateral or as a reference asset in a derivative;
- Borrower and counterparty leveraged lending reporting should consider exposures booked in other business units throughout the institution, including indirect exposures such as default swaps and total return swaps, naming the distributed paper as a covered or referenced asset or collateral exposure through repo transactions. Additionally, the institution should consider positions in the held for sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its subsidiaries or affiliates.

Deal Sponsors

A financial institution that relies on sponsor support as a secondary source of repayment typically develops guidelines for evaluating the qualifications of financial sponsors and implements processes to regularly monitor a sponsor's financial condition. Deal sponsors may provide valuable support to borrowers such as strategic planning, management, and other tangible and intangible benefits. Sponsors may also provide sources of financial support for borrowers that fail to achieve projections. Generally, a financial institution rates a borrower based on an analysis of the borrower's standalone financial condition. However, a financial institution may consider support from a sponsor in assigning internal risk ratings when the institution can document the sponsor's history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. However, even with documented capacity and a history of support, the sponsor's potential contributions may not mitigate supervisory concerns absent a documented commitment of continued support. An evaluation of a sponsor's financial support typically includes the following:

- The sponsor's historical performance in supporting its investments, financially and otherwise;
- The sponsor's economic incentive to support, including the nature and amount of capital contributed at inception;
- Documentation of degree of support (for example, a guarantee, comfort letter, or verbal assurance);
- Consideration of the sponsor's contractual investment limitations;
- To the extent feasible, a periodic review of the sponsor's financial statements and trends, and an analysis of its liquidity, including the ability to fund multiple deals;
- Consideration of the sponsor's dividend and capital contribution practices;
- The likelihood of the sponsor supporting a particular borrower compared to other deals in the sponsor's portfolio; and,
- Guidelines for evaluating the qualifications of a sponsor and a process to regularly monitor the sponsor's performance.

Independent Credit Review

A financial institution with a strong and independent credit review function demonstrates the ability to identify portfolio risks and documented authority to escalate inappropriate risks and other findings to their senior management. Due to the elevated risks inherent in leveraged lending, and depending on the relative size of a financial institution's leveraged lending business, there is greater importance for the institution's credit review function to assess the performance of the leveraged portfolio more frequently and in greater depth than other segments in the loan portfolio. To be most effective, such assessments should be performed by individuals with the expertise and experience for these types of loans and the borrower's industry. Portfolio reviews should generally be conducted at least annually. For many financial institutions, the risk characteristics of leveraged portfolios, such as high reliance on enterprise value, concentrations, adverse risk rating trends, or portfolio performance, may dictate more frequent reviews.

A financial institution that staffs its internal credit review function appropriately and ensures that the function has sufficient resources is most capable of providing timely, independent, and accurate assessments of leveraged lending transactions. Effective reviews evaluate the level of risk, risk rating integrity, valuation methodologies, and the quality of risk management. Such internal credit reviews that review the institution's leveraged lending practices, policies, and procedures provide management with a complete assessment of the leveraged lending program.

Stress Testing

A financial institution typically develops and implements guidelines for conducting periodic portfolio stress tests on loans originated to hold as well as loans originated to distribute, and sensitivity analyses to quantify the potential impact of changing economic and market conditions on its asset quality, earnings, liquidity, and capital. The sophistication of stress-testing practices and sensitivity analyses are most effective when they are consistent with the size, complexity, and risk characteristics of the institution's leveraged loan portfolio. To the extent a financial institution is required to conduct enterprise-wide stress tests, the leveraged portfolio should be included in any such tests.

Conflicts of Interest

A financial institution typically develops appropriate policies and procedures to address and to prevent potential conflicts of interest when it has both equity and lending positions. For example, an institution may be reluctant to use an aggressive collection strategy with a problem borrower because of the potential impact on the value of an institution's equity interest. A financial institution may encounter pressure to provide financial or other privileged client information that could benefit an affiliated equity investor. Such conflicts also may occur when the underwriting financial institution serves as financial advisor to the seller and simultaneously offers financing to multiple buyers (that is, stapled financing). Similarly, there may be conflicting interests among the different lines of business within a financial institution or between the financial institution and its affiliates. When these situations occur, potential conflicts of interest arise between the financial institution and its customers. Effective policies and procedures clearly define potential conflicts of interest, identify appropriate risk management controls and procedures, enable employees to report potential conflicts of interest to management for action without fear of retribution, and ensure compliance with applicable laws. Further, management should have an established training program for employees on appropriate practices to follow to avoid conflicts of interest.

Oil and Gas Lending

Industry Overview

Oil and gas (O&G) lending is complex and highly specialized due to factors such as global supply and demand, geopolitical uncertainty, weather-related disruptions, fluctuations and volatility in currency markets (i.e. the strength of the U.S. dollar compared to global currency markets), and changes in environmental and other governmental policies. As such, companies and borrowers that are directly or indirectly tied to the O&G industry frequently experience expansion and contraction within key operational areas of their businesses that will directly impact their financial condition and repayment capacity.

The O&G industry has four interconnected segments:

- Upstream - exploration and production (E&P) companies
- Midstream - transporting, treating, processing, storing, and marketing to Upstream companies
- Downstream - refining and marketing
- Support/Services - equipment, services, or support activities (e.g. drilling, workover units, and water hauling services)

O&G lending to Upstream companies for E&P activities is a specialized form of lending, and is the primary focus of this section (see Reserve-Based Lending below). Loans to Midstream, Downstream and Support/Service companies are generally structured similar to other commercial loans. In addition, Midstream companies often raise capital through Master Limited Partnerships that are publicly traded. The highest credit risk is typically found in Support/Services and Upstream lending, which are more directly affected by changes in production and commodity prices.

Reserve-Based Lending

Loans for E&P activities are typically secured by proved reserves and governed by a borrowing base, an arrangement known as reserve-based lending, or RBL. Effective credit risk management in RBL requires conservative underwriting, appropriate structuring, experienced and knowledgeable lending staff, and sound loan administration practices. It is also important for the board and senior management to consider the unique risks associated with this type of lending when developing RBL policies and approving and administering such loans. These risks include, but are not limited to, credit, concentration, market volatility/pricing, limited purpose collateral, production, operational, legal, compliance/environmental, interest rate, liquidity, strategic, and third-party risk.

RBL may appear similar to traditional asset based lending (ABL), but there are notable differences. The primary source of repayment for ABL is the orderly liquidation of the collateral (receivables and inventory) into cash. Such loans are typically structured with strong controls over the collateral, such as a lock box arrangement. In contrast, the primary source of repayment for RBL is the cash flows derived from the extraction of O&G reserves. An independent, third-party reserve engineering report serves as the primary underwriting tool to estimate the future cash stream and establish a “borrowing base,” which is a collateral base agreed to by the borrower and lender that is used to limit the amount of funds the lender advances the borrower. The borrowing base is subject to periodic redeterminations, typically semiannually, that can result in the reduction of the borrowing base commitment when commodity prices and reserves are declining.

Types of Reserves

Lenders should generally only consider proved reserves, defined as having at least a 90 percent probability that the quantities actually recovered will equal or exceed the estimate, in determining collateral value. Within the proved reserves category, Proved Developed Producing (PDP), Proved Developed Non-Producing (PDNP), and Proved Undeveloped (PUD) reserves are collectively known as P1. As described below, PDNP and PUD require capital expenditures (CAPEX) to bring the non-producing and undeveloped reserves online as PDP:

- PDP represents reserves that are recoverable from existing wells with existing equipment and operating methods that are producing at the time of the engineering report estimate.
- PDNP reserves include both shut-in (PDSI) and behind the pipe (PDBP) reserves, and production can be initiated or restored with relatively low

expenditures compared to the cost of drilling a new well.

  - PDSI reserves are completion intervals that are open, but have not started producing; were shut-in for market conditions or pipeline connections; or not capable of production for mechanical reasons.
  - PDBP reserves are those expected to be recovered from existing wells that require additional completion work or future completion prior to the start of production.

- PUD reserves are expected to be recovered only after making future investment. These reserves have been proved by independent engineering reports, but do not have a well infrastructure in place.

Other categories of reserves include "probable" (P2) and "possible" (P3). Probable reserves are relatively uncertain, while possible reserves are considered speculative in nature. Probable and possible reserves should not receive any value when determining the borrowing base.

Reserve Engineering Reports

Reserve engineering reports are an estimate of the volumes of O&G reserves that are likely to be recovered based on reasonable assumptions regarding physical characteristics of the reservoir, available technology, and operating efficiencies. The significant reliance on engineering reports in underwriting RBL facilities requires sound internal controls over the collateral evaluation process. Reserve reports must be objective; based on reasonable, well-documented assumptions; and completed independently of the loan origination and collection functions. It is important for management to document the qualifications and independence of the engineer, and to periodically evaluate the production performance, which includes a comparison of production projections to actual results.

RBL collateral value consists of a point-in-time estimate of the present value (PV) of future net revenue (FNR) derived from the production and sale of existing O&G reserves, net of operating expenses, production taxes, royalties, and CAPEX, discounted at an appropriate rate. The engineering reports should contain sufficient information and documentation to support the assumptions and the analysis used to derive the forecasted cash flows and discounted PV. Bank management should provide clear guidance to the engineer at engagement regarding discount rates, pricing assumptions, operating expense escalation rates, and risk-adjustment guidelines limiting higher risk reserves. The engineer will conduct an analysis of production reports from the subject properties, and project estimated reserve depletion.

Borrowing Base

The collateral base securing each facility should be primarily comprised of PDP reserves. Inclusion of PDNP reserves in the collateral evaluation should be supported with sufficient documentation to demonstrate that the borrower has the financial capacity to convert PDNP reserves to PDP reserves by making the necessary investments to restore or initiate production within the near-term.

To include PUDs in the borrowing base calculation, the borrower should have sufficient liquidity and positive Free Cash Flow to meet operational needs, and debt service requirements, as well as be able to fund (or obtain the funding for) the CAPEX that would be required to convert these undeveloped reserves into production. Potential sale and/or marketability of the PUDs can also be considered when evaluating collateral values, provided there is adequate documentation of recent PUD sales.

Lenders use risk-adjustment factors to lower the value of unseasoned producing and non-producing reserves before applying borrowing base advance rates. Bank management should consider policy limits on production vs. non-production reserves, the oil and gas mix, maximum production coming from one well (single well concentration risk), and other risk-adjustment factors. Ideally, management achieves diversification in the geographic location of reserve fields, and establishes limits on the lowest number of producing wells needed to establish an acceptable borrowing base.

Typically, the advance rate for high-quality proved (P1) reserves should rarely exceed 65 percent (a typical range is 50 to 65 percent) of the PV of FNR. If the lender determines that PDNP or PUD reserves are to be considered in the borrowing base, these reserves should generally not exceed 25 to 35 percent of the total borrowing base. In addition, PDNP and PUD reserves should be risk-adjusted (65 to 75 percent for PDNP and 25 to 50 percent for PUD, for example) prior to applying the advance rate. Lenders may apply separate risk-adjusted advance rates for each proved reserve category in the borrowing base. During extended periods of low or declining commodity prices, it is not uncommon for banks to increase the risk adjustment for PDNP and PUD reserves.

As part of the underwriting process, lending personnel typically prepare both base-case and sensitivity-case analyses that focus on the ability of converting the underlying collateral into cash to repay the loan, including an estimate of the impact that sustained adverse changes in market conditions would have on a company's repayment ability. A base-case analysis uses standard assumption scenarios and generally includes a discount to current prices against the forward curve (projected futures pricing estimates of the commodity). A sensitivity case analysis subjects the O&G reserves to adverse external factors such as lower market prices and/or higher operating expenses to ascertain the effect on loan repayment. Full debt service capacity (DSC) should be analyzed using both the base-case and sensitivity-case scenarios.

Discount Rates

The Securities and Exchange Commission (SEC) requires publicly traded companies to report the value of their reserves using a standard discount rate of 10 percent in accordance with ASC Topic 932, Extractive Activities - Oil and Gas. In evaluating collateral valuations for RBL facilities, banks often utilize alternative discount rates. For creditworthy borrowers and during more benign operating cycles, a 9 percent discount rate is commonly used. For higher-risk borrowers or during volatile or declining market cycles for O&G, higher discount rates are typically used. If a discount rate is selected that significantly differs from generally accepted discount rates, examiners should assess management's documentation supporting its rationale. Some banks may use multiple discount rates under certain circumstances. An example may include establishing a standard discount rate for performing credits and a higher rate for higher risk facilities.

Price Decks

Prudent management regularly evaluates, and updates as necessary, its pricing assumptions for RBL, commonly referred to as the institution's price deck. The price deck is a forecast used to derive cash flow and collateral value assumptions, and typically is approved by the board of directors or a specifically designated board committee. Pricing assumptions typically represent the most significant variable in driving the final estimate of value, and must be well-supported.

Each institution's price deck typically reflects both base-case and sensitivity-case pricing scenarios. Pricing assumptions for the sensitivity case are generally sufficiently conservative and used to determine whether the borrower has the financial capacity to generate adequate cash flow to repay the debt during a prolonged low commodity price environment. Price deck considerations include, for example, current commodity pricing, forward curve projections (future price considerations), cost assumptions, discount rates, and timing of the various reports. Management should also document any risk-based adjustments applied to each proved reserve category. While the risk-adjusted base case projections will generally be used to underwrite RBLs, management should consider the ability to repay the debt using the risk-adjusted sensitivity case to determine potential exposure due to adverse market price fluctuations.

Loan Structure

RBL credit facilities are typically structured as a revolving line of credit (RLOC), a reducing revolving line of credit (RRLOC), or an amortizing term loan, governed by a well-supported and fully documented borrowing base. These credit facilities generally should fully amortize within the half-life of the reserves (that is, the time in years required to produce one-half of the total estimated recoverable production) with repayment aligning with projected cash flows. In other words, the term of the loans should be tied to the economic life of the underlying asset. This is often represented as the "reserve tail tests" that are based on the economic half-life of the reserves or the cash flow remaining after projected loan payout.

Loan durations should be fairly short-term and directly tied to the economic life of the asset (generally 50 to 60 percent of the economic life of the proved reserves or the proved reserves' half-life). The terms generally depend on the projected and actual reserve production (reserve run data), as well as the type and range of collateral (PDP, PDNP, or PUD). A reasonable portion of the estimated revenues should remain after the debt has fully amortized (reserve tail). Borrowing bases should be re-determined at least semiannually, subject to an updated reserve engineering report.

Covenants

Appropriate use of covenants is imperative in managing credit risk for O&G loans. Lenders typically require financial covenants to instill discipline in the lending relationship, including the borrower's leverage position, repayment capacity, and liquidity. In addition, covenants should limit cash distributions to owners/shareholders, and should include standard performance and financial reporting requirements. Examples of commonly used ratios/covenants for evaluating E&P companies include Free Cash Flow (FCF), Interest Coverage, Fixed Charge Coverage, Current Ratio, Quick Ratio, Senior Debt/EBITDA(X), and Total Debt/EBITDA(X). The calculation of earnings before interest, taxes, depreciation, and amortization (EBITDA) typically incorporates maintenance CAPEX (X) due to its impact on the amount of projected FCF that is available after debt service to support operations.

Hedging

When used properly, hedging may be an effective tool to help protect the borrower and the lender from sharp commodity price declines by providing a stable cash flow stream. E&P companies frequently use hedging instruments such as futures contracts, swaps, collars, and put options to reduce price risk exposure. Generally, hedges should be limited to no more than 85 percent of projected production volumes. Counterparties should be limited to reputable, financially sound companies that are approved in accordance with the institution's O&G loan policy. If the hedges are taken as collateral or part of the borrowing base, the advance rate and any limitations on the hedging position should be documented in the loan agreement. If hedges are sold or monetized, the proceeds of such should generally be applied to the respective debt.

Borrower and Financial Analysis

Management should have a clear understanding of the overall financial health of the borrower that includes an assessment of the borrower's ability to maintain operations through adverse market conditions. E&P companies in sound financial condition should have strong cash flow from reliable revenue sources and well-controlled operating expenses. Companies should also have adequate sources of liquidity and effective working capital management, sound reserve development practices, well-defined criteria for divestiture, adequate capital structure, manageable levels of debt, and appropriate financial reporting. As part of the overall financial analysis of the relationship, updated engineering data should be well-documented and should enable the lender to determine the borrower's capacity to service the debt. Any over-advance situation should have a reasonable plan and timeframe to cure the over-advance.

The principals of successful E&P companies should be experienced and have a well-documented track record of managing through all stages of the business cycle. In good times, company management should be able to identify, acquire, and develop reserves profitably and in line with expectations. During declining price cycles, company management should be able to demonstrate the ability to streamline operations, maintain reasonable production, manage working capital, strategically reduce CAPEX, and make sound divestitures to ensure repayment of debt. Bank management should evaluate the borrower's cost cycle, which reflects not only the ability to generate cash flow from production, but also the CAPEX necessary to replace depleted reserves. Working capital management is critically important, as delinquent payments to vendors can result in a negative working capital position (due to accounts payable increasing) and an increased leverage ratio.

Financial analysis typically includes the following:

- Adequacy of operating cash flows to service existing total debt;
- Overall compliance with financial covenants, including borrowing base limitations as detailed in the loan agreement;
- Reasonableness of the company's budget assumptions and projections;
- Comparison of borrower provided production projections with actual results;
- Working capital, tangible net worth, and leverage positions; and
- Impact of capital expenses and recent acquisitions.

O&G Loan Policy Guidelines

The O&G loan policy should provide sufficient guidance to loan officers, clearly convey appropriate policy limitations and monitoring procedures, and detail appropriate underwriting standards and practices. The O&G policy should clearly indicate those industry segments (Upstream, Midstream, Downstream, and Support/Services) the board chooses to lend to and include guidance on each of those segments.

For institutions engaged in RBL, appropriate policies address reserve measurement and valuation analysis, borrowing base determinations, production history analysis, financial statement and ratio analysis, commitment advances, discount rates, price deck formulation, financial covenants, steps to cure an over-advance situation, and ALLL considerations. Specific guidelines typically cover the following areas:

- Lending objectives, risk appetite, portfolio limits, target market, and concentration limits;
- Methodology and requirements for monitoring O&G markets, including pricing, supply and demand trends, overall market trends, and industry analysis;
- Board and committee oversight over the O&G lending and engineering departments;
- Officer and committee lending limits;
- Borrowing base calculations and risk-adjustments;
- Price deck considerations and adjustments;
- Advance rates, risk-adjusted values for PDP, PDNP, and PUD reserves, and requirement to risk adjust the discount value of nonproducing reserves before applying advance rates;
- Frequency and required details of borrowing base redeterminations and price deck revaluations;
- Requirements for independent engineering reports and analysis thereof;
- Well concentration guidelines and maximum per single well limits;

- Financial covenants, minimum ratio and other financial information requirements, and review requirements (e.g. current ratio, fixed charge coverage, cash flow coverage, leverage ratios);
- Collateral valuation requirements, including required remaining collateral at payout;
- Renewal and restructuring guidelines, including nonaccrual and troubled debt restructuring implications;
- Remedies for declining collateral or over-advanced situations, such as Monthly Commitment Reductions, pledge of additional reserves as collateral, and sale of non-productive reserves;
- Minimum required insurance (including property, liability, and environmental);
- Defined loan safety or coverage factors and/or loan value policies, including other debt that is "pari-passu" (i.e. all debts sharing equally in the production cash flows available to amortize debt);
- Typical amortization, payout, and loan repayment terms, including maximum terms for production revolvers and term loans;
- Guarantor requirements;
- Hedging requirements, policies, and limitations;
- Stress-testing and sensitivity analysis and requirements thereof; and
- Monitoring requirements for the risks inherent in loans dependent on royalty interests in production revenues for repayment.

Credit Risk Rating Assessment and Classification Guidelines

An appropriate O&G loan policy also addresses specific credit risk review procedures for the O&G portfolio and O&G loan grading criteria. Risk rating definitions should be clearly defined. RBL that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or underlying collateral generally will not be adversely classified for supervisory purposes. However, if any of the following circumstances are present, a more in-depth and comprehensive analysis of the credit is needed to determine whether the loan has potential or well-defined weaknesses:

- The loan balance exceeds 65 percent of the PV of FNR of PDP, or the cash flow analysis indicates that the loan will not amortize within the reserve half-life;
- The credit is not performing in accordance with contractual terms (repayment of interest and principal);
- Advance rates exceed the institution's limits or industry standards for proved reserves;
- Frequent over-advances occur at subsequent borrowing base redeterminations;
- Excessive operating leverage;
- Covenant defaults;
- Delinquent payables, or other evidence of poor working capital management;
- Significant current or likely future disruptions in production;
- Frequent financial statement revisions or changes in chosen accounting method;
- Maintenance or capital expenditures significantly exceed budgeted forecasts; or
- The credit is identified by the institution as a "distressed" credit.

Examiners are to consider all information relevant to evaluating the prospects that the loan will be repaid, including the borrower's creditworthiness, the cash flow provided by the borrower's operation, the collateral supporting the loan, integrity and reliability of the engineering data, borrowing base considerations, primary source of repayment, and any support provided by financially responsible guarantors and co-borrowers. If the borrower's circumstances reveal well-defined weaknesses, adverse classification of the loan relationship is likely warranted. The level and severity of classification of distressed, collateral-dependent RBLs will depend on the quality of the underlying collateral, based on the most recent re-determined and risk-adjusted borrowing base that is contractually obligated to be funded.

The portion of the loan commitment(s) secured by the NPV of total risk-adjusted proved reserves should be classified Substandard. When the potential for loss may be mitigated by the outcome of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined, the remaining balance secured by the NPV of total unrisked proved reserves should be classified Doubtful. The portion of the loan commitment(s) that exceeds 100 percent of the NPV of total unrisked proved reserves, and is uncollectible, should be classified Loss. These guidelines may be adjusted depending on the borrower's specific situation and should not replace examiner judgment.

The following tables illustrate an example of the rating methodology for a classified borrower. Actual pricing, discount rates, and risk adjustment factors applied by the institution may vary according to current market conditions and the nature of the reserves. Examiners should closely review the key assumptions made by the institution in arriving at the current collateral valuation.

Example: Collateral Valuation ($ Million)
Discounted NPV at 9% and using NYMEX Strip Pricing

Valuation Basis	Hedges	PDP	PDNP	PUD	Total Proved
Unrisked NPV	$10	$50	$20	$40	$120
Risk adjustment factors	100%	100%	75%	50%	
Risked & Adjusted NPV	$10	$50	$15	$20	$95
		Total collateral value:			$95

Example: Classification ($ Million)
Borrowing base commitment on RBL is $125 million

	TC	Pass	SM	II	III	IV
RBL	$125			$95	$25	$5
Total	$125			$95	$25	$5

TC: Total Commitment SM: Special Mention
II: Substandard III: Doubtful IV: Loss

Note: The $25 million of Doubtful represents the difference between the unrisked NPV and the risked NPV. If the borrower's prospects for further developing PDNP and PUD reserves to producing status are unlikely or not supported by a pending event, this amount should be reflected as Loss.

Institutions should follow accounting principles when determining whether a loan should be placed on nonaccrual. Each extension should be independently evaluated to determine whether it should be on nonaccrual; that is, nonaccrual status should not be automatically applied to multiple loans or extensions of credit to a single borrower if only one loan meets the criteria for nonaccrual status. However, multiple loans to one borrower that are structured as pari-passu to principal and interest and supported by the same repayment source should not be treated differently for nonaccrual or troubled debt restructuring purposes, regardless of collateral lien position.

Real Estate Loans

General

Real estate loans are part of the loan portfolios of almost all commercial banks. Real estate loans include credits advanced for the purchase of real property. However, the term may also encompass extensions granted for other purposes, but for which primary collateral protection is real property.

The degree of risk in a real estate loan depends primarily on the loan amount in relation to collateral value, the interest rate, and most importantly, the borrower's ability to repay in an orderly fashion. It is extremely important that an institution's real estate loan policy ensure that loans are granted with the reasonable probability the debtor will be able and willing to meet the payment terms. Placing undue reliance upon a property's appraised value in lieu of an adequate initial assessment of a debtor's repayment ability is a potentially dangerous mistake.

Historically, many banks have jeopardized their capital structure by granting ill-considered real estate mortgage loans. Apart from unusual, localized, adverse economic conditions which could not have been foreseen, resulting in a temporary or permanent decline in realty values, the principal errors made in granting real estate loans include inadequate regard to normal or even depressed realty values during periods when it is in great demand thus inflating the price structure, mortgage loan amortization, the maximum debt load and repayment capacity of the borrower, and failure to reasonably restrict mortgage loans on properties for which there is limited demand.

A principal indication of a troublesome real estate loan is an improper relationship between the amount of the loan, the potential sale price of the property, and the availability of a market. The potential sale price of a property may or may not be the same as its appraised value. The current potential sale price or liquidating value of the property is of primary importance and the appraised value is of secondary importance. There may be little or no current demand for the property at its appraised value and it may have to be disposed of at a sacrifice value.

Examiners must appraise not only individual mortgage loans, but also the overall mortgage lending and administration policies to ascertain the soundness of its mortgage loan operations as well as the liquidity contained in the account. Institutions generally establish policies that address the following factors: the maximum amount that may be loaned on a given property, in a given category, and on all real estate loans; the need for appraisals (professional judgments of the present and/or future value of the real property) and for amortization on certain loans.

Real Estate Lending Standards

Section 18(o) of the FDI Act requires the Federal banking agencies to adopt uniform regulations prescribing standards for loans secured by liens on real estate or made for the purpose of financing permanent improvements to real estate. For FDIC-supervised institutions, Part 365 of the FDIC Rules and Regulations requires each institution to adopt and maintain written real estate lending policies that are consistent with sound lending principles, appropriate for the size of the institution and the nature and scope of its operations. Within these general parameters, the regulation specifically requires an institution to establish policies that include:

- Portfolio diversification standards;
- Prudent underwriting standards including loan-to-value limits;
- Loan administration procedures;
- Documentation, approval and reporting requirements; and
- Procedures for monitoring real estate markets within the institution's lending area.

These policies also should consider the Interagency Guidelines for Real Estate Lending Policies and must be reviewed and approved annually by the institution's board of directors.

The interagency guidelines, which are an appendix to Part 365, are intended to help institutions satisfy the regulatory requirements by outlining the general factors to consider when developing real estate lending standards. The guidelines suggest maximum supervisory loan-to-value (LTV) limits for various categories of real estate loans and explain how the agencies will monitor their use.

Institutions are expected to establish their own internal LTV limits consistent with their needs. These internal limits should not exceed the following recommended supervisory limits:

- 65 percent for raw land;
- 75 percent for land development;
- 80 percent for commercial, multi-family, and other non-residential construction;
- 85 percent for construction of a 1-to-4 family residence;
- 85 percent for improved property; and
- Owner-occupied 1-to-4 family home loans have no suggested supervisory LTV limits. However, for any such loan with an LTV ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

Certain real estate loans are exempt from the supervisory LTV limits because of other factors that significantly reduce risk. These include loans guaranteed or insured by the Federal, State or local government as well as loans to be sold promptly in the secondary market without recourse. A complete list of excluded transactions is included in the guidelines.

Because there are a number of credit factors besides LTV limits that influence credit quality, loans that meet the supervisory LTV limits should not automatically be considered sound, nor should loans that exceed the supervisory LTV limits automatically be considered high risk. However, loans that exceed the supervisory LTV limit should be identified in the institution's records and the aggregate amount of these loans reported to the institution's board of directors at least quarterly. The guidelines further State that the aggregate amount of loans in excess of the supervisory LTV limits should not exceed the institution's total capital. Moreover, within that aggregate limit, the total loans for all commercial, agricultural and multi-family residential properties (excluding 1-to-4 family home loans) should not exceed 30 percent of total capital.

Institutions should develop policies that are clear, concise, consistent with sound real estate lending practices, and meet their needs. Policies should not be so complex that they place excessive paperwork burden on the institution. Therefore, when evaluating compliance with Part 365, examiners should carefully consider the following:

- The size and financial condition of the institution;
- The nature and scope of the institution's real estate lending activities;
- The quality of management and internal controls;
- The size and expertise of the lending and administrative staff; and
- Market conditions.

It is important to distinguish between the regulation and the interagency guidelines. While the guidelines are included as an appendix to the regulation, they are not part of the regulation. Therefore, when an apparent violation of Part 365 is identified, it should be listed in the Report of Examination in the same manner as other apparent violations. Conversely, when an examiner determines that an institution is not in conformance with the guidelines and the deficiency is a safety and soundness concern, an appropriate comment should be included in the examination report; however, the deficiency would not be a violation of the regulation.

Examination procedures for various real estate loan categories are included in the ED Modules.

Commercial Real Estate Loans

These loans comprise a major portion of many banks' loan portfolios. When problems exist in the real estate markets that the institution is servicing, it is necessary for examiners to devote additional time to the review and evaluation of loans in these markets.

There are several warning signs that real estate markets or projects are experiencing problems that may result in real estate values decreasing from original appraisals or projections. Adverse economic developments and/or an overbuilt market can cause real estate projects and loans to become troubled. Signs of troubled real estate markets or projects include, but are not limited to:

- Rent concessions or sales discounts resulting in cash flow below the level projected in the original appraisal.
- Changes in concept or plan: for example, a condominium project converting to an apartment project.
- Construction delays resulting in cost overruns which may require renegotiation of loan terms.
- Slow leasing or lack of sustained sales activity and/or increasing cancellations which may result in protracted repayment or default.
- Lack of any sound feasibility study or analysis.
- Periodic construction draws which exceed the amount needed to cover construction costs and related overhead expenses.
- Identified problem credits, past due and non-accrual loans.

Real Estate Construction Loans

A construction loan is used to construct a particular project within a specified period of time and should be controlled by supervised disbursement of a predetermined sum of money. It is generally secured by a first mortgage or deed of trust and backed by a purchase or takeout agreement from a financially responsible permanent lender. Construction loans are vulnerable to a wide variety of risks. The major risk arises from the necessity to complete projects within specified cost and time limits. The risk inherent in construction lending can be limited by establishing policies which specify type and extent of institution involvement. Such policies generally define procedures for controlling disbursements and collateral margins and assuring timely completion of the projects and repayment of the institution's loans.

Before entering a construction loan agreement, it is appropriate for the institution to investigate the character, expertise, and financial standing of all related parties. Documentation files would then include background information concerning reputation, work and credit experience, and financial statements. Such documentation indicates that the developer, contractor, and subcontractors have demonstrated the capacity to successfully complete the type of project to be undertaken. The appraisal techniques used to value a proposed construction project are essentially the same as those used for other types of real estate. The institution should realize that appraised collateral values are not usually met until funds are advanced and improvements made.

The institution, the builder, and the property owner typically join in a written building loan agreement that specifies the performance of each party during the entire course of construction. Loan funds are generally disbursed based upon either a standard payment plan or a progress payment plan. The standard payment plan is normally used for residential and smaller commercial construction loans and utilizes a pre-established schedule for fixed payments at the end of each specified stage of construction. The progress payment plan is normally used for larger, more complex, building projects. The plan is generally based upon monthly disbursements totaling 90 percent of the value with 10 percent held back until the project is completed.

Although many credits advanced for real estate acquisition, development or construction are properly considered loans secured by real estate, other such credits are, in economic substance, "investments in real estate ventures". A key feature of these transactions is that the institution as lender plans to share in the expected residual profit from the ultimate sale or other use of the development. These profit sharing arrangements may take the form of equity kickers, unusually high interest rates, a percentage of the gross rents or net cash flow generated by the project, or some other form of profit participation over and above a reasonable amount for interest and related loan fees. These extensions of credit may also include such other characteristics as nonrecourse debt, 100 percent financing of the development cost (including origination fees, interest payments, construction costs, and even profit draws by the developer), and lack of any substantive financial support from the borrower or other guarantors. Acquisition, Development, and Construction (ADC) arrangements that are in substance real estate investments of the institution should be reported accordingly.

The following are the basic types of construction lending:

- <u>Unsecured Front Money</u> **-** Unsecured front money loans are working capital advances to a borrower who may be engaged in a new and unproven venture. Many bankers believe that unsecured front money lending is not prudent unless the institution is involved in the latter stages of construction financing. A builder planning to start a project before construction funding is obtained often uses front money loans. The funds may be used to acquire or develop a building site, eliminate title impediments, pay architect or standby fees, and/or meet minimum working capital requirements established by construction lenders. Repayment often comes from the first draw against construction financing. Unsecured front money loans used for a developer's equity investment in a project or to cover initial costs overruns are symptomatic of an undercapitalized, inexperienced or inept builder.

- Land Development Loans **-** Land development loans are generally secured purchase or development loans or unsecured advances to investors and speculators. Secured purchase or development loans are usually a form of financing involving the purchase of land and lot development in anticipation of further construction or sale of the property. A land development loan should be predicated upon a proper title search and/or mortgage insurance. The loan amount should be based on appraisals on an "as is" and "as completed" basis. Projections should be accompanied by a study explaining the effect of property improvements on the market value of the land. There should be a sufficient spread between the amount of the development loan and the estimated market value to allow for unforeseen expenses. Appropriate repayment programs typically are structured to follow the sales or development program. In the case of an unsecured land development loan to investors or speculators, it is prudent for institution management to analyze the borrower's financial statements for sources of repayment other than the expected return on the property development.

- Commercial Construction Loans **-** Loans financing commercial construction projects are usually collateralized, and such collateral is generally identical to that for commercial real estate loans. Supporting documentation should include a recorded mortgage or deed of trust, title insurance policy and/or title opinions, appropriate liability insurance and other coverages, land appraisals, and evidence that taxes have been paid to date. Additional documents relating to commercial construction loans include loan agreements, takeout commitments, tri-party (buy/sell) agreements, completion or corporate bonds, and inspection or progress reports.

- Residential Construction Loans **-** Residential construction loans may be made on a speculative basis or as prearranged permanent financing. Smaller banks often engage in this type of financing and the aggregate total of individual construction loans may equal a significant portion of their capital funds. Prudence dictates that permanent financing be assured in advance because the cost of such financing can have a substantial effect on sales. Proposals to finance speculative housing should be evaluated in accordance with predetermined policy standards compatible with the institution's size, technical competence of its management, and housing needs of its service area.

  The prospective borrower's reputation, experience, and financial condition should be reviewed. The finished project's realistic marketability in favorable and unfavorable market conditions is also an important consideration.

  In addition to normal safeguards such as a recorded first mortgage, acceptable appraisal, construction agreement, draws based on progress payment plans and inspection reports, an institution dealing with speculative contractors should institute control procedures tailored to the individual circumstances. A predetermined limit on the number of unsold units to be financed at any one time is typically included in the loan agreement to avoid overextending the contractor's capacity. Loans on larger residential construction projects are usually negotiated with prearranged permanent financing. Documentation of tract loans frequently includes a master note allocated for the entire project and a master deed of trust or mortgage covering all land involved in the project. Payment of the loan will depend largely upon the sale of the finished homes. As each sale is completed, the institution makes a partial release of the property covered by its master collateral document. In addition to making periodic inspections during the course of construction, periodic progress reports (summary of inventory lists maintained for each tract project) typically are made on the entire project. A comprehensive inventory list shows each lot number, type of structure, release price, sales price, and loan balance.

The exposure in any type of construction lending is that the full value of the collateral does not exist at the time the loan is granted. Therefore, it is important for management to ensure funds are used properly to complete construction or development of the property serving as collateral. If default occurs, the institution must be in a position to either complete the project or to salvage its construction advances. The various mechanic's and materialmen's liens, tax liens, and other judgments that arise in such cases are distressing to even the most seasoned lender. Every precaution should be taken by the lender to minimize any outside attack on the collateral. The construction lender may not be in the preferred position indicated by documents in the file. Laws of some states favor the subcontractors (materialmen's liens, etc.), although those of other states protect the construction lender to the point of first default, provided certain legal requirements have been met. Depending on the type and size of project being funded, construction lending can be a complex and fairly high-risk venture. For this reason, institution management should ensure that it has enacted policies and retained sufficiently trained personnel before engaging in this type of lending.

Home Equity Loans

A home equity loan is a loan secured by the equity in a borrower's residence. It is generally structured in one of two ways. First, it can be structured as a traditional second mortgage loan, wherein the borrower obtains the funds for the full amount of the loan immediately and repays the debt with a fixed repayment schedule. Second, the home equity borrowing can be structured as a line of credit, with a check, credit card, or other access to the line over its life.

The home equity line of credit has evolved into the dominant form of home equity lending. This credit instrument generally offers variable interest rates and flexible repayment terms. Additional characteristics of this product line include relatively low interest rates as compared to other forms of consumer credit, absorption by some banks of certain fees (origination, title search, appraisal, recordation cost, etc.) associated with establishing a real estate-related loan. The changes imposed by the Tax Reform Act of 1986 relating to the income tax deductibility of interest paid on consumer debt led to the increased popularity of home equity lines of credit.

Home equity lending is widely considered to be a low-risk lending activity. These loans are secured by housing assets, the value of which historically has performed well. Nevertheless, the possibility exists that local housing values or household purchasing power may decline, stimulating abandonment of the property and default on the debt secured by the housing. Certain features of home equity loans make them particularly susceptible to such risks. First, while the variable rate feature of the debt reduces the interest rate risk of the lender, the variable payment size exposes the borrower to greater cash flow risks than would a fixed-rate loan, everything else being equal. This, in turn, exposes the lender to greater credit risk. Another risk is introduced by the very nature of the home equity loan. Such loans are generally secured by a junior lien. Thus, there is less effective equity protection than in a first lien instrument. Consequently, a decline in the value of the underlying housing results in a much greater than proportional decline in the coverage of a home equity loan. This added leverage makes them correspondingly riskier than first mortgages.

Institutions that make these kinds of loans typically adopt specific policies and procedures for dealing with this product line. Management expertise in mortgage lending and open-end credit procedures is critical to the appropriate administration of the portfolio. Another major concern is that borrowers will become overextended and the institution will have to initiate foreclosure proceedings. Therefore, underwriting standards should emphasize the borrower's ability to service the line from cash flow rather than the sale of the collateral, especially if the home equity line is written on a variable rate basis. If the institution has offered a low introductory interest rate, repayment capacity should be analyzed at the rate that could be in effect at the conclusion of the initial term.

Other important considerations include acceptable loan-to-value and debt-to-income ratios, and proper credit and collateral documentation, including adequate appraisals and written evidence of prior lien status. Another significant risk concerns the continued lien priority for subsequent advances under a home equity line of credit. State law governs the status of these subsequent advances. It is also important that the institution's program include periodic reviews of the borrower's financial condition and continuing ability to repay the indebtedness.

The variation in contract characteristics of home equity debt affects the liquidity of this form of lending. For debt to be easily pooled and sold in the secondary market, it needs to be fairly consistent in its credit and interest rate characteristics. The complexity of the collateral structures, coupled with the uncertain maturity of revolving credit, makes home equity loans considerably less liquid than straight first lien, fixed maturity mortgage loans.

While home equity lending is considered to be fairly low-risk, subprime home equity loans and lending programs exist at some banks. These programs have a higher level of risk than traditional home equity lending programs. Individual or pooled home equity loans that have subprime characteristics should be analyzed using the information provided in the subprime section of this Manual.

Agricultural Loans

Introduction

Agricultural loans are an important component of many community institution loan portfolios. Agricultural banks represent a material segment of commercial banks and constitute an important portion of the group of banks over which the FDIC has the primary Federal supervisory responsibility.

Agricultural loans are used to fund the production of crops, fruits, vegetables, and livestock, or to fund the purchase or refinance of capital assets such as farmland, machinery and equipment, breeder livestock, and farm real estate improvements (for example, facilities for the storage, housing, and handling of grain or livestock). The production of crops and livestock is especially vulnerable to two risk factors that are largely outside the control of individual lenders and borrowers: commodity prices and weather conditions. While examiners must be alert to, and critical of, operational and managerial weaknesses in agricultural lending activities, they must also recognize when the institution is taking reasonable steps to deal with these external risk factors. Accordingly, loan restructurings or extended repayment terms, or other constructive steps to deal with financial difficulties faced by agricultural borrowers because of adverse weather or commodity conditions, will not be criticized if done in a prudent manner and with proper risk controls and management oversight. Examiners should recognize these constructive steps and fairly portray them in oral and written communications regarding examination findings. This does not imply, however, that analytical or classification standards should be compromised. Rather, it means that the institution's response to these challenges will be considered in supervisory decisions.

Agricultural Loan Types and Maturities

Production or Operating Loans **-** Short-term (one year or less) credits to finance seed, fuel, chemicals, land and machinery rent, labor, and other costs associated with the production of crops. Family living expenses are also sometimes funded, at least in part, with these loans. The primary repayment source is sale of the crops at the end of the production season when the harvest is completed.

Feeder Livestock Loans **-** Short-term loans for the purchase of, or production expenses associated with, cattle, hogs, sheep, poultry or other livestock. When the animals attain market weight and are sold for slaughter, the proceeds are used to repay the debt.

Breeder Stock Loans **-** Intermediate-term credits (generally three to five years) used to fund the acquisition of breeding stock such as beef cows, sows, sheep, dairy cows, and poultry. The primary repayment source is the proceeds from the sale of the offspring of these stock animals, or their milk or egg production.

Machinery and Equipment Loans **-** Intermediate-term loans for the purchase of a wide array of equipment used in the production and handling of crops and livestock. Cash flow from farm earnings is the primary repayment source. Loans for grain handling and storage facilities are also sometimes included in this category, especially if the facilities are not permanently affixed to real estate.

Farm Real Estate Acquisition Loans **-** Long-term credits for the purchase of farm real estate, with cash flow from earnings representing the primary repayment source. Significant, permanent improvements to the real estate, such as for livestock housing or grain storage, may also be included within this group.

Carryover Loans **-** This term is used to describe two types of agricultural credit. The first is production or feeder livestock loans that are unable to be paid at their initial, short-term maturity, and which are rescheduled into an intermediate or long-term amortization. This situation arises when weather conditions cause lower crop yields, commodity prices are lower than anticipated, production costs are higher than expected, or other factors result in a shortfall in available funds for debt repayment. The second type of carryover loan refers to already-existing term debt whose repayment terms or maturities need to be rescheduled because of inadequate cash flow to meet existing repayment requirements. This need for restructuring can arise from the same factors that lead to carryover production or feeder livestock loans. Carryover loans are generally restructured on an intermediate or long-term amortization, depending upon the type of collateral provided, the borrower's debt service capacity from ongoing operations, the debtor's overall financial condition and trends, or other variables. The restructuring may also be accompanied by acquisition of Federal guarantees through the farm credit system to lessen risk to the institution.

Agricultural Loan Underwriting Guidelines

Many underwriting standards applicable to commercial loans also apply to agricultural credits. The discussion of those shared standards is therefore not repeated. Some items, however, are especially pertinent to agricultural credit and therefore warrant emphasis.

Financial and Other Credit Information **-** As with any type of lending, sufficient information must be available so that the institution can make informed credit decisions. Basic information includes balance sheets, income statements, cash flow projections, loan officer file comments, and collateral inspections, verifications, and valuations. Generally, financial information should be updated not less than annually (loan officer files should be updated as needed and document all significant meetings and events). Credit information should be analyzed by management so that appropriate and timely actions are taken, as necessary, to administer the credit.

Institutions should be given some reasonable flexibility as to the level of sophistication or comprehensiveness of the aforementioned financial information, and the frequency with which it is obtained, depending upon such factors as the credit size, the type of loans involved, the financial strength and trends of the borrower, and the economic, climatic or other external conditions which may affect loan repayment. It may therefore be inappropriate for the examiner to insist that all agricultural borrowers be supported with the full complement of balance sheets, income statements, and other data discussed above, regardless of the nature and amount of the credit or the debtor's financial strength and payment record.

Nonetheless, while recognizing some leeway is appropriate, most of the institution's agricultural credit lines, and all of its larger or more significant ones, should be sufficiently supported by the financial information mentioned.

Cash Flow Analysis - History clearly demonstrated that significant problems can develop when banks fail to pay sufficient attention to cash flow adequacy in underwriting agricultural loans. While collateral coverage is important, the primary repayment source for intermediate and long-term agricultural loans is not collateral but cash flow from ordinary operations. This principle should be evident in the institution's agricultural lending policies and implemented in its actual practices. Cash flow analysis is therefore an important aspect of the examiner's review of agricultural loans. Assumptions in cash flow projections should be reasonable and consider not only current conditions but also the historical performance of the farming operation.

Collateral Support - Whether a loan or line of credit warrants unsecured versus secured status in order to be prudent and sound is a matter the examiner has to determine based on the facts of the specific case. The decision should generally consider such elements as the borrower's overall financial strength and trends, profitability, financial leverage, degree of liquidity in asset holdings, managerial and financial expertise, and amount and type of credit. Nonetheless, as a general rule, intermediate and long-term agricultural credit is typically secured, and many times production and feeder livestock advances will also be collateralized. Often the security takes the form of an all-inclusive lien on farm personal property, such as growing crops, machinery and equipment, livestock, and harvested grain. A lien on real estate is customarily taken if the loan was granted for the purchase of the property, or if the borrower's debts are being restructured because of debt servicing problems. In some cases, the institution may perfect a lien on real estate as an abundance of caution.

Examiner review of agricultural related collateral valuations varies depending on the type of security involved. Real estate collateral should be reviewed using normal procedures. Feeder livestock and grain are highly liquid commodities that are bought and sold daily in active, well-established markets. Their prices are widely reported in the daily media; so, obtaining their market values is generally easy. The market for breeder livestock may be somewhat less liquid than feeder livestock or grain, but values are nonetheless reasonably well known and reported through local or regional media or auction houses. If such information on breeding livestock is unavailable or is considered unreliable, slaughter prices may be used as an alternative (these slaughter prices comprise "liquidation" rather than "going concern" values). The extent of use and level of maintenance received significantly affect machinery and equipment values. Determining collateral values can therefore be very difficult as maintenance and usage levels vary significantly. Nonetheless, values for certain pre-owned machinery and equipment, especially tractors, combines, and other harvesting or crop tillage equipment, are published in specialized guides and are based on prices paid at farm equipment dealerships or auctions. These used machinery guides may be used as a reasonableness check on the valuations presented on financial statements or in management's internal collateral analyses.

Prudent agricultural loan underwriting also includes systems and procedures to ensure that the institution has a valid note receivable from the borrower and an enforceable security interest in the collateral, should judicial collection measures be necessary. Among other things, such systems and procedures will confirm that promissory notes, loan agreements, collateral assignments, and lien perfection documents are signed by the appropriate parties and are filed, as needed, with the appropriate State, county, and/or municipal authorities. Flaws in the legal enforceability of loan instruments or collateral documents will generally be unable to be corrected if they are discovered only when the credit is distressed and the borrower relationship strained.

Structuring - Orderly liquidation of agricultural debt, based on an appropriate repayment schedule and a clear understanding by the borrower of repayment expectations, helps prevent collection problems from developing. Amortization periods for term indebtedness should correlate with the useful economic life of the underlying collateral and with the operation's debt service capacity. A too-lengthy amortization period can leave the institution under secured in the latter part of the life of the loan, when the borrower's financial circumstances may have changed. A too-rapid amortization, on the other hand, can impose an undue burden on the cash flow capacity of the farming operation and thus lead to loan default or disruption of other legitimate financing needs of the enterprise. It is also generally preferable that separate loans or lines of credit be established for each loan purpose category financed by the institution.

Administration of Agricultural Loans

Two aspects of prudent loan administration deserve emphasis: collateral control and renewal practices for production loans.

Collateral Control - Production and feeder livestock loans are sometimes referred to as self liquidating because sale of the crops after harvest, and of the livestock when they reach maturity, provides a ready repayment source for these credits. These self-liquidating benefits may be lost, however, if the institution does not monitor and exercise sufficient control over the disposition of the proceeds from the sale. In agricultural lending, collateral control is mainly accomplished by periodic on-site inspections and verifications of the security pledged, with the results of those inspections documented, and by implementing procedures to ensure sales proceeds are applied to the associated debt before those proceeds are released for other purposes. The recommended frequency of collateral inspections varies depending upon such things as the nature of the farming operation, the overall credit soundness, and the turnover rate of grain and livestock inventories.

Renewal of Production Loans **-** After completion of the harvest, some farm borrowers may wish to defer repayment of some or all of that season's production loans, in anticipation of higher market prices at a later point (typically, crop prices are lower at harvest time when the supply is greater). Such delayed crop marketing will generally require production loan extensions or renewals. In these situations, the institution must strike an appropriate balance of, on the one hand, not interfering with the debtor's legitimate managerial decisions and marketing plans while, at the same time, taking prudent steps to ensure its production loans are adequately protected and repaid on an appropriate basis. Examiners should generally not take exception to reasonable renewals or extensions of production loans when the following factors are favorably resolved:

- The borrower has sufficient financial strength to absorb market price fluctuations. Leverage and liquidity in the balance sheet, financial statement trends, profitability of the operation, and past repayment performance are relevant indices.
- The borrower has sufficient financial capacity to support both old and new production loans. That is, in a few months subsequent to harvest, the farmer will typically be incurring additional production debt for the upcoming crop season.
- The institution has adequately satisfied itself of the amount and condition of grain in inventory, so that the renewed or extended production loans are adequately supported. Generally, this means that a current inspection report will be available.

Classification Guidelines for Agricultural Credit

When determining the level of risk in a specific lending relationship, the relevant factual circumstances must be reviewed in total. This means, among other things, that when an agricultural loan's primary repayment source is jeopardized or unavailable, adverse classification is **not** automatic. Rather, such factors as the borrower's historical performance and financial strength, overall financial condition and trends, the value of any collateral, and other sources of repayment must be considered. In considering whether a given agricultural loan or line of credit should be adversely classified, collateral margin is an important, though not necessarily the determinative, factor. If that margin is so overwhelming as to remove all reasonable prospect of the institution sustaining some loss, it is generally inappropriate to adversely classify such a loan. Note, however, that if there is reasonable uncertainty as to the value of that security, because of an illiquid market or other reasons, that uncertainty can, when taken in conjunction with other weaknesses, justify an adverse classification of the credit, or, at minimum, may mean that the margin in the collateral needs to be greater to offset this uncertainty. Moreover, when assessing the adequacy of the collateral margin, it must be remembered that deteriorating financial trends will, if not arrested, typically result in a shrinking of that margin. Such deterioration can also reduce the amount of cash available for debt service needs.

That portion of an agricultural loan(s) or line of credit, which is secured by grain, feeder livestock, and/or breeder livestock, will generally be withheld from adverse classification. The basis for this approach is that grain and livestock are highly marketable and provide good protection from credit loss. However, that high marketability also poses potential risks that must be recognized and controlled. The following conditions must therefore be met in order for this provision to apply:

- The institution must take reasonable steps to verify the existence and value of the grain and livestock. This generally means that on-site inspections must be made and documented. Although the circumstances of each case must be taken into account, the general policy is that, for the classification exclusion to apply, inspections should have been performed not more than 90 days prior to the examination start date for feeder livestock and grain collateral, and not more than six months prior to the examination start date for breeder stock collateral. Copies of invoices or bills of sale are acceptable substitutes for inspection reports prepared by institution management, in the case of loans for the purchase of livestock.
- Loans secured by grain warehouse receipts are generally excluded from adverse classification, up to the market value of the grain represented by the receipts.
- The amount of credit to be given for the livestock or grain collateral should be based on the daily, published, market value as of the examination start date, less marketing and transportation costs, feed and veterinary expenses (to the extent determinable), and, if material in amount, the accrued interest associated

with the loan(s). Current market values for breeder stock may be derived from local or regional newspapers, area auction barns, or other sources considered reliable. If such valuations for breeding livestock cannot be obtained, the animals' slaughter values may be used.

- The institution must have satisfactory practices for controlling sales proceeds when the borrower sells livestock and feed and grain.
- The institution must have a properly perfected and enforceable security interest in the assets in question.

Examiners should exercise great caution in granting the grain and livestock exclusion from adverse classification in those instances where the borrower is highly leveraged, or where the debtor's basic operational viability is seriously in question, or if the institution is in an under-secured position. The issue of control over proceeds becomes extremely critical in such highly distressed credit situations. If the livestock and grain exclusion from adverse classification is not given in a particular case, institution management should be informed of the reasons why.

With the above principles, requirements, and standards in mind, the general guidelines for determining adverse classification for agricultural loans are as follows, listed by loan type.

<u>Feeder Livestock Loans</u> **-** The self-liquidating nature of these credits means that they are generally not subject to adverse classification. However, declines in livestock prices, increases in production costs, or other unanticipated developments may result in the revenues from the sale of the livestock not being adequate to fully repay the loans. Adverse classification may then be appropriate, depending upon the support of secondary repayment sources and collateral, and the borrower's overall financial condition and trends.

<u>Production Loans</u> **-** These loans are generally not subject to adverse classification if the debtor has good liquidity and/or significant fixed asset equities, or if the cash flow information suggests that current year's operations should be sufficient to repay the advances. The examiner should also take into account any governmental support programs or Federal crop insurance benefits from which the borrower may benefit. If cash flow from ongoing operations appears insufficient to repay production loans, adverse classification may be in order, depending upon the secondary repayment sources and collateral, and the borrower's overall financial condition and trends.

<u>Breeder Stock Loans</u> **-** These loans are generally not adversely classified if they are adequately secured by the livestock and if the term debt payments are being met through the sale of offspring (or milk and eggs in the case of dairy and poultry operations). If one or both of these conditions is not met, adverse classification may be in order, depending upon the support of secondary repayment sources and collateral, and the borrower's overall financial condition and trends.

<u>Machinery and Equipment Loans</u> **-** Loans for the acquisition of machinery and equipment will generally not be subject to adverse classification if they are adequately secured, structured on an appropriate amortization program (see above), and are paying as agreed. Farm machinery and equipment is often the second largest class of agricultural collateral, hence its existence, general state of repair, and valuation should be verified and documented during the institution's periodic on-site inspections of the borrower's operation. Funding for the payments on machinery and equipment loans sometimes comes, at least in part, from other loans provided by the institution, especially production loans. When this is the case, the question arises whether the payments are truly being "made as agreed." For examination purposes, such loans will be considered to be paying as agreed if cash flow projections, payment history, or other available information, suggests there is sufficient capacity to fully repay the production loans when they mature at the end of the current production cycle. If the machinery and equipment loan is not adequately secured, or if the payments are not being made as agreed, adverse classification should be considered.

<u>Carryover Debt</u> **-** Carryover debt results from the debtor's inability to generate sufficient cash flow to service the obligation as it is currently structured. It therefore tends to contain a greater degree of credit risk and must receive close analysis by the examiner. When carryover debt arises, the institution should determine the basic viability of the borrower's operation, so that an informed decision can be made on whether debt restructuring is appropriate. It will thus be useful for institution management to know how the carryover debt came about: Did it result from the obligor's financial, operational or other managerial weaknesses; from inappropriate credit administration on the institution's part, such as over lending or improper debt structuring; from external events such as adverse weather conditions that affected crop yields; or from other causes? In many instances, it will be in the long-term best interests of both the institution and the debtor to restructure the obligations. The restructured obligation should generally be rescheduled on a term basis and require clearly identified collateral, amortization period, and payment amounts. The amortization period may be intermediate or long term depending upon the useful economic life of the available collateral, and on realistic projections of the operation's payment capacity.

There are no hard and fast rules on whether carryover debt should be adversely classified, but the decision should generally consider the following: borrower's overall financial condition and trends, especially financial leverage (often measured in farm debtors with the debt-to-assets ratio); profitability levels, trends, and prospects; historical repayment performance; the amount of carryover debt relative to the operation's size; realistic projections of debt service capacity; and the support provided by secondary collateral. Accordingly, carryover loans to borrowers who are moderately to highly leveraged, who have a history of weak or no profitability and barely sufficient cash flow projections, as well as an adequate but slim collateral margin, will generally be adversely classified, at least until it is demonstrated through actual repayment performance that there is adequate capacity to service the rescheduled obligation. The classification severity will normally depend upon the collateral position. At the other extreme are cases where the customer remains fundamentally healthy financially, generates good profitability and ample cash flow, and who provides a comfortable margin in the security pledged. Carryover loans to this group of borrowers will not ordinarily be adversely classified.

Installment Loans

An installment loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for the purchase of heavy equipment or industrial vehicles may also be included. In addition, the department may grant indirect loans for the purchase of consumer goods.

The examiner's emphasis in reviewing the installment loan department should be on the overall procedures, policies and credit qualities. The goal should not be limited to identifying current portfolio problems, but should include potential future problems that may result from ineffective policies, unfavorable trends, potentially dangerous concentrations, or nonadherence to established policies. Direct installment lending policies typically address the following factors: loan applications and credit checks; terms in relation to collateral; collateral margins; perfection of liens; extensions, renewals and rewrites; delinquency notification and follow-up; and charge-offs and collections. For indirect lending, the policy typically addresses direct payment to the institution versus payment to the dealer, acquisition of dealer financial information, possible upper limits for any one dealer's paper, other standards governing acceptance of dealer paper, and dealer reserves and charge-backs.

Lease Accounting

ASC Topic 840, *Leases*, is the current lease accounting standard for non-public business entities and entities that have not adopted ASC Topic 842, *Leases*. ASC Topic 842 is effective for public business entities (as defined in U.S. GAAP) and will become effective for banks that are not public business entities, for fiscal years beginning after December 15, 2019, and interim reporting periods within fiscal years beginning after December 15, 2020. As such, a calendar year end non-public business entity's first reporting period will be December 31, 2020. Early adoption is permitted.

Direct Lease Financing

Leasing is a recognized form of term debt financing for fixed assets. While leases differ from loans in some respects, they are similar from a credit viewpoint because the basic considerations are cash flow, repayment capacity, credit history, management and projections of future operations. Additional considerations for a lease transaction are the property type and its marketability in the event of default or lease termination. Those latter considerations do not radically alter the manner in which an examiner evaluates collateral for a lease. The assumption is that the lessee/borrower will generate sufficient funds to liquidate the lease/debt. Sale of leased property/collateral remains a secondary repayment source and, except for the estimated residual value at the expiration of the lease, will not, in most cases, become a factor in liquidating the advance. When the institution is requested to purchase property of significant value for lease, it may issue a commitment to lease, describing the property, indicating cost, and generally outlining the lease terms. After all terms in the lease transaction are resolved by negotiation between the institution and its customer, an order is usually written requesting the institution to purchase the property. Upon receipt of that order, the institution purchases the property requested and arranges for delivery and, if necessary, installation. A lease contract is drawn incorporating all the points covered in the commitment letter, as well as the rights of the institution and lessee in the event of default. The lease contract is generally signed simultaneously with the signing of the order to purchase and the agreement to lease.

Lessor Accounting under ASC Topic 840

The types of assets that may be leased are numerous, and the accounting for direct leasing is a complex subject which is discussed in detail in ASC Topic 840, *Leases*. Familiarity with ASC Topic 840 is a prerequisite for the management of any institution engaging in or planning to engage in direct lease financing. The following terms are commonly encountered in direct lease financing:

- Net Lease, one in which the institution is not directly or indirectly obligated to assume the expenses of maintaining the equipment. This restriction does not prohibit the institution from paying delivery and set up charges on the property.
- Full Payout Lease, one for which the institution expects to realize both the return of its full investment and the cost of financing the property over the term of the lease. This payout can come from rentals, estimated tax benefits, and estimated residual value of the property.
- Leveraged Lease, in which the institution as lessor purchases and becomes the equipment owner by providing a relatively small percentage (20-40%) of the capital needed. Balance of the funds is borrowed by the lessor from long-term lenders who hold a first lien on the equipment and assignments of the lease and lease rental payments. This specialized and complex form of leasing is prompted mainly by a desire on the part of the lessor to shelter income from taxation. Creditworthiness of the lessee is paramount and the general rule is an institution should not enter into a leveraged lease transaction with any party to whom it would not normally extend unsecured credit.
- Rentals, which include only those payments reasonably anticipated by the institution at the time the lease is executed.

Lessor Accounting under ASC Topic 842

ASC Topic 842, *Leases* does not fundamentally change lessor accounting; however, it aligns terminology between lessee and lessor accounting and brings key aspects of lessor accounting into alignment with the FASB's new revenue recognition guidance in ASC Topic 606. As a result, the classification difference between direct financing leases and sales-type leases for lessors moves from a risk-and-rewards principle to a transfer of control principle. As such, an institution as lessor is required to classify a lease as a sales-type, direct financing, or operating leases. Additionally, there is no longer a distinction in the treatment of real estate and non-real estate leases by lessors.

Leases classified as leveraged leases prior to the adoption of ASC Topic 842 may continue to be accounted for under ASC Topic 840 unless subsequently modified. ASC Topic 842 eliminates leveraged lease accounting for leases that commence after an institution adopts the new accounting standard.

For more information refer to the Call Report Glossary for the accounting for leases or ASC Topic 842.

Examiner Consideration

Examiners should determine whether bank management carefully evaluates all lease variables, including the estimate of the residual value. Institutions may be able to realize unwarranted lease income in the early years of a contract by manipulating the lease variables. In addition, an institution can offer the lessee a lower payment by assuming an artificially high residual value during the initial structuring of the lease. But this technique may present the institution with serious long-term problems because of the reliance on speculative or nonexistent residual values.

Often, lease contracts contain an option permitting the lessee to continue use of the property at the end of the original term, working capital restrictions and other restrictions or requirements similar to debt agreements and lease termination penalties. Each lease is an individual contract written to fulfill the lessee's needs. Consequently, there may be many variations of each of the above provisions. However, the underlying factors remain the same: there is a definite contractual understanding of the positive right to use the property for a specific period of time, and required payments are irrevocable.

Examination procedures for reviewing lease financing activities are included in the ED Modules in the Loan References section.

Floor Plan Loans

Floor plan (wholesale) lending is a form of retail goods inventory financing in which each loan advance is made against a specific piece of collateral. As each piece of collateral is sold by the dealer, the loan advance against that piece of collateral is repaid. Items commonly subject to floor plan debt are automobiles, home appliances, furniture, television and stereophonic equipment, boats, mobile homes and other types of merchandise usually sold under a sales finance contract. Drafting agreements are a relatively common approach utilized in conjunction with floor plan financing. Under this arrangement, the institution establishes a line of credit for the borrower and authorizes the good's manufacturer to draw drafts on the institution in payment for goods shipped. The institution agrees to honor these drafts, assuming proper documentation (such as invoices, manufacturer's statement of origin, etc.) is provided. The method facilitates inventory purchases by, in effect, guaranteeing payment to the manufacturer for merchandise supplied. Floor plan loans involve all the basic risks inherent in any form of inventory financing. However, because of the banker's inability to exercise full control over the floored items, the exposure to loss may be greater than in other similar types of financing. Most dealers have minimal capital bases relative to debt. As a result, close and frequent review of the dealer's financial information is necessary. As with all inventory financing, collateral value is of prime importance. Control requires the institution to determine the collateral value at the time the loan is placed on the books, frequently inspect the collateral to determine its condition, and impose a curtailment requirement sufficient to keep collateral value in line with loan balances.

Handling procedures for floor plan lines will vary greatly depending on institution size and location, dealer size and the type of merchandise being financed. In many cases, the term "trust receipt" is used to describe the debt instrument existing between the institution and the dealer. Trust receipts may result from drafting agreements between an institution and a manufacturer for the benefit of a dealer. In other instances, the dealer may order inventory, bring titles or invoices to the institution, and then obtain a loan secured or to be secured by the inventory. Some banks may use master debt instruments, and others may use a trust receipt or note for each piece of inventory. The method of perfecting a security interest also varies from state to state. The important point is that an institution enacts realistic handling policies and ensures that its collateral position is properly protected.

Examination procedures and examiner considerations for reviewing floor plan lending activities are included in the ED Modules in the Loan References section.

Check Credit and Credit Card Loans

Check credit is defined as the granting of unsecured revolving lines of credit to individuals or businesses. Check credit services are provided by the overdraft system, cash reserve system, and special draft system. The most common is the overdraft system. In that method, a transfer is made from a pre-established line of credit to a customer's demand deposit account when a check which would cause an overdraft position is presented. Transfers normally are made in stated increments, up to the maximum line of credit approved by the institution, and the customer is notified that the funds have been transferred. In a cash reserve system, customers must request that the institution transfer funds from their pre-established line of credit to their demand deposit account before negotiating a check against them. A special draft system involves the customer negotiating a special check drawn directly against a pre-established line of credit. In that method, demand deposit accounts are not affected. In all three systems, the institution periodically provides its check credit customers with a statement of account activity. Required minimum payments are computed as a fraction of the balance of the account on the cycle date and may be made by automatic charges to a demand deposit account.

Most institution credit card plans are similar. The institution solicits retail merchants, service organizations and others who agree to accept a credit card in lieu of cash for sales or services rendered. The parties also agree to a discount percentage of each sales draft and a maximum dollar amount per transaction. Amounts exceeding that limit require prior approval by the institution. Merchants also may be assessed a fee for imprinters or promotional materials. The merchant deposits the institution credit card sales draft at the institution and receives immediate credit for the discounted amount. The institution assumes the credit risk and charges the nonrecourse sales draft to the individual customer's credit card account. Monthly statements are rendered by the institution to the customer who may elect to remit the entire amount, generally without service charge, or pay in monthly installments, with an additional percentage charged on the outstanding balance each month. A cardholder also may obtain cash advances from the institution or dispensing machines. Those advances accrue interest from the transaction date. An institution may be involved in a credit card plan in three ways:

- Agent Bank, which receives credit card applications from customers and sales drafts from merchants and forwards such documents to banks described below, and is accountable for such documents during the process of receiving and forwarding.
- Sublicensee Bank, which maintains accountability for credit card loans and merchant's accounts; may maintain its own center for processing payments and drafts; and may maintain facilities for embossing credit cards.
- Licensee Bank, which is the same as sublicensee institution, but in addition may perform transaction processing and credit card embossing services for sublicensee banks, and also acts as a regional or national clearinghouse for sublicensee banks.

Check credit and credit card loan policies typically address procedures for careful screening of account applicants; establishment of internal controls to prevent interception of cards before delivery, merchants from obtaining control of cards, or customers from making fraudulent use of lost or stolen card; frequent review of delinquent accounts, accounts where payments are made by drawing on reserves, and accounts with steady usage; delinquency notification procedures; guidelines for realistic charge-offs; removal of accounts from delinquent status (curing) through performance not requiring a catch-up of delinquent principal; and provisions that preclude automatic reissuance of expired cards to obligors with charged-off balances or an otherwise unsatisfactory credit history with the institution.

Examination procedures for reviewing these activities are included in the ED Modules. Also, the FDIC has separate manuals on Credit Card Specialty Bank Examination Guidelines and Credit Card Securitization Activities.

Credit Card-related Merchant Activities

Merchant credit card activities basically involve the acceptance of credit card sales drafts for clearing by a financial institution (clearing institution). For the clearing institution, these activities are generally characterized by thin profit margins amidst high transactional and sales volumes. Typically, a merchant's customer will charge an item on a credit card, and the clearing institution will give credit to the merchant's account. Should the customer dispute a charge transaction, the clearing institution is obligated to honor the customer's legitimate request to reverse the transaction. The Clearing Institution must then seek reimbursement from the merchant. Problems arise when the merchant is not creditworthy and is unable, or unwilling, to reimburse the clearing institution. In these instances, the clearing institution will incur a loss. Examiners should review for the existence of any such contingent liabilities.

To avoid losses and to ensure the safe and profitable operation of a clearing institution's credit card activities, the merchants with whom it contracts for clearing services should be financially sound and honestly operated. To this end, safe and sound merchant credit card activities include clear and detailed acceptance standards for merchants, such as the following:

- Scrutinizing prospective merchants using the same care and diligence used in evaluating prospective borrowers.
- Closely monitoring merchants with controls to ensure that early warning signs are recognized so that problem merchants can be removed from a clearing institution's program promptly to minimize loss exposure.
- Establishing an account administration program that incorporates periodic reviews of merchants' financial statements and business activities in cases of merchants clearing large dollar volumes.
- Establishing an internal periodic reporting system of merchant account activities regardless of the amount or number of transactions cleared, with these reports reviewed for irregularities so problematic merchant activity is identified quickly.
- Developing policies that follow the guidelines established by the card issuing networks.

Another possible problem with merchant activities involves clearing institutions that sometimes engage the services of agents, such as an independent sales organization (ISO). ISOs solicit merchants' credit card transactions for a clearing institution. In some cases, the ISOs actually contract with merchants on behalf of clearing institutions. Some of these contracts are entered into by the ISOs without the review and approval of the clearing institutions. At times, clearing institutions unfortunately rely too much on the ISOs to oversee account activity. In some cases, clearing institutions have permitted ISOs to contract with disreputable merchants. Because of the poor condition of the merchant, or ISO, or both, these clearing institutions can ultimately incur heavy losses.

A financial institution with credit card clearing activities typically develops its own internal controls and procedures to ensure sound agent selection standards before engaging an ISO. ISOs that seek to be compensated solely on the basis of the volume of signed-up merchants should be carefully scrutinized. A clearing institution should adequately supervise the ISO's activities, just as the institution would supervise any third party engaged to perform services for any aspect of the institution's operations. Also, institutions typically and appropriately reserve the right to ratify or reject any merchant contract that is initiated by an ISO.

Examination procedures for reviewing credit card related merchant activities are included in the ED Modules in the Supplemental Modules Section and in the Credit Card Activities Manual.

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OTHER CREDIT ISSUES

Appraisals

Appraisals are professional judgments of the market value of real property. Three basic valuation approaches are used by professional appraisers in estimating the market value of real property; the cost approach, the market data or direct sales comparison approach, and the income approach. The principles governing the three approaches are widely known in the appraisal field and are referenced in parallel regulations issued by each of the Federal banking agencies. When evaluating collateral, the three valuation approaches are not equally appropriate.

- **Cost Approach -** In this approach, the appraiser estimates the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value of the land. The cost approach is particularly helpful when reviewing draws on construction loans. However, as the property increases in age, both reproduction cost and depreciation become more difficult to estimate. Except for special purpose facilities, the cost approach is usually inappropriate in a troubled real estate market because construction costs for a new facility normally exceed the market value of existing comparable properties.

- **Market Data or Direct Sales Comparison Approach -** This approach examines the price of similar properties that have sold recently in the local market, estimating the value of the subject property based on the comparable properties' selling prices. It is very important that the characteristics of the observed transactions be similar in terms of market location, financing terms, property condition and use, timing, and transaction costs. The market approach generally is used in valuing owner-occupied residential property because comparable sales data is typically available. When adequate sales data is available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties is not sufficient to justify a conclusion.
- **The Income Approach -** The economic value of an income-producing property is the discounted value of the future net operating income stream, including any "reversion" value of property when sold. If competitive markets are working perfectly, the observed sales price should be equal to this value. For unique properties or in depressed markets, value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method for valuing the property. The income approach converts all expected future net operating income into present value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is often used to estimate the present value of future income streams. For troubled properties, however, the more explicit discounted cash flow (net present value) method is more typically utilized for analytical purposes. In the rent method, a time frame for achieving a "stabilized", or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Valuation of Troubled Income-Producing Properties

When an income property is experiencing financial difficulties due to general market conditions or due to its own characteristics, data on comparable property sales is often difficult to obtain. Troubled properties may be hard to market, and normal financing arrangements may not be available. Moreover, forced and liquidation sales can dominate market activity. When the use of comparables is not feasible (which is often the case for commercial properties), the net present value of the most reasonable expectation of the property's income-producing capacity - not just in today's market but over time - offers the most appropriate method of valuation in the supervisory process.

Estimates of the property's value should be based upon reasonable and supportable projections of the determinants of future net operating income: rents (or sales), expenses, and rates of occupancy. The primary considerations for these projections include historical levels and trends, the current market performance achieved by the subject and similar properties, and economically feasible and defensible projections of future demand and supply conditions. If current market activity is dominated by a limited number of transactions or liquidation sales, high capitalization and discount rates implied by such transactions should not be used. Rather, analysts should use rates that reflect market conditions that are neither highly speculative nor depressed.

Appraisal Regulation

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 requires that appraisals prepared by certified or licensed appraisers be obtained in support of real estate lending and mandates that the Federal financial institutions regulatory agencies adopt regulations regarding the preparation and use of appraisals in certain real estate related transactions by financial institutions under their jurisdiction. In addition, Title XI created the Appraisal Subcommittee (Subcommittee) of the Federal Financial Institutions Examination Council (FFIEC) to provide oversight of the real estate appraisal process as it relates to federally related real estate transactions. The Subcommittee is composed of six members, each of whom is designated by the head of their respective agencies. Each of the five financial institution regulatory agencies which comprise the FFIEC and the U.S. Department of Housing and Urban Development are represented on Subcommittee. A responsibility of the Subcommittee is to monitor the state certification and licensing of appraisers. It has the authority to disapprove a state appraiser regulatory program, thereby disqualifying the state's licensed and certified appraisers from conducting appraisals for federally related transactions.

The Subcommittee gets its funding by charging state certified and licensed appraisers an annual registration fee. The fee income is used to cover Subcommittee administrative expenses and to provide grants to the Appraisal Foundation.

Formed in 1987, the Appraisal Foundation was established as a private not for profit corporation bringing together interested parties within the appraisal industry, as well as users of appraiser services, to promote professional standards within the appraisal industry. The Foundation sponsors two independent boards referred to in Title XI, The Appraiser Qualifications Board (AQB) and The Appraisal Standards Board (ASB). Title XI specifies that the minimum standards for state appraiser certification are to be the criteria for certification issued by the AQB. Title XI does not set specific criteria for the licensed classification. These are individually determined by each state. Additionally, Title XI requires that the appraisal standards prescribed by the Federal agencies, at a minimum, must be the appraisal standards promulgated by the ASB. The ASB has issued The Uniform Standards of Professional Appraisal Practice (USPAP) which set the appraisal industry standards for conducting an appraisal of real estate. To the appraisal industry, USPAP is analogous to generally accepted accounting principles for the accounting profession.

In conformance with Title XI, Part 323 of the FDIC regulations identifies which real estate related transactions require an appraisal by a certified or licensed appraiser and establishes minimum standards for performing appraisals. Substantially similar regulations have been adopted by each of the Federal financial institutions regulatory agencies.

Real estate-related transactions include real estate loans, mortgage-backed securities, institution premises, real estate investments, and other real estate owned. All real estate-related transactions by FDIC-insured institutions not specifically exempt are, by definition, "federally related transactions" subject to the requirements of the regulation. Exempt real estate-related transactions include:

- The transaction value is $250,000 or less;
- A lien on real estate has been taken as collateral in an abundance of caution;
- The transaction is not secured by real estate;
- A lien on real estate has been taken for purposes other than the real estate's value;
- The transaction is a business loan that: (i) has a transaction value of $1 million or less; and (ii) is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
- A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;
- The transaction involves an existing extension of credit at the lending institution, provided that: (i) There has been no obvious and material change in the market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or (ii) There is no advancement of new monies, other than funds necessary to cover reasonable closing costs;
- The transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by, a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met FDIC regulatory requirements for appraisals at the time of origination;
- The transaction is wholly or partially insured or guaranteed by a United States government agency or United States government sponsored agency;
- The transaction either; (i) Qualifies for sale to a United States government agency or United States government sponsored agency; or (ii) Involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;
- The regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law; or
- The FDIC determines that the services of an appraiser are not necessary in order to protect Federal financial and public policy interests in real estate-related financial transaction or to protect the safety and soundness of the institution.
- The transaction is a commercial real estate transaction that has a transaction value of $500,000 or less.

Section 323.4 establishes minimum standards for all appraisals in connection with federally related transactions. Appraisals performed in conformance with the regulation must conform to the requirements of the USPAP and certain other listed standards. The applicable sections of USPAP are the Preamble (ethics and competency), Standard 1 (appraisal techniques), Standard 2 (report content), and Standard 3 (review procedures). USPAP Standards 4 through 10 concerning appraisal services and appraising personal property do not apply to federally related transactions.

An appraisal satisfies the regulation if it is performed in accordance with all of its provisions and it is still current and meaningful. In other words, a new appraisal does not necessarily have to be done every time there is a transaction, provided the institution has an acceptable process in place to review existing appraisals.

Adherence to the appraisal regulations should be part of the examiner's overall review of the lending function. An institution's written appraisal program should contain specific administrative review procedures that provide some evidence, such as a staff member's signature on an appraisal checklist that indicates the appraisal was reviewed and that all standards were met. In addition, the regulation requires that the appraisal contain the appraiser's certification that it was prepared in conformance with USPAP. When analyzing individual transactions, examiners should review appraisal reports to determine the institution's conformity to its own internal appraisal policies and for compliance with the regulation. Examiners may need to conduct a more detailed review if the appraisal does not have sufficient information, does not explain assumptions, is not logical, or has other major deficiencies that cast doubt as to the validity of its opinion of value. Examination procedures regarding appraisal reviews are included in the Examination Documentation Modules.

Loans in a pool such as an investment in mortgage- backed securities or collateralized mortgage obligations should have some documented assurance that each loan in the pool has an appraisal in accordance with the regulation. Appropriate evidence could include an issuer's certification of compliance.

All apparent violations of Part 323 should be listed in the examination report in the usual manner. Significant systemic failures to meet standards and procedures could call for formal corrective measures.

Interagency Appraisal and Evaluation Guidelines

The Interagency Appraisal and Evaluation Guidelines dated December 2, 2010 address supervisory matters relating to real estate-related financial transactions and provide guidance to examining personnel and federally regulated institutions about prudent appraisal and evaluation policies, procedures, practices, and standards that are consistent with the appraisal regulation.

An institution's real estate appraisal and evaluation policies and procedures will be reviewed as part of the examination of the institution's overall real estate-related activities. An institution's policies and procedures typically are incorporated into an effective appraisal and evaluation program. Examiners will consider the institution's size and the nature of its real estate-related activities when assessing the appropriateness of its program.

When analyzing individual transactions, examiners should review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and comply with the agencies' appraisal regulations and the institution’s internal policies. Examiners also will review the steps taken by an institution to ensure that the individuals who perform its appraisals and evaluations are qualified and are not subject to conflicts of interest. Institutions that fail to maintain a sound appraisal or evaluation program or to comply with the agencies' appraisal regulations will be cited in examination reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

Appraisal and Evaluation Program **-** An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish an effective real estate appraisal and evaluation program. Effective programs:

- Establish selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals or evaluations;
- Provide for the independence of the person performing appraisals or evaluations;
- Identify the appropriate appraisal for various lending transactions;
- Establish criteria for contents of an evaluation;
- Provide for the receipt of the appraisal or evaluation report in a timely manner to facilitate the underwriting decision;
- Assess the validity of existing appraisals or evaluations to support subsequent transactions;
- Establish criteria for obtaining appraisals or evaluations for transactions that are otherwise exempt from the agencies' appraisal regulations; and
- Establish internal controls that promote compliance with these program standards.

<u>Selection of Individuals Who May Perform Appraisals and Evaluations</u> **-** An institution's program establishes criteria to select, evaluate, and monitor the performance of the individual(s) who performs a real estate appraisal or evaluation. Appropriate criteria ensure that:

- The selection process is non-preferential and unbiased;
- The individual selected possesses the requisite education, expertise and competence to complete the assignment;
- The individual selected is capable of rendering an unbiased opinion; and

- The individual selected is independent and has no direct or indirect interest, financial or otherwise, in the property or the transaction.

Under the agencies' appraisal regulations, the appraiser must be selected and engaged directly by the institution or its agent. The appraiser's client is the institution, not the borrower. Also, an institution may not use an appraisal that has been “readdressed” – appraisal reports that are altered by the appraiser to replace any references to the original client with the institution’s name. An institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, as long as the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable.

<u>Independence of the Appraisal and Evaluation Function</u> **-** Because the appraisal and evaluation process is an integral component of the credit underwriting process, it should be isolated from influence by the institution's loan production process. An appraiser and an individual providing evaluation services should be independent of the loan and collection functions of the institution and have no interest, financial or otherwise, in the property or the transaction. In addition, individuals independent from the loan production area should oversee the selection of appraisers and individuals providing evaluation services. If absolute lines of independence cannot be achieved, an institution must be able to clearly demonstrate that it has prudent safeguards to isolate its collateral evaluation process from influence or interference from the loan production process. That is, no single person should have sole authority to render credit decisions on loans which they ordered or reviewed appraisals or evaluations.

The agencies recognize, however, that it is not always possible or practical to separate the loan and collection functions from the appraisal or evaluation process. In some cases, such as in a small or rural institution or branch, the only individual qualified to analyze the real estate collateral may also be a loan officer, other officer, or director of the institution. To ensure their independence, such lending officials, officers, or directors abstain from any vote or approval involving loans on which they performed an appraisal or evaluation.

<u>Transactions That Require Appraisals</u> **-** Although the agencies' appraisal regulations exempt certain categories of real estate-related financial transactions from the appraisal requirements, most real estate transactions over $250,000 ($500,000 for commercial real estate transactions) are considered federally related transactions and thus require appraisals. A "federally related transaction" means any real estate-related financial transaction, in which the agencies engage, contract for, or regulate and that requires the services of an appraiser. An agency also may impose more stringent appraisal requirements than the appraisal regulations require, such as when an institution's troubled condition is attributable to real estate loan underwriting problems.

<u>Minimum Appraisal Standards</u> **-** The agencies' appraisal regulations include five minimum standards for the preparation of an appraisal. The appraisal must:

- Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards. Although allowed by USPAP, the agencies' appraisal regulations do not permit an appraiser to appraise any property in which the appraiser has an interest, direct or indirect, financial or otherwise;
- Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction. As discussed below, appraisers have available various appraisal development and report options; however, not all options may be appropriate for all transactions. A report option is acceptable under the agencies' appraisal regulations only if the appraisal report contains sufficient information and analysis to support an institution's decision to engage in the transaction.
- Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units. This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods. For federally related transactions, an appraisal is to include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal. For properties where improvements are to be constructed or rehabilitated, the regulated institution may also request a prospective market value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development for the purpose of the agencies' appraisal regulations. For proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs and entrepreneurial profit. For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commission, rent losses, and tenant

improvements from an estimate based on stabilized occupancy;
- Be based upon the definition of market value set forth in the regulation. Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations; and,
- Be performed by state licensed or certified appraisers in accordance with requirements set forth in the regulation.

Appraisal Options - An appraiser typically uses three market value approaches to analyze the value of a property cost, income, and sales market. The appraiser reconciles the results of each approach to estimate market value. An appraisal will discuss the property's recent sales history and contain an opinion as to the highest and best use of the property. An appraiser must certify that he/she has complied with USPAP and is independent. Also, the appraiser must disclose whether the subject property was inspected and whether anyone provided significant assistance to the person signing the appraisal report.

An institution may engage an appraiser to perform either a Complete or Limited Appraisal. When performing a Complete Appraisal assignment, an appraiser must comply with all USPAP standards - without departing from any binding requirements - and specific guidelines when estimating market value. When performing a Limited Appraisal, the appraiser elects to invoke the Departure Provision which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches to value; however, departure from standards designated as binding requirements is not permitted. There are numerous binding requirements which are detailed in the USPAP. Use of the USPAP Standards publication as a reference is recommended. The book provides details on each appraisal standard and advisory opinions issued by the Appraisal Standards Board.

An institution and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the institution or other intended users of the appraisal report. The agencies do not prohibit the use of a Limited Appraisal for a federally related transaction, but the agencies believe that institutions should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

Complete and Limited Appraisal assignments may be reported in three different report formats: a Self-Contained Report, a Summary Report, or a Restricted Report. The major difference among these three reports relates to the degree of detail presented in the report by the appraiser. The Self-Contained Appraisal Report provides the most detail, while the Summary Appraisal Report presents the information in a condensed manner. The Restricted Report provides a capsulated report with the supporting details maintained in the appraiser's files.

The agencies believe that the Restricted Report format will not be appropriate to underwrite a significant number of federally related transactions due to the lack of sufficient supporting information and analysis in the appraisal report. However, it might be appropriate to use this type of appraisal report for ongoing collateral monitoring of an institution's real estate transactions and under other circumstances when an institution's program requires an evaluation.

Moreover, since the institution is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The institution's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written engagement letter that outlines the institution's expectations and delineates each party's responsibilities, especially for large, complex, or out-of-area properties.

Transactions That Require Evaluations - A formal opinion of market value prepared by a state licensed or certified appraiser is not always necessary. Instead, less formal evaluations of the real estate may suffice for transactions that are exempt from the agencies' appraisal requirements.

Additionally, prudent institutions establish criteria for obtaining appraisals or evaluations for safety and soundness reasons for transactions that are otherwise exempt from the agencies' appraisal regulations.

Evaluation Content - Prudent standards for preparing evaluations typically require that evaluations:

- Be written;
- Include the preparer's name, address, and signature, and the effective date of the evaluation;
- Describe the real estate collateral, its condition, its current and projected use;
- Describe the source(s) of information used in the analysis;
- Describe the analysis and supporting information, and;

- Provide an estimate of the real estate's market value, with any limiting conditions.

An appropriate evaluation report includes calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. Documentation should be sufficient to allow an institution to understand the analysis, assumptions, and conclusions. An institution's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties might provide a basis for evaluations.

An appropriate evaluation provides an estimate of value to assist the institution in assessing the soundness of the transaction. Prudent practices may include more detailed evaluations as an institution engages in more complex real estate-related financial transactions, or as its overall exposure increases. For example, an evaluation for a home equity loan might be based primarily on information derived from a sales data services organization or current tax assessment information, while an evaluation for an income-producing real estate property describes the current and expected use of the property and includes an analysis of the property's rental income and expenses.

Qualifications of Evaluation Providers **-** Individuals who prepare evaluations should have real estate-related training or experience and knowledge of the market relevant to the subject property. Based upon their experience and training, professionals from several fields may be qualified to prepare evaluations of certain types of real estate collateral. Examples include individuals with appraisal experience, real estate lenders, consultants or sales persons, agricultural extension agents, or foresters. Institutions should document the qualifications and experience level of individuals whom the institution deems acceptable to perform evaluations. An institution might also augment its in-house expertise and hire an outside party familiar with a certain market or a particular type of property. Although not required, an institution may use state licensed or certified appraisers to prepare evaluations. As such, Limited Appraisals reported in a Summary or Restricted format may be appropriate for evaluations of real estate-related financial transactions exempt from the agencies' appraisal requirements.

Valid Appraisals and Evaluations **-** The institution may use an existing appraisal or evaluation to support a subsequent transaction, if the institution documents that the existing estimate of value remains valid. Therefore, a prudent appraisal and evaluation program includes criteria to determine whether an existing appraisal or evaluation remains valid to support a subsequent transaction. Criteria for determining whether an existing appraisal or evaluation remains valid will vary depending upon the condition of the property and the marketplace, and the nature of any subsequent transaction. Factors that could cause changes to originally reported values include: the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; improvements to, or lack of maintenance of, the subject property or competing surrounding properties; changes in zoning; or environmental contamination. The institution must document the information sources and analyses used to conclude that an existing appraisal or evaluation remains valid for subsequent transactions.

Renewals, Refinancings, and Other Subsequent Transactions **-** The agencies' appraisal regulations generally allow appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings; however, in certain situations an appraisal is required. If new funds are advanced in excess of reasonable closing costs, an institution is expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions or in the physical aspects of the property that threatens the institution's real estate collateral protection.

The decision to reappraise or reevaluate the real estate collateral should be guided by the regulatory exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends on the condition and quality of the loan, the soundness of the underlying collateral and the validity of the existing appraisal or evaluation.

A reappraisal would not be required when an institution advances funds to protect its interest in a property, such as to repair damaged property, because these funds would be used to restore the damaged property to its original condition. If a loan workout involves modification of the terms and conditions of an existing credit, including acceptance of new or additional real estate collateral, which facilitates the orderly collection of the credit or reduces the institution's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs.

An institution may engage in a subsequent transaction based on documented equity from a valid appraisal or evaluation, if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. If a property, however, has reportedly appreciated because of a planned change in use of the property, such as rezoning, an appraisal would be required for a federally related transaction, unless another exemption applied.

Program Compliance - Appropriate appraisal and evaluation programs establish effective internal controls that promote compliance with the program's standards. An individual familiar with the appraisal regulations should ensure that the institution's appraisals and evaluations comply with the appraisal regulations and the institution's program. Typically, loan administration files document this compliance review, although a detailed analysis or comprehensive analytical procedures are not required for every appraisal or evaluation. For some loans, the compliance review may be part of the loan officer's overall credit analysis and may take the form of either a narrative or a checklist. Examiners should determine whether corrective action for noted deficiencies was undertaken by the individual who prepared the appraisal or evaluation.

Effective appraisal and evaluation programs have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, non-residential real estate construction loans, or out-of-area real estate. These comprehensive analytical procedures are typically designed to verify that the methods, assumptions, and conclusions are reasonable and appropriate for the transaction and the property. These procedures provide for a more detailed review of selected appraisals and evaluations prior to the final credit decision. The individual(s) performing these reviews should have the appropriate training or experience, and be independent of the transaction.

Appraisers and persons performing evaluations are responsible for any deficiencies in their reports. Deficient reports should be returned to them for correction. Unreliable appraisals or evaluations should be replaced prior to the final credit decision. Examiners should be mindful that changes to an appraisal's estimate of value are permitted only as a result of a review conducted by an appropriately qualified state licensed or certified appraiser in accordance with Standard III of USPAP.

Portfolio Monitoring - The institution also typically develops criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques, even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

Referrals - Financial institutions are encouraged to make referrals directly to state appraiser regulatory authorities when a state licensed or certified appraiser violates USPAP, applicable State law, or engages in other unethical or unprofessional conduct. Examiners finding evidence of unethical or unprofessional conduct by appraisers will forward their findings and recommendations to their supervisory office for appropriate disposition and referral to the State, as necessary.

Examination Treatment

All apparent violations of the appraisal regulation should be described in the schedule of violations of laws and regulations. Management's comments and any commitments for correcting the practices that led to the apparent violation should be included. Violations that are technical in nature and do not impact the value conclusion generally should not require a new appraisal. (These technical violations should not be relisted in subsequent examinations.) Since the point of an appraisal is to help make sound loan underwriting decisions, getting an appraisal on a loan already made simply to fulfill the requirements of the appraisal regulation, would be of little benefit. However, an institution should be expected to obtain a new appraisal on a loan in violation of the appraisal regulation when there is a safety and soundness reason for such action. For example, construction loans and lines of credit need to have the value of the real estate reviewed frequently in order for the institution to properly manage the credit relationship. A new appraisal might also be needed to determine the proper classification for examination purposes of a collateral dependent loan.

Loan Participations

A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead institution originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. The lead (originating) institution retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Properly structured, loan participations allow selling banks to accommodate large loan requests which would otherwise exceed lending limits, diversify risk, and improve liquidity. Participating banks are able to compensate for low local loan demand or invest in large loans without servicing burdens and origination costs. If not appropriately structured and documented, a participation loan can present unwarranted risks to both the seller and purchaser of the loan. Examiners should determine the nature and adequacy of the participation arrangement as well as analyze the credit quality of the loan.

Accounting

The proper accounting treatment for loan participations is governed by ASC Topic 860, *Transfers and Servicing,* that applies to the transferor (seller) of assets and the transferee (purchaser).

Before considering whether the conditions for a sale have been met, the transfer of a portion of an entire financial asset must first meet the definition of a participating interest.

A participating interest in an entire financial asset, as defined in ASC Topic 860, has all of the following characteristics:

- From the date of transfer, it must represent a proportionate (pro-rata) ownership interest in the entire financial asset;
- From the date of the transfer, all cash flows received from the entire financial asset, except any cash flows allocated as compensation for servicing or other services performed (which must not be subordinated and must not significantly exceed an amount that would fairly compensate a substitute service provider should one be required), must be divided proportionately among the participating interest holders in an amount equal to their share of ownership;
- The rights of each participating interest holder (including the lead lender) must have the same priority, no interest is subordinated to another interest, and no participating interest holder has recourse to the lead lender or another participating interest holder other than standard representations and warranties and ongoing contractual servicing and administration obligations; and
- No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to do so.

If the financial asset meets the definition of a participating interest, the institution must then determine if the participating interest qualifies for sale treatment. The sale criteria focus on whether or not control is effectively transferred to the purchaser.

A transfer of an entire financial asset, a group of financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

- The transferred financial assets have been isolated from the seller, meaning that the purchaser's interest in the loan is presumptively beyond the reach of the seller and its creditors, even in bankruptcy or other receivership;
- Each purchaser has the right to pledge or exchange its interest in the loan, and there are no conditions that both constrain the purchaser from taking advantage of that right to pledge or exchange and provide more than a trivial benefit to the seller; and
- The seller or their agents do not maintain effective control over the transferred financial assets. Examples of a seller maintaining effective control include an agreement that both entitles and obligates the seller to repurchase or redeem the purchaser's interest in the loan prior to the loan's maturity, an agreement that provides the seller with the unilateral ability to cause the purchaser to return its interest in the loan to the seller (other than through a cleanup call), or an agreement that permits the purchaser to require the seller to repurchase its interest in the loan at a price so favorable to the purchaser that it is probable that the purchaser will require the seller to repurchase.

Right to Repurchase

Some loan participation agreements may give the seller a contractual right to repurchase the participated interest in the loan at any time. In this case, the seller's right to repurchase the participation effectively provides the seller with a call option on a specific asset that would preclude sale accounting if the asset is not readily obtainable in the marketplace. If a loan participation agreement contains such a provision, freestanding or attached, it constrains the purchaser from pledging or exchanging its participating interest, and results in the seller maintaining effective control over the participating interest. In such cases, the transfer would be accounted for as a secured borrowing.

For additional information on the transfer of loan participations refer to the Call Report Glossary entry: “Transfers of Financial Assets”.

Recourse Arrangements

Recourse arrangements may, or may not, preclude loan participations from being accounted for as sales for financial reporting purposes. The date of the participation and the formality of the recourse provision affect the accounting for the transaction. Formal recourse provisions may affect the accounting treatment of a participation depending upon the date that the participation is transferred to another institution. Implicit recourse provisions would not affect the financial reporting treatment of a participation because the accounting standards look to the contractual terms of asset transfers in determining whether or not the criteria necessary for sales accounting treatment have been met. Although implicit recourse provisions would not affect the accounting treatment of a loan participation, they may affect the risk-based capital treatment of a participation.

If an originating selling institution has transferred a loan participation to a participating institution with recourse on or before December 31, 2001, the existence of the recourse obligation in and of itself does not preclude sale accounting for the transfer. If a loan participation transferred with recourse on or before December 31, 2001, meets the three conditions then in effect for the transferor to have surrendered control over the transferred assets, the transfer should be accounted for as a sale for financial reporting purposes. However, a loan participation sold with recourse is subject to the banking agencies' risk-based capital requirements.

If an originating selling institution transfers a loan participation with recourse on or after January 1, 2002, the participation generally will not be considered isolated from the originating lender in an FDIC receivership. Section 360.6 of the FDIC Rules and Regulations limits the FDIC's ability to reclaim loan participations transferred *without recourse* as defined in the regulations, but does not limit the FDIC's ability to reclaim loan participations transferred with recourse. Under Section 360.6, a participation subject to an agreement that requires the originating lender to repurchase the participation or to otherwise compensate the participating institution due to a default on the underlying loan is considered a participation *with recourse*. As a result, a loan participation transferred *with recourse* on or after January 1, 2002, generally should be accounted for as a secured borrowing and not as a sale for financial reporting purposes. This means that the originating lender should not remove the participation from its loan assets on the balance sheet, but should report the loan participation as a secured borrowing.

Call Report Treatment

When a loan participation meets the definition of a participating interest and the conditions for sale treatment are met, the seller removes the participated interest in the loan from the balance sheet. The purchaser reports the participating interest in "Loans" in the Report of Condition, and in Call Report Schedule RC-C - Loans and Lease Financing Receivables, based upon collateral, borrower, or purpose. When a loan participation does not meet the definition of a participating interest, or if a transfer of a participating interest does not meet all of the conditions for sale accounting, the transfer must be reported as a secured borrowing with a pledge of collateral. In these situations, because the transferred loan participation does not qualify for sale accounting, the transferring institution must continue to report the transferred participation (as well as the retained portion of the loan) in "Loans" in the Report of Condition, based upon collateral, borrower, and purpose. As a consequence, the transferred loan participation should be included in the originating lender's loans and leases for purposes of determining the appropriate level for the institution's allowance for loan and lease losses.

The transferring institution should also report the transferred loan participation as a secured borrowing in "Other Borrowed Money" in the Report of Condition.

Independent Credit Analysis

An institution purchasing a participation loan is expected to perform the same degree of independent credit analysis on the loan as if it were the originator. To determine if a participation loan meets its credit standards, a participating institution must obtain all relevant credit information and details on collateral values, lien status, loan agreements and participation agreements before a commitment is made to purchase. The absence of such information may be evidence that the participating institution has not been prudent in its credit decision.

During the life of the participation, the participant should monitor the servicing and the status of the loan. In order to exercise control of its ownership interest, a purchasing institution must ascertain that the selling institution will provide complete and timely credit information on a continuing basis.

The procedures for purchasing loan participations should be provided for in the institution's formal lending policy. The criteria for participation loans should be consistent with that for similar direct loans. The policy would normally require the complete analysis of the credit quality of obligations to be purchased, determination of value and lien status of collateral, and the maintenance of full credit information for the life of the participation.

Participation Agreements

A participation loan can present unique problems if the borrower defaults, the lead institution becomes insolvent, or a party to the participation arrangement does not perform as expected. These contingencies should be considered in a written participation agreement. The agreement should clearly state the limitations the originating and participating banks impose on each other and the rights all parties retain. In addition to the general terms of the participation transaction, comprehensive participation agreements specifically include the following considerations:

- The obligation of the lead institution to furnish timely credit information and to provide notification of material changes in the borrower's status;
- Requirements that the lead institution consult with participants prior to modifying any loan, guaranty, or security agreements and before taking any action on defaulted loans;
- The specific rights and remedies available to the lead and participating banks upon default of the borrower;

- Resolution procedures when the lead and participating banks cannot agree on the handling of a defaulted loan;
- Resolution of any potential conflicts between the lead institution and participants in the event that more than one loan to the borrower defaults; and
- Provisions for terminating the agency relationship between the lead and participating banks upon such events as insolvency, breach of duty, negligence, or misappropriation by one of the parties.

Participations Between Affiliated Institutions

Examiners should ascertain that banks do not relax their credit standards when dealing with affiliated institutions and that participation loans between affiliated institutions comply with Section 23A of the Federal Reserve Act. The Federal Reserve Board's staff has interpreted that the purchase of a participation loan from an affiliate is exempt from Section 23A provided that the commitment to purchase is obtained by the affiliate before the loan is consummated by the affiliate, and the decision to participate is based upon the institution's independent evaluation of the creditworthiness of the loan. If these criteria are not strictly met, the loan participation could be subject to the qualitative and/or quantitative restrictions of Section 23A. Refer to the Related Organizations Section of this Manual which describes transactions with affiliates.

Sales of 100 Percent Loan Participations

In some cases, depository institutions structure loan originations and participations with the intention of selling 100 percent of the underlying loan amount. Certain 100 percent loan participation programs raise unique safety and soundness issues that should be addressed by an institution's policies, procedures and practices.

If not appropriately structured, these 100 percent participation programs can present unwarranted risks to the originating institution including legal, reputation and compliance risks. Therefore, agreements to mitigate these risks clearly state the limitations the originating and participating institutions impose on each other and the rights all parties retain. This typically includes the originating institution stating that loan participants are participating in loans and are not investing in a business enterprise. The policies of an institution engaged in these originations typically address safety and soundness concerns and include criteria to address:

- The program's objectives – these should be of a commercial nature (structured as commercial undertakings and not as investments in securities).
- The plan of distribution – participants should be limited to sophisticated financial and commercial entities and sophisticated persons and the participations should not be sold directly to the public.
- The credit requirements applicable to the borrower - the originating institution should structure 100% loan participation programs only for borrowers who meet the originating institution's credit requirements.
- Access afforded program participants to financial information on the borrower - the originating institution should allow potential loan participants to obtain and review appropriate credit and other information to enable the participants to make an informed credit decision.

Environmental Risk Program

Examiners are to ascertain whether a lending institution has appropriate safeguards and controls to limit exposure to potential environmental liability associated with real property held as collateral. The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws have become important factors in evaluating real estate transactions and making loans secured by real estate. Environmental contamination, and liability associated with environmental contamination, may have a significant adverse effect on the value of real estate collateral, which may in certain circumstances cause an insured institution to abandon its right to the collateral. It is also possible for an institution to be held directly liable for the environmental cleanup of real property collateral acquired by the institution. The cost of such a cleanup may exceed by many times the amount of the loan made to the borrower. A loan may be affected adversely by potential environmental liability even where real property is not taken as collateral. For example, a borrower's capacity to make payments on a loan may be threatened by environmental liability to the borrower for the cost of a hazardous contamination cleanup on property unrelated to the loan with the institution. The potential for environmental liability may arise from a variety of Federal and State environmental laws and from common law tort liability.

Guidelines for an Environmental Risk Program

As part of the institution's overall decision-making process, the environmental risk program typically includes procedures for identifying and evaluating potential environmental concerns associated with lending practices and other actions relating to real property. The board of directors normally reviews and approves the program and designates a senior officer knowledgeable in environmental matters responsible for program implementation. The environmental risk program should be tailored to the needs of the lending institution. That is, institutions that have a heavier concentration of loans to higher risk industries or localities of known contamination may require a more elaborate and sophisticated environmental risk program than institutions that lend more to lower risk industries or localities. An effective environmental risk program should provide for staff training, set environmental policy guidelines and procedures, require an environmental review or analysis during the application process, include loan documentation standards, and establish appropriate environmental risk assessment safeguards in loan workout situations and foreclosures.

Examination Procedures

Examiners should review an institution's environmental risk program as part of the examination of its lending and investment activities. When analyzing individual credits, examiners should review the institution's compliance with its own environmental risk program. Failure to establish or comply with an appropriate environmental program should be criticized and corrective action required.

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LOAN PROBLEMS

It would be impossible to list all sources and causes of problem loans. They cover a multitude of mistakes an institution may permit a borrower to make, as well as mistakes directly attributable to weaknesses in the institution's credit administration and management. Some well-constructed loans may develop problems due to unforeseen circumstances on the part of the borrower; however, institution management must endeavor to protect a loan by every means possible. One or more of the items in the following list is often basic to the development of loan problems.

Many of these items may also be indicative of potential institution fraud and/or insider abuse. Additional information on the warning signs and suggested areas for investigation are included in the Bank Fraud and Insider Abuse Section of this Manual.

Poor Selection of Risks

Problems in this area may reflect the absence of sound lending policies, and/or management's lack of sound credit judgment in advancing certain loans. The following are general types of loans which may fall within the category of poor risk selection. It should be kept in mind that these examples are generalizations, and the examiner must weigh all relevant factors in determining whether a given loan is indeed a poor risk.

- Loans to finance new and untried business ventures which are inadequately capitalized.
- Loans based more upon the expectation of successfully completing a business transaction than on sound worth or collateral.
- Loans for the speculative purchase of securities or goods.
- Collateral loans made without adequate margin of security.
- Loans made because of other benefits, such as the control of large deposit balances, and not based upon sound worth or collateral.
- Loans made without adequate owner equity in underlying real estate security.
- Loans predicated on collateral which has questionable liquidation value.
- Loans predicated on the unmarketable stock of a local corporation when the institution is at the same time lending directly to the corporation. Action which may be beneficial to the institution from the standpoint of the one loan may be detrimental from the standpoint of the other loan.
- Loans which appear to be adequately protected by collateral or sound worth, but which involve a borrower of poor character risk and credit reputation.
- Loans which appear to be adequately protected by collateral, but which involve a borrower with limited or unassessed repayment ability.
- An abnormal amount of loans involving out-of-territory borrowers (excluding large banks properly staffed to handle such loans).
- Loans involving brokered deposits or link financing.

Overlending

It is almost as serious, from the standpoint of ultimate losses, to lend a sound financial risk too much money as it is to lend to an unsound risk. Loans beyond the reasonable capacity of the borrower to repay invariably lead to the development of problem loans.

Failure to Establish or Enforce Liquidation Agreements

Loans granted without a well-defined repayment program violate a fundamental principle of sound lending. Regardless of what appears to be adequate collateral protection, failure to establish at inception or thereafter enforce a program of repayment almost invariably leads to troublesome and awkward servicing problems, and in many instances is responsible for serious loan problems including eventual losses. This axiom of sound lending is important not only from the lender's standpoint, but also the borrower's.

Incomplete Credit Information

Lending errors frequently result because of management's failure to obtain and properly evaluate credit information. Adequate comparative financial statements, income statements, cash flow statements and other pertinent statistical support should be available. Other essential information, such as the purpose of the borrowing and intended plan or sources of repayment, progress reports, inspections, memoranda of outside information and loan conferences, correspondence, etc., should be contained in the institution's credit files. Failure of an institution's management to give proper attention to credit files makes sound credit judgment difficult if not impossible.

Overemphasis on Loan Income

Misplaced emphasis upon loan income, rather than soundness, almost always leads to the granting of loans possessing undue risk. In the long run, unsound loans usually are far more expensive than the amount of revenue they may initially produce.

Self-Dealing

Pronounced self-dealing practices are often present in serious problem institution situations and in banks which fail. Such practices with regard to loans are found in the form of overextensions of unsound credit to insiders, or their interests, who have improperly used their positions to obtain unjustified loans. Active officers, who serve at the pleasure of the ownership interests, are at times subjected to pressures which make it difficult to objectively evaluate such loans. Loans made for the benefit of ownership interests that are carried in the name of a seemingly unrelated party are sometimes used to conceal self-dealing loans.

Technical Incompetence

Technical incompetence usually is manifested in management's inability to obtain and evaluate credit information or put together a well-conceived loan package. Management weaknesses in this area are almost certain to lead to eventual loan losses. Problems can also develop when management, technically sound in some forms of lending, becomes involved in specialized types of credit in which it lacks expertise and experience.

Lack of Supervision

Loan problems encountered in this area normally arise for one of two reasons:

- Absence of effective active management supervision of loans which possessed reasonable soundness at inception. Ineffective supervision almost invariably results from lack of knowledge of a borrower's affairs over the life of the loan. It may well be coupled with one or more of the causes and sources of loan problems previously mentioned.
- Failure of the board and/or senior management to properly oversee subordinates to determine that sound policies are being carried out.

Lack of Attention to Changing Economic Conditions

Economic conditions, both national and local, are continuously changing, management must be responsive to these changes. This is not to suggest that lending policies should be in a constant state of flux, nor does it suggest that management should be able to forecast totally the results of economic changes. It does mean, however, that bankers should realistically evaluate lending policies and individual loans in light of changing conditions. Economic downturns can adversely affect borrowers' repayment potential and can lessen an institution's collateral protection. Reliance on previously existing conditions as well as optimistic hopes for economic improvement can, particularly when coupled with one or more of the causes and sources of loan problems previously mentioned, lead to serious loan portfolio deterioration.

Competition

Competition among financial institutions for growth, profitability, and community influence sometimes results in the compromise of sound credit principles and acquisition of unsound loans. The ultimate cost of unsound loans outweighs temporary gains in growth, income and influence.

Potential Problem Indicators by Document

The preceding discussions describe various practices or conditions which may serve as a source or cause of weak loans. Weak loans resulting from these practices or conditions may manifest themselves in a variety of ways. While it is impossible to provide a complete detailing of potential "trouble indicators", the following list, by document, may aid the examiner in identifying potential problem loans during the examination process.

- **Debt Instrument -** Delinquency; irregular payments or payments not in accordance with terms; unusual or frequently modified terms; numerous renewals with little or no principal reduction; renewals that include interest; and extremely high interest rate in relation to comparable loans granted by the institution or the going rate for such loans in the institution's market area.

- **Liability Ledger -** Depending on the type of debt, failure to amortize in a regular fashion over a reasonable period of time, e.g., on an annual basis, seasonally, etc.; and a large number of out-of-territory borrowers, particularly in cases where these types of loans have increased substantially since the previous examination.
- **Financial and Operating Statements -** Inadequate or declining working capital position; excessive volume or negative trend in receivables; unfavorable level or negative trend in inventory; no recent aging of receivables, or a marked slowing in receivables; drastic increase in volume of payables; repeated and increasing renewals of carry-over operating debt; unfavorable trends in sales and profits; rapidly expanding expenses; heavy debt-to-worth level and/or deterioration in this relationship; large dividend or other payments without adequate or reasonable earnings retention; and net worth enhancements resulting solely from reappraisal in the value of fixed assets.
- **Cash Flow Documentation -** Absence of cash flow statements or projections, particularly as related to newly established term borrowers; projections indicating an inability to meet required interest and principal payments; and statements reflecting that cash flow is being provided by the sale of fixed assets or nonrecurring situations.
- **Correspondence and Credit Files -** Missing and/or inadequate collateral or loan documentation, such as financial statements, security agreements, guarantees, assignments, hypothecation agreements, mortgages, appraisals, legal opinions and title insurance, property insurance, loan applications; evidence of borrower credit checks; corporate or partnership borrowing authorizations; letters indicating that a borrower has suffered financial difficulties or has been unable to meet established repayment programs; and documents that reveal other unfavorable factors relative to a line of credit.
- **Collateral -** Collateral evidencing a speculative loan purpose or collateral with inferior marketability characteristics (single purpose real estate, restricted stock, etc.) which has not been compensated for by other reliable repayment sources; and collateral of questionable value acquired subsequent to the extension of the credit.

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SELECTING A LOAN REVIEW SAMPLE IN A RISK-FOCUSED EXAMINATION

Examiners are expected to select a sample of loans that is of sufficient size, scope, and variety to enable them to reach reliable conclusions about the aforementioned aspects of an institution’s overall lending function, and tailor the loan review sample based on an institution’s business model, complexity, risk profile, and lending activities. The review may include all sources of credit exposure arising from loans and leases, including guarantees, letters of credit, and other commitments.

Assessing the Risk Profile

Prior to developing the loan review sample, examiners are to assess the risk profile of the loan portfolio by reviewing the institution’s management reports and policies as well as agency available information. This includes evaluating concerns detailed in prior Reports of Examination (ROEs), issues detailed in the institution’s loan exception reports and internal loan reviews, and the historical accuracy of independent credit rating or grading systems. The Uniform Bank Performance Report provides information relative to loan mix and recent trends, such as concentrations of credit, rapid growth, and loan yields higher or lower than peer in different portfolio segments. Examiners are also to consider changes in local economic or market conditions that could affect the portfolio’s risk profile. Numerous economic tools and resources are available to examiners to assist in planning the loan review.

As part of the examination planning activities, examiners are to consider whether management has implemented any material changes in the institution’s business lines, loan products, lending policies, markets, or personnel since the prior examination. Additionally, examiners should consider whether activities conducted by a branch, subsidiary, affiliate, or third party partner warrant particular attention.

Examiners are to consider the historical adequacy of the institution’s policies and practices relative to credit underwriting, administration, and loan grading for each significant loan type. Examiners should review recent management reports and Board or committee packages before selecting a targeted sample to determine whether the Board of Directors and officers are receiving sufficient information to remain abreast of emerging trends and changes in the loan portfolio’s risk profile.

Selecting the Sample

The size and composition of the loan sample should be commensurate with the quantity of credit risk, the adequacy of risk management practices, and the institution's financial condition and business model. There are no established or expected levels of minimum or maximum coverage, or penetration, ratios for loan review samples. Rather, examiners should use judgment when determining the focus and extent of loan sampling. Ensuring that the appropriate types of loans are in the sample is more meaningful than how much of the overall portfolio is reviewed.

Examiners must make the most efficient use of resources, and should sample loans of sufficient size, scope and variety to enable them to form reliable conclusions about overall credit quality and the adequacy of credit risk management and governance. Examiners' understanding of the institution's business model, risk profile, complexity, external and internal reports, as well as discussions with management, will be highly instrumental in identifying loans to be included in a judgmental sample. Examiners may also leverage the institution's external and internal loan reviews when determining the loan sample. For example, examiners may want to exclude loans already covered in institution loan reviews or follow-up on loans identified as problems in the loan reviews.

If information gathered indicates weaknesses in underwriting or credit administration practices, or if the institution is engaging in lending activities with significant or increasing risk, the examiner should select a robust sample to fully assess the risk areas. Conversely, institutions with stable, well-managed loan functions exhibiting few signs of change should have more streamlined reviews, focusing more on newer originations and less on loans that were deemed of satisfactory quality at previous examinations that continue to perform as agreed. However, in all instances, examiners should sample enough credits, including new and various-sized credits, to assess the adequacy of asset quality, underwriting practices, and credit risk management, in order to support ROE findings and assigned ratings.

Nonhomogeneous Loan Sample

Nonhomogeneous loans include acquisition, development and construction, commercial real estate, commercial and industrial, and agricultural credits. The nonhomogeneous loan sample generally should include a sufficient number of loans to transaction test various segments of the loan portfolio, but it is unnecessary to review all loans in a particular segment. Rather, the loan review should encompass enough loans in each portfolio segment to support examination conclusions about credit quality and credit management practices relative to underwriting standards and credit administration.

In general, a sampling of loans in the following segments should be included in the overall loan review sample, as applicable to a particular institution:

- Adversely classified or listed for Special Mention in prior ROEs.
- Delinquent, nonaccrual, impaired, or renegotiated/restructured (particularly loans with multiple renewals).
- Internally adversely classified by the institution.
- Rated by the institution as a marginally acceptable credit.
- Subject to prior supervisory criticism or corrective actions.
- Upgraded or removed from internal adverse classification since the prior examination, to ensure that procedures for managing the watch list are appropriate.
- Insider loans (directors, officers, employees, principal shareholders, or related interests at any insured depository institution).
- Originated since the prior examination, including those in new or expanding product lines.
- Participations.
- Out of territory.
- Part of a significant credit concentration or growth area.
- Flagged for potential fraud.
- Contain outlier characteristics (e.g. higher risk loans, credits with policy exceptions).
- Originated by specific loan officers, particularly those with known concerns or weaknesses.
- In geographic areas exposed to changes in market conditions.
- Various sized loans (larger, mid-sized, and smaller loan amounts).

As part of a risk-focused and forward-looking approach to loan review, loans that had been reviewed at previous examinations that had sufficient performance, collateral and documentation, and continue to amortize as agreed, may be more appropriate for Discuss Only or not included at all, which would allow more resources to be focused on new originations or other loans not previously reviewed that would help evaluate areas of significant or growing risk.

Homogeneous Pool Sample

Assessing the quality of homogeneous retail consumer credit on a loan-by-loan basis is burdensome for both institutions and examiners due to portfolios generally consisting of a large number of loans with relatively low balances. Instead, examiners should assess the quality of retail consumer loans based on the borrowers' repayment performance. Examiners generally should review and classify retail consumer loans in accordance with the procedures discussed later in this section under the Interagency Retail Credit Classification Policy subheading.

The EIC may supplement the classification of retail loans with a direct review of larger consumer loans or by sampling various segments when the risk assessment supports doing so. Such an expansion may be warranted when homogeneous lending is a major business line of the institution or when examiners note rapid growth, new products, weaknesses in the loan review or audit program, weaknesses in management information systems, or other factors that raise concerns. The EIC also may conduct limited transaction testing to focus on specific risk characteristics, such as the underwriting standards for new loans or the revised terms granted in workouts or modifications.

Sampling for Trading and Derivatives Activities. At institutions that are active in such markets, examiners should include an assessment of credit exposures arising from matching loans with derivatives (generally swaps or forwards) to hedge a particular type of risk. For example, an institution can use a swap to contractually exchange a stream of floating-rate payments for a stream of fixed-rate payments to hedge interest rate risk. Such activities create a credit exposure relative to both the loan and the derivative. When warranted, examiners should review a sufficient number of loan relationships with these exposures to assess the institution's overall exposure and management's ability to prudently manage derivatives activities. Examiners also should review a sample of credit relationships established solely for the purpose of facilitating derivatives activities.

Determining the Depth of the Review

Examiners should assign loans to be reviewed into one of three groupings, "In Scope" (full review), "Discuss Only" (limited review), and, when applicable, "Group" (pooled loans).

In Scope. This sample consists of loans that warrant the most comprehensive level of review. Examiners are to review loan files to the extent needed to assess the risk in the credit, conformance to lending risk management policies and procedures, and compliance with applicable laws and regulations. Examiners should document the assessment of the borrower's repayment capacity, collateral protection, and overall risk to the institution on individual linesheets. Documentation should also note underwriting exceptions, administrative weaknesses, and apparent violations.

For institutions with stable, well-managed loan functions, In Scope loans should generally focus on newer originations and insider loans. In these situations, if certain loans from previous examinations are included In Scope, examiners have the ability to leverage documentation from previous reviews and focus on updates to the essential credit information.

Discuss Only. This sample is to consist of loans subject to a limited level of review, and examiners are to discuss these credits with institution management. Such discussions can be an effective method of confirming the adequacy of loan grading systems and credit administration practices, particularly when the In Scope sample indicates the institution has adequate risk management practices, and when the institution has a stable, well-managed loan function and exhibits few signs of change. Examiners should briefly document key issues raised during these discussions, but examiners do not need to complete full linesheets. When warranted, examiners may conduct a limited file review or assessment of specific work-out plans and performance metrics for these loans.

Credits should be reallocated from Discuss Only to In Scope if management disagrees with the classification, material concerns with credit underwriting or administration practices are identified, or the EIC or Asset Manager determines a more comprehensive review is warranted.

Group. This sample could include loans with similar risk characteristics that merit review on a pooled basis. Examiners generally should discuss or classify the loans not on an individual basis but as a pool, and apply the findings and conclusions to the entire Group. Examiners may use multiple Groups to focus on the adequacy of credit underwriting and administration practices or to address different risk attributes in stratified segments. The Group sample may be appropriate for specific categories of homogeneous retail consumer credit, such as automobile, credit card, or residential mortgage loans.

Adjusting Loan Review

The EIC has the flexibility, after communicating with the case manager and receiving concurrence of field management, to adjust the loan review sample at any point during the examination based on findings. The rationale for significant changes in the examination plan will be clearly communicated to institution management, along with any adjustments to the breadth or depth of procedures, personnel, and examination schedule.

Accepting an Institution's Internal Ratings

If the institution's internal grading system (watch list) is determined to be accurate and reliable, examiners can use the institution's data for preparing the applicable examination report pages and schedules, for determining the overall level of classifications, and for providing supporting comments regarding the quality of the loan portfolio.

Loan Penetration Ratio

The FDIC has not established any minimum or maximum loan penetration ratios.

The objectives for loan review on an examination include an analysis of credit quality through transaction testing and an assessment of credit administration practices. Achieving a specific loan penetration ratio is not to be the driving factor in determining the loan review sample. Rather, examiners should focus on reviewing a sufficient number of loans in various segments of the portfolio to assess overall risk in the portfolio and to support examination findings, and then calculate the resultant loan penetration ratio for informational purposes only and enter the ratio in the Summary Analysis of Examination Report.

Large Bank Loan Review

In addition to point-in-time examinations conducted at most community banks, the FDIC utilizes targeted loan reviews conducted under a supervisory plan, guiding a continuous examination program for certain institutions. These targeted programs are generally warranted to ensure effective monitoring and examination activity related to larger and more complex institutions. While the supervisory plan and continuous examination processes and procedures may differ in some respects from the point in time approach, the principles contained in the preceding loan review instructions are applicable to examination activities for all institutions supervised by the FDIC.

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LOAN EVALUATION AND CLASSIFICATION

Loan Evaluation

To properly analyze any credit, an examiner must acquire certain fundamental information about a borrower's financial condition, purpose and terms of the borrowing, and prospects for its orderly repayment. The process involved in acquiring the foregoing information will necessarily vary with the type and sophistication of records utilized by the institution.

Review of Files and Records

Commercial loan liability ledgers or comparable subsidiary records vary greatly in quality and detail. Generally, they will provide the borrower's total commercial loan liability to the institution, and the postings thereto will depict a history of the debt. Collateral records should be scrutinized to acquire the necessary descriptive information and to ascertain that the collateral held to secure the notes is as transcribed.

Gathering credit information is an important process and should be done with care to obtain the essential information, which will enable the examiner to appraise the loans accurately and fairly. Failure to obtain and record pertinent information contained in the credit files can reflect unfavorably on examiners, and a good deal of examiner and loan officer time can be saved by carefully analyzing the files. Ideally, credit files will also contain important correspondence between the institution and the borrower. However, this is not universally the case; in some instances, important correspondence is deliberately lodged in separate files because of its sensitive character. Correspondence between the institution and the borrower can be especially valuable to the examiner in developing added insight into the status of problem credits.

Verification of loan proceeds is one of the most valuable and effective loan examining techniques available to the examiner and often one of the most ignored. This verification process can disclose fraudulent or fictitious notes, misapplication of funds, loans made for the benefit or accommodation of parties other than the borrower of record, or utilization of loans for purposes other than those reflected in the institution's files. Verification of the disbursement of a selected group of large or unusual loans, particularly those subject to classification or Special Mention and those granted under circumstances which appear illogical or incongruous is important. However, it is more important to carry the verification process one step further to the apparent utilization of loan proceeds as reflected by the customer's deposit account or other related institution records. The examiner should also determine the purpose of the credit and the expected source of repayment.

Examination Procedures regarding loan portfolio analysis are included in the ED Modules.

Additional Transaction Testing

Part of the assessment of loan administration practices includes transaction testing. Such testing can verify that the institution's written policies and practices are implemented as intended. Testing can also be useful in detecting potential fraudulent or irregular activity. In particular, examiners are required to verify a sample of loans that paid off during or just prior to the on-site portion of the examination. Such verification would include reviewing the loan file, payoff tickets, and tracing the source of funds for the payoff.

Loan Discussion

The examiner must comprehensively review all data collected on the individual loans. In most banks, this review should allow the majority of loans to be passed without criticism, eliminating the need for discussing these lines with the appropriate institution officer(s). No matter how thoroughly the supporting loan files have been reviewed, there will invariably be a number of loans which will require additional information or discussion before an appropriate judgment can be made as to their credit quality, relationship to other loans, proper documentation, or other circumstances related to the overall examination of the loan portfolio. Such loans require discussion with the appropriate institution officer(s) as do other loans for which adequate information has been assembled to indicate that classification or Special Mention is warranted.

Proper preparation for the loan discussion is essential, and the following points should be given due consideration by the examiner. Loans which have been narrowed down for discussion should be reviewed in depth to insure a comprehensive grasp of all factual material. Careful advance preparation can save time for all concerned. Particularly with regard to large, complicated lines, undue reliance should not be placed on memory to cover important points in loan discussion. Important weaknesses and salient points to be covered in discussion, questions to be asked, and information to be sought should be noted. The loan discussion should not involve discussion of trivialities since the banker's time is valuable, and it is no place for antagonistic remarks and snide comments directed at loan officers. The examiner should listen carefully to what the banker has to say, and concisely and accurately note this information. Failure to do so can result in inaccuracies and make follow-up at the next examination more difficult.

Loan Analysis

In the evaluation of individual loans, the examiner should weigh carefully the information obtained and arrive at a judgment as to the credit quality of the loans under review. Each loan is appraised on the basis of its own characteristics. Consideration is given to the risk involved in the project being financed; the nature and degree of collateral security; the character, capacity, financial responsibility, and record of the borrower; and the feasibility and probability of its orderly liquidation in accordance with specified terms. The willingness and ability of a debtor to perform as agreed remains the primary measure of a loan's risk. This implies that the borrower must have earnings or liquid assets sufficient to meet interest payments and provide for reduction or liquidation of principal as agreed at a reasonable and foreseeable date. However, it does not mean that borrowers must at all times be in a position to liquidate their loans, for that would defeat the original purpose of extending credit.

Following analysis of specific credits, it is important that the examiner ascertain whether troublesome loans result from inadequate lending and collection policies and practices or merely reflect exceptions to basically sound credit policies and practices. In instances where troublesome loans exist due to ineffective lending practices and/or inadequate supervision, it is quite possible that existing problems will go uncorrected and further loan quality deterioration may occur. Therefore, the examiner should not only identify problem loans, but also ascertain the cause(s) of these problems. Weaknesses in lending policies or practices should be stressed, along with possible corrective measures, in discussions with the institution's senior management and/or the directorate and in the Report of Examination.

Loan Classification

To quantify and communicate the results of the loan review, the examiner must arrive at a decision as to which loans are to be subjected to criticism and/or comment in the examination report. Adversely classified loans are allocated on the basis of risk to three categories: Substandard; Doubtful; and Loss.

Other loans of questionable quality, but involving insufficient risk to warrant classification, are designated as Special Mention loans. Loans lacking technical or legal support, whether or not adversely classified, should be brought to the attention of the institution's management. If the deficiencies in documentation are severe in scope or volume, a schedule of such loans should be included in the Report of Examination.

Loan classifications are expressions of different degrees of a common factor, risk of nonpayment. All loans involve some risk, but the degree varies greatly. It is incumbent upon examiners to avoid classification of sound loans. The practice of lending to sound businesses or individuals for reasonable periods is a legitimate banking function. Adverse classifications should be confined to those loans which are unsafe for the investment of depositors' funds.

If the internal grading system is determined to be accurate and reliable, examiners can use the institution's data for preparing the applicable examination report pages and schedules, for determining the overall level of classifications, and for providing supporting comments regarding the quality of the loan portfolio. If the internal classifications are overly conservative, examiners should make appropriate adjustments and include explanations in the report's comments.

The Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions was issued on October 29, 2013, by the Office of the Comptroller of the Currency, the FDIC, and the Federal Reserve Board. The attachment to this interagency statement provides definitions of Substandard, Doubtful, and Loss categories used for adversely classifying institution assets. Amounts classified Loss should be promptly eliminated from the institution's books.

Uniform guidelines have been established by the FDIC regarding the Report of Exam treatment of assets classified Doubtful. The general policy is not to require charge-off or similar action for Doubtful classifications. Examiners should make a statement calling for an institution to charge-off a portion of loans classified Doubtful only when State law or policy requires. Further, any such statement should be clear as to the intended purpose of bringing the institution into conformity with those State requirements. An exception is made for formal actions under Section 8 of the FDI Act.

A statement addressing the chargeoff of loans classified Loss is a required comment Report of Examination when the amount is material. Amounts classified Loss should be promptly eliminated from the institution's books.

Definitions

- **Substandard -** Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
- **Doubtful -** Loans classified Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions, and values, highly questionable and improbable.
- **Loss -** Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

There is a close relationship between classifications, and no classification category should be viewed as more important than the other. The uncollectibility aspect of Doubtful and Loss classifications makes their segregation of obvious importance. The function of the Substandard classification is to indicate those loans which are unduly risky and, if unimproved, may be a future hazard.

A complete list of adversely classified loans is to be provided to management, either during or at the close of an examination.

Special Mention Assets

Definition - A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Use of Special Mention - The Special Mention category is not to be used as a means of avoiding a clear decision to classify a loan or pass it without criticism. Neither should it include loans listed merely "for the record" when uncertainties and complexities, perhaps coupled with large size, create some reservations about the loan. If weaknesses or evidence of imprudent handling cannot be identified, inclusion of such loans in Special Mention is not justified.

Ordinarily, Special Mention credits have characteristics which corrective management action would remedy. Often weak origination and/or servicing policies are the cause for the Special Mention designation. Examiners should not misconstrue the fact that most Special Mention loans contain management correctable deficiencies to mean that loans involving merely technical exceptions belong in this category. However, instances may be encountered where technical exceptions are a factor in scheduling loans for Special Mention.

Careful identification of loans which properly belong in this category is important in determining the extent of risk in the loan portfolio and providing constructive criticism for institution management. While Special Mention Assets should not be combined with adversely classified assets, their total should be considered in the analysis of asset quality and management, as appropriate.

The nature of this category precludes inclusion of smaller lines of credit unless those loans are part of a large grouping listed for related reasons. Comments on loans listed for Special Mention in the Report of Examination should be drafted in a fashion similar to those for adversely classified loans. There is no less of a requirement upon the examiner to record clearly the reasons why the loan is listed. The major thrust of the comments should be towards achieving correction of the deficiencies identified.

Troubled Commercial Real Estate Loan Classification Guidelines

Additional classification guidelines have been developed to aid the examiner in classifying troubled commercial real estate loans. These guidelines are intended to supplement the uniform guidelines discussed above. After performing an analysis and evaluation of the project, the examiner must determine the classification of any exposure.

The following guidelines are to be applied in instances where the obligor is devoid of other reliable means of repayment, with support of the debt provided solely by the project. If other types of collateral or other sources of repayment exist, the project should be evaluated in light of these mitigating factors.

- **Substandard -** Any such troubled real estate loan or portion thereof should be classified Substandard when well-defined weaknesses are present which jeopardize the orderly liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
- **Doubtful -** Doubtful classifications have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable. A Doubtful classification may be appropriate in cases where significant risk exposures are perceived, but Loss cannot be determined because of specific reasonable pending factors which may strengthen the credit in the near term. Examiners should attempt to identify Loss in the credit where possible thereby limiting the excessive use of the Doubtful classification.
- **Loss -** Advances in excess of calculated current fair value which are considered uncollectible and do not warrant continuance as bankable assets. There is little or no prospect for near term improvement and no realistic strengthening action of significance pending.

Technical Exceptions

Deficiencies in documentation of loans should be brought to the attention of management for remedial action. Failure of management to effect corrections may lead to the development of greater credit risk in the future. Moreover, an excessive number of technical exceptions may be a reflection on management's quality and ability. Inclusion of the schedule "Assets With Credit Data or Collateral Documentation Exceptions" and various comments in the Report of Examination is appropriate in certain circumstances. Refer to the Report of Examination Instructions for further guidance.

Past Due and Nonaccrual

Overdue loans are not necessarily subject to adverse criticism. Nevertheless, a high volume of overdue loans almost always indicates liberal credit standards, weak servicing practices, or both. Because loan renewal and extension policies vary among banks, comparison of their delinquency ratios may be misleading. A more significant method of evaluating this factor lies in determination of the trend within the institution under examination, keeping in mind the distortion resulting from seasonal influences, economic conditions, or the timing of examinations. It is important for the examiner to carefully consider the makeup and reasons for the volume of overdue loans. Only then can it be determined whether the volume of past due paper is a significant factor reflecting adversely on the quality or soundness of the overall loan portfolio or the efficiency and quality of management. It is important that overdue loans be computed on a uniform basis. This allows for comparison of overdue totals between examinations and/or with other banks.

The Report of Examination includes information on overdue and nonaccrual loans. Loans which are still accruing interest but are past their maturity or on which either interest or principal is due and unpaid (including unplanned overdrafts) are separated by loan type into two distinct groupings: 30 to 89 days past due and 90 days or more past due. Nonaccrual loans may include both current and past due loans. In the case of installment credit, a loan will not be considered overdue until at least two monthly payments are delinquent. The same will apply to real estate mortgage loans, term loans or any other loans payable on regular monthly installments of principal and interest.

Some modification of the overdue criteria may be necessary because of applicable State law, joint examinations, or unusual circumstances surrounding certain kinds of loans or in individual loan situations. It will always be necessary for the examiner to ascertain the institution's renewal and extension policies and procedures for collecting interest prior to determining which loans are overdue, since such practices often vary considerably from institution to institution. This is important not only to validate which loans are actually overdue, but also to evaluate the soundness of such policies. Standards for renewal should be aimed at achieving an orderly liquidation of loans and not at maintaining a low ratio of past due paper through unwarranted extensions or renewals.

In larger departmentalized banks or banks with large branch systems, it may be informative to analyze delinquencies by determining the source of overdue loans by department or branch. This is particularly true if a large volume of overdue loans exist. The production of schedules delineating overdue loans by department or branch is encouraged if it will aid in pinpointing the source of a problem or be otherwise informative.

Continuing to accrue income on assets which are in default as to principal and interest overstates an institution's assets, earnings, and capital. Call Report Instructions indicate that where the period of default of principal or interest equals or exceeds 90 days, the accruing of income should be discontinued unless the asset is well-secured and in process of collection. A debt is well-secured if collateralized by liens on or pledges of real or personal property, including securities that have a realizable value sufficient to discharge the debt in full; or by the guarantee of a financially responsible party. A debt is in process of collection if collection is proceeding in due course either through legal action, including judgment enforcement procedures, or, in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or its restoration to a current status. Institutions are strongly encouraged to follow this guideline not only for reporting purposes but also bookkeeping purposes. There are several exceptions, modifications and clarifications to this general standard. First, consumer loans and real estate loans secured by one-to-four family residential properties are exempt from the nonaccrual guidelines. Nonetheless, these exempt loans should be subject to other alternative methods of evaluation to assure the institution's net income is not materially overstated. Second, any State statute, regulation or rule which imposes more stringent standards for nonaccrual of interest should take precedence over these instructions. Third, reversal of previously accrued but uncollected interest applicable to any asset placed in a nonaccrual status, and treatment of subsequent payments as either principal or interest, should be handled in accordance with generally accepted accounting principles. Acceptable accounting treatment includes reversal of all previously accrued but uncollected interest against appropriate income and balance sheet accounts.

Nonaccrual Loans That Have Demonstrated Sustained Contractual Performance

The following information applies to borrowers who have resumed paying the full amount of scheduled contractual interest and principal payments on loans that are past due and in nonaccrual status. Although a prior arrearage may not have been eliminated by payments from a borrower, the borrower may have demonstrated sustained performance over a period of time in accordance with the contractual terms. Such loans to be returned to accrual status, even though the loans have not been brought fully current, provided two criteria are met:

- All principal and interest amounts contractually due (including arrearage) are reasonably assured of repayment within a reasonable period, and
- There is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in accordance with the contractual terms involving payments of cash or cash equivalents.

When the regulatory reporting criteria for restoration to accrual status are met, previous charge-offs taken would not have to be fully recovered before such loans are returned to accrual status. Loans that meet the above criteria would continue to be disclosed as past due, as appropriate, until they have been brought fully current.

Troubled Debt Restructuring - Multiple Note Structure

The basic example of a trouble debt restructuring (TDR) multiple note structure is a troubled loan that is restructured into two notes where the first or "A" note represents the portion of the original loan principal amount which is expected to be fully collected along with contractual interest. The second part of the restructured loan, or "B" note, represents the portion of the original loan that has been charged-off.

Such TDRs generally may take any of three forms. In certain TDRs, the "B" note may be a contingent receivable that is payable only if certain conditions are met (e.g., sufficient cash flow from property). For other TDRs, the "B" note may be contingently forgiven (e.g., note "B" is forgiven if note "A" is paid in full). In other instances, an institution would have granted a concession (e.g., rate reduction) to the troubled borrower, but the "B" note would remain a contractual obligation of the borrower. Because the "B" note is not reflected as an asset on the institution's books and is unlikely to be collected, for reporting purposes the "B" note could be viewed as a contingent receivable.

Institutions may return the "A" note to accrual status provided the following conditions are met:

- The restructuring qualifies as a TDR as defined by ASC Subtopic 310-40*, Receivables – Troubled Debt Restructurings by Creditors* and there is economic substance to the restructuring.
- The portion of the original loan represented by the "B" note has been charged-off. The charge-off must be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. The charge-off must be recorded before or at the time of the restructuring.
- The "A" note is reasonably assured of repayment and of performance in accordance with the modified terms.
- In general, the borrower must have demonstrated sustained repayment performance (either immediately before or after the restructuring) in accordance with the modified terms for a reasonable period prior to the date on which the "A" note is returned to accrual status. A sustained period of payment performance generally would be a minimum of six months and involve payments in the form of cash or cash equivalents.

Under existing reporting requirements, the "A" note would be disclosed as a TDR. In accordance with these requirements, if the "A" note yields a market rate of interest and performs in accordance with the restructured terms, such disclosures could be eliminated in the year following restructuring. To be considered a market rate of interest, the interest rate on the "A" note at the time of restructuring must be equal to or greater than the rate that the institution is willing to accept for a new receivable with comparable risk.

Interagency Retail Credit Classification Policy

The quality of consumer credit soundness is best indicated by the repayment performance demonstrated by the borrower. Because retail credit generally is comprised of a large number of relatively small balance loans, evaluating the quality of the retail credit portfolio on a loan-by-loan basis is burdensome for the institution being examined and examiners. To promote an efficient and consistent credit risk evaluation, the FDIC, the Comptroller of Currency, the Federal Reserve and the former Office of Thrift Supervision adopted the Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy.)

Retail credit includes open-end and closed-end credit extended to individuals for household, family, and other personal expenditures. It includes consumer loans and credit cards. For purposes of the policy, retail credit also includes loans to individuals secured by their personal residence, including home equity and home improvement loans.

In general, retail credit should be classified based on the following criteria:

- Open-end and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified Substandard.
- Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be charged-off. The charge-off should be taken by the end of the month in which the 120-or 180-day time period elapses.
- Unless the institution can clearly demonstrate and document that repayment on accounts in bankruptcy is likely to occur, accounts in bankruptcy should be charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the delinquency time frames specified in this classification policy, whichever is shorter. The charge-off should be taken by the end of the month in which the applicable time period elapses. Any loan balance not charged-off should be classified Substandard until the borrower re-establishes the ability and willingness to repay (with demonstrated payment performance for six months at a minimum) or there is a receipt of proceeds from liquidation of collateral.
- Fraudulent loans should be charged off within 90 days of discovery or within the delinquency time frames specified in this classification policy, whichever is

shorter. The charge-off should be taken by the end of the month in which the applicable time period elapses.

- Loans of deceased persons should be charged off when the loss is determined or within the delinquency time frames adopted in this classification policy, whichever is shorter. The charge-off should be taken by the end of the month in which the applicable time period elapses.
- One-to-four family residential real estate loans and home equity loans that are delinquent 90 days or more with loan-to-value ratios greater than 60 percent, should be classified Substandard.

When an open- or closed-end residential or home equity loan is 180 days past due, a current assessment of value should be made and any outstanding loan balance in excess of the fair value of the property, less cost to sell, should be classified Loss.

Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent should not be classified. However, home equity loans where the institution does not hold the senior mortgage, that are delinquent 90 days or more should be classified Substandard, even if the loan-to-value ratio is equal to, or less than, 60 percent.

If an institution can clearly document that the delinquent loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities, with an estimated fair value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. In the process of collection means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

This policy does not preclude an institution from adopting an internal classification policy more conservative than the one detailed above. It also does not preclude a regulatory agency from using the Doubtful or Loss classification in certain situations if a rating more severe than Substandard is justified. Loss in retail credit should be recognized when the institution becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in this policy.

Re-aging, Extensions, Deferrals, Renewals, or Rewrites

Re-aging is the practice of bringing a delinquent account current after the borrower has demonstrated a renewed willingness and ability to repay the loan by making some, but not all, past due payments. Re-aging of open-end accounts, or extensions, deferrals, renewals, or rewrites of closed-end accounts should only be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use of a policy is acceptable when it is based on recent, satisfactory performance and the true improvement in a borrower's other credit factors, and when it is structured in accordance with internal policies.

The decision to re-age a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that institution personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower shows the ability to repay the loan.

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. An account eligible for re-aging, extension, deferral, renewal, or rewrite should exhibit the following:

- The borrower should show a renewed willingness and ability to repay the loan.
- The account should exist for at least nine months before allowing a re-aging, extension, renewal, referral, or rewrite.
- The borrower should make at least three minimum consecutive monthly payments or the equivalent lump sum payment before an account is re-aged. Funds may not be advanced by the institution for this purpose.
- No loan should be re-aged, extended, deferred, renewed, or rewritten more than once within any twelve-month period; that is, at least twelve months must have elapsed since a prior re-aging. In addition, no loan should be re-aged, extended, deferred, renewed, or rewritten more than two times within any five-year period.
- For open-end credit, an over limit account may be re-aged at its outstanding balance (including the over limit balance, interest, and fees). No new credit may

be extended to the borrower until the balance falls below the designated predelinquency credit limit.

Partial Payments on Open-End and Closed-End Credit

Institutions should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing delinquency. Alternatively, the institution may aggregate payments and give credit for any partial payment received. For example, if a regular installment payment is $300 and the borrower makes payments of only $150 per month for a six-month period, the loan would be $900, or three full months delinquent. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

Examination Considerations

Examiners should determine whether institutions' policies and practices consider the Retail Classification Policy, understanding that there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur regardless of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims. Conversely, the Retail Classification Policy does not preclude examiners from reviewing and classifying individual large dollar retail credit loans that exhibit signs of credit weakness regardless of delinquency status.

In addition to reviewing loan classifications, the examiner should review the ALLL to assess whether it is at an appropriate level. Sound risk and account management systems typically include:

- Prudent retail credit lending policies,
- Measures to monitor adherence to policy,
- Detailed operating procedures, and
- Appropriate internal controls.

Institutions lacking sound policies or failing to implement or effectively follow established policies will be subject to criticism.

Examination Treatment

Use of the formula classification approach can result in numerous small dollar adversely classified items. Although these classification details are not always included in the Report of Examination, an itemized list is to be left with management. A copy of the listing should also be retained in the examination work papers.

Examiner support packages are available which have built in parameters of the formula classification policy, and which generate a listing of delinquent consumer loans to be classified in accordance with the policy. Use of this package may expedite the examination in certain cases, especially in larger banks.

Losses are one of the costs of doing business in consumer installment credit departments. It is important for the examiner to give consideration to the amount and severity of installment loan charge-offs when examining the department. Excessive loan losses are the product of weak lending and collection policies and therefore provide a good indication of the soundness of the consumer installment loan operation. The examiner should be alert also to the absence of installment loan charge-offs, which may indicate that losses are being deferred or concealed through unwarranted rewrites or extensions.

Dealer lines should be scheduled in the report under the dealer's name regardless of whether the contracts are accepted with or without recourse. Any classification or totaling of the nonrecourse line can be separately identified from the direct or indirect liability of the dealer. Comments and format for scheduling the indirect contracts will be essentially the same as for direct paper. If there is direct debt, comments will necessarily have to be more extensive and probably will help form a basis for the indirect classification.

No general rule can be established as to the proper application of dealers' reserves to the examiner's classifications. Such a rule would be impractical because of the many methods used by banks in setting up such reserves and the various dealer agreements utilized. Generally, where the institution is handling a dealer who is not financially responsible, weak contracts warrant classification irrespective of any balance in the dealer's reserve. Fair and reasonable judgment on the part of the examiner will determine application of dealer reserves.

If the amount involved would have a material impact on capital, consumer loans should be classified net of unearned income. Large business-type loans placed in consumer installment loan departments should receive individual review and, in all cases, the applicable unearned income discount should be deducted when such loans are classified.

Impaired Loans, Troubled Debt Restructurings, Foreclosures, and Repossessions

Loan Impairment – The accounting standard for impaired loans is ASC Subtopic 310-10. A loan is impaired when, based on current information and events, it is probable that an institution will be unable to collect all amounts due according to the contractual terms of the loan agreement (i.e., principal and interest). Impaired loans encompass all loans that are restructured in a troubled debt restructuring, including smaller balance homogenous loans that are typically exempt from ASC Subtopic 310-10. However, the standard does not include loans that are measured at fair value or the lower of cost or fair value.

When a loan is impaired under ASC Subtopic 310-10, the amount of impairment should be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate (i.e., the contractual interest rate adjusted for any net deferred loan fees or costs and premium or discount existing at the origination or acquisition of the loan). As a practical expedient, impairment may also be measured based on a loan's observable market price. The fair value of the collateral must be used if the loan is collateral dependent. An impaired loan is collateral dependent if repayment would be expected to be provided solely by the sale or continued operation of the underlying collateral.

If the measure of a loan calculated in accordance with ASC Subtopic 310-10 is less than the recorded investment in the loan (typically the face amount of the loan, plus accrued interest, adjusted for any premium or discount, deferred fee or cost, less any charge-offs), impairment on that loan should be recognized as a part of the ALLL. In general, when the amount of the recorded investment in the loan exceeds the amount calculated under ASC Subtopic 310-10 and that amount is determined to be uncollectible, this excess amount should be promptly charged-off against the ALLL. In all cases, when an impaired loan is collateral dependent and the repayment of the loan is expected from the sale of the collateral, any portion of the recorded investment in the loan in excess of the fair value less cost to sell of the collateral should be charged-off.

Troubled Debt Restructuring - The accounting for TDRs is set forth in ASC Subtopic 310-40, *Receivables-Troubled Debt Restructurings by Creditors*. A restructuring constitutes a troubled debt restructuring if the institution for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. A troubled debt restructuring takes place when an institution grants a concession to a debtor in financial difficulty. Examiners are expected to reflect all TDRs in examination reports in accordance with this accounting guidance and institutions are expected to follow these principles when filing the Call Report.

TDRs may be divided into two broad groups: those where the borrower transfers assets to the creditor in full or partial satisfaction of the debt, which would include foreclosures; and those in which the terms of a debtor's obligation are modified, which may include reduction in the stated interest rate to an interest rate that is less than the current market rate for new obligations with similar risk, extension of the maturity date, or forgiveness of principal or interest. A third type of restructuring combines a receipt of assets and a modification of loan terms. A loan extended or renewed at an interest rate equal to the current market interest rate for new debt with similar risk is not reported as a restructured loan for examination purposes.

Transfer of Assets to the Creditor - An institution that receives assets (except long-lived assets that will be sold) from a borrower in full satisfaction of the recorded investment in the loan should record those assets at fair value. If the fair value of the assets received is less than the institution's recorded investment in the loan, a loss is charged to the ALLL. When property is received in full satisfaction of an asset other than a loan (e.g., a debt security), the loss should be reflected in a manner consistent with the balance sheet classification of the asset satisfied. When long-lived assets that will be sold, such as real estate, are received in full satisfaction of a loan, the real estate is recorded at its fair value less cost to sell. This fair value (less cost to sell) becomes the "cost" of the foreclosed asset.

To illustrate, assume an institution forecloses on a defaulted mortgage loan of $100,000 and takes title to the property. If the fair value of the property at the time of foreclosure is $90,000 and costs to sell are estimated at $10,000, a $20,000 loss should be immediately recognized by a charge to the ALLL. The cost of the foreclosed asset becomes $80,000. If the institution is on an accrual basis of accounting, there may also be adjusting entries necessary to reduce both the accrued interest receivable and loan interest income accounts. Assume further that in order to effect sale of the realty to a third party, the institution is willing to offer a new mortgage loan (e.g., of $100,000) at a concessionary rate of interest (e.g., 10 percent while the market interest rate for new loans with similar risk is 20 percent). Before booking this new transaction, the institution must establish its "economic value" or what would be the cash price paid. Pursuant to ASC Subtopic 835-30, *Interest – Imputation of Interest*, the value is represented by the sum of the present value of the income stream to be received from the new loan, discounted at the current market interest rate for this type of credit, and the present value of the principal to be received, also discounted at the current market interest rate. This economic value (calculated by discounting the cash flows at the current market interest rate) becomes the proper carrying value for the property at its sale date. Since the sales price of $78,000 is less than the property's carrying amount of $80,000), an additional loss has been incurred and should be immediately recognized. This additional loss should be reflected in the allowance if a relatively brief period has elapsed between foreclosure and subsequent resale of the property. However, the loss should be treated as loss on the sale of real estate if the asset has been held for a longer period. The new loan would be placed on the books at its face value ($100,000) and the difference between the new loan amount and the "economic value" ($78,000) is treated as unearned discount ($22,000). For examination and Call Report purposes, the asset would be shown net of the unearned discount which is reduced periodically as it is earned over the life of the new loan. The $22,000 discount is accreted into interest income over the life of the loan as long as the loan remains in accrual status.

The basis for this accounting approach is the assumption that financing the resale of the property at a concessionary rate exacts an opportunity cost which the institution must recognize. That is, unearned discount represents the present value of the "imputed" interest differential between the concessionary and market rates of interest. Present value accounting also assumes that both the institution and the third party who purchased the property are indifferent to a cash sales price at the "economic value" or a higher financed price repayable over time.

Modification of Terms - When the terms of a TDR provide for a reduction of interest or principal, the institution should measure any loss on the restructuring in accordance with the guidance for impaired loans as set forth in ASC Subtopic 310-10 unless the loans are measured at fair value or the lower of cost or fair value. The amount of impairment of the restructured loan using the appropriate measurement method in ASC Subtopic 310-10 is reported as a component in determining the overall ALLL If any amount of the calculated impairment is determined to be uncollectible, that amount should be promptly charged-off against the ALLL.

For example, in lieu of foreclosure, an institution chooses to restructure a $100,000 loan to a borrower which had originally been granted with an interest rate of 10 percent for 10 years. The institution and the borrower have agreed to capitalize the accrued interest ($10,000) into the note balance, but the restructured terms will permit the borrower to repay the debt over 10 years at a six percent interest rate. The institution does not believe the loan is collateral dependent. In this situation, the institution would determine the amount of impairment on the TDR as the difference between the present value of the expected cash flows discounted at the 10 percent rate specified in the original contract and the recorded investment in loan of $110,000. This amount of the calculated impairment becomes a component of the overall ALLL.

Combination Approach - In some instances, the institution may receive assets in partial rather than full satisfaction of a loan or security and may also agree to alter the original repayment terms. In these cases, the recorded investment in the loan should be reduced by the fair value of the assets received (less cost to sell, if appropriate). The remaining recorded investment in the loan is accounted for as a TDR.

Examination Report Treatment - Examiners should continue to classify TDRs, including any impaired collateral dependent loans, based on the definitions of Loss, Doubtful, and Substandard. When an impaired loan is collateral dependent and the loan is expected to be satisfied by the sale of the collateral, any portion of the recorded investment in the loan which exceeds the fair value of the collateral, less cost to sell is the amount of impairment included in the ALLL. This is the amount of Loss on that loan that should be promptly charged-off. For other loans that are impaired loans, the amount of the recorded investment in the loan over the amount of the calculated impairment is recognized as a component of the ALLL. However, when available information confirms that loans and leases (including any recorded accrued interest, net deferred loan fees or costs, and unamortized premium or discount) other than impaired collateral dependent loans (dependent on the sale of the collateral), or portions thereof, are uncollectible, these amounts should be promptly charged-off against the ALLL.

An examiner should not require an additional allowance for credit losses of impaired loans over and above what is calculated in accordance with these standards. An additional allowance on impaired loans may be supported based on consideration of institution-specific factors, such as historical loss experience compared with estimates of such losses and concerns about the reliability of cash flow estimates, the quality of an institution's loan review function, and controls over its process for estimating its ASC Subtopic 310-10 allowance.

Other Considerations - Examiners may encounter situations where impaired loans and TDRs are identified, but the institution has not properly accounted for the transactions. Where incorrect accounting treatment resulted in an overstatement of earnings, capital and assets, it will be necessary to determine the proper carrying values for these assets, utilizing the best available information developed by the examiner after consultation with institution management. Nonetheless, proper accounting for impaired loans and TDRs is the responsibility of institution management. Examiners should not spend a disproportionate amount of time developing the appropriate accounting entries, but instead discuss with and require corrective action by institution management when the institution's treatment is not in accordance with accepted accounting guidelines. It must also be emphasized that collectibility and proper accounting and reporting are separate matters; restructuring a borrower's debt does not ensure collection of the loan or security. As with all other assets, adverse classification should be assigned if analysis indicates there is risk of loss present. Examiners should take care, however, not to discourage or be critical of institution management's legitimate and reasonable attempts to achieve debt settlements through concessionary terms. In many cases, restructurings offer the only realistic means for an institution to bring about collection of weak or nonearning assets. Finally, the volume of impaired loans and restructured debts having concessionary interest rates should be considered when evaluating the institution's earnings performance and assigning the earnings performance rating.

Examination procedures for reviewing TDRs are included in the ED Modules.

Report of Examination Treatment of Classified Loans

The Items Subject to Adverse Classification page allows an examiner to present pertinent and readily understandable comments related to loans which are adversely classified. In addition, the Analysis of Loans Subject to Adverse Classification page permits analysis of present and previous classifications from the standpoint of source and disposition. These loan schedules should be prepared in accordance with the Report of Examination Instructions.

An examiner must present, in writing, relevant and readily understandable comments related to criticized loans. Therefore, a thorough understanding of all factors surrounding the loan is required and only those germane to description, collectibility, and management plans should be included in the comments. Comments should be concise, but brevity is not to be accomplished by omission of appropriate information. Comments should be informative and factual data emphasized. The important weaknesses of the loan should not be overshadowed by extraneous information which might well have been omitted. An ineffective presentation of a classified loan weakens the value of a Report of Examination and frequently casts doubt on the accuracy of the classifications. The essential test of loan comments is whether they justify the classification.

Careful organization is an important ingredient of good loan comments. Generally, loan comments should include the following items:

- **Identification -** Indicate the name and occupation or type of business of the borrower. Cosigners, endorsers and guarantors should be identified and in the case of business loans, it should be clear whether the borrower is a corporation, partnership, or sole proprietorship.
- **Description -** The make-up of the debt should be concisely described as to type of loan, amount, origin and terms. The history, purpose, and source of repayment should also be indicated.
- **Collateral -** Describe and evaluate any collateral, indicating the marketability and/or condition thereof. If values are estimated, note the source.
- **Financial Data -** Current balance sheet information along with operating figures should be presented, if such data are considered necessary. The examiner must exercise judgment as to whether a statement should be detailed in its entirety. When the statement is relevant to the classification, it is generally more effective to summarize weaknesses with the entire statement presented. On the other hand, if the statement does not significantly support or detract from the loan, a very brief summarization of the statement is in order.
- **Summarize the Problem -** The examiner's comments should explicitly point out reasons for the classification. Where portions of the line are accorded different classifications or are not subject to classification, comments should clearly set forth the reasoning for the split treatment.
- **Management's Intentions -** Comments should include any corrective program contemplated by management.

Examiners should avoid arbitrary or penalty classifications, nor should "conceded" or "agreed" be given as the principal reason for adverse classifications. Management's opinions and ideas should not have to be emphasized; if a classification is well-founded, the facts will speak for themselves. If well-written, there is little need for long summary comments reemphasizing major points of the loan write-up.

When the volume of loan classifications reaches the point of causing supervisory concern, analysis of present and previous classifications from the standpoint of source and disposition becomes very important. For this reason, the

Analysis of Loans Subject to Adverse Classification page should be completed in banks possessing characteristics which present special supervisory problems; when the volume or composition of adversely classified loans has changed significantly since the previous examination, including both upward and downward movements; and, in such other special or unusual situations as examiners deem appropriate. Generally, the page should not include consumer loans and overdrafts and it should be footnoted to indicate that these assets are not included.

Issuance of "Express Determination" Letters to Institutions for Federal Income Tax Purposes

Tax Rules - The Internal Revenue Code and tax regulations allow a deduction for a loan that becomes wholly or partially worthless. All pertinent evidence is taken into account in determining worthlessness. Special tax rules permit a federally supervised depository institution to elect a method of accounting under which it conforms its tax accounting for bad debts to its regulatory accounting for loan charge-offs, provided certain conditions are satisfied. Under these rules, loans that are charged-off pursuant to specific orders of the institution's supervisory authority or that are classified by the institution as Loss assets under applicable regulatory standards are conclusively presumed to have become worthless in the taxable year of the charge-offs.

To be eligible for this accounting method for tax purposes, an institution must file a conformity election with its Federal income tax return. The tax regulations also require the institution's primary Federal supervisory authority to expressly determine that the institution maintains and applies loan loss classification standards that are consistent with the regulatory standards of its supervisory authority.

An institution must request an "express determination" letter before making the election. To continue using the tax-book conformity method, the institution must request a new letter at each subsequent examination that covers the loan review process. If the examiner does not issue an "express determination" letter at the end of such an examination, the institution's election of the tax-book conformity method is revoked automatically as of the beginning of the taxable year that includes the date of examination. However, that examiner's decision not to issue an "express determination" letter does not invalidate an institution's election for any prior years. The supervisory authority is not required to rescind any previously issued "express determination" letters.

When an examiner does not issue an "express determination" letter, the institution is still allowed tax deductions for loans that are wholly or partially worthless. However, the burden of proof is placed on the institution to support its tax deductions for loan charge-offs.

Examination Guidelines - Institutions are responsible for requesting "express determination" letters during examinations that cover their loan review process, i.e., during safety and soundness examinations. Examiners should not alter the scope or frequency of examinations merely to permit banks to use the tax-book conformity method.

When requested by an institution that has made or intends to make the election under Section 1.166-2(d)(3) of the tax regulations, the examiner-in-charge should issue an "express determination" letter, provided the institution does maintain and apply loan loss classification standards that are consistent with the FDIC's regulatory standards. The letter should only be issued at the completion of a safety and soundness examination at which the examiner-in-charge has concluded that the issuance of the letter is appropriate.

An "express determination" letter should be issued to an institution only if:

- The examination indicates that the institution maintains and applies loan loss classification standards that are consistent with the FDIC's standards regarding the identification and charge-off of such loans; and
- There are no material deviations from the FDIC's standards.

Minor criticisms of the institution's loan review process as it relates to loan charge-offs or immaterial individual deviations from the FDIC's standards should not preclude the issuance of an "express determination" letter.

An "express determination" letter should not be issued if:

- The institution's loan review process relating to charge-offs is subject to significant criticism;
- Loan charge-offs reported in the Report of Condition and Income (Call Reports) are consistently overstated or understated; or
- There is a pattern of loan charge-offs not being recognized in the appropriate year.

When the issuance of an "express determination" letter is appropriate, it should be prepared on FDIC letterhead using the following format. The letter should be signed and dated by the examiner-in-charge and provided to the institution for its files. The letter is not part of the Report of Examination.

Express Determination Letter for IRS Regulation 1.166-2(d)(3)

“In connection with the most recent examination of [Name of Bank], by the Federal Deposit Insurance Corporation, as of [examination date], we reviewed the institution’s loan review process as it relates to loan charge-offs. Based on our review, we concluded that the institution, as of that date, maintained and applied loan loss classification standards that were consistent with regulatory standards regarding loan charge-offs.

This statement is made on the basis of a review that was conducted in accordance with our normal examination procedures and criteria. It does not in any way limit or preclude any formal or informal supervisory action (including enforcement actions) by this supervisory authority relating to the institution’s loan review process or the level at which it maintains its allowance for loan and lease losses.

[signature]
Examiner-in-charge
[date signed]

When an "express determination" letter is issued to an institution, a copy of the letter as well as documentation of the work performed by examiners in their review of the institution's loan loss classification standards should be maintained in the workpapers. A copy of the letter should also be forwarded to the Regional Office with the Report of Examination. The issuance of an “express determination” letter should be noted in the Report of Examination according to procedure in the Report of Examination Instructions. An express determination letter should not be issued subsequent to the Report of Examination being finalized and distributed to the institution.

When an examiner-in-charge concludes that the conditions for issuing a requested "express determination" letter have not been met, the examiner-in-charge should discuss the reasons for this conclusion with the Regional Office. The examiner-in-charge should then advise institution management that the letter cannot be issued and explain the basis for this conclusion. A comment indicating that a requested "express determination" letter could not be issued, together with a brief statement of the reasons for not issuing the letter are addressed in the Report of Examination Instructions.

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CONCENTRATIONS

Generally a concentration is a significantly large volume of economically-related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. Adequate diversification of risk allows the institution to avoid the excessive risks imposed by credit concentrations. It should also be recognized, however, that factors such as location and economic environment of the area limit some institutions' ability to diversify. Where reasonable diversification realistically cannot be achieved, the resultant concentration calls for capital levels higher than the regulatory minimums.

Concentrations generally are not inherently bad, but do add a dimension of risk which the management of the institution should consider when formulating plans and policies. In formulating these policies, management typically addresses goals for portfolio mix and limits within the loan and other asset categories. The institution's business strategy, management expertise and location should be considered when reviewing the policy. Management should also consider the need to track and monitor the economic and financial condition of specific geographic locations, industries and groups of borrowers in which the institution has invested heavily. All concentrations should be monitored closely by management and receive a more in-depth review than the diversified portions of the institution's assets. Failure to monitor concentrations can result in management being unaware how significant economic events might impact the overall portfolio. This will also allow management to consider areas where concentration reductions may be necessary. Management and the board can monitor any reduction program using accurate concentration reports. If management is not properly monitoring concentration levels and limits, examiners may consider criticizing management.

To establish a meaningful tracking system for concentrations of credit, financial institutions should be encouraged to consider the use of codes to track individual borrowers, related groups of borrowers, industries, and individual foreign countries. Financial institutions should also be encouraged to use the North American Industry Classification System (NAICS) or similar code to track industry concentrations. Any monitoring program should be reported regularly to the board of directors.

Refer to the Report of Examination Instructions for guidance in identifying and listing concentrations in the examination report.

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FEDERAL FUNDS SOLD AND REPURCHASE AGREEMENTS

Federal funds sold and securities purchased under agreement for resale represent convenient methods to employ excess funds to enhance earnings. Federal funds are excess reserve balances and take the form of a one-day transfer of funds between banks. These funds carry a specified rate of interest and are free of the risk of loss due to fluctuations in market prices entailed in buying and selling securities. However, these transactions are usually unsecured and therefore do entail potential credit risk. Securities purchased under agreement for resale represent an agreement between the buying and selling banks that stipulates the selling institution will buy back the securities sold at an agreed price at the expiration of a specified period of time.

Federal funds sold are not "risk free" as is often supposed, and the examiner will need to recognize the elements of risk involved in such transactions. While the selling of funds is on a one-day basis, these transactions may evolve into a continuing situation. This development is usually the result of liability management techniques whereby the buying institution attempts to utilize the acquired funds to support a rapid expansion of its loan-investment posture and as a means of enhancing profits. Of particular concern to the examiner is that, in many cases, the selling institution will automatically conclude that the buying institution's financial condition is above reproach without proper investigation and analysis. If this becomes the case, the selling institution may be taking an unacceptable risk unknowingly.

Another area of potential risk involves selling Federal funds to an institution which may be acting as an intermediary between the selling institution and the ultimate buying institution. In this instance, the intermediary institution is acting as agent with the true liability for repayment accruing to the third institution. Therefore, it is particularly important that the original selling institution be aware of this situation, ascertain the ultimate disposition of its funds, and be satisfied as to the creditworthiness of the ultimate buyer of the funds.

Clearly, the "risk free" philosophy regarding the sale of Federal funds is inappropriate. Selling banks must take the necessary steps to assure protection of their position. The examiner is charged with the responsibility of ascertaining that selling banks have implemented and adhered to policy directives in this regard to forestall any potentially hazardous situations.

Examiners should encourage management of banks engaged in selling Federal funds to implement a policy with respect to such activity. This policy generally would consider matters such as the aggregate sum to be sold at any one time, the maximum amount to be sold to any one buyer, the maximum duration of time the institution will sell to any one buyer, a list of acceptable buyers, and the terms under which a sale will be made. As in any form of lending, thorough credit evaluation of the prospective purchaser, both before granting the credit extension and on a continuing basis, is a necessity. Such credit analysis emphasizes the borrower's ability to repay, the source of repayment, and alternative sources of repayment should the primary source fail to materialize. While sales of Federal funds are normally unsecured unless otherwise regulated by State statutes, and while collateral protection is no substitute for thorough credit review, it is prudent for the selling institution to consider the possibility of requiring security if sales agreements are entered into on a continuing basis for specific but extended periods of time, or for overnight transactions which have evolved into longer term sales. Where the decision is made to sell Federal funds on an unsecured basis, the selling institution should be able to present logical reasons for such action based on conclusions drawn from its credit analysis of the buyer and bearing in mind the potential risk involved.

A review of Federal funds sold between examinations may prompt examiners to broaden the scope of their analysis of such activity if the transactions are not being handled in accordance with sound practices as outlined above. Where the institution has not developed a formal policy regarding the sale of Federal funds or fails to conduct a credit analysis of the buyer prior to a sale and during a continuous sale of such funds, the matter should be discussed with management. In such discussion, it is incumbent upon examiners to inform management that their remarks are not intended to cast doubt upon the financial strength of any institution to whom Federal funds are sold. Rather, the intent is to advise the banker of the potential risks of such practices unless safeguards are developed. The need for policy formulation and credit review on all Federal funds sold should be reinforced via a comment in the Report of Examination. Also, if Federal funds sold to any one buyer equals or exceeds 100 percent of the selling institution's Tier 1 Capital, it should be listed on the Concentrations schedule unless secured by U.S. Government securities. Based on the circumstances, the examiner should determine the appropriateness of additional comments regarding risk diversification.

Securities purchased under an agreement to resell are generally purchased at prevailing market rates of interest. The purchasing institution must keep in mind that the transaction merely represents another form of lending. Therefore, considerations normally associated with granting secured credit should be made. Repayment or repurchases by the selling institution is a major consideration, and the buying institution should satisfy itself that the selling institution will be able to generate the necessary funds to repurchase the securities on the prescribed date. Policy guidelines typically limit the amount of money extended to one seller. Collateral coverage arrangements should be controlled by procedures similar to the safeguards used to control any type of liquid collateral. Securities held under such an arrangement should not be included in the institution's investment portfolio but should be reflected in the Report of Examination under the caption Securities Purchased Under Agreements to Resell. Transactions of this nature do not require entries to the securities account of either institution with the selling institution continuing to collect all interest and transmit such payments to the buying institution.

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FUNDAMENTAL LEGAL CONCEPTS AND DEFINITIONS

Laws and regulations that apply to credit extended by banks are more complicated and continually in a state of change. However, certain fundamental legal principles apply no matter how complex or innovative a lending transaction. To avoid needless litigation and ensure that each loan is a legally enforceable claim against the borrower or collateral, adherence to certain rules and prudent practices relating to loan transactions and documentation is essential. An important objective of the examiner's analysis of collateral and credit files is not only to obtain information about the loan, but also to determine if proper documentation procedures and practices are being utilized. While examiners are not expected to be experts on legal matters, it is important they be familiar with the Uniform Commercial Code (UCC) adopted by their respective states as well as other applicable State laws governing credit transactions. A good working knowledge of the various documents necessary to attain the desired collateral or secured position, and how those documents are to be used or handled in the jurisdiction relevant to the institution under examination, is also essential.

Uniform Commercial Code – Secured Transactions

Article 9 of the UCC governs secured transactions; i.e., those transactions which create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts. Article 9 was significantly revised effective July 1, 2001, but each individual state must adopt the changes for it to become law. Because some states have enacted modified versions of the UCC and subsequent revisions, each applicable State statute should be consulted.

General Provisions

A Security Agreement is an agreement between a debtor and a secured party that creates or provides for a security interest. The Debtor is the person that has an interest in the collateral other than a security interest. The term Debtor also includes a seller of payment intangibles or promissory notes. The obligor is the person who owes on a secured transaction. The Secured Party is the lender, seller or other person in whose favor there is a security interest.

Grant of Security Interest

For a security interest to be enforceable against the debtor or third party with respect to the collateral, the collateral must be in the possession of the secured party pursuant to agreement, or the debtor must sign a security agreement which covers the description of the collateral.

Collateral

Any description of personal property or real estate is a sufficient description of the collateral whether or not it is specific if it reasonably identifies what is described. If the parties seek to include property acquired after the signing of the security agreement as collateral, additional requirements must be met.

Unless otherwise agreed a security agreement gives the secured party the rights to proceeds from the sale, exchange, collection or disposition of the collateral.
In some cases, the collateral that secures an obligation under one security agreement can be used to secure a new loan, too. This can be done by using a cross-collateralization clause in the security agreement.

Perfecting the Security Interest

Three terms basic to secured transactions are attachment, security agreement and security interest. Attachment refers to that point when the creditor's legal rights in the debtor's property come into existence or "attach." This does not mean the creditor necessarily takes physical possession of the property, or does it mean acquisition of ownership of the property. Rather, it means that before attachment, the borrower's property is free of any legal encumbrance, but after attachment, the property is legally bound by the creditor's security interest. In order for the creditor's security interest to attach, there must be a security agreement in which the debtor authenticates and provides a description of the collateral. A creditor's security interest can be possessory or nonpossessory, a secured party with possession pursuant to “agreement” means that the “agreement” for possession has to be an agreement that the person will have possession for purposes of security. The general rule is an institution must take possession of deposit accounts (proprietary), letter of credit rights, electronic chattel, paper, stocks and bonds to perfect a security interest therein. In a transaction involving a nonpossessory security interest, the debtor retains possession of the collateral. A security interest in collateral automatically attaches to the proceeds of the collateral and is automatically perfected in the proceeds if the credit was advanced to enable the purchase

A party's security interest in personal property is not protected against a debtor's other creditors unless it has been perfected. A security interest is perfected when it has attached and when all of the applicable steps required for perfection, such as the filing of a financing statement or possession of the collateral, have been taken. These provisions are designed to give notice to others of the secured party's interest in the collateral, and offer the secured party the first opportunity at the collateral if the need to foreclose should arise. If the security interest is not perfected, the secured party loses its secured status.

Right to Possess and Dispose of Collateral

Unless otherwise agreed, when a debtor defaults on a secured loan, a secured party has the right to take possession of the collateral without going to court if this can be done without breaching the peace. Alternatively, if the security agreement so provides, the secured party may require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties.

A secured party may then sell, lease or otherwise dispose of the collateral with the proceeds applied as follows: (a) foreclosure expenses, including reasonable attorneys' fees and legal expenses; (b) the satisfaction of indebtedness secured by the secured party's security interest in the collateral; and (c) the satisfaction of indebtedness secured by any subordinate security interest in the collateral if the secured party receives written notification of demand before the distribution of the proceeds is completed. If requested by the secured party, the holder of a subordinate security interest must furnish reasonable proof of his interest, and unless he does so, the secured party need not comply with his demand.

Examiners should determine institution policy concerning the verification of lien positions prior to advancing funds. Failure to perform this simple procedure may result in the institution unknowingly assuming a junior lien position and, thereby, greater potential loss exposure. Management may check filing records personally or a lien search may be performed by the filing authority or other responsible party. This is especially important when the institution grants new credit lines.

Agricultural Liens

An agricultural lien is generally defined as an interest, other than a security interest, in farm products that meets the following three conditions:

- The lien secures payment or performance of an obligation for goods or services furnished in connection with a debtor’s farming operation or rent on real property leased by a debtor in connection with its farming operation.
- The lien is created by statute in favor of a person that in the ordinary course of its business furnished goods or services to a debtor in connection with a debtor’s farming operation or leased property to a debtor in connection with the debtor’s farming operation.
- The lien’s effectiveness does not depend on the person’s possession of the personal property.

An agricultural lien is therefore non-possessory. Law outside of UCC-9 governs creation of agricultural liens and their attachment to collateral. An agricultural lien cannot be created or attached under Article 9. Article 9, however, does govern perfection. In order to perfect an agricultural lien, a financing statement must be filed. A perfected agricultural lien on collateral has priority over a conflicting security interest in or agricultural lien on the same collateral if the statute creating the agricultural lien provides for such priority. Otherwise, the agricultural lien is subject to the same priority rules as security interests (for example, date of filing).

A distinction is made with respect to proceeds of collateral for security interests and agricultural liens. For security interests, collateral includes the proceeds under Article 9. For agricultural liens, the collateral does not include proceeds unless State law creating the agricultural lien gives the secured party a lien on proceeds of the collateral subject to the lien.

Special Filing Requirements – There is a national uniform Filing System form. Filers, however are not required to use them. If permitted by the filing office, parties may file and otherwise communicate by means of records communicated and stored in a media other than paper. A peculiarity common to all states is the filing of a lien on aircraft; the security agreement must be submitted to the Federal Aviation Administration in Oklahoma City, Oklahoma.

Default and Foreclosure - As a secured party, an institution's rights in collateral only come into play when the obligor is in default. What constitutes default varies according to the specific provisions of each promissory note, loan agreement, security agreement, or other related documents. After an obligor has defaulted, the creditor usually has the right to foreclose, which means the creditor seizes the security pledged to the loan, sells it and applies the proceeds to the unpaid balance of the loan. For consumer transactions, there are strict consumer notification requirements prior to disposition of the collateral. For consumer transactions, the lender must provide the debtor with certain information regarding the surplus or deficiency in the disposition of collateral. There may be more than one creditor claiming a right to the sale proceeds in foreclosure situations. When this occurs, priority is generally established as follows: (1) Creditors with a perfected security interest (in the order in which lien perfection was attained); (2) Creditors with an unperfected security interest; and (3) General creditors.

Under the UCC procedure for foreclosing security interests, four concepts are involved. First is repossession or taking physical possession of the collateral, which may be accomplished with judicial process or without judicial process (known as self-help repossession), so long as the creditor commits no breach of the peace. The former is usually initiated by a replevin action in which the sheriff seizes the collateral under court order. A second important concept of UCC foreclosure procedures is redemption or the debtor's right to redeem the security after it has been repossessed. Generally, the borrower must pay the entire balance of the debt plus all expenses incurred by the institution in repossessing and holding the collateral. The third concept is retention that allows the institution to retain the collateral in return for releasing the debtor from all further liability on the loan. The borrower must agree to this action, hence would likely be so motivated only when the value of the security is likely to be less than or about equal to the outstanding debt. Finally, if retention is not agreeable to both borrower and lender, the fourth concept, resale of the security, comes into play. Although sale of the collateral may be public or private, notice to the debtor and other secured parties must generally be given. The sale must be commercially reasonable in all respects. Debtors are entitled to any surplus resulting from sale price of the collateral less any unpaid debt. If a deficiency occurs (i.e., the proceeds from sale of the collateral were inadequate to fully extinguish the debt obligation), the institution has the right to sue the borrower for this shortfall. This is a right it does not have under the retention concept.

Exceptions to the Rule of Priority - There are three exceptions to the general rule that the creditor with the earliest perfected security interest has priority. The first concerns a specific secured transaction in which a creditor makes a loan to a dealer and takes a security interest in the dealer's inventory. Suppose such a creditor files a financing statement with the appropriate public official to perfect the security interest. While it might be possible for the dealer's customers to determine if an outstanding security interest already exists against the inventory, it would be impractical to do so. Therefore, an exception is made to the general rule and provides that a buyer in the ordinary course of business, i.e., an innocent purchaser for value who buys in the normal manner, cuts off a prior perfected security interest in the collateral.

The second exception to the rule of priority concerns the vulnerability of security interests perfected by doing nothing. While these interests are perfected automatically, with the date of perfection being the date of attachment, they are extremely vulnerable at the hands of subsequent bona fide purchasers. Suppose, for example, a dealer sells a television set on a secured basis to an ultimate consumer. Since the collateral is consumer goods, the security interest is perfected the moment if attaches. But if the original buyer sells the television set to another person who buys it in good faith and in ignorance of the outstanding security interest, the UCC provides that the subsequent purchase cuts off the dealer's security interest. This second exception is much the same as the first except for one important difference: the dealer (creditor) in this case can be protected against purchase of a customer's collateral by filing a financing statement with the appropriate public official.

The third exception regards the after-acquired property clause that protects the value of the collateral in which the creditor has a perfected security interest. The after-acquired property clause ordinarily gives the original creditor senior priority over creditors with later perfected interests. However, it is waived as regards the creditor who supplies replacements or additions to the collateral or the artisan who supplies materials and services that enhance the value of the collateral as long as a perfected security interest in the replacement or additions, or collateral is held.

Borrowing Authorization

Borrowing authorizations in essence permit one party to incur liability for another. In the context of lending, this usually concerns corporations. A corporation may enter into contracts within the scope of the powers authorized by its charter. In order to make binding contracts on behalf of the corporation, the officers must be authorized to do so either by the board of directors or by expressed or implied general powers. Usually a special resolution expressly gives certain officers the right to obligate the corporate entity, pledge assets as collateral, agree to other terms of the indebtedness and sign all necessary documentation on behalf of the corporate entity.

Although a general resolution is perhaps satisfactory for the short-term, unsecured borrowings of a corporation, a specific resolution of the corporation's board of directors is generally advisable to authorize such transactions as term loans, loans secured by security interests in the corporation's personal property, or mortgages on real estate. Further, mortgaging or pledging substantially all of the corporation's assets without prior approval of the shareholders of the corporation is often prohibited, therefore, an institution may need to seek advice of counsel to determine if shareholder consent is required for certain contemplated transactions.

Loans to corporations should indicate on their face that the corporation is the borrower. The corporate name should appear followed by the name, title and signature of the appropriate officer. If the writing is a negotiable instrument, the UCC states the party signing is personally liable as a general rule. To enforce payment against a corporation, the note or other writing should clearly show that the debtor is a corporation.

Bond and Stock Powers

As mentioned previously, an institution generally obtains a security interest in stocks and bonds by possession. The documents which allow the institution to sell the securities if the borrower defaults are called stock powers and bond powers. The examiner should ensure the institution has, for each borrower who has pledged stocks or bonds, one signed stock power for all stock certificates of a single issuer, and a separate signed bond power for each bond instrument. The signature must agree with the name on the actual stock certificate or bond instrument. Refer to Federal Reserve Board Regulations Part 221 (Reg U) for further information on loans secured by investment securities.

Comaker

Two or more persons who are parties to a contract or promise to pay are known as comakers. They are a unit to the performance of one act and are considered primarily liable. In the case of default on an unsecured loan, a judgment would be obtained against all. A release against one is a release against all because there is but one obligation and if that obligation is released as to one obligor, it is released as to all others.

Loan Guarantee

Since banks often condition credit advances upon the backup support provided by third party guarantees, examiners should understand the legal fundamentals governing guarantees. A guarantee may be a guarantee of payment or of collection. "Payment guaranteed" or equivalent words added to a signature means that if the instrument is not paid when due, the guarantor will pay it according to its terms without resort by the holder to any other party. "Collection guaranteed" or equivalent words added to a signature means that if the instrument is not paid when due, the guarantor will pay it, but only after the holder has reduced to judgment a claim against the maker and execution has been returned unsatisfied, or after the maker has become insolvent or it is otherwise useless to proceed against such a party.

Contracts of guarantee are further divided into a limited guarantee which relates to a specific note (often referred to as an "endorsement") or for a fixed period of time, or a continuing guarantee which, in contrast, is represented by a separate instrument and enforceable for future (duration depends upon State law) transactions between the institution and the borrower or until revoked. A well-drawn continuing guarantee contains language substantially similar to the following: "This is an absolute and unconditional guarantee of payment, is unconditionally delivered, and is not subject to the procurement of a guarantee from any person other than the undersigned, or to the performance or happening of any other condition." The aforementioned unambiguous terms are necessary to the enforceability of contracts of guarantee, as they are frequently entered into solely as an accommodation for the borrower and without the guarantor's participation in the benefits of the loan. Thus, courts tend to construe contracts of guarantee strictly against the party claiming under the contract. Unless the guarantee is given prior to or at the time the initial loan is made, the guarantee may not be enforceable because of the difficulty of establishing that consideration was given. Institutions should not disburse funds on such loans until they have the executed guarantee agreement in their possession. Institutions should also require the guarantee be signed in the presence of the loan officer, or, alternatively, that the guarantor's signature be notarized. If the proposed guarantor is a partnership, joint venture, or corporation, the examiner should ensure the signing party has the legal authority to enter into the guarantee agreement. Whenever there is a question concerning a corporation's authority to guarantee a loan, counsel should be consulted and a special corporate resolution passed by the organization's board of directors.

Subordination Agreement

An institution extending credit to a closely held corporation may want to have the company's officers and shareholders subordinate to the institution's loan any indebtedness owed them by the corporation. This is accomplished by execution of a subordination agreement by the officers and shareholders. Subordination agreements are also commonly referred to as standby agreements. Their basic purpose is to prevent diversion of funds from reduction of institution debt to reduction of advances made by the firm's owners or officers.

Hypothecation Agreement

This is an agreement whereby the owner of property grants a security interest in collateral to the institution to secure the indebtedness of a third party. Institutions often take possession of the stock certificates, plus stock powers endorsed in blank, in lieu of a hypothecation agreement. Caution, however, dictates that the institution take a hypothecation agreement setting forth the institution's rights in the event of default.

Real Estate Mortgage

A mortgage may be defined as a conveyance of realty given with the intention of providing security for the payment of debt. There are several different types of mortgage instruments but those commonly encountered are regular mortgages, deeds of trust, equitable mortgages, and deeds absolute given as security.

Regular Mortgages - The regular mortgage involves only two parties, the borrower and the lender. The mortgage document encountered in many states today is referred to as the regular mortgage. It is, in form, a deed or conveyance of realty by the borrower to the lender followed or preceded by a description of the debt and the property, and includes a provision to the effect that the mortgage be released upon full payment of the debt. Content of additional paragraphs and provisions varies considerably.

Deeds of Trust - In the trust deed, also known as the deed of trust, the borrower conveys the realty not to the lender but to a third party, a trustee, in trust for the benefit of the holder of the notes(s) that constitutes the mortgage debt. The deed of trust form of mortgage has certain advantages, the principle being that in a number of states it can be foreclosed by trustee's sale under the power of sale clause without court proceedings.

Equitable Mortgages - As a general rule, any instrument in writing by which the parties show their intention that realty be held as security for the payment of a debt, constitutes an equitable mortgage capable of being foreclosed in a court of equity.

Deeds Absolute Given as Security - Landowners who borrow money may give as security an absolute deed to the land. "Absolute deed" means a quitclaim or warranty deed such as is used in an ordinary realty sale. On its face, the transaction appears to be a sale of the realty; however, the courts treat such a deed as a mortgage where the evidence shows that the instrument was really intended only as security for a debt. If such proof is available, the borrower is entitled to pay the debt and demand reconveyance from the lender, as in the case of an ordinary mortgage. If the debt is not paid, the grantee must foreclose as if a regular mortgage had been made.

The examiner should determine whether the institution has performed a title and lien search of the property prior to taking a mortgage or advancing funds. Proper procedure calls for an abstractor bringing the abstract up to date, and review of the abstract by an attorney or title insurance company. If an attorney performs the task, the abstract will be examined and an opinion prepared indicating with whom title rests, along with any defects and encumbrances disclosed by the abstract. Like an abstractor, an attorney is liable only for damages caused by negligence. If a title insurance company performs the task of reviewing the abstract, it does essentially the same thing; however, when title insurance is obtained, it represents a contract to make good, loss arising through defects in title to real estate or liens or encumbrances thereon. Title insurance covers various items not covered in an abstract and title opinion. Some of the more common are errors by abstractors or attorneys include unauthorized corporate action, mistaken legal interpretations, and unintentional errors in public records by public officials. Once the institution determines title and lien status of the property, the mortgage can be prepared and funds advanced. The institution should record the mortgage immediately after closing the loan. Form, execution, and recording of mortgages vary from state to state and therefore must conform to the requirements of State law.

Collateral Assignment

An assignment is generally considered as the transfer of a legal right from one person to another. The rights acquired under a contract may be assigned if they relate to money or property, but personal services may not be assigned. Collateral assignments are used to establish the institution's rights as lender in the property or asset serving as collateral. It is generally used for loans secured by savings deposits, certificates of deposit or other cash accounts as well as loans backed by cash surrender value of life insurance. In some instances, it is used in financing accounts receivable and contracts. If a third party holder of the collateral is involved, such as life insurance company or the payor of an assigned contract, an acknowledgement should be obtained from that party as to the institution's assigned interest in the asset for collateral purposes.

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CONSIDERATION OF BANKRUPTCY LAW AS IT RELATES TO COLLECTIBILITY OF A DEBT

Introduction

Familiarity with the basic terms and concepts of the Federal bankruptcy law (formally known as the Bankruptcy Reform Act of 1978) is necessary in order for examiners to make informed judgments concerning the likelihood of collection of loans to bankrupt individuals or organizations. The following paragraphs present an overview of the subject. Complex situations may arise where more in-depth consideration of the bankruptcy provisions may be necessary and warrant consultation with the institution's attorney, Regional Counsel or other member of the Regional Office staff. For the most part, however, knowledge of the following information when coupled with review of credit file data and discussion with institution management should enable examiners to reach sound conclusions as to the eventual repayment of the institution's loans.

Forms of Bankruptcy Relief

Liquidation and rehabilitation are the two basic types of bankruptcy proceedings. Liquidation is pursued under Chapter 7 of the law and involves the bankruptcy trustee collecting all of the debtor's nonexempt property, converting it into cash and distributing the proceeds among the debtor's creditors. In return, the debtor obtains a discharge of all debts outstanding at the time the petition was filed which releases the debtor from all liability for those pre-bankruptcy debts.

Rehabilitation (sometimes known as reorganization) is effected through Chapter 11 or Chapter 13 of the law and in essence provides that creditors' claims are satisfied not via liquidation of the obligor's assets but rather from future earnings. That is, debtors are allowed to retain their assets but their obligations are restructured and a plan is implemented whereby creditors may be paid.

Chapter 11 bankruptcy is available to all debtors, whether individuals, corporations or partnerships. Chapter 13 (sometimes referred to as the "wage earner plan"), on the other hand, may be used only by individuals with regular incomes and when their unsecured debts are under $100,000 and secured debts less than $350,000. The aforementioned rehabilitation plan is essentially a contract between the debtor and the creditors. Before the plan may be confirmed, the bankruptcy court must find it has been proposed in good faith and that creditors will receive an amount at least equal to what would be received in a Chapter 7 proceeding. In Chapter 11 reorganization, all creditors are entitled to vote on whether or not to accept the repayment plan. In Chapter 13 proceedings, only secured creditors are so entitled. A majority vote binds the minority to the plan, provided the latter will receive pursuant to the plan at least the amount they would have received in a straight liquidation. The plan is fashioned so that it may be carried out in three years although the court may extend this to five years.

Most cases in bankruptcy courts are Chapter 7 proceedings, but reorganization cases are increasingly common. From the creditor's point of view, Chapter 11 or 13 filings generally result in greater debt recovery than do liquidation situations under Chapter 7. Nonetheless, the fact that reorganization plans are tailored to the facts and circumstances applicable to each bankrupt situation means that they vary considerably and the amount recovered by the creditor may similarly vary from nominal to virtually complete recovery.

Functions of Bankruptcy Trustees

Trustees are selected by the borrower's creditors and are responsible for administering the affairs of the bankrupt debtor's estate. The bankrupt's property may be viewed as a trust for the benefit of the creditors, consequently it follows the latter should, through their elected representatives, exercise substantial control over this property.

Voluntary and Involuntary Bankruptcy

When a debtor files a bankruptcy petition with the court, the case is described as a voluntary one. It is not necessary the individual or organization be insolvent in order to file a voluntary case. Creditors may also file a petition, in which case the proceeding is known as an involuntary bankruptcy. However, this alternative applies only to Chapter 7 cases and the debtor generally must be insolvent, i.e., unable to pay debts as they mature, in order for an involuntary bankruptcy to be filed.

Automatic Stay

Filing of the bankruptcy petition requires (with limited exceptions) creditors to stop or "stay" further action to collect their claims or enforce their liens or judgements. Actions to accelerate, set off or otherwise collect the debt are prohibited once the petition is filed, as are post- bankruptcy contacts with the obligor. The stay remains in effect until the debtor's property is released from the estate, the bankruptcy case is dismissed, the debtor obtains or is denied a discharge, or the bankruptcy court approves a creditor's request for termination of the stay. Two of the more important grounds applicable to secured creditors under which they may request termination are as follows: (1) The debtor has no equity in the encumbered property, and the property is not necessary to an effective rehabilitation plan; or (2) The creditor's interest in the secured property is not adequately protected. In the latter case, the law provides three methods by which the creditor's interests may be adequately protected: the creditor may receive periodic payments equal to the decrease in value of the creditor's interest in the collateral; an additional or substitute lien on other property may be obtained; or some other protection is arranged (e.g., a guarantee by a third party) to adequately safeguard the creditor's interests. If these alternatives result in the secured creditor being adequately protected, relief from the automatic stay will not be granted. If relief from the stay is obtained, creditors may continue to press their claims upon the bankrupt's property free from interference by the debtor or the bankruptcy court.

Property of the Estate

When a borrower files a bankruptcy petition, an "estate" is created and, under Chapter 7 of the law, the property of the estate is passed to the trustee for distribution to the creditors. Certain of the debtor's property is exempt from distribution under all provisions of the law (not just Chapter 7), as follows: homeowner's equity up to $7,500; automobile equity and household items up to $1,200; jewelry up to $500; cash surrender value of life insurance up to $4,000; Social Security benefits (unlimited); and miscellaneous items up to $400 plus any unused portion of the homeowner's equity. The bankruptcy code recognizes a greater amount of exemptions may be available under State law and, if State law is silent or unless it provides to the contrary, the debtor is given the option of electing either the Federal or State exemptions. Examiners should note that some liens on exempt property which would otherwise be enforceable are rendered unenforceable by the bankruptcy. A secured lender may thus become unsecured with respect to the exempt property. The basic rule in these situations is that the debtor can render unenforceable judicial liens on any exempt property and security interests that are both nonpurchase money and nonpossessory on certain household goods, tools of the trade and health aids.

Discharge and Objections to Discharge

The discharge, as mentioned previously, protects the debtor from further liability on the debts discharged. Sometimes, however, a debtor is not discharged at all (i.e., the creditor has successfully obtained an "objection to discharge") or is discharged only as regards to a specific creditor(s) and a specific debt(s) (an action known as "exception to discharge"). The borrower obviously remains liable for all obligations not discharged, and creditors may pursue customary collection procedures with respect thereto. Grounds for an "objection to discharge" include the following actions or inactions by the bankrupt debtor (this is not an all-inclusive list): fraudulent conveyance within 12 months of filing the petition; unjustifiable failure to keep or preserve financial records; false oath or account or presentation of a false claim in the bankruptcy case and estate, respectively; withholding of books or records from the trustee; failure to satisfactorily explain any loss or deficiency of assets; refusal to testify when legally required to do so; and receiving a discharge in bankruptcy within the last six full years. Some of the bases upon which creditors may file "exceptions to discharge" are: nonpayment of income taxes for the three years preceding the bankruptcy; money, property or services obtained through fraud, false pretenses or false representation; debts not scheduled on the bankruptcy petition and which the creditor had no notice; alimony or child support payments (this exception may be asserted only by the debtor's spouse or children, property settlements are dischargeable); and submission of false or incomplete financial statements. If an institution attempts to seek an exception on the basis of false financial information, it must prove the written financial statement was materially false, it reasonably relied on the statement, and the debtor intended to deceive the institution. These assertions can be difficult to prove. Discharges are unavailable to corporations or partnerships. Therefore, after a bankruptcy, corporations and partnerships often dissolve or become defunct.

Reaffirmation

Debtors sometimes promise their creditors after a bankruptcy discharge that they will repay a discharged debt. An example wherein a debtor may be so motivated involves the home mortgage. To keep the home and discourage the mortgagee from foreclosing, a debtor may reaffirm this obligation. This process of reaffirmation is an agreement enforceable through the judicial system. The law sets forth these basic limitations on reaffirmations: the agreement must be signed before the discharge is granted; a hearing is held and the bankruptcy judge informs the borrower there is no requirement to reaffirm; and the debtor has the right to rescind the reaffirmation if such action is taken within 30 days.

Classes of Creditors

The first class of creditors is known as priority creditors. As the name implies, these creditors are entitled to receive payment prior to any others. Priority payments include administrative expenses of the debtor's estate, unsecured claims for wages and salaries up to $2,000 per person, unsecured claims for employee benefit plans, unsecured claims of individuals up to $900 each for deposits in conjunction with rental or lease of property, unsecured claims of governmental units and certain tax liabilities. Secured creditors are only secured up to the extent of the value of their collateral. They become unsecured in the amount by which collateral is insufficient to satisfy the claim. Unsecured creditors are of course the last class in terms of priority.

Preferences

Certain actions taken by a creditor before or during bankruptcy proceedings may be invalidated by the trustee if they result in some creditors receiving more than their share of the debtor's estate. These actions are called "transfers" and fall into two categories. The first involves absolute transfers, such as payments received by a creditor; the trustee may invalidate this action and require the payment be returned and made the property of the bankrupt estate. A transfer of security, such as the granting of a mortgage, may also be invalidated by the trustee. Hence, the trustee may require previously encumbered property be made unencumbered, in which case the secured party becomes an unsecured creditor. This has obvious implications as regards loan collectibility.

Preferences are a potentially troublesome area for banks and examiners should have an understanding of basic principles applicable to them. Some of the more important of these are listed here.

- A preference may be invalidated (also known as "avoided") if it has all of these elements: the transfer was to or for the benefit of a creditor; the transfer was made for or on account of a debt already outstanding; the transfer has the effect of increasing the amount a creditor would receive in Chapter 7 proceedings; the transfer was made within 90 days of the bankruptcy filing, or within one year if the transfer was to an insider who had reasonable cause to believe the debtor was insolvent at the time of transfer; and the debtor was insolvent at the time of the transfer. Under bankruptcy law, borrowers are presumed insolvent for 90 days prior to filing the bankruptcy petition.
- Payment to a fully secured creditor is not a preference because such a transfer would not have the effect of increasing the amount the creditor would otherwise receive in a Chapter 7 proceeding. Payment to a partially secured creditor does, however, have the effect of increasing the creditor's share and is thus deemed a preference which the trustee may avoid.
- Preference rules also apply to a transfer of a lien to secure past debts, if the transfer has all five elements set forth under the first point.
- There are certain situations wherein a debtor has given a preference to a creditor but the trustee is not permitted to invalidate it. A common example concerns floating liens on inventory under the Uniform Commercial Code. These matters are subject to complex rules, however, and consultation with the Regional Office may be advisable when this issue arises.

Setoffs

Setoffs occur when a party is both a creditor and a debtor of another; amounts which a party owes are netted against amounts which are owed to that party. If an institution exercises its right of setoff properly and before the bankruptcy filing, the action is generally upheld in the bankruptcy proceedings. Setoffs made after the bankruptcy may also be valid but certain requirements must be met of which the following are especially important: First, the debts must be between the same parties in the same right and capacity. For example, it would be improper for the institution to setoff the debtor's loan against a checking account of the estate of the obligor's father, of which the debtor is executor. Second, both the debt and the deposit must precede the bankruptcy petition filing. Third, the setoff may be disallowed if funds were deposited in the institution within 90 days of the bankruptcy filing and for the purpose of creating or increasing the amount to be set off.

Transfers Not Timely Perfected or Recorded

Under most circumstances, an institution which has not recorded its mortgage or otherwise fails to perfect its security interest in a proper timely manner runs great risk of losing its security. This is a complex area of the law but prudence clearly dictates that liens be properly obtained and promptly filed so that the possibility of losing the protection provided by collateral is eliminated.

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SYNDICATED LENDING

Overview

Syndicated loans often represent a substantial portion of the commercial and industrial loan portfolios of large banks. A syndicated loan involves two or more banks contracting with a borrower, typically a large or middle market corporation, to provide funds at specified terms under the same credit facility. The average commercial syndicated credit is in excess of $100 million. Syndicated credits differ from participation loans in that lenders participate jointly in the origination process, as opposed to one originator selling undivided participation interests to third parties. In a syndicated transaction, each financial institution receives a pro rata share of the income based on the level of participation in the credit. Additionally, one or more lenders take on the role of *lead* or *agent* (co-agents in the case of more than one) of the credit and assume responsibility of administering the loan for the other lenders. The agent may retain varying percentages of the credit, which is commonly referred to as the hold *level*.

The syndicated-lending market formed to meet basic needs of lenders and borrowers, such as:

- Raising large amounts of money,
- Enabling geographic diversification,
- Obtaining working capital quickly and efficiently,
- Diversifying credit risk among banks, and
- Gaining attractive pricing advantages.

In times of excess liquidity in the marketplace, spreads typically are quite narrow for investment-grade facilities, thus making it a borrower's market. This may be accompanied by an easing of the structuring and covenants. In spite of tightening margins, commercial banks are motivated to compete regarding pricing in order to retain other business as well as generate fee income.

Relaxing covenants and pricing may result in lenders relying heavily on market valuations, or so-called "enterprise values" in arriving at credit decisions. These values are derived by applying a current-period multiple to cash flows (which uses data from comparable companies within the same industry), or discounting projected cash flows over several years (which typically uses an average cost of capital as the discount rate). This value represents the intangible business value of a company as a going concern, which often exceeds its underlying hard assets.

Many deals involve merger and acquisition financing. While the primary originators of the syndicated loans are commercial banks, most of the volume is sold and held by other investors.

A subset of syndicated lending is leveraged lending which refers to borrowers with an elevated level of debt and debt service compared with cash flow. By their very nature, these instruments are of higher risk.

Syndication Process

There are four phases in loan syndications: Pre-Launch, Launch, Post-Launch, and Post-Closing.

The Pre-Launch Process - During this phase, the syndicators identify the borrower's needs and perform their initial due diligence. Industry information is gathered and analyzed, and background checks may be performed. Potential pricing and structure of the transaction takes shape. Formal credit write-ups are sent to credit officers for review and to senior members of the syndication group for pricing approval. Competitive bids are sent to the borrower. The group then prepares for the launch.

An information memorandum is prepared by the agent. This memorandum is a formal and confidential document that should address all principal credit issues relating to the borrower and to the project being financed. It typically contains an overview of the transaction including a term sheet, an overview of the borrower's business, and quarterly and annual certified financial statements. This document acts as both the marketing tool and as the source of information for the syndication.

The Launch Phase - The transaction is launched into the market when banks are sent the information memoranda mentioned above. Legal counsel commences to prepare the documentation. Negotiations take place between the banks and the borrower over pricing, collateral, covenants, and other terms. Often there is an institution meeting so potential participants can discuss the company's business and industry both with the lead agent and with the company.

Post-Launch Phase - Typically there is a two-week period for potential participants to evaluate the transaction and to decide whether or not to participate in the syndication. During this period, banks do their due diligence and credit approval. Often this entails running projection models, including stress tests, doing business and industry research, and presenting the transaction for the approval process once the decision is made to commit to the transaction.

After the commitment due date, participating banks receive a draft credit agreement for their comments. Depending upon the complexity of the agreement, they usually have about a week to make comments. The final credit agreement is then negotiated based on the comments and the loan would then close two to five days after the credit agreement is finalized.

Post-Closing Phase - Post-Closing, there usually is an ongoing dialogue with the borrower about financial/operating performance as well as quarterly credit agreement covenant compliance checks. Annually, a full credit analysis typically is done as well as annual meetings of the participants for updates on financial and operating performance. Both the agent institution and the participants need to assess the loan protection level by analyzing the business risk as well as the financial risk. Each industry has particular dominant risks to be assessed.

Loan Covenants

Loan covenants are special conditions included in a loan agreement that the borrower is required to fulfill in order for the loan agreement to remain valid. Typically, covenants cover several domains but can broadly be divided into financial and non-financial categories. Effective financial covenants establish an operating framework using conditions defined in absolute amounts or ratios. If exceeded by the borrower, the covenants provide lenders the opportunity to further strengthen collateral controls or adjust interest rates. Some examples are:

Net Worth test: restricts the total amount of debt a borrower can incur, expressed as a percentage of net worth.

Current Ratio/ Quick Ratio test: measures liquidity.

Interest, Debt Service or Fixed Charge Coverage test: assures that some level of cash flow is generated by a company above its interest expense and other fixed obligations. The proxy for cash flow is usually EBITDA (earnings before interest, taxes, depreciation and amortization).

Capital Expenditure Limitations: generally set according to the company's business plan and then measured accordingly.

Borrowing Base Limitations: lending formula typically based on eligible accounts receivable and inventory. At times, the formula may also include real estate or other non-current assets.

Leverage test: actual leverage covenant levels vary by industry segment. Typical ratios include Total Debt divided by EBITDA, Senior Debt divided by EBITDA and Net Debt (subtracts cash) divided by EBITDA.

Non-financial covenants may include restrictions on other matters such as management changes, provisions of information, guarantees, disposal of assets, etc.

Credit Rating Agencies

The large credit rating agencies (Standard and Poor's, Moody's, and Fitch Investor Services) provide coverage of many syndicated loans at origination and periodically during the life of the loan. Credit ratings issued by these agencies reflect a qualitative and quantitative evaluation of financial and other information of the prospective borrower, including information provided by the borrower and other non-public information.

Credit ratings may represent the overall corporate credit rating of a borrower or reflect analysis of a borrower's specific financial instruments, such as their syndicated loans. Credit ratings for each financial instrument reflect the general credit risk of the borrower, their ability to repay the debt, and the probability of the borrower defaulting on the instrument in question. Some credit rating agencies also provide separate ratings that consider the financial loss the holder of a financial instrument such as a syndicated loan may incur if a borrower defaults.

Overview of the Shared National Credit (SNC) Program

The Shared National Credit (SNC) Program is an interagency initiative administered jointly by the FDIC, Federal Reserve Board, and the Office of the Comptroller of the Currency. The program was established in the 1970's for the purpose of ensuring consistency among the three Federal banking regulators in the classification of large syndicated credits.

Definition of a SNC

Any loan or formal loan commitment, including any asset such as other real estate, stocks, notes, bonds and debentures taken for debts previously contracted, extended to a borrower by a supervised institution, or any of its subsidiaries and affiliates, which in original amount aggregates $100 million or more and, which is shared by three or more unaffiliated institutions under a formal lending agreement; or, a portion of which is sold to two or more unaffiliated institutions, with the purchasing institution(s) assuming its pro rata share of the credit risk.

SNC's generally include:

- Loans administered by a domestic office of a supervised institution;
- Domestic commercial and real estate loans and all international loans to borrowers in the private sector; and
- Acceptances, commercial letters of credit, standby letters of credit or similar bonds or guarantees, note issuance facilities, revolving underwriting facilities, Eurodollar facilities, syndications, and similar extensions or commitments, and lease financing receivables.

SNCs Do Not Include:

- Credits shared solely between affiliated supervised institutions;
- Private sector credits that are 100 percent guaranteed by a sovereign entity;
- International credits or commitments administered in a foreign office;
- Direct credits to sovereign borrowers.

SNC Review and Rating Process

Teams of interagency examiners review and risk rate a sample of credits at agent banks during the first and third quarters of each year. Of note, SNC reviews occur regularly at agent banks originating a significant level of SNC credits. For agent banks with smaller SNC portfolios, credits are only reviewed through the program on an ad hoc basis. The SNC review sample is based on internal rating, industry, size, and the number of regulated participants. The regulatory rating assigned by an interagency team of examiners is reported to all participating banks shortly after the conclusion of the on-site review voting period. Ratings remain active on a rolling two review basis (approximately 1 year), thus avoiding duplicate reviews of the same loan and ensuring consistent treatment with regard to regulatory credit ratings. Examiners should not change SNC ratings during risk management examinations. Any material change in a borrower's condition should be reported to the national SNC coordinator.

The SNC rating process includes risk rating, accrual and TDR status. Impairment measurement and ALLL treatment are not addressed in the SNC rating and should be reviewed at each participant institution. Current and historical SNC ratings can be accessed through the FDIC's internal systems. Designated SNC credits not reviewed in the current SNC sample will be listed as "Not Rated." These credits may be reviewed separately at the participant institution if significant to the examination scope or an examiner believes that the credit may carry an adverse rating.

The FDIC's SNC office can provide examiners with additional information to facilitate the review of "Not Rated" credits or copies of line sheets used in the interagency SNC review to help examiners explain rating rationales to participant banks. In those situations where a "Not Rated" credit is reviewed at the participant institution and an adverse rating is assigned, examiners should communicate their findings to the national SNC coordinator.

SNC Rating Communication and Distribution Process

At the conclusion of each semi-annual SNC review, electronic reports are generated, and notifications are sent via email to participant institution contacts. They are provided a link to retrieve a summary of ratings, applicable loan write-ups, cover letter and a list of agent institution contacts. These reports are available to examiners upon request and can be retransmitted to the participant institution contact if needed. The notification email also marks the beginning of a 14 day window for banks to file an appeal.

Appeals Process

Agent and participant banks may appeal any preliminary rating. Agent and participant banks have 14 days from the electronic distribution of preliminary results to submit an appeal. The written appeal details the reasons why the institution is disputing the classification and includes documentation supporting the institution's position. The written appeal is sent to the applicable agency of the agent institution for the credit in question. An interagency appeals panel reviews the appeal, determines the final disposition of the credit, and informs the institution of its decision in writing. Ratings changed by the appeals process are communicated electronically to all affected participant banks.

Additional Risks Associated with Syndicated Loan Participations

An institution that purchases a participation interest in large loan syndications faces the same risks as an institution purchasing an ordinary loan participation from another institution. Examiners should reference the manual section on *Loan Participations* for a more in depth discussion of related risks. As discussed in that section, an institution purchasing a participation loan is expected to perform the same degree of independent credit analysis on the loan as if it were the originator. The same holds true for banks purchasing participation interests in large syndications. Institutions that lack the resources or skill sets to perform an independent credit analysis on a complex loan syndication generally refrain from participating in such a transaction.

In some cases, an institution may enter into a sub-participation agreement in which the institution purchases a piece of a participation from another syndicated loan participant rather than directly from the agent institution. As a result, the sub-participant may not be registered with or known to the agent institution and may not receive timely notification of risk ratings or adverse credit actions from either the agent institution or the SNC system.

Additionally, sub-participants may not have the same legal rights or remedies as participants of record in the syndicate, which may give rise to other transactional and operational risk concerns.

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CREDIT SCORING

Automated credit scoring systems allow institutions to underwrite and price loans more quickly than was possible in the past. This efficiency has enabled some banks to expand their lending into national markets and originate loan volumes once considered infeasible. Scoring also reduces unit-underwriting costs, while yielding a more consistent loan portfolio that is easily securitized. These benefits have been the primary motivation for the proliferation of credit scoring systems among both large and small institutions.

Credit scoring systems identify specific characteristics that help define predictive variables for acceptable performance (delinquency, amount owed on accounts, length of credit history, home ownership, occupation, income, etc.) and assign point values relative to their overall importance. These values are then totaled to calculate a credit score, which helps institutions to rank order risk for a given population. Generally, an individual with a higher score will perform better relative to an individual with a lower credit score.

Few, if any, institutions have an automated underwriting system where the credit score is used exclusively to make the credit decision. Some level of human review is usually present to provide the flexibility needed to address individual circumstances. Institutions typically establish a minimum cut-off score below which applicants are denied and a second cutoff score above which applicants are approved. However, there is usually a range, or "gray area," in between the two cut-off scores where credits are manually reviewed and credit decisions are judgmentally determined.

Most, if not all, systems also provide for overrides of established cut-off scores. If the institution's scoring system effectively predicts loss rates and reflects management's risk parameters, excessive overrides will negate the benefits of an automated scoring system. Therefore, it is critical for management to monitor and control overrides. Institutions typically develop acceptable override limits and prepare monthly override reports that provide comparisons over time and against the institution's parameters. Override reports also typically identify the approving officer and include the reason for the override.

Although banks often use more than one type of credit scoring methodology in their underwriting and account management practices, many systems incorporate credit bureau scores. Credit bureau scores are updated periodically and validated on an ongoing basis against performance in credit bureau files. Scores are designed to be comparable across the major credit bureaus; however, the ability of any score to estimate performance outcome probabilities depends on the quality, quantity, and timely submission of lender data to the various credit bureaus. Often, the depth and thoroughness of data available to each credit bureau varies, and as a consequence, the quality of scores varies.

As a precaution, institutions that rely on credit bureau scores often sample and compare credit bureau reports to determine which credit bureau most effectively captures data for the market(s) in which the institution does business. For institutions that acquire credit from multiple regions, use of multiple scorecards may be appropriate, depending on apparent regional credit bureau strength. In some instances, it may be worthwhile for institutions to pull scores from each of the major credit bureaus and establish rules for selecting an average value. By tracking credit bureau scores over time and capturing performance data to differentiate which score seems to best indicate probable performance outcome, institutions can select the best score for any given market. Documenting such efforts to differentiate and select the best credit bureau score supports a deliberative decision process.

Although some institutions develop their own scoring models, most are built by outside vendors and subsequently maintained by the institution. Vendors build scoring models based upon specific information and parameters provided by institution management. Therefore, management must clearly communicate with the vendor and ensure that the scorecard developer clearly understands the institution's objectives. Bank management that adheres closely to vendor manual specifications for system maintenance and management, particularly those that provide guidance for periodically assessing performance of the system, achieve the most reliable results.

Scoring models generally become less predictive as time passes. Certain characteristics about an applicant, such as income, job stability, and age change over time, as do overall demographics. One-by-one, these changes will result in significant shifts in the profile of the population. Once a fundamental change in the profile occurs, the model is less able to identify potentially good and bad applicants. As these changes continue, the model loses its ability to rank order risk. Thus, for the best results, institutions must periodically validate the system's predictability, refine scoring characteristics when necessary, and document these efforts.

Institutions initially used credit scoring for consumer lending applications such as credit card, auto, and mortgage lending. However, credit scoring eventually gained acceptance in the small business sector. Depending on the manner in which it is implemented, credit scoring for small business lending may represent a fundamental shift in underwriting philosophy if institutions view a small business loan as more of a high-end consumer loan and, thus, grant credit more on the strength of the principals' personal credit history and less on the fundamental strength of the business. While this may be appropriate in some cases, it is important to remember that the income from small business remains the primary source of repayment for most loans. Institutions that do not analyze business financial statements or periodically review their lines of credit may lose an opportunity for early detection of credit problems.

The effectiveness of any scoring system directly depends on the policies and procedures established to guide and enforce proper use. The most effective policies include an overview of the institution's scoring objectives and operations; the establishment of authorities and responsibilities over scoring systems; the use of a chronology log to track internal and external events that affect the scoring system; the establishment of institution officials responsible for reporting, monitoring, and reviewing overrides; as well as the provision of a scoring system maintenance program to ensure that the system continues to rank risk and to predict default and loss under the original parameters.

Examiners should refer to the Credit Card Specialty Bank Examination Guidelines and the Credit Card Activities section of the Examination Modules for additional information on credit scoring systems.

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SUBPRIME LENDING

Introduction

There is no universal definition of a subprime loan in the industry, but subprime lending is generally characterized as a lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers. Institutions often refer to subprime lending by other names such as the nonprime, nonconforming, high coupon, or alternative lending market.

Well-managed subprime lending can be a profitable business line; however, it is a high-risk lending activity. Successful subprime lenders carefully control the elevated credit, operating, compliance, legal, market, and reputation risks as well as the higher overhead costs associated with more labor-intensive underwriting, servicing, and collections. Subprime lending should only be conducted by institutions that have a clear understanding of the business and its inherent risks, and have determined these risks to be acceptable and controllable given the institution's staff, financial condition, size, and level of capital support. In addition, subprime lending should only be conducted within a comprehensive lending program that employs strong risk management practices to identify, measure, monitor, and control the elevated risks that are inherent in this activity. Finally, subprime lenders need to retain capital support that is consistent with the volume and nature of the additional risks assumed. If the risks associated with this activity are not properly controlled, subprime lending may be considered an unsafe and unsound banking practice.

The term, subprime, refers to the credit characteristics of the borrower at the loan's origination, rather than the type of credit or collateral considerations. Subprime borrowers typically have weakened credit histories that may include a combination of payment delinquencies, charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria. Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- Bankruptcy in the last 5 years;
- Relatively high default probability as evidenced by, for example, a Fair Isaac and Co. risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
- Debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers. Additionally, this definition may not match all market or institution-specific subprime definitions, but should be viewed as a starting point from which examiners should expand their review of the institution's lending program.

Subprime lenders typically use the criteria above to segment prospects into subcategories such as, for example, A, B, C, and D. However, subprime subcategories can vary significantly among lenders based on the credit grading criteria. What may be an "A" grade definition at one institution may be a "B" grade at another institution, but generally each grade represents a different level of credit risk.

While the industry often includes borrowers with limited or no credit histories in the subprime category, these borrowers can represent a substantially different risk profile than those with a derogatory credit history and are not inherently considered subprime. Rather, consideration should be given to underwriting criteria and portfolio performance when determining whether a portfolio of loans to borrowers with limited credit histories should be treated as subprime for examination purposes.

Subprime lending typically refers to a lending program that targets subprime borrowers. Institutions engaging in subprime lending generally have knowingly and purposefully focused on subprime lending through planned business strategies, tailored products, and explicit borrower targeting. An institution's underwriting guidelines and target markets should provide a basis for determining whether it should be considered a subprime lender. The average credit risk profile of subprime loan programs will exhibit the credit risk characteristics listed above, and will likely display significantly higher delinquency and/or loss rates than prime portfolios. High interest rates and fees are a common and relatively easily identifiable characteristic of subprime lending. However, high interest rates and fees by themselves do not constitute subprime lending.

Subprime lending does not include traditional consumer lending that has historically been the mainstay of community banking, nor does it include making loans to subprime borrowers as discretionary exceptions to the institution's prime retail lending policy. In addition, subprime lending does not refer to: prime loans that develop credit problems after acquisition; loans initially extended in subprime programs that are later upgraded, as a result of their performance, to programs targeted to prime borrowers; or community development loans as defined in the CRA regulations.

For supervisory purposes, a subprime lender is defined as an insured institution or institution subsidiary that has a subprime lending program with an aggregate credit exposure greater than or equal to 25 percent of Tier 1 capital. Aggregate exposure includes principal outstanding and committed, accrued and unpaid interest, and any retained residual assets relating to securitized subprime loans.

Capitalization

The FDIC's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles than exist in subprime loan programs. Therefore, these requirements may not be sufficient to reflect the risks associated with subprime portfolios. Each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime lending activities, and for fully documenting the methodology and analysis supporting the amount specified.

Examiners will evaluate the capital adequacy of subprime lenders on a case-by-case basis, considering, among other factors, the institution's own documented analysis of the capital needed to support its subprime lending activities. Capital levels are typically risk sensitive, that is, allocated capital should reflect the level and variability of loss estimates within reasonably conservative parameters. Institutions generally specify a direct link between the estimated loss rates used to determine an appropriate ALLL, and the unexpected loss estimates used to determine capital.

The sophistication of this analysis should be commensurate with the size, concentration level, and relative risk of the institution's subprime lending activities and consider the following elements:

- Portfolio growth rates;
- Trends in the level and volatility of expected losses;
- The level of subprime loan losses incurred over one or more economic downturns, if such data/analyses are available;
- The impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets;
- Any deterioration in the average credit quality over time due to adverse selection or retention;
- The amount, quality, and liquidity of collateral securing the individual loans;
- Any asset, income, or funding source concentrations;
- The degree of concentration of subprime credits;
- The extent to which current capitalization consists of residual assets or other potentially volatile components;
- The degree of legal and/or reputation risk associated with the subprime business line(s) pursued; and
- The amount of capital necessary to support the institution's other risks and activities.

Given the higher risk inherent in subprime lending programs, examiners should reasonably expect, as a starting point, that an institution would hold capital against such portfolios in an amount that is one and one half to three times greater than what is appropriate for non-subprime assets of a similar type. Refinements typically depend on the factors analyzed above, with particular emphasis on the trends in the level and volatility of loss rates, and the amount, quality, and liquidity of collateral securing the loans. Institutions with significant subprime programs generally have capital ratios that are well above the averages for their traditional peer groups or other similarly situated institutions that are not engaged in subprime lending.

Some subprime asset pools warrant increased supervisory scrutiny and monitoring, but not necessarily additional capital. For example, well-secured loans to borrowers who are slightly below what is considered prime quality may entail minimal additional risks compared to prime loans, and may not require additional capital if adequate controls are in place to address the additional risks. On the other hand, institutions that underwrite higher-risk subprime pools, such as unsecured loans or high loan-to-value second mortgages, may need significantly higher levels of capital, perhaps as high as 100% of the loans outstanding depending on the level and volatility of risk. Because of the higher inherent risk levels and the increased impact that subprime portfolios may have on an institution's overall capital, examiners should document and reference each institution's subprime capital evaluation in their comments and conclusions regarding capital adequacy.

Stress Testing

An institution's capital adequacy analysis typically includes stress testing as a tool for estimating unexpected losses in its subprime lending pools. Institutions may project the performance of their subprime loan pools under conservative stress test scenarios, including an estimation of the portfolio's susceptibility to deteriorating economic, market, and business conditions. Portfolio stress testing scenarios may include "shock" testing of basic assumptions such as delinquency rates, loss rates, and recovery rates on collateral. It may also consider other potentially adverse scenarios, such as: changing attrition or prepayment rates; changing utilization rates for revolving products; changes in credit score distribution; and changes in the capital markets demand for whole loans, or asset-backed securities supported by subprime loans.

These are representative examples. Actual factors will vary by product, market segment, and the size and complexity of the portfolio relative to the institution's overall operations. Whether stress test scenarios are performed manually, or through automated modeling techniques, the Regulatory Agencies will expect that:

- The process is clearly documented, rational, and easily understood by the board and senior management;
- The inputs are reliable and relate directly to the subject portfolios;
- Assumptions are well documented and conservative; and
- Any models are subject to a comprehensive validation process.

The results of the stress test exercises should be a documented factor in the analysis and determination of capital adequacy for the subprime portfolios.

Institutions that engage in subprime lending without adequate procedures to estimate and document the level of capital necessary to support their activities should be criticized. Where capital is deemed inadequate to support the risk in subprime lending activities, examiners should consult with their Regional Office to determine the appropriate course of action.

Risk Management

The following items are essential components of an effective risk management program for subprime lenders.

Planning and Strategy. Prior to engaging in subprime lending, the board and management ensure that proposed activities are consistent with the institution's overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear solicitation and origination strategy that allows for after-the-fact assessment of underwriting performance, and establishing appropriate feedback and control systems. Appropriate risk assessment processes extend beyond credit risk and appropriately incorporate operating, compliance, market, liquidity, reputation and legal risks.

Institutions establishing an appropriate subprime lending program proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal control problems and to determine if favorable initial profitability estimates are realistic and sustainable. Strategic plan performance analysis is generally conducted frequently in order to detect adverse trends or circumstances and take appropriate action in a timely manner.

Management and Staff. Prior to engaging in subprime lending, the board typically ensures that management and staff possess sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of activity. Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account origination, and collections strategies and techniques often differ from those employed for prime credit; thus it is generally not sufficient to have the same staff responsible for both subprime and prime loans. Servicing and collecting subprime loans can be very labor intensive and requires a greater volume of staff with smaller caseloads. Lenders should monitor staffing levels, staff experience, and the need for additional training as performance is assessed over time. Compensation programs should not depend primarily on volume or growth targets. Any targets used should be weighted towards factors such as portfolio quality and risk-adjusted profitability.

Lending Policies and Procedures. Lenders typically have comprehensive written policies and procedures, specific to each subprime lending product that set limits on the amount of risk that will be assumed and address how the institution will control portfolio quality and avoid excessive exposure. Prudent institutions implement policies and procedures before initiating the activity. Institutions may originate subprime loans through a variety of channels, including dealers, brokers, correspondents, and marketing firms. Regardless of the source, it is critical that underwriting policies and procedures incorporate the risk tolerances established by the board and management and explicitly define underwriting criteria and exception processes. Subprime lending policies and procedures typically address the items outlined in the loan reference module of the ED Modules for subprime lending. If the institution elects to use scoring systems for approvals or pricing, the model should be tailored to address the behavioral and credit characteristics of the subprime population targeted and the products offered. It is generally not acceptable to rely on models developed for standard risk borrowers or products. Furthermore, the models should be reviewed frequently and updated as necessary to ensure assumptions remain valid.

Given the higher credit risk associated with the subprime borrower, effective subprime lenders use mitigating underwriting guidelines and risk-based pricing to reduce the overall risk of the loan. These guidelines include lower loan-to-value ratio requirements and lower maximum loan amounts relative to each risk grade within the portfolio. Given the high-risk nature of subprime lending, the need for thorough analysis and documentation is heightened relative to prime lending. Compromises in analysis or documentation can substantially increase the risk and severity of loss. In addition, successful subprime lenders develop criteria for limiting the risk profile of borrowers selected, giving consideration to factors such as the frequency, recency, and severity of delinquencies and derogatory items; length of time with re-established credit; and reason for the poor credit history.

Since the past credit deficiencies of subprime borrowers reflect a higher risk profile, appropriate subprime loan programs are based upon the borrowers' current reasonable ability to repay and a prudent debt amortization schedule. Loan repayment should not be based upon foreclosure proceedings or collateral repossession. Institutions are to recognize the additional default risks and determine if these risks are acceptable and controllable without resorting to foreclosure or repossession that could have been predetermined by the loan structure at inception.

Profitability and Pricing. A key consideration for lenders in the subprime market is the ability to earn risk-adjusted yields that appropriately compensate the institution for the increased risk and costs assumed. Successful institutions have a comprehensive framework for pricing decisions and profitability analysis that considers all costs associated with each subprime product, including origination, administrative/servicing, expected charge-offs, funding, and capital. In addition, such pricing frameworks allow for fluctuations in the economic cycle. Fees often comprise a significant portion of revenue in subprime lending. Consideration should be given to the portion of revenues derived from fees and the extent to which the fees are a recurring and viable source of revenue. Profitability projections typically are incorporated into the business plan. Also, effective management teams track actual performance against projections regularly and have a process for addressing variances.

Loan Review and Monitoring. Consistent with the safety and soundness standards prescribed in Appendix A to Part 364 of the FDIC Rules and Regulations, institutions must have comprehensive analysis and information systems that identify, measure, monitor and control the risks associated with subprime lending. Such analysis promotes understanding of the portfolio and early identification of adverse quality/performance trends. Systems employed must possess the level of detail necessary to properly evaluate subprime activity. Examples of portfolio segmentation and trend analyses are discussed in the subprime lending loan reference module of the ED Modules.

Comprehensive analysis considers the effects of portfolio growth and seasoning, which can mask true performance by distorting delinquency and loss ratios. Vintage, lagged delinquency, and lagged loss analysis methods are sometimes used to account for growth, seasoning, and changes in underwriting. Analysis should also take into account the effect of cure programs on portfolio performance. Refer to the glossary of the Credit Card Specialty Bank Examination Guidelines for definitions of vintage, roll rate, and migration analysis.

Servicing and Collections. Defaults occur sooner and in greater volume than in prime lending; thus a well-developed servicing and collections function is essential for the effective management of subprime lending. Strong procedures and controls are necessary throughout the servicing process; however, particular attention is warranted in the areas of new loan setup and collections to ensure the early intervention necessary to properly manage higher risk borrowers. Prudent lenders also have well-defined written collection policies and procedures that address default management (e.g., cure programs and repossessions), collateral disposition, and strategies to minimize delinquencies and losses. This aspect of subprime lending is very labor intensive but critical to the program's success.

Cure programs include practices such as loan restructuring, re-aging, renewal, extension, or consumer credit counseling. Cure programs typically are used only when the institution has substantiated the customer's renewed willingness and ability to pay. Appropriate controls help ensure cure programs do not mask poor initial credit risk selection or defer losses. Effective subprime lenders may use short-term loan restructure programs to assist borrowers in bringing loans current when warranted, but will often continue to report past due status on a contractual basis. Cure programs that alter the contractual past due status may mask actual portfolio performance and inhibit the ability of management to understand and monitor the true credit quality of the portfolio.

Repossession and resale programs are integral to the subprime business model. Policies and procedures for foreclosure and repossession activities typically specifically address the types of cost/benefit analysis to be performed before pursuing collateral, including valuation methods employed; timing of foreclosure or repossession; and accounting and legal requirements. Effective policies clearly outline whether the institution will finance the sale of the repossessed collateral, and if so, the limitations that apply. Institutions that track the performance of such loans are able to assess the adequacy of these policies.

Compliance and Legal Risks. Subprime lenders generally run a greater risk of incurring legal action given the higher fees, interest rates, and profits; targeting customers who have little experience with credit or damaged credit records; and aggressive collection efforts. Because the risk is dependent, in part, upon the public perception of a lender's practices, the nature of these risks is inherently unpredictable. Institutions that engage in subprime lending must take special care to avoid violating consumer protection laws. An adequate compliance management program must identify, monitor and control the consumer protection hazards associated with subprime lending. The institution should have a process in place to handle the potential for heightened legal action. In addition, management should have a system in place to monitor consumer complaints for recurring issues and ensure appropriate action is taken to resolve legitimate disputes.

Audit. The institution's audit scope should provide for comprehensive independent reviews of subprime activities. Appropriate audit procedures include, among other things, a sample of a sufficient volume of accounts to verify the integrity of the records, particularly with respect to payments processing.

Third Parties. Subprime lenders may use third parties for a number of functions from origination to collections. In dealing with high credit-risk products, effective management teams take steps to ensure that exposures from third-party practices or financial instability are minimized. This includes proper due diligence performed prior to contracting with a third party vendor and on an ongoing basis. Appropriate contracts provide the institution with the ability to control and monitor third party activities (e.g. growth restrictions, underwriting guidelines, outside audits, etc.) and discontinue relationships that prove detrimental to the institution.

Special care must be taken when purchasing loans from third party originators. Some originators who sell subprime loans charge borrowers high up-front fees, which may be financed into the loan. These fees provide incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. These fees also increase the likelihood that the originator will attempt to refinance the loans. Appropriate contracts restrict the originator from the churning of customers. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation. Effective management also ensures that third party conflicts of interest are avoided. For example, if a loan originator provides recourse for poorly performing loans purchased by the institution, the originator or related interest thereof should not also be responsible for processing and determining the past due status of the loans.

Securitizations. Securitizing subprime loans carries inherent risks, including interim credit, liquidity, interest rate, and reputation risk, that are potentially greater than those for securitizing prime loans. The subprime loan secondary market can be volatile, resulting in significant liquidity risk when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions may be forced to sell loan pools at deep discounts. If an institution lacks adequate personnel, risk management procedures, or capital support to hold subprime loans originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans typically develop a contingency plan that addresses back-up purchasers of the securities, whole loans, or the attendant servicing functions, alternate funding sources, and measures for raising additional capital. An institution's liquidity and funding structure should not be overly dependent upon the sale of subprime loans.

Given some of the unique characteristics of subprime lending, accounting for the securitization process requires assumptions that can be difficult to quantify reliably, and erroneous assumptions can lead to the significant overstatement of an institution's assets. Prudent institutions take a conservative approach when accounting for these transactions and ensure compliance with existing regulatory guidance. Refer to outstanding examination instructions for further information regarding securitizations.

Classification

The Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy) governs the evaluation of consumer loans. This policy establishes general classification thresholds based on delinquency, but also grants examiners the discretion to classify individual retail loans that exhibit signs of credit weakness regardless of delinquency status. An examiner may also classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account management practices that are deficient. Given the high-risk nature of subprime portfolios and their greater potential for loan losses, the delinquency thresholds for classification set forth in the Retail Classification Policy should be considered minimums. Well-managed subprime lenders recognize the heightened risk-of-loss characteristics in their portfolios and, if warranted, internally classify their delinquent accounts well before the timeframes outlined in the interagency policy. If examination classifications are more severe than the Retail Classification Policy suggests, the examination report should explain the weaknesses in the portfolio and fully document the methodology used to determine adverse classifications.

ALLL Analysis

An institution's appropriately documented ALLL analysis identifies subprime loans as a specific risk exposure separate from the prime portfolio. In addition, the analysis segments the subprime lending portfolios by risk exposure such as specific product, vintage, origination channel, risk grade, loan to value ratio, or other grouping deemed relevant.

Adversely classified subprime loans (to include, at a minimum, all loans past due 90 days or more) should be reviewed for impairment, and an appropriate allowance should be established consistent with accounting requirements. For subprime loans that are not adversely classified, the ALLL should be sufficient to absorb at least all estimated credit losses on outstanding balances over the current operating cycle, typically 12 months. To the extent that the historical net charge-off rate is used to estimate credit losses, it should be adjusted for changes in trends, conditions, and other relevant factors, including business volume, underwriting, risk selection, account management practices, and current economic or business conditions that may alter such experience.

Subprime Auto Lending

Underwriting. Subprime auto lenders use risk-based pricing of loans in addition to more stringent advance rates, discounting, and dealer reserves than those typically used for prime auto loans to mitigate the increased credit risk. As credit risk increases, advance rates on collateral decrease while interest rates, dealer paper discounts, and dealer reserves increase. In addition to lower advance rates, collateral values are typically based on the wholesale value of the car. Lenders will typically treat a new dealer with greater caution, using higher discounts and/or purchasing the dealer's higher quality paper until a database and working relationship is developed.

Servicing and Collections. Repossession is quick, generally ranging between 30 to 60 days past due and sometimes earlier. The capacity of a repossession and resale operation operated by a prime lender could easily be overwhelmed if the lender begins targeting subprime borrowers, leaving the lender unable to dispose of cars quickly. Resale methods include wholesale auction, retail lot sale, and/or maintaining a database of retail contacts. While retail sale will command a greater price, subprime lenders may consider limiting the time allocated to retail sales before sending cars to auction in order to ensure adequate cash flow and avoid excessive inventory build-up. Refinancing resales are usually limited and tightly controlled, as this practice can mask losses. Lenders typically implement a system for tracking the location of the collateral.

Subprime Residential Real Estate Lending

Underwriting. To mitigate the increased risk, subprime residential real estate lenders use risk-based pricing in addition to more conservative LTV ratio requirements and cash-out restrictions than those typically used for prime mortgage loans. As the credit risk of the borrower increases, the interest rate increases and the loan-to-value ratio and cash-out limit decreases. Prudent loan-to-value ratios are an essential risk mitigant in subprime real estate lending and generally range anywhere from 85 percent to 90 percent for A- loans, to 65 percent for lower grades. High loan-to-value (HLTV) loans are generally not considered prudent in subprime lending. HLTV loans should be targeted at individuals who warrant large unsecured debt, and then only in accordance with outstanding regulatory guidance. The appraisal process takes on increased importance given the greater emphasis on collateral. Prepayment penalties are sometimes used on subprime real estate loans, where allowed by law, given that prepayment rates are generally higher and more volatile for subprime real estate loans. Government Sponsored entities, Fannie Mae and Freddie Mac, have participated in the subprime mortgage market to a limited degree through purchases of subprime loans and guarantees of subprime securitizations.

Servicing and Collections. Collection calls begin early, generally within the first 10 days of delinquency, within the framework of existing laws. Lenders generally send written correspondence of intent to foreclosure or initiate other legal action early, often as early as 31 days delinquent. The foreclosure process is generally initiated as soon as allowed by law. Updated collateral valuations are typically obtained early in the collections process to assist in determining appropriate collection efforts. Frequent collateral inspections are often used by lenders to monitor the condition of the collateral.

Subprime Credit Card Lending

Underwriting. Subprime credit card lenders use risk-based pricing as well as tightly controlled credit limits to mitigate the increased credit risk. In addition, lenders may require full or partial collateral coverage, typically in the form of a deposit account at the institution, for the higher-risk segments of the subprime market. Initial credit lines are set at low levels, such as $300 to $1,000, and subsequent line increases are typically smaller than for prime credit card accounts. Increases in credit lines should be subject to stringent underwriting criteria similar to that required at origination.

Underwriting for subprime credit cards is typically based upon credit scores generated by sophisticated scoring models. These scoring models use a substantial number of attributes, including the frequency, severity, and recency of previous delinquencies and major derogatory items, to determine the probability of loss for a potential borrower. Subprime lenders typically target particular subprime populations through prescreening models, such as individuals who have recently emerged from bankruptcy. Review of the attributes in these models often reveals the nature of the institution's target population.

Servicing and Collections. Lenders continually monitor customer behavior and credit quality and take proactive measures to avert potential problems, such as decreasing or freezing credit lines or providing consumer counseling, before the problems become severe or in some instances before the loans become delinquent. Lenders often use sophisticated scoring systems to assist in monitoring credit quality and frequently re-score customers. Collection calls on delinquent loans begin early, generally within the first 10 days delinquent, and sometimes as early as 1-day delinquent, within the framework of existing laws. Lenders generally send written correspondence within the first 30 days in addition to calling. Account suspensions occur early, generally within the first 45 days of delinquency or immediately upon a negative event such as refusal to pay. Accounts over 90 days past due are generally subject to account closure and charge-off. In addition, account closures based upon a borrower's action, such as repeated refusal to pay or broken promises to bring the account current within a specified time frame, may occur at any time in the collection process. Account closure practices are generally more aggressive for relatively new credit card accounts, such as those originated in the last six months.

Payday Lending

Payday lending is a particular type of subprime lending. Payday loans (also known as deferred deposit advances) are small dollar, short-term, unsecured loans that borrowers promise to repay out of their next paycheck or regular income payment (such as social security check). Payday loans are usually priced at a fixed dollar fee, which represents the finance charge. Because these loans have such short terms to maturity, the cost of borrowing, expressed as an annual percentage rate is very high.

In return for the loan, the borrower usually provides the lender with a check or debit authorization for the amount of the loan plus the fee. The check is either post-dated to the borrower's next payday or the lender agrees to defer presenting the check for payment until a future date, usually two weeks or less. When the loan is due, the lender expects to collect the loan by depositing the check or debiting the borrower's account or by having the borrower redeem the check with a cash payment. If the borrower informs the lender that he or she does not have the funds to repay the loan, the loan is often refinanced (payday lenders may use the terms "rollover," "same day advance," or "consecutive advance") through payment of an additional finance charge. If the borrower does not redeem the check in cash and the loan is not refinanced, the lender normally puts the check or debit authorization through the payment system. If the borrower's deposit account has insufficient funds, the borrower typically incurs a NSF charge on this account. If the check or the debit is returned to the lender unpaid, the lender also may impose a returned item fee plus collection charges on the loan.

Significant Risks

Credit Risk. Borrowers who obtain payday loans generally have cash flow difficulties and few, if any, lower-cost borrowing alternatives. In addition, some payday lenders perform minimal analysis of the borrower's ability to repay either at the loan's inception or upon refinancing; they may merely require a current pay stub or proof of a regular income source and evidence that the customer has a checking account. Other payday lenders use scoring models and consult nationwide databases that track bounced checks and persons with outstanding payday loans. However, payday lenders typically do not obtain or analyze information regarding the borrower's total level of indebtedness or information from the major national credit bureaus. The combination of the borrower's limited financial capacity, the unsecured nature of the credit, and the limited underwriting analysis of the borrower's ability to repay pose substantial credit risk for insured depository institutions.

Legal and Reputation Risk**.** Federal law authorizes Federal and state-chartered insured depository institutions making loans to out-of-state borrowers to "export" favorable interest rates provided under the laws of the State where the institution is located. That is, a state-chartered institution is allowed to charge interest on loans to out-of-state borrowers at rates authorized by the State where the institution is located, regardless of usury limitations imposed by the State laws of the borrower's residence. Nevertheless, institutions face increased reputation risk when they enter into certain arrangements with payday lenders, including arrangements to originate loans on terms that could not be offered directly by the payday lender.

Transaction Risk**.** Payday loans are a form of specialized lending not typically found in state nonmember institutions, and are most frequently originated by specialized nonbank firms subject to State regulation. Payday loans can be subject to high levels of transaction risk given the large volume of loans, the handling of documents, and the movement of loan funds between the institution and any third party originators. Because payday loans may be underwritten off-site, there also is the risk that agents or employees may misrepresent information about the loans or increase credit risk by failing to adhere to established underwriting guidelines.

Third-Party Risk**.** Insured depository institutions may have payday lending programs that they administer directly, using their own employees, or they may enter into arrangements with third parties. In the latter arrangements, the institution typically enters into an agreement in which the institution funds payday loans originated through the third party. These arrangements also may involve the sale to the third party of the loans or servicing rights to the loans. Institutions also may rely on the third party to provide additional services that the institution would normally provide, including collections, advertising and soliciting applications. The existence of third party arrangements may, when not properly managed, significantly increase institutions' transaction, legal, and reputation risks.

Arrangements with third parties should be guided by written contract and approved by the institution's board. The arrangement typically:

- Describe the duties and responsibilities of each party, including the scope of the arrangement;
- Specify that the third party will comply with all applicable laws and regulations;
- Specify which party will provide consumer compliance related disclosures;
- Authorize the institution to monitor the third party and periodically review and verify that the third party and its representatives are complying with its agreement with the institution;
- Authorize the institution and the appropriate banking agency to have access to such records of the third party and conduct onsite transaction testing and operational reviews at the third party locations as necessary or appropriate to evaluate such compliance;
- Require the third party to indemnify the institution for potential liability resulting from action of the third party with regard to the payday lending program; and
- Address customer complaints, including any responsibility for third-party forwarding and responding to such complaints.

Effective bank management sufficiently monitors the third party with respect to its activities and performance. Bank management dedicates sufficient staff with the necessary expertise to oversee the third party. The institution's oversight program includes monitoring the third party's financial condition, its controls, and the quality of its service and support, including its resolution of consumer complaints if handled by the third party. Oversight programs that are documented sufficiently facilitate the monitoring and management of the risks associated with third-party relationships.

Concentrations

Given the risk inherent in payday lending, concentrations of credit in this line of business pose a significant safety and soundness concern. In the context payday lending, a concentration would be defined as a volume of payday loans totaling 25 percent or more of an institution's Tier 1 capital. Where concentrations of payday lending are noted, institution management should be criticized for a failure to diversify risks. Appropriate supervisory action may be necessary to address concentrations, including directing the institution to reduce its loans to an appropriate level, or raising additional capital.

Capital Adequacy

Payday lending is among the highest risk subsets of subprime lending, and significantly higher levels of capital than the starting point for subprime loans - one and a half to three times what is appropriate for nonsubprime assets of a similar type – typically is required. Institutions that underwrite payday loans may be required to maintain as high as one hundred percent of the loans outstanding (dollar-for-dollar capital), depending on the level and volatility of risk. Risks to consider when determining capital requirements include the unsecured nature of the credit, the relative levels of risk of default, loss in the event of default, and the level of classified assets. The degree of legal or reputation risk associated with payday lending should also be considered, especially as it relates to third party agreements.

Allowance for Loan and Lease Losses

As with other loan types, institutions should maintain an ALLL that is appropriate to absorb estimated credit losses with the payday portfolio. Although the contractual term of each payday loan may be short, institutions' methodologies for estimating credit losses on these loans should take into account the fact that many payday loans remain continuously outstanding for longer periods because of renewals and rollovers. In addition, institutions should evaluate the collectibility of accrued fees and finance charges on payday loans and employ appropriate methods to ensure that income is accurately measured.

Classifications

The Retail Classification Policy establishes general classification thresholds for consumer loans based on delinquency, but also grants examiners the discretion to classify individual retail loans that exhibit signs of credit weakness regardless of delinquency status. Examiners also may classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account management practices that are deficient.

Most payday loans have well-defined weaknesses that jeopardize the liquidation of the debt. Weaknesses include limited or no analysis of repayment capacity and the unsecured nature of the credit. In addition, payday loan portfolios are characterized by a marked proportion of obligors whose paying capacity is questionable. As a result of these weaknesses, payday loan portfolios are typically classified Substandard.

Furthermore, payday loans that have been outstanding for extended periods of time evidence a high risk of loss. While such loans may have some recovery value, it is not practical or desirable to defer writing off these essentially worthless assets. Payday loans that are outstanding for greater than 60 days from origination generally meet the definition of Loss. In certain circumstances, earlier charge-off may be appropriate (e.g., the institution does not renew beyond the first payday and the borrower is unable to pay, the institution closes an account). The institution's policies regarding consecutive advances also should be considered when determining Loss classifications. Where the economic substance of consecutive advances is substantially similar to "rollovers" – without appropriate "cooling off" or waiting periods – examiners should treat these loans as continuous advances and classify accordingly.

Examiners would normally not classify loans for which the institution has documented adequate paying capacity of the obligors and/or sufficient collateral protection or credit enhancement.

Renewals/Rewrites

The Retail Classification Policy establishes guidelines for extensions, deferrals, renewals, or rewrites of closed-end accounts. Despite the short-term nature of payday loans, borrowers that request an extension, deferral, renewal, or rewrite should exhibit a renewed willingness and ability to repay the loan. Institutions can refer to the Retail Classification Policy standards that control the use of extensions, deferrals, renewals, or rewrites of payday loans. In consideration of the Retail Classification Policy, institutions' standards typically:

- Limit the number and frequency of extensions, deferrals, renewals, and rewrites;
- Prohibit additional advances to finance unpaid interest and fees and simultaneous loans to the same customer; and
- Ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained.

In addition to the above items, prudent institutions also:

- Establish appropriate "cooling off" or waiting periods between the time a payday loan is repaid and another application is made:
- Establish the maximum number of loans per customer that are allowed within one calendar year or other designated time period; and
- Provide that no more than one payday loan is outstanding with the institution at a time to any one borrower.

Accrued Fees and Finance Charges

It is important for institutions to evaluate the collectibility of accrued fees and finance charges on payday loans because a portion of accrued interest and fees is generally not collectible. Although regulatory reporting instructions do not require payday loans to be placed on nonaccrual based on delinquency status, institutions should employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status. After a loan is placed on nonaccrual status, subsequent fees and finance charges imposed on the borrower would not be recognized in income and accrued, but unpaid fees and finance charges normally would be reversed from income.

INTRODUCTION

Overview

Securities and end-user derivatives (investment) activities can provide banks with earnings, liquidity, and capital appreciation. Carefully constructed positions can also reduce overall bank risk exposures. However, investment activities can also create considerable risk exposures, particularly:

- Market risk,
- Credit risk,
- Liquidity risk,
- Operating risk,
- Legal risk,
- Settlement risk, and
- Interconnection risk.

This section provides guidance, policy, and sound practices regarding:

- Policies, procedures and risk limits,
- Internal controls,
- Unsuitable investment activities,
- Risk Identification, measurement, and reporting,
- Board and senior management oversight,
- Compliance,
- Report of examination treatment, and
- Other guidance (trading, accounting, and information services).

Use this section to assess how effectively a bank's board and management identifies, measures, monitors, and controls investment activity risks. Incorporate findings into relevant examination assessments, including sensitivity to market risk, liquidity, asset quality, and management.

Refer to the Capital Markets Examination Handbook for reference information on a wide range of activities and instruments, including fixed income instruments, mutual funds, derivatives, sensitivity to market risk, portfolio management, and specialized examination procedures. That handbook's information focuses more closely on specific activities and instruments than this section's general guidance.

Policy Statement

The Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (Policy Statement) was adopted by the FDIC, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Office of Thrift Supervision, and National Credit Union Administration, effective May 26, 1998. The Policy Statement provides guidance and sound principles to bankers for managing investment securities and derivatives risks. It makes clear the importance of board oversight and management supervision, and focuses on risk management. The Policy Statement covers all securities used for investment purposes and all end-user derivative instruments used for non-trading purposes. It applies to all federally-insured commercial banks, savings banks, and savings associations. Notably, the Policy Statement:

- Underscores the importance of board oversight and management supervision,
- Emphasizes effective risk management,
- Contains no specific constraints on holding "high risk" mortgage derivative products,
- Eliminates the requirement to obtain the former regulatory volatility test for mortgage derivative products, and
- Applies to all permissible investment securities and end-user derivatives.

The Policy Statement declares that banks should implement programs to manage the market, credit, liquidity, legal, operational, and other risks that result from investment activities. Adequate risk management programs identify, measure, monitor, and control these risks.

Failure to understand and adequately manage investment activity risks is an unsafe and unsound practice.

Risk Management Process Summary

This subsection provides guidance for evaluating a risk management program's effectiveness at identifying, measuring, monitoring, and controlling investment activity risks. It also includes guidance for assessing those risks relative to overall risk exposure.

Management should establish a risk management program that identifies, measures, monitors, and controls investment activity risks. Its intricacy and detail should be commensurate with the bank's size, complexity, and investment activities. Thus, the program should be tailored to the bank's needs and circumstances. Regardless, an effective risk management program will include the following processes:

- The board should adopt policies that establish clear goals and risk limits.
- The board should review and act upon management's reports.

- The board should establish an independent review function and review its reports.
- Management should develop investment strategies to achieve the board's goals.
- Management should analyze and select investments consistent with its strategies.
- Management should maintain an effective internal control program.
- Management should regularly measure the portfolio's risk levels and performance.
- Management should provide periodic reports to the board.
- The board and management should periodically evaluate and, when warranted, modify the program.

The following sections of the guidance cover each of the above steps in greater detail.

Management must determine, consistent with board policy, how investment activity risks will be managed. The Policy Statement provides considerable flexibility by permitting banks to manage risk on an individual instrument basis, on an aggregate portfolio basis, or on a whole bank basis.

Banks that engage in less complex activities may effectively manage investment activity risk on an individual instrument basis. That is, each instrument's risk and return is evaluated independently. An instrument's contribution to overall portfolio risk and return may only be considered in general terms. This approach requires rather specific individual instrument risk limits, but typically does not involve aggregate portfolio analysis.

Banks with complex or extensive investment activities should strongly consider the portfolio approach for managing investment activity risk. Under a portfolio approach, management evaluates an instrument's contribution to overall portfolio risk and return. It requires portfolio risk limits and a system for aggregating and measuring overall portfolio risk and return. More complex aggregate portfolio risk and return measurements should be incorporated into overall interest rate risk or asset/liability management programs.

In recommending that all banks *consider* portfolio or whole bank risk management, the Policy Statement notes that such approaches generally provide certain advantages over the individual instrument approach, including:

- Integrated management of risk and return
- Understanding of each instrument's contribution to overall risk and return
- Increased flexibility when selecting instruments

POLICIES, PROCEDURES, AND RISK LIMITS

Policies

The board is responsible for adopting comprehensive, written investment policies that clearly express the board's investment goals and risk tolerance. Policies should be tailored to the bank's needs and should address:

- The board's investment goals,
- Authorized activities and instruments,
- Internal controls and independent review,
- Selecting broker/dealers,
- Risk limits,
- Risk and performance measurement,
- Reporting, and
- Accounting and taxation.

At most banks, the investment portfolio serves as a secondary source of both earnings and liquidity. At some banks, the investment portfolio is a primary earnings component. The policies should articulate the investment portfolio's purpose, risk limits, and return goals. Return goals should express the board's earnings objectives for the investment portfolio. The board may also establish portfolio performance targets.

Policies should describe all authorized investment activities and set guidelines for new products or activities. Further, policies should delegate investment authority, including naming specific personnel. The board's approved policies should also provide management with general guidelines for selecting securities broker/dealers and limiting broker/dealer credit risk exposure.

The bank should have policies that ensure an understanding of the market risks associated with investment securities and derivative instruments before purchase. Accordingly, banks should have policies that define the characteristics of authorized instruments. The policy should sufficiently detail the characteristics of authorized instruments. For example, a policy that merely authorizes the purchase of agency securities would not be sufficiently detailed. The price sensitivities of agency pass-throughs, step-up structured notes, agency callable debt or leveraged inverse floaters are very different. Therefore, the policy should delineate the authorized types of agency securities that may be purchased. Management should analyze the risks in an instrument that has not been authorized and should seek the board's permission to alter the list of authorized instruments before purchase.

Banks should have policies that specify the analysis of the risk of an investment that must be conducted prior to purchase. The pre-purchase analysis is meant to discover and quantify all relevant risks in the investment. Not all investments will require pre-purchase analysis. Relatively simple or standardized instruments, the risks of which are well known to the bank, would likely require no or significantly less analysis than would more complex or volatile instruments. Policies should delineate which of the authorized investments do not require pre-purchase analysis.

The list of authorized instruments may include instruments of varying characteristics. Policies should divide the spectrum of authorized investments into segments of instruments of similar risk characteristics. Policies should also require appropriate pre-purchase analysis for each segment.

Risk Limits

To effectively oversee investment activities, the board must approve the bank's risk limits. Management should set these risk limits, consistent with the board's goals, objectives, and risk appetite. The risk limits should be formally approved and incorporated within the board's policies. Limits may be expressed in terms of bank-wide risk, investment portfolio risk, portfolio segment risk, or even individual instrument risk.

Risk limits should be consistent with the bank's strategic plans and overall asset/liability management objectives. Limits should be placed on:

- Market risk,
- Credit risk,
- Liquidity risk,
- Asset types, and
- Maturities.

At a minimum, risk limits should be expressed relative to meaningful standards, such as capital or earnings. More complex investment activities may require more detailed risk limits.

Market risk limits should at least quantify maximum permissible portfolio or individual instrument price sensitivity as percentage of capital or earnings. Capital-based risk limits clearly illustrate the potential threat to the bank's viability, while earnings-based limits reflect potential profitability effects. In addition, the board may choose to establish limits relative to earnings, total assets, total investment securities, or other standards.

Credit risk limits should generally restrict management to investment grade instruments. The board may permit management to acquire nonrated instruments; however, these instruments should be consistent with investment grade standards. For example, management may wish to purchase a nonrated bond issued by a local municipality. Regardless, the board should carefully monitor such activity.

Liquidity risk limits should restrict positions in less marketable instruments. These limits should apply to securities that management would have difficulty selling at or near fair value. Less marketable instruments may not meet the board's investment goals, and holdings should generally be small. Obscure issues, complex instruments, defaulted securities, and instruments with thin markets may all have limited liquidity.

Asset type limits should limit concentrations in specific issuers, market sectors, and instrument types. These limits will require management to diversify the portfolio. When properly diversified, a portfolio can have lower risk for a given yield or can earn a higher yield for a given risk level. For example, the board may limit total investment in a particular instrument type to a specific percentage of capital.

Maturity limits should place restrictions on the maximum stated maturity, weighted average maturity, or duration of instruments that management may purchase. Longer-term securities have greater interest rate risk, price risk, and cash flow uncertainty than shorter-term instruments possess. Therefore, maturity limits should complement market risk limits, liquidity risk limits, and the board's investment goals.

In addition, management should establish a standard risk measurement methodology. The measurement system must capture all material risks and accurately calculate risk exposures. Management should provide the board with consistent, accurate risk measurements in a format that directly illustrates compliance with the board's risk limits. Refer to the Risk and Performance Measurement subsection for additional guidance.

INTERNAL CONTROLS

Internal Control Program

Effective internal controls are the first line of defense in supervising investment activity operating risks. Ineffective controls can lead to bank failures. Consequently, examiners will carefully evaluate the internal control program. Examiners will emphasize separation of duties between the individuals who execute, settle, and account for transactions.

The internal control program should be commensurate with the volume and complexity of the investment activity conducted, and should be as independent as practical from related operations.

The board has responsibility for establishing general internal control guidelines, which management should translate into clear procedures that govern daily operations. Management's internal control program should include procedures for the following:

- Portfolio valuation,
- Personnel,
- Settlement,
- Physical control and documentation,
- Conflict of interest,
- Accounting,
- Reporting, and
- Independent review.

Internal controls should promote efficiency, reliable internal and regulatory reporting, and compliance with regulations and bank policies.

Portfolio valuation procedures should require independent portfolio pricing. The availability of independent pricing provides an effective gauge of the market depth for thinly traded instruments, allowing management to assess the potential liquidity of specific issues. For these and other illiquid or complex instruments, completely independent pricing may be difficult to obtain. In such cases, estimated or modeled values may be used. However, management should understand and agree with the methods and assumptions used to estimate value.

Personnel guidelines should require sufficient staffing resources and expertise for the bank's approved investment activities.

Settlement practices should be evaluated against the guidelines provided in the Settlement Practices, Confirmation and Delivery Requirements, and Delivery Documentation Addenda.

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Physical control and documentation requirements should include:

- Possessing and controlling purchased instruments,
- Saving and safeguarding important documents, and
- Invoice review.

Invoice review requirements should address standards for all securities and derivatives sold or purchased. Invoices and confirmations display each instrument's original purchase price, which provides a basis to establish book value and to identify reporting errors. Invoice reviews can also be used when determining if the bank is involved in any of the following inappropriate activities:

- Engaging one securities dealer or representative for virtually all transactions.
- Purchasing from or selling to the bank's trading department.
- Unsuitable investment practices (refer to following page.).
- Inaccurate reporting.

Conflict of interest guidelines should govern all employees authorized to purchase and sell securities for the bank. These guidelines should ensure that all directors, officers, and employees act in the bank's best interest. The board should adopt polices that address authorized employees' personal relationships, including securities transactions, with the bank's approved securities broker/dealers. The board may also adopt policies that address the circumstances under which directors, officers, and employees may accept gifts, gratuities, or travel expenses from securities broker/dealers and associated personnel.

Accounting practices should be evaluated against the standards, opinions, and interpretations listed in this section.

Reporting procedures should be evaluated against the guidelines discussed in the Risk Reporting subsection Risk Identification, Assessment and Reporting.

Independent review of the risk management program should be conducted at regular intervals to ensure the integrity, accuracy, and reasonableness of the program. Independent review may encompass external audits or an internal audit program. At many banks, however, evaluation by personnel independent of the portfolio management function will suffice. The independent review program's scope and formality should correspond to the size and complexity of the bank's investment activities. Independent review of investment activity should be at least commensurate with the independent review of other primary bank activities. It should assess:

- Adherence to the board's policies and risk limits,

- The risk measurement system's adequacy and accuracy,
- The reporting system's timeliness, accuracy, and usefulness,
- Personnel resources and capabilities,
- Compliance with regulatory standards,
- The internal control environment,
- Accounting and documentation practices, and
- Conflicts of interest.

Banks with complex investment activities should consider augmenting the independent review with internal or external auditors, while banks with less complex investment activities may rely on less formal review. Sophisticated risk measurement systems, particularly those developed in-house, should be independently tested and validated.

Independent review findings should be reported directly to the board at least annually. The board should carefully review the independent review reports and ensure that material exceptions are corrected.

Examiners will evaluate the independent review's scope and veracity, and will rely on sound independent review findings during examinations. However, when the independent review is unsatisfactory, examiners will perform review procedures to reach independent conclusions. When warranted, examiners will conduct a detailed review of all investment activities.

UNSUITABLE INVESTMENT ACTIVITIES

Trading activity within the held-to-maturity (HTM) or available-for-sale (AFS) portfolio is an unsuitable investment activity and may be considered unsafe and unsound. Each of the following activities are unsuitable within the HTM or AFS portfolio, and any resulting securities acquisitions should be reported as trading assets. The bank's internal control program should be designed to prevent the following unsuitable investment activities:

- Gains trading,
- When-issued securities,
- Pair-offs,
- Extended settlement,
- Repositioning repurchase agreement, and
- Adjusted trading.

Gains trading is the purchase and subsequent sale of a security at a profit after a short holding period, while securities acquired for this purpose that cannot be sold at a profit are retained in the AFS or HTM portfolio. Gains trading may be intended to defer loss recognition, as unrealized losses on debt securities in such categories do not directly affect regulatory capital and generally are not reported in income until the security is sold.

Examiners should scrutinize institutions with a pattern of reporting significant amounts of realized gains on sales of non-trading securities (typically, AFS securities) after short holding periods while continuing to hold other non-trading securities with significant amounts of unrealized losses. If, in the examiner's judgment, such a practice has occurred, the examiner should consult with the Regional Office for additional guidance on whether some or all of the securities reported outside of the trading category will be designated as trading assets.

When-issued securities trading is the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities. A purchaser of a when-issued security acquires the risks and rewards of owning a security and may sell the when-issued security at a profit before having to take delivery and pay for it.

Pair-offs are security purchase transactions that are closed-out or sold at or before the settlement date. In a pair-off, an institution commits to purchase a security. Then, before the predetermined settlement date, the bank pairs-off the purchase with a sale of the same security. Pair-offs are settled net when one party to the transaction remits the difference between the purchase and sale price to the counterparty. Pair-offs may also involve the same sequence of events using swaps, options on swaps, forward commitments, options on forward commitments, or other off-balance sheet derivative contracts.

Extended Settlement is the use of a securities trade settlement period in excess of the regular-way settlement period. Regular-way settlement for U.S. Government and Federal agency securities (except mortgage-backed securities and derivative contracts) is one business day after the trade date. Regular-way settlement for corporate and municipal securities is three business days after the trade date, and for mortgage-backed securities it can be up to 60 days or more after the trade date. The use of a settlement period in excess of the regular-way settlement period to facilitate speculation is considered a trading activity.

A **repositioning repurchase agreement** is offered by a dealer to allow an institution that has entered into a when-issued trade or a pair-off (which may include an extended settlement) that cannot be closed out at a profit on the payment or settlement date to hold its **speculative** position until the security can be sold at a gain. The institution purchasing the security pays the dealer a small margin that approximates the actual loss in the security. The dealer then agrees to fund the purchase of the security by buying it back from the purchaser under a resale agreement. Any securities acquired through a dealer financing technique such as a repositioning repurchase agreement that is used to fund the speculative purchase of securities should be reported as trading assets.

A **short sale** is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on a fall in the price of the security. Short sales should be conducted in the trading portfolio. A short sale that involves the delivery of the security sold short by borrowing it from the depository institution's AFS or HTM portfolio should not be reported as a short sale. Instead, it should be reported as a sale of the underlying security with gain or loss recognized in current earnings.

Adjusted trading involves the sale of a security to a broker or dealer at a price above the prevailing market value and the simultaneous purchase and booking of a different security, frequently a lower rated or quality issue or one with a longer maturity, at a price above its market value. Thus, the dealer is reimbursed for losses on the purchase from the institution and ensured a profit. Such transactions inappropriately defer the recognition of losses on the security sold and establish an excessive cost basis for the newly acquired security. Consequently, such transactions are prohibited and may be in violation of 18 U.S.C. Sections 1001-False Statements or Entries and 1005-False Entries.

RISK IDENTIFICATION, MEASUREMENT, AND REPORTING

Risk Identification

All investment activities create risk exposures, but the risk types and levels depend upon the activity conducted. The following guidance summarizes the major risk exposures. Refer to the Capital Markets Examination Handbook for additional guidance on specific instruments, markets, and strategies.

Market risk is the possibility that an instrument will lose value due to a change in the price of an underlying instrument, change in the value of an index of financial instruments, changes in various interest rates, or other factors. Frequently, an instrument will increase a bank's market risk due to price volatility, embedded options, leverage factors, or other structural factors. The three principal types of market risk are price risk, interest rate risk and basis risk.

<u>Price risk</u> is the possibility that an instrument's price fluctuation will unfavorably affect income, capital, or risk reduction strategies. Price risk is usually influenced by other risks. For example, a bond's price risk could be a function of rising interest rates, while a currency-linked note's price risk could be a function of devaluation in the linked currency.

<u>Interest rate risk</u> is the possibility that an instrument's value will fluctuate in response to current or expected market interest rate changes.

<u>Yield curve risk</u> is the possibility that an instrument's value will fluctuate in response to a nonparallel yield curve shift. Yield curve risk is a form of interest rate risk.

<u>Basis risk</u> is the possibility that an instrument's value will fluctuate at a rate that differs from the change in value of a related instrument. For example, three-month Eurodollar funding is not perfectly correlated with Treasury bill yields. This imperfect correlation between funding cost and asset yield creates basis risk.

Credit risk is the possibility of loss due to a counterparty's or issuer's default, or inability to meet contractual payment terms. The amount of credit risk equals the replacement cost (also referred to as *current exposure*) of an identical instrument. The replacement cost is established by assessing the instrument's current market value rather than its value at inception.

In addition, default exposes a bank to market risk. After default, losses on a now unhedged position may occur before the defaulted hedge instrument can be replaced. Such losses would have been largely (or completely) offset if the counterparty had not defaulted.

Exchange-traded derivatives (futures, options, and options on futures) contain minimal credit risk. These instruments are marked-to-market at the end of each trading day, or on an intra-day basis, by the exchange clearinghouse. Position value changes are settled on a cash basis at least daily. To reduce credit risk, all exchange participants must post a performance bond or maintain margin with the exchange. Many over-the-counter (OTC) transactions use collateral agreements. OTC transaction collateral agreements can be one- or two-sided (only one party is required to post collateral on out-of-the-money positions, or both are required to post such collateral). Netting and collateral agreements and their specific terms can materially reduce credit risk exposure. For additional explanation of the treatment of netting for capital calculations, refer to Part 325 of the FDIC Rules and Regulations.

In managing credit exposure, institutions should consider settlement and pre-settlement credit risk. The selection of dealers, investment bankers, and brokers is particularly important in effectively managing these risks. When selecting a dealer, investment banker, or broker, management should, at a minimum:

- Review each firm's most current financial statements, such as annual reports and credit reports, and evaluate its ability to honor its commitments.
- Inquire into the general reputation of the firm by contacting previous or current customers.
- Review information from State or Federal securities regulators and industry self-regulatory organizations such as NASD Regulation, Inc., concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel.

Liquidity risk is the possibility that an instrument cannot be obtained, closed out, or sold at (or very close to) its economic value. As individual markets evolve, their liquidity will gradually change, but market liquidity can also fluctuate rapidly during stress periods. In some markets, liquidity can vary materially during a single day. Some markets are liquid for particular maturities or volumes, but are illiquid for others. For example, the Eurodollar futures market is liquid for contracts with maturities up to four years, but liquidity decreases for greater maturities (although maturities of up to 10 years are listed).

Many instruments trade in established secondary markets with a large number of participating counterparties. This ensures liquidity under normal market conditions. However, uniquely tailored or more thinly traded products may not have sufficient supply, demand, or willing counterparties in periods of market stress.

Operational risk is the possibility that inadequate internal controls or procedures, human error, system failure or fraud can cause losses. Operating risk can result in unanticipated open positions or risk exposures that exceed established limits.

Legal risk is the possibility that legal action will preclude a counterparty's contractual performance. Legal risk may occur when a contract or instrument violates laws or regulations. Legal risk may also occur when a law or regulation prohibits a counterparty from entering into a particular contract, or if an individual is not authorized to execute transactions on behalf of the counterparty. Banks should ensure that all agreements are enforceable and that counterparties can legally enter into specific transactions.

Settlement risk is the possibility of loss from a counterparty that does not perform after the investor has delivered funds or assets (before receiving the contractual proceeds). Settlement risk may result from time differences between foreign counterparties, delivery that is not synchronized with payment, or method of payment delays. Few transactions are settled on a real-time basis, and any delay in receiving funds or assets after delivering funds or assets will create settlement risk.

The most famous settlement risk example occurred in the foreign exchange markets. German regulators closed Bankhaus Herstatt after it had received deutschemarks on its foreign exchange trades, but before it had sent out its currency payments. Settlement risk is sometimes referred to as Herstatt risk.

Interconnection risk is the possibility of loss due to changes in interest rates, indices or other instrument values that may or may not be held by the investor. Cash flows associated with an instrument may be directly or indirectly tied to a number of other rates, indices or instrument values. These interconnections frequently involve cross-border and cross-market links and a wide range of individual financial instruments.

For example, a U.S. dollar denominated structured note may have a coupon formula linked to a currency exchange rate. Structured notes with coupon payments linked to the relationship between the Mexican peso and the U.S. dollar fell substantially in value when the peso fluctuated in the wake of the assassination of a Mexican presidential candidate.

Risk Measurement

Effective investment activity oversight requires accurate risk measurement. Without periodic assessments, management can not determine the success of its investment strategies. Further, the board can not determine if management has achieved the board's goals or complied with its policies.

Risk measurement should be tailored to the cash flow characteristics of each particular instrument type. For example, a mortgage derivative product should be given far more sophisticated analysis than a U.S. Treasury bill. Management's analysis should focus on risk, return, and compliance with risk limits.

Authorized investment instruments should be segregated into groups of like risk characteristics. There will likely be a group of relatively simple or standardized instruments, the risks of which are well known to the bank, which will require no pre-purchase analysis. All other authorized instruments will require pre-purchase analysis. It is important that these groups be well defined and that the pre-purchase analysis is tailored to capture the risks of the instruments. For example, it would not be appropriate to group dual-indexed structured notes with agency pass-throughs. The characteristics of these two types of instruments are different and each will require separate and distinct pre-purchase analysis. It would also not be appropriate to group simple agency pass-throughs with inverse floater collateralized mortgage obligations (CMOs). The inverse floaters are not only subject to similar prepayment optionality as the pass-throughs but also contain leverage and vastly different cash flow characteristics.

In addition to pre-purchase analysis, management should also periodically monitor investment portfolio risks. As with pre-purchase analysis, this periodic analysis should identify and measure the instrument's or the portfolio's risk characteristics. Management can perform this periodic analysis on an individual instrument basis or total portfolio (or bank) basis.

The market risk measurement system used to conduct pre-purchase analysis and periodic monitoring should be commensurate with the size and nature of the investment portfolio. For detailed comments regarding the types of risk measurement systems, refer to the Sensitivity to Market Risk section of this Manual. The risk measurement system should identify and measure all material risks. Management should translate its measurements into results that illustrate compliance with the board's risk limits. For example, to measure market risk the system should:

- Identify and measure the price sensitivity of embedded options (modified and Macaulay duration measures do not capture option risk).[1]
- Use interest rate shocks large enough to measure realistic potential market movements and risk (such as 100, 200, and 300 basis points).
- Include adjustments (for example, convexity) to accurately measure price changes when interest rate movements exceed 100 basis points.[2]
- Subject instruments to nonparallel interest rate shocks when those instruments are exposed to risk from changes in the yield curve's shape.

While management may measure risk and performance on an individual instrument basis, broader risk management should be considered. Management may aggregate individual instrument risk and return measurements to produce risk and return results for the entire investment portfolio. Portfolio results may then be aggregated into the bank's overall interest rate risk measurement system. Aggregation does not necessarily require complex systems. Management may simply combine individual instrument results to calculate portfolio analysis, or use portfolio results to compile whole bank analysis. Examiners should coordinate risk aggregation review with the staff completing the Sensitivity to Market Risk review.

Risk Reporting

To properly exercise its oversight responsibilities, the board must review periodic investment activity reports. The board should require management to periodically provide a complete investment activity report. Report frequency and substance should be commensurate with the portfolio's complexity and risk profile. Management's reports to the board should:

- Summarize all investment activity,
- Clearly illustrate investment portfolio risk and return,
- Evaluate management's compliance with the investment policy and all risk limits, and
- List exceptions to internal policy and regulatory requirements.

Management should receive reports that contain sufficient detail to comprehensively and frequently assess the portfolio.

Management should regularly ensure compliance with internal policies and regulatory requirements. In addition, management should periodically evaluate portfolio performance. The board should review and consider each policy exception. Management should present exceptions for approval before engaging in an unauthorized activity. Recurring exceptions should prompt close scrutiny from the board. When warranted, the board may consider changing its policies to permit an activity. The board should take strong action when management fails to seek prior approval for an unauthorized activity.

[1] Macaulay duration is the weighted average term to maturity of a security's cash flows. Modified duration is a measurement of the change in the value of an instrument in response to a change in interest rates. Refer to the Capital Markets Examination Handbook for additional information.

[2] Convexity is a measure of the way duration and price change when interest rates change. Refer to the Capital Markets Examination Handbook for additional information.

BOARD AND SENIOR MANAGEMENT OVERSIGHT

Board Oversight

Throughout this guidance, “board” references either the board or directors or a designated board committee. Board oversight is vital to effective investment risk management, and the board has very specific investment activity responsibilities. The board should adopt policies that establish guidelines for management and periodically review management’s performance. The board should:

- Approve broad goals and risk limits,
- Adopt major investment and risk management policies,
- Understand the approved investment activities,
- Ensure competent investment management,
- Periodically review management’s investment activity,
- Require management to demonstrate compliance with the board’s goals and risk limits, and
- Mandate an independent review program and review its findings.

Senior Management Oversight

Management is responsible for daily oversight of all investment activity. Management should:

- Establish policies, procedures, and risk limits to achieve the board’s goals,
- Implement operational policies that establish a strong internal control environment,
- Understand all approved investment activities and the related risks,
- Identify, measure, monitor, and control investment activity risks,
- Report investment activity and risks to the board;,
- Ensure that its staff is competent and adequately trained, and
- Adhere to securities broker/dealer selection policies.

Investment activity risk is not effectively managed if the board and management do not fulfill their responsibilities. Ineffective risk management can be an unsafe and unsound practice. While the board or management may obtain professional advice to supplement their understanding of investment activities and risks, their responsibilities can not be transferred to another party. The board and senior management should also periodically evaluate and, when warranted, modify the risk management process.

Investment Strategies

Management should employ reasonable investment strategies to achieve the board’s portfolio objectives. A strategy is a set of plans that management uses to direct daily portfolio operations. In order to develop sound strategies, management must understand the board’s goals, applicable risk limits, and related instruments and markets. Investment strategies should also be consistent with the following:

- Overall strategic goals,
- Capital position,
- Asset/liability structure,
- Earnings composition, and
- Competitive market position.

Strategies will vary widely between banks, ranging from simple to extremely complex. However, any strategy should be documented, reasonable, and supportable. Examiners will evaluate strategies to determine their effect on risk levels, earnings, capital, liquidity, asset quality, and overall safety and soundness. Additional guidance on investment strategies and market risk modification strategies is provided in this section under the headings Investment Strategies and the Market Risk Modification respectively.

Delegation of Investment Authority

Investment authority may be delegated to a third party, with specific board approval. Regardless of whether the board’s policies permit management to delegate investment authority to a third party, management must understand every investment’s risk, return, and cash flow characteristics. To conduct its independent analysis, management may rely on information and industry standard analysis tools provided by the broker/dealer, provided that:

- The analysis uses reasonable calculation methods and assumptions,
- Management understands the analysis and assumptions, and
- Management’s investment decisions remain independent.

If management does not understand an investment’s risk characteristics, then management should not engage in that activity until it possesses the necessary knowledge. Failure to adequately understand and manage investment activity risks constitutes an unsafe and unsound practice.

Before delegating investment authority to a third party, management should thoroughly evaluate the third party's reputation, performance, creditworthiness, and regulatory background. Any third party arrangement should be governed by a formal written agreement that specifies:

- Compensation,
- Approved broker/dealers,
- Investment goals,
- Approved activities and investments,
- Risk limits,
- Risk and performance measurement,
- Reporting requirements,
- Settlement practices, and
- Independent review.

In addition, written agreements should require that all trade invoices, safekeeping receipts, and investment analyses are readily available to the bank.

Program Evaluation

Periodically, the board and management should evaluate the risk management program to ensure that its investment activities reasonably meet the board's goals and the bank's strategic needs. Without such an assessment, the board and management cannot prudently oversee investment activities. The scope and detail of the evaluation should correspond to the bank's size, complexity, and investment activities. At most banks, annual evaluations should be sufficient. In larger or more complex banks, quarterly (or more frequent) evaluation may be necessary.

The board should review management's reports, including an investment activity summary, portfolio risk and performance measures, and independent review findings to identify broad weaknesses and determine if:

- Stated goals accurately represent the board's objectives,
- Risk limits properly reflect the board's risk tolerance,
- Risk limits reasonably protect the bank's safety and soundness,
- Management has appropriately pursued the board's goals,
- Internal controls remain adequate,
- Any new activities are warranted, and
- Policies provide sufficient guidance for management.

The board should first consider the bank's current and expected condition, competitive environment, and strategic plans. Then, the board should reassess its portfolio goals to ensure that they do not conflict with the overall strategic plan. When necessary, the board should adjust its portfolio goals.

After evaluating its goals, the board should then affirm that the existing risk limits accurately reflect the board's risk tolerance. When warranted, the board should consider either relaxing or tightening the risk limits placed on management. Before altering its risk limits, the board should discuss the effects of accepting increased or reduced risk. The board should consider if increased or diminished risk would produce satisfactory returns.

In addition, the board should evaluate management's performance. That review should encompass management's success at achieving the board's goals, adherence to policies and risk limits, and maintenance of an effective control environment. The board should determine the cause of any material deficiencies and obtain management's commitment to rectify those deficiencies.

Finally, the board should determine if any changes to its policies are warranted. For example, management may request authority to engage in new investment activities. The board should carefully consider such requests and determine if the proposed activity comports with its investment goals and risk tolerance.

Management should review the portfolio management program in more detail to identify both broad and specific weaknesses. Management's responsibilities include:

- Measuring portfolio risk and performance,
- Validating risk measurement systems' adequacy and accuracy,
- Reporting portfolio activity and performance to the board,
- Adjusting investment strategies to better achieve the board's goals, and
- Correcting policy and regulatory exceptions.

At many banks, the periodic evaluation will result in few program alterations. Less complex programs will naturally require fewer modifications than more complex programs. Successful programs will similarly need fewer changes than unsuccessful programs. Examiners will assess the periodic evaluations to determine if the board and management effectively oversee the portfolio management process.

COMPLIANCE

Permissible Activities

Part 362 of the FDIC's Rules and Regulations, "Activities and Investments of Insured State Banks," (Part 362) implements Section 24 of the Federal Deposit Insurance Act. Part 362 generally prohibits investment activities that are not permissible for national banks, with certain exceptions. National bank investment activities are governed by the National Bank Act (12 USC 21 et seq.) and Office of the Comptroller of the Currency (OCC) regulations (12 CFR Part 1). 12 CFR Part 1 outlines five general types of investments that are permissible for national banks. A copy of the updated rule may be found at the OCC's Internet site, http://www.occ.treas.gov/ftp/regs/part1a.txt.

In limited circumstances, the FDIC may grant an exception to Part 362, on a case-by-case basis, if the FDIC determines that:

- The activity presents no significant risk to the deposit insurance fund, and
- The bank complies with the FDIC's capital regulations.

While Part 362 contains investment type restrictions, it does not include the investment amount restrictions that apply to national banks.

REPORT OF EXAMINATION TREATMENT

Adverse Classification

Examiners may adversely classify subinvestment quality securities and off-balance sheet derivatives in the Report of Examination. Any classifications should be consistent with the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts. This Agreement addresses the examination treatment for adversely classified assets and:

- Provides definitions of the Substandard, Doubtful, and Loss categories used for criticizing bank and thrift assets,
- Defines characteristics of investment quality and subinvestment quality securities.,
- Establishes specific guidance for the classification of subinvestment quality debt securities and other-than-temporary impairment on investment quality debt securities, and
- Provides examiners discretion in classifying debt securities beyond a ratings-based approach in certain cases.

Substandard assets are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Doubtful assets have all the weaknesses found in Substandard assets, with the added characteristic that the weaknesses make collection or liquidation in full (on the basis of currently existing facts, conditions, and values) highly questionable and improbable.

Loss classifications are assigned to assets that are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future. Amounts classified Loss should be promptly charged off.

Investment quality debt securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group generally includes investment securities in the four highest rating categories provided by nationally recognized statistical rating organizations (NRSROs) and unrated debt securities of equivalent quality. The Securities and Exchange Commission (SEC) lists the following as NRSROs:

- Dominion Bond Rating Service Ltd.,
- Fitch, Inc.,
- Moody's Investors Service, and
- Standard & Poor's Division of the McGraw Hill Companies Inc.

(Check the SEC's website to find the most current list of NRSROs).

When two or more NRSROs list different credit ratings for the same instrument, examiners will generally base their assessments on the more recently issued ratings.

Since investment quality debt securities do not exhibit weaknesses that justify an adverse classification rating, examiners generally will not classify them. However, published credit ratings occasionally lag demonstrated changes in credit quality and examiners may, in limited cases, classify a security notwithstanding an investment grade rating.

Some debt securities may have investment quality ratings by one (or more) rating agencies and sub-investment quality ratings by others. Examiners will generally classify such securities, particularly when the most recently assigned rating is not investment quality. However, an examiner has discretion to "pass" a debt security with both investment and sub-investment quality ratings. The examiner may use that discretion if, for example, the institution has demonstrated through its documented credit analysis that the security is the credit equivalent of investment grade.

Some individual debt securities have ratings for principal, but not interest. The absence of a rating for interest typically reflects uncertainty regarding the source and amount of interest the investor will receive. Because of the speculative nature of the interest component, examiners will generally classify such securities, regardless of the rating for the principal.

Non-rated debt securities have no ratings from a NRSRO and the FDIC expects institutions holding individually large non-rated debt security exposures, or having significant aggregate exposures from small individual holdings, to demonstrate that they have made prudent pre-acquisition credit decisions and have effective, risk-based standards for the ongoing assessment of credit risk. Examiners will review the institution's program for monitoring and measuring the credit risk of such holdings and, if the assessment process is considered acceptable, generally will rely upon those assessments during the examination process. If an institution has not established independent risk-based standards and a satisfactory process to assess the quality of such exposures, examiners may classify such securities, including those of a credit quality deemed to be the equivalent of subinvestment grade, as appropriate.

Some non-rated debt securities held in investment portfolios represent small exposures relative to capital, both individually and in aggregate. While institutions generally have the same supervisory requirements (as applicable to large holdings) to show that these holdings are the credit equivalent of investment grade at purchase, comprehensive credit analysis subsequent to purchase may be impractical and not cost effective. For such small individual exposures, institutions should continue to obtain and review available financial information, and assign risk ratings. Examiners may rely upon the bank's internal ratings when evaluating such holdings.

Foreign debt securities are often assigned transfer risk ratings for cross border exposures from the Interagency Country Exposure Review Committee (ICERC). However, examiners should use the guidelines in the Uniform Agreement rather than ICERC transfer risk ratings in assigning security classifications, except when the ICERC ratings result in a more severe classification.

Subinvestment quality debt securities are those in which the investment characteristics are distinctly or predominantly speculative. This group generally includes debt securities, including hybrid equity instruments (i.e. trust preferred securities), in grades below the four highest rating categories, unrated debt securities of equivalent quality, and defaulted debt securities.

Other Types of Securities such as certain equity holdings or securities with equity-like risk and return profiles, have highly speculative performance characteristics. Examiners should generally classify such holdings based upon an assessment of the applicable facts and circumstances.

Treatment of Declines in Fair Value

Under generally accepted accounting principles (GAAP), an institution must assess whether a decline in fair value below the amortized cost of a security – that is, the depreciation on the security – is a "temporary" or "other-than-temporary" impairment. When the decline in fair value on an individual security represents other-than-temporary impairment, the cost basis of the security must be written down to fair value, thereby establishing a new cost basis for the security, and the amount of the write-down must be reflected in current period earnings. This new cost basis should not be adjusted through earnings for subsequent recoveries in fair value. If an institution's process for assessing impairment is considered acceptable, examiners may use those assessments in determining the appropriate classification of declines in fair value below amortized cost on individual debt securities.

Any decline in fair value below amortized cost on defaulted debt securities will be classified as indicated in the General Debt Security Classification Guidelines Table following. Apart from classification, for impairment write-downs or charge-offs on adversely classified debt securities, the existence of a payment default will generally be considered a presumptive indicator of other-than-temporary impairment.

The following table outlines the uniform classification approach the agencies will generally use when assessing credit quality in debt securities portfolios:

General Debt Security Classification Guidelines Table			
Security Type	**Classification**		
	Substandard	***Doubtful***	***Loss***
Investment quality debt securities with "temporary" impairment	----	----	----
Investment quality debt securities with "other than temporary" impairment	----	----	Impairment
Subinvestment quality debt securities with "temporary" impairment	Amortized Cost	----	----
Subinvestment quality debt securities with "other than temporary" impairment, including defaulted debt securities.	Fair Value	----	Impairment
NOTE: Impairment is the amount by which amortized cost exceeds fair value.			

The General Debt Security Classification Guidelines do not apply to private debt and equity holdings in a small business investment company or Edge Act Corporation. The Uniform Agreement does not apply to securities held in trading accounts, provided the institution demonstrates through its trading activity a short term holding period or holds the security as a hedge for a valid customer derivative contract.

Examiner Discretion in Classifying Securities

Examiners may assign a more or less severe classification for an individual debt security than would otherwise apply based on the security's rating depending upon a review of applicable facts and circumstances. However, examiners may not assign a Loss classification to the depreciation on an individual debt security when this impairment is determined to be temporary. Examiners have discretion to "pass" a debt security with both investment and sub-investment quality ratings. For an investment quality debt, examiners have the discretion to assign a more severe classification when justified by credit information the examiner believes is not reflected in the rating, to properly reflect the security's credit risk. As mentioned above, published credit ratings occasionally lag demonstrated changes in credit quality and examiners may, in limited cases, classify a security notwithstanding an investment grade rating.

Furthermore, examiners may in limited cases "pass" a debt security that is rated below investment quality. For example, when the institution has an accurate and robust credit risk management framework and has demonstrated, based on recent, materially positive, credit information, and properly documented credit analysis, that the security is the credit equivalent of investment grade, examiners have the discretion to "pass" the security, irrespective of the rating.

When an institution has developed an accurate, robust, and documented credit risk management framework to analyze its securities holdings, examiners can depart from the General Guidelines in favor of individual asset review in determining whether to classify those holdings. A robust credit risk management framework entails appropriate pre-acquisition credit due diligence by qualified staff that grades a security's credit risk based upon an analysis of the repayment capacity of the issuer and the structure and features of the security. It also involves the continual monitoring of holdings to ensure that risk ratings are reviewed regularly and updated in a timely fashion when significant new information is received.

The credit analysis of securities should vary based on the structural complexity of the security, the type of collateral and external ratings. The credit risk management framework should reflect the size, complexity, quality, and risk characteristics of the securities portfolio, the risk appetite and policies of the institution, and the quality of its credit risk management staff, and should reflect changes to these factors over time. Policies and procedures should identify the extent of credit analysis and documentation required to satisfy sound credit risk management standards.

Subinvestment Quality Available-for-Sale (AFS) Debt Securities

Consistent with Statement of Financial Accounting Standards (FAS) 115, AFS debt securities are "marked-to-market" and carried at their fair value on the balance sheet for regulatory reporting purposes. The unrealized holding gains (losses) on these securities, net of tax effects, are excluded from earnings and reported in a separate component of equity capital on the balance sheet. However, for purposes of determining a bank's regulatory capital under Part 325 of the FDIC's regulations, any unrealized holding gains (losses) on these AFS debt securities that are included in the separate equity capital component generally are ignored. As a result, any amortized cost amount in excess of fair value on an AFS debt security – that is, the amount of impairment or depreciation – normally is not deducted in determining regulatory capital.

However, in order to appropriately reflect in regulatory capital calculations the effect of any depreciation on a subinvestment quality AFS debt security, when the depreciation on such a security is deemed to be other than temporary and is therefore classified Loss, the depreciation should be deducted in determining Tier 1 capital. In addition, consistent with FAS 115 and Emerging Issues Task Force (EITF) Issue No. 03-1, when the depreciation represents an impairment that is other than temporary, the bank should recognize an impairment loss in current period earnings equal to the difference between the security's amortized cost and its fair value. This fair value then becomes the new cost basis for the AFS debt security and the new cost basis should not be adjusted through earnings for subsequent recoveries in value. Nevertheless, this AFS debt security must continue to be "marked-to-market" with the unrealized holding gains (losses) reported directly in equity capital.

For subinvestment quality AFS debt securities with temporary impairment, amortized cost rather than the lower amount at which these securities are carried on the balance sheet, i.e., fair value, is classified Substandard. This classification is consistent with the regulatory capital treatment of AFS debt securities. As mentioned above, under GAAP, unrealized holding gains (losses) on AFS debt securities are excluded from earnings and reported in a separate component of equity capital. In contrast, these unrealized holding gains (losses) are excluded from regulatory capital. Accordingly, the amount classified Substandard on these subinvestment quality AFS debt securities, i.e., amortized cost, also excludes the balance sheet adjustment for unrealized losses.

Subinvestment Quality AFS Equity Securities Equity securities may also be adversely classified if identified weaknesses warrant such treatment. Some investment advisory services issue rankings for equity instruments, which generally indicate projected investment performance rather than credit quality. Examiners should not rely on equity rankings to adversely classify equity investments. However, any AFS equity security whose cost is in excess of its fair value – that is, an equity security that has impairment or depreciation – must be evaluated to determine whether the impairment is temporary or other than temporary. When the impairment is determined to be other than temporary, the amount of the impairment should be classified Loss. In this situation, the equity security itself may be considered subinvestment quality, in which case examiners should also adversely classify the fair value of the equity security Substandard. Consistent with the treatment of AFS debt securities, when the impairment on an AFS equity security is determined to be other than temporary, the bank should recognize an impairment loss in current period earnings equal to the difference between the security's cost and its fair value. This fair value then becomes the new cost basis for the AFS equity security and the new cost basis should not be adjusted through earnings for subsequent recoveries in value. Nevertheless, this AFS equity security must continue to be "marked-to-market" with the unrealized holding gains (losses) reported directly in equity capital.

Securities with Substantial Prepayment Risks FAS 115, as amended by FAS 140, does not permit a debt security to be designated as held-to-maturity (HTM) if it can be prepaid or otherwise settled in such a way that the security holder would not recover substantially all of its recorded investment. Thus, those debt securities with a risk of substantial investment loss in the event of early prepayment, such as interest-only stripped mortgage backed securities and principal-linked structured notes, cannot be treated as HTM securities and carried at amortized cost. Rather, these securities should be categorized as either trading or AFS securities and reported at their fair value on the balance sheet for regulatory reporting purposes. The General Debt Security Classification Guidelines shown above should be applied to these securities when they have been categorized as AFS securities.

Determining Fair Value

As currently defined under GAAP, the fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices are the best evidence of fair value and must be used as the basis for measuring fair value, if available. If quoted market prices are not available, the estimate of fair value must be based on the best information available in the circumstances. The estimate of fair value must consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances.

In order to properly classify a security or determine any necessary regulatory capital adjustment, examiners must determine its fair value. Examiners will review management's fair values for all adversely classified securities. When management's valuation for an adversely classified security appears reasonable, examiners will use that value to determine classification amounts. If management's valuation does not appear reasonable, examiners will discuss concerns with management and request that management provide a more reasonable valuation during the examination. When management cannot provide a reasonable valuation during the examination, examiners should use the information services provided by the Capital Markets Branch of the Division of Supervision and Consumer Protection in Washington, D.C.

Qualitative Capital Adequacy Considerations for Securities

Although unrealized holding gains (losses) on HTM and AFS debt securities normally are not recognized in calculating a bank's regulatory capital ratios, examiners should evaluate the extent of any unrealized appreciation or depreciation on these debt securities in making an overall qualitative assessment of the bank's capital adequacy and in evaluating whether the bank has an effective risk management system for securities. Such a risk management system should include:

- Policies, procedures, and limits,
- Risk identification, measurement, and reporting, and
- Internal controls.

Examiners should discuss any concerns that result from this assessment with management.

OTHER GUIDANCE

Trading

Trading activities involve strategies or transactions designed to profit from short term price changes. Trading activities almost always employ active strategies, which assume that the bank can consistently outperform the market. Trading programs can generate significant earnings, but also create unique risk exposures. The board and management have the responsibility to identify, measure, monitor, and control trading activity risks.

Failure to adequately understand and manage trading activity risks is an unsafe and unsound practice.

This section's investment activity guidance also applies to all trading activity. In addition, trading programs should include:

- Specific board approval and periodic review,
- Separate policies and procedures,
- Management that possesses sufficient expertise,
- Segregated accounting and reporting,
- A risk measurement system that quantifies potential trading loss,
- Performance measurement relative to established benchmarks,
- Strong conflict of interest guidelines, and
- Appropriately rigorous internal controls.

The trading program's risk measurement system should identify and measure all material risks, including potential trading loss for defined periods. For example, the system could measure potential one day trading loss for a given set of statistical assumptions. Management's assumptions should be reasonable, supported, and consistent. Results should be translated into terms that clearly illustrate compliance with the board's trading risk limits.

To measure the performance of the bank's trading activity, trading desks, or individual traders, management will generally seek to compare their results to established performance standards or to benchmarks. For example, a benchmark's return represents the return for simply adopting a passive investment strategy in a similar class of investments. Performance evaluation benchmarks commonly used are market indexes. Indexes frequently used as equity portfolio benchmarks include the Standard and Poor's 500 Index and the Russell 2000 Index. An index frequently used as a bond portfolio benchmark is the Lehman Brothers Aggregate Bond Index. Management should select benchmarks that provide realistic comparative value. When the trading portfolio consistently fails to achieve returns at least equivalent to reasonable benchmarks, management should assess whether the program achieves the board's objectives.

Whenever a bank reports or demonstrates trading activity, examiners should refer to Part 325 of the FDIC's Rules and Regulations and determine if the bank adheres to all trading-related requirements.

Accounting

Accurate accounting is essential to the evaluation of a bank's risk profile and the assessment of its financial condition and capital adequacy. Reporting treatment for securities and derivative holdings should be consistent with the bank's business objectives, generally accepted accounting principles (GAAP), and regulatory reporting standards. When necessary, examiners should consult regional accounting specialists for additional guidance. A listing of pertinent accounting guidance is included in the Accounting Guidance portion of this section.

FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, must be adopted for Call Report purposes by all banks. It requires banks to divide their securities holdings among three categories: held-to-maturity (HTM), available-for-sale (AFS), and trading. Different accounting treatment applies to each category. Only debt securities which management has the positive intent and ability to hold to maturity may be designated as HTM and carried at amortized cost. AFS securities are those that management has not designated for trading or as HTM. AFS securities are reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate capital component. Securities held for trading must be reported at fair value, with unrealized gains and losses recognized in current earnings and regulatory capital. Proper categorization ensures that trading gains and losses are promptly recognized in earnings and regulatory capital. Refer to the Call Report Instructions for additional information.

Reporting trading assets as HTM or AFS is an unsafe and unsound practice. The substance of management's securities activities determines whether securities reported as HTM or AFS are, in fact, held for trading. While there are no standard benchmarks for identifying trading activity, trading generally reflects active and frequent buying and selling of securities for the purpose of generating profits on short-term fluctuations in price.

Examiners should also evaluate the extent of any unrealized gains and losses on both AFS and HTM securities when evaluating capital adequacy.

FAS 144, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and its predecessor amended FAS 115 and clarified that a debt security may not be classified HTM if it can contractually be prepaid or otherwise settled in such a way that the bank would not recover substantially all of its recorded investment. This provision is effective for financial assets held on or acquired after January 1, 1997 (no grandfather provision).

Premiums and discounts should be accounted for according to the Call Report Instructions. Inadequately amortized premium amounts should be adversely classified as Loss.

Trade date accounting is preferred (to settlement date accounting) for Call Report purposes to report HTM, AFS, and trading assets (other than derivatives). However, if the reported amounts under settlement date accounting would not be materially different from those under trade date accounting, settlement date accounting is acceptable.

Derivatives regulatory reporting instructions require that derivatives be reported in accordance with GAAP, and in particular FAS 133, *Accounting for Derivative Instruments and Hedging Activities*; FAS 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities-an amendment of FAS 133,* and FAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities.* In addition, the reporting should conform to the interpretive reporting guidance provided in the regulatory reporting instructions. These instructions state that derivatives generally should be marked to market, with resulting market value gains and losses recognized in current earnings. However, if certain criteria are met, banks may defer the recognition in income of gains and losses on derivative instruments used for hedging until they recognize in income the effects of related changes on the items hedged.

Market risk modification (including hedging) transactions accounting should be consistent with the board's risk management and accounting policies. Consistent with GAAP, derivatives and the hedged assets and liabilities must be designated when the hedging transaction is initiated. Management should retain adequate documentation to support deferrals of gains and losses, including the market risk modifications strategy and performance criteria.

Examiners having questions regarding the accounting for derivatives should consult with their regional accounting specialist.

Information Services

The Capital Markets Branch can help examiners identify a security's characteristics and risks. Capital Markets can provide a variety of security and derivative data to examiners, including prices, credit ratings, historical interest rates, mortgage prepayment forecasts, derivatives market summaries, and other information.

Prices and ratings should be requested through the Capital Markets Branch's Security Information Request System (SIRS). To use SIRS, examiners complete a computer data entry form and transmit it via electronic mail to a dedicated address. The Capital Markets Branch will enter all available data in the form and transmit it to the examiner within five business days of receipt. The data entry form is an automated Excel file that may be downloaded from the Capital Markets Branch's FDIC website.

Examiners should first submit a sample of a bank's securities and derivatives. When sampling results in material, unresolvable discrepancies, examiners may expand the sample and seek management's commitment to address any deficiencies. Prices provided by the Capital Markets Branch should not be substituted for management's prices, unless significant deficiencies are not resolved. Examiners should only submit requests to price an entire portfolio when a material safety and soundness concern exists.

The Capital Markets Branch obtains price and rating information from several sources. Prices are indications of value, but do not necessarily represent potential purchase or sale values. Whenever available, prices are drawn from market observations. However, many instruments do not trade on organized exchanges. In such circumstances, the Capital Markets Branch's sources provide estimated prices that have been derived from valuation models. These estimated prices are indications of value, not precise purchase or sale prices. Credit ratings are obtained from several of the NRSROs.

Historical interest rates are provided in the Market Index and Rate Application (MIRA). MIRA contains a ten-year database of rates, current forward rates, summary reports, yield curves, and an index comparison analysis feature. MIRA is an automated Excel template which examiners may download from the Capital Markets Branch's FDICnet site.

Mortgage prepayment forecasts and derivative market summaries are provided in a simple spreadsheet format and may be downloaded from the Capital Markets Branch's FDICnet site.

Other information, including detailed analytics and financial information for debt and equity issuers, may be requested on an individual basis. In addition, examiners may contact the Capital Markets Branch for guidance on examination procedures, supervisory policy, and Report of Examination treatment. Examiners should coordinate those requests with a Senior Capital Markets and Securities Specialist in their assigned regional office before contacting the Capital Markets Branch.

Settlement Practices, Confirmation and Delivery Requirements, and Delivery Documentation

Settlement Practices

Inadequate understanding of standard settlement practices coupled with poor internal controls can result in unnecessary costs or losses.

U.S. Treasury and Agency securities normally settle the next full business day after the trade date. Transactions involving U. S. Treasury and Agency obligations are typically in book-entry form, rather than in physical certificate form. Book-entry is an electronic registration, transfer, and settlement system that enables the rapid and accurate registration and transfer of securities with concurrent cash settlement. Book-entry reduces handling costs and quickens transaction completion. U. S. Treasury and Agency book-entry securities are delivered and cleared over the Federal Reserve Wire System (Fedwire) on a delivery versus payment basis. Acceptance of the security automatically debits the payment amount from the buyer's account and credits it to the seller's account. The payment and securities involved are transferred over the Fedwire system. The Federal Reserve Bank of New York maintains the book-entry custody system. All depository banks are eligible to maintain book-entry accounts at their local Reserve bank, provided that they also maintain a funds account with their Reserve bank.

Corporate and municipal bonds normally settle three full business days after the date of the transaction. The Municipal Securities Rulemaking Board Rule G-15 established guidelines for the settlement of municipal securities transactions. Corporate and municipal debt securities are available in book-entry and registered, definitive form. Book-entry corporate and municipal bonds settle through the Depository Trust Company (DTC). Members effect securities deliveries through DTC via computerized bookkeeping entries.

Mortgage securities settlement procedures are more complex than those for government, corporate, and municipal bonds. The Bond Market Association developed the "Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities" (Uniform Practices) to establish industry standards for mortgage securities settlements. Since the Uniform Practices are updated frequently, banks engaged in mortgage and asset-backed securities transactions should keep abreast of current settlement standards. The current Uniform Practices are summarized in the following paragraphs.

Government National Mortgage Association (GNMA) guaranteed mortgage pass-through securities are available in book-entry and definitive form. While most GNMA securities have been converted to book-entry, some physical certificates still exist. Book-entry GNMA securities settle through the Participants Trust Company (PTC) MBS Depository.

The Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) both issue Real Estate Mortgage Investment Conduits (REMICs) and mortgage pass-through securities. Since 1985, these securities have been issued in book-entry form only. Nearly all of the agency's securities that were issued in definitive, registered form before 1985 have been converted to book-entry. Book-entries are transferred, delivered, and settled through the Fedwire system.

Private label CMOs/REMICs (those issued by an entity other than FNMA and FHLMC) and asset backed securities (ABSs) are available in book-entry and registered, definitive form. Book-entry private label CMOs/REMICs and ABSs settle through the DTC. Private label pass-through securities are only available in physical form.

Confirmation and Delivery Requirements

Within one business day following the trade date, each party in a CMO/REMIC, stripped mortgage-backed security (SMBS), or ABS transaction should send a written confirmation of the transaction to the other party. Banks should have procedures established to issue, receive, and verify confirmations in a timely fashion. A bank is bound to a particular trade if it does not object to the written confirmation within 10 days of its receipt. Failure to exercise appropriate controls over confirmation procedures may result in the receipt or delivery of incorrect securities and improper payment amounts. The confirmation must contain the following information:

- Price,
- Trade date,
- Coupon rate,
- Maturity date,
- Settlement date,
- CUSIP number,
- Settlement amount,
- Original face amount,
- Security description,
- Confirming party's name and address, and
- Designation of "purchase from" and “sale to."

Confirmation procedures for mortgage pass-through securities differ from those for CMOs/REMICs, SMBSs, and ABSs, due to the manner in which mortgage pass-through securities typically trade. Most trades of mortgage pools occur on a To Be Announced (TBA) basis. In TBA transactions, information on the mortgage pools, such as pool numbers, is not known at trade time. Instead, the seller notifies the buyer of the pool numbers and original face values of the underlying securities at least 48 hours before delivery. No later than the second business day before the settlement date of each TBA transaction, the seller must transmit the following information to the buyer:

- Price
- Coupon rate and product
- Trade date and settlement date
- Pool, group, or other identification number
- Issue date and maturity date for new pools
- Identification of firm sending the information
- Original face amount for each pool or group number within the transaction

This information may be transmitted to the buyer verbally or by fax. If agreed to by both parties, the information may also be sent electronically. If the seller does not transmit the required information before the 48-hour deadline, the seller can not make delivery earlier than two business days after such information is transmitted. The seller must then promptly confirm in writing the following information:

- Price,
- Settlement date,
- Current face amount,
- Proceeds to be paid,
- Amount of accrued interest,
- Identification of the "contra party,"
- Designation of "purchase from" or "sale to,"
- Pool, group, or other identification number,
- Original face value for each pool or group number,
- Confirming party's name, address, and telephone number,
- Securities' description, settlement month, coupon rate, and product type, and
- Additional information as agreed to by the parties of the transaction.

The delivery variance permitted on TBA trades is plus or minus 2.50 percent of the dollar amount of the transaction agreed to by the parties. There is no variance permitted on transactions in which the seller provides the buyer with a specific pool number and a specific original face amount at the time of the trade. The 2.50 percent variance is applicable to each $1,000,000 within a TBA trade larger than $1,000,000. There are a maximum number of pools that may be delivered to satisfy a TBA trade. For securities with coupon rates below 12 percent, no more than three pools per $1,000,000 may be delivered. Up to four pools per $1,000,000 may be delivered for securities with coupons of 12 percent and above. TBA transactions that do not conform to these guidelines may result in "failed" trades.

The settlement amount (sum of the principal amount and accrued interest) is the amount payable by the buyer to the seller on the settlement date. Refer to the Capital Markets Examination Handbook for settlement amount formulas.

Delivery Documentation

Banks that purchase and sell mortgage-backed and other related securities in physical form must be aware of the documentation requirements contained in the Uniform Practices. Physical securities must have assignments for their registration in the name of the buyer on the books of the issuer or transfer agent. Each certificate must be accompanied by an assignment on the certificate or separate assignment for each certificate containing a signature that corresponds to the name written on the certificate. A detached assignment (standard corporate bond power) must provide for the irrevocable appointment of an attorney with power of substitution and must include a full description of the security, maturity date, series number, interest rate, and par amount. Each assignment, endorsement, alteration, and erasure must bear a guarantee acceptable to the issuer or transfer agent. A certificate registered in the name of a party other than a natural person will constitute good delivery only if it is accompanied by evidence of the authority of the assignor to transfer the securities.

If a trade has a settlement date between a record date and a payable date, delivery of the securities must be accompanied by a due bill. A due bill is a document delivered by a seller of a security to a buyer evidencing that any principal and interest received by the seller past the record date will be paid to the buyer by the seller upon submission of the due bill for redemption. The record date is the date set by the trustee for determining who will be paid principal and interest on a security. Book-entry messages are considered acceptable due bill substitutes for securities transferred over Fedwire, DTC, or PTC. Due bills and book-entry messages cease to be valid after 60 days from their issue date. A bank may experience considerable delays in attempting to recover payments without the use of a due bill, which can result in the accumulation of significant principal and interest receivable accounts. If delivery and payment on a trade occur after a record date and on or after a payable date, delivery of the securities must be accompanied by a check for the principal and interest due.

Examiners may review the bank's procedures for good delivery verification and interview bank personnel. The bank's policies for mortgage-backed and other related securities should conform to the Uniform Practices, and the operations staff should be thoroughly familiar with these standards. Failed trade frequency and costs will provide a general quality indicator for the overall settlement practices.

When a bank is on the sell side of a TBA trade, pools must be delivered to the buyer within good delivery guidelines. The process of assigning pools to a TBA transaction is known as allocation. While allocation is a critical part of the settlement process, relatively little effort is normally expended on this function by traders and senior management. Instead, the operations staff is usually responsible for performing allocations. The independent review should periodically confirm that the allocations meet good delivery guidelines. Prudent allocation controls will reduce the likelihood of costly "fails."

The operations department should also be aware of the Uniform Practices for reclamations. A reclamation is a claim for the right to return or the right to demand the return of a security that has been previously accepted as a result of bad delivery or other irregularities in the settlement process. Either party may make a reclamation if information is discovered after delivery, which if known at the time of delivery, would have caused the delivery not to constitute good delivery. Reclamation must be made within the stated time limits established by the Bond Market Association.

INVESTMENT STRATEGIES

Passive strategies generally do not require forecasting or complex analysis. Rather, management seeks to mirror a particular market segment’s performance or to retire predetermined liabilities. Adopting a passive investment strategy is a management decision to not attempt to outperform the market. Passive strategies typically incur lower expenses than do active strategies.

<u>Indexing</u> involves assembling a portfolio that closely resembles the risk and return characteristics of a preferred market index. For fixed-income portfolios, the portfolio may possess the same maturity, duration, credit quality characteristics, coupon, industrial classification, call or sinking fund features as the index. Advantages of passive bond portfolio management using indexing include low management and advisory fees, performance that mirrors the market, and low costs due to minimal turnover and no research. Disadvantages include performance that is no better than average, no immunization against interest rate risk, no guarantee that a specific liability stream can be funded from the portfolio, and the exclusion of many different types of bonds in the market. For example, zero-coupon U. S. Treasuries and most asset-backed securities are generally excluded from most conventional broad bond market indexes.

<u>Immunization</u> is a strategy that is employed to provide protection against the interest rate risk of a liability stream. The strategy requires that a bond portfolio be structured so that its interest rate risk characteristics (Macaulay duration) match those of the liability stream. The strategy, which is often referred to as "duration matching," requires advanced calculations and frequent re-balancing.

Active strategies involve detailed analysis, such as forecasting future events or interest rates, and selecting investments that will perform best under those conditions. Active strategies typically incur greater expenses than passive strategies, due to their higher transaction volume and complex analysis.

An interest-rate expectations strategy is an attempt to maximize return based on a forecast of future interest rate movements. An example of this strategy consists of adjusting the duration of a bond portfolio to take advantage of expected changes in interest rates. The success of this strategy depends on the accurate forecasting of future interest rates.

An individual security selection strategy is an attempt to identify individual instruments that will outperform other similarly rated instruments. The most common of this type of strategy identifies an issue as undervalued because its yield is higher that that of comparably rated issues or its yield is expected to decline because credit analysis indicates the issue's rating will change. The success of this strategy depends on superior skill in performing credit analysis. An active strategy assumes that the investor will attempt to outperform the market.

Many other investment strategies may be employed without measuring risk on a portfolio basis. Two commonly used active strategies include yield curve strategies and yield spread strategies.

Yield curve strategies involve the positioning of fixed-income portfolios to capitalize on or protect against expected changes in the shape of the Treasury yield curve. These strategies may be referred to as "riding the yield curve." Three common yield curve strategies are bullet strategies, ladder strategies, and barbell strategies.

A *bullet* portfolio is constructed so that the maturity of the securities is highly concentrated at one point on the yield curve. A *laddered* portfolio spreads instruments (and reinvestment risk) across the maturity spectrum and provides regular cash flows. A typical laddered portfolio is constructed with approximately equal percentages of the portfolio maturing at different segments of the yield curve. A *barbell* portfolio concentrates instruments at the short term and long term extremes of the maturity spectrum. Barbell strategies can be used to take advantage of, or compensate for, non-parallel shifts in the yield curve. These strategies are based on the theory that the value of long-term bonds will appreciate more when long-term market interest rates fall, than shorter-term bonds depreciate even if short-term market interest rates simultaneously rise (a non-parallel yield curve shift). The ability to reinvest the proceeds from maturing short-term bonds at higher short-term rates provides this value. The actual performance of a barbell strategy will depend upon both the type of non-parallel shift (e.g. steepening or flattening) and the magnitude of the shift. For example, barbell strategies will be disadvantageous if long-term market interest rates rise while short-term rates remain unchanged.

Yield spread[3] strategies involve the positioning of fixed-income portfolios to profit on expected changes in yield spreads between sectors of the bond market. These sectors can vary by type of issuer (such as Treasury, agencies, corporates, and mortgage-backed securities), quality or credit (such as Treasuries, triple A, double A), coupon (such as high-coupon/premium bonds, low coupon/discount bonds), and maturity (such as short, intermediate, or long term). Spreads can change for a variety of reasons. For example, the spread between top quality and lower quality bonds tends to narrow as business conditions improve, and widen when business conditions deteriorate. Making changes in the portfolio to take advantage of changes in spreads will often result in accepting additional credit risk or extension risk.

Cash flow matching strategies attempt to match the cash flow requirements of a bank's liabilities with the cash flows provided by specific investments. This approach is also known as dedicating a portfolio. Bonds are selected with maturities, principal amounts and coupon payments that match the bank's liability payment stream. Theoretically, this cash flow matching process can be continued until all liabilities have been matched by the cash flows from securities in the portfolio. Interest rate risk reduction is the primary advantage of this strategy, since a known amount of cash sufficient to fund the required payment schedule will be generated with certainty. The inability to reposition the securities being used to match liabilities, the possibility of bonds being called, and the possibility of bonds going into default are the primary disadvantages of this strategy. Cash flow matching strategies are becoming more popular in banks that use FHLB borrowings.

Using *total return* measurement in determining an investment strategy better incorporates the investor's interest rate expectations over time than either a simple yield to maturity or yield to call investment selection. The total return for an individual bond consists of the change in the market value over the measurement period; the coupon received; and the reinvestment interest on the cash flows received during the measurement period. For bond portfolios, the total return is the weighted average of the

[3] Yield spread is the yield premium of one bond over another. Traditional analysis of the yield premium for a non-U.S. Treasury bond involves calculating the difference between the yield-to-maturity of the bond in question and the yield-to-maturity of a U.S. Treasury security with a comparable maturity.

returns of the bonds in the portfolio. Selecting investments based solely on their yield to maturity assumes holding those bonds to maturity and ignores the reinvestment return on interim coupon payments.

Modern portfolio theory (MPT) refers to a variety of portfolio construction, asset valuation, and risk measurement concepts and models that rely on the application of statistical and quantitative techniques. MPT is an approach used for managing investment risk. The theory states that by creating an efficient portfolio, an investor can increase portfolio return without a commensurate risk increase, or reduce portfolio risk without a commensurate return reduction.

First, an investor should determine the required portfolio risk and return levels. By diversifying risk through prudent investment choices, an investor can reduce portfolio risk. Risk averse investors (such as most banks) require a greater expected return in exchange for assuming increased risk. Diversifying the portfolio among different asset classes, maturities, and other characteristics can provide a greater expected return without a commensurate risk increase.

The investor adds or removes assets from the portfolio in order to maintain or alter overall portfolio risk and return characteristics. The investor focuses on the entire portfolio's cash flow characteristics, risk, and return. An individual instrument may be extremely risky if evaluated independently. However, its cash flow characteristics may improve the overall portfolio's risk and return performance.

For example, an interest-only strip may be very price sensitive (market risk) under declining rate scenarios. However, that instrument may offset some or all of a portfolio's price sensitivity under rising interest rate scenarios. Each instrument's individual cash flow characteristics are analyzed to determine the instrument's incremental effect on the overall portfolio's cash flow characteristics.

This approach also demands periodic performance measurement. The investor must accurately measure both risk and return for the overall portfolio and for major portfolio segments. That is, the investor must determine if the portfolio earned a return that adequately compensated the investor for the risk level assumed. Such measurements require accurate pricing information, detailed accounting systems, and a sophisticated risk measurement system.

No particular investment strategy is superior to any other. Management must determine reasonable strategies that effectively achieve the board's goals. Refer to the Capital Markets Handbook for additional information.

MARKET RISK MODIFICATION STRATEGIES

Market risk modification strategies involve using financial instruments whose cash flow fluctuations partially or completely offset the cash flow variability of an asset, liability, or balance sheet segment. Any financial instrument with the desired cash flow characteristics may be used to modify market risk, including off-balance sheet derivatives, mortgage-backed securities, and structured notes. For many banks, market risk modification is an integral part of asset/liability management. This section provides summary guidance for market risk modification strategies. Refer to the Capital Markets Examination Handbook for more detailed information.

Bank earnings result primarily from the spread between earning asset yields and funding costs. Market interest rate changes can narrow the net interest margin and can reduce the economic value of equity. In response, management may attempt to modify the bank's market risk profile to reduce risk or improve performance.

Risk Management Process

Management must evaluate many factors before implementing a market risk modification strategy, including:

- Market risk exposure,
- The board's risk tolerance,
- Current and expected interest rate volatility,
- Cash flow forecasts,
- Strategy time horizon,
- Specific instruments and cost, and
- Potential effectiveness.

To devise a successful strategy (or simply determine if a strategy is needed), management must first quantify the bank's market risk and identify the positions whose market risk should be modified. Then, management must devise a strategy to modify those positions' market risk.

This process requires thorough understanding of the bank's market risk and cash flow characteristics for all on and off-balance sheet positions. For most banks, market risk results primarily from repricing imbalances between earning assets and funding. When developing strategy, therefore, management should typically evaluate the repricing and cash flow characteristics for all on and off-balance sheet positions. If management uses a market risk modification strategy without assessing its effects on overall bank market risk, then management may actually worsen the bank's market risk profile. Failure to understand and adequately manage those risks is an unsafe and unsound practice.

Next, management must determine the strategy's intended time horizon (the length of time the strategy must remain in place) and number of periods needed. Horizon length is an important factor, since many long-term derivatives and some securities have limited liquidity. The number of periods can be an equally important factor. For example, a strategy that involves the value of a single cash position to be liquidated or acquired on a single future date may be described as a single-period strategy. However, a multi-period strategy involves liquidation or acquisition of a cash position over successive periods. Offsetting such positions can involve a sequence of instruments that mature in corresponding periods.

Prior to implementing any market risk modification strategy, management should evaluate all related costs, including transaction costs, analysis and monitoring expense, and foregone interest income on funds paid to mark positions to market (for example, margin maintenance).

Once a strategy has been implemented, management must regularly monitor the strategy's effectiveness. However, careful development and monitoring can not guarantee a strategy will achieve the intended market risk objectives. Management should periodically evaluate instrument performance to determine if the strategy remains appropriate and effective. When warranted, management should adjust the strategy.

The examination of this area should focus on evaluating management's understanding and reporting of the instruments used in any risk modification strategies. This understanding will be reflected in a program for reviewing and documenting financial contracts and counterparty information. Determining the effectiveness of risk modification strategies should be conducted as part of the rate sensitivity module. The interest rate risk review should be able to rely on the individual investment findings of the securities and derivatives review.

Board and Management Oversight

The board and management must understand and regularly evaluate the risks and benefits from all market risk modification strategies used. Market risk modification strategies can involve complex transactions and instruments, which may include significant risk. In addition, market risk modification strategies may require enhanced management expertise and internal controls.

The board maintains oversight responsibility for all market risk modification strategies. In that role, the board should adopt policies that establish management's responsibility for developing, implementing, and monitoring the process. Those policies should specify:

- Risk limits,
- Specific exposures needing modification,
- Accounting treatment,
- Reporting,
- Monitoring,
- Permissible strategies and instruments,
- Counterparty credit risk guidelines,
- Activity limits, and
- Analysis and documentation standards.

ACCOUNTING GUIDANCE

AICPA Audit and Accounting Guide: Banks and Savings Institutions
Chapter 5 – Investments in Debt and Equity Securities
Chapter 8 – Mortgage Banking Activities and Loan Sales
Chapter 15 – Futures, Forwards, Options, Swaps, and Similar Financial Instruments

APB - Accounting Principles Board Opinions
EITF - Consensus Positions of the Emerging Issues Task Force
FAS - FASB Statements
FIN - FASB Interpretations
FTB - FASB Technical Bulletins
PB - AICPA Practices Bulletins
SOP - AICPA Statements of Position

APB 18
The Equity Method of Accounting for Investments in Common Stock

EITF 00-9
Classification of a Gain or Loss from a Hedge of Debt That is Extinguished

EITF 98-15
Structured Notes Acquired for a Specified Investment Strategy

EITF 96-12
Recognition of Interest Income and Balance Sheet Classification of Structured Notes

EITF 96-11
Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FAS No. 115

EITF 95-11
Accounting for Derivative Instruments Containing Both a Written Option-Based Component and a Forward-Based Component

EITF 93-18
Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate

EITF 90-19
Convertible Bonds with Issuer Option to Settle for Cash Upon Conversion

EITF 90-17
Hedging Foreign Currency Risks with Purchased Options

EITF 89-4
Accounting for Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate

EITF 89-18
Divestitures of Certain Investment Securities to an Unregulated Common Controlled Entity Under FIRREA

EITF 88-9
Put Warrants

EITF 88-8
Mortgage Swaps

EITF 87-20
Offsetting Certificates of Deposit Against High-Coupon Debt

EITF 87-1
Deferral Accounting for Cash Securities That Are Used to Hedge Rate or Price Risk

EITF 86-40
Investments in Open-End Mutual Funds That Invest in U.S. Government Securities

EITF 86-28
Accounting Implications of Indexed Debt Instruments

EITF 86-25
Offsetting Foreign Currency Swaps

EITF 86-15
Increasing-Rate Debt

EITF 85-29
Convertible Bonds with a “Premium Put”

EITF 85-20
Recognition of Fees for Guaranteeing a Loan

EITF 85-17
Accrued Interest Upon Conversion of Convertible Debt

EITF 84-7
Termination of Interest Rate Swaps

FAS 149
Amendment of Statement 133 on Derivative Instruments and Hedging Activities

FAS 140
Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (Effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001)

FAS 138
Accounting for Certain Derivative Instruments and Certain Hedging Activities-an amendment of FASB Statement No. 133

FAS 134
Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise

FAS 115
Accounting for Certain Investments in Debt and Equity Securities

FAS 107
Disclosures About Fair Value of Financial Instruments

FAS 65
Accounting for Certain Mortgage Banking Activities

FAS 91
Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases

FAS 52
Foreign Currency Translation

FIN-41
Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements

FIN-39
Offsetting of Amounts Related to Certain Contracts

FTB 94-1
Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring

FTB 87-3
Accounting for Mortgage Servicing Fees and Rights

FTB 79-19
Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee

PB 4
Accounting for Foreign Debt/Equity Swaps

SOP 90-3
Definition of the Term "Substantially the Same" for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position

OVERVIEW

Financial institutions maintain cash on hand and at correspondent banks to comply with statutory reserve requirements and to meet customer demands. Cash accounts include U.S. and foreign coin and currency on hand and transit, clearing, and cash items. Demand and time deposits maintained at correspondent banks are often known as due from accounts, or correspondent balances. Banks maintain correspondent accounts to facilitate the transfer of funds.

Cash

Every bank must maintain a certain amount of U.S. and/or foreign coin and currency on hand. To avoid having excess nonearning assets and to minimize exposure to misappropriation and robbery, each bank should establish a policy to maintain cash balances at the minimum levels necessary to meet reserve requirements and customer demands. Federal Reserve Regulation D governs the level of required reserves. Part 326 of the FDIC Rules and Regulations requires banks to adopt appropriate security procedures to discourage robberies and to assist in apprehending persons who commit such acts.

Clearings

The term clearing is used to describe the activities involved with processing financial transactions from the time a transaction is made until it is settled. Clearing items include checks, drafts, notes, and other items that represent instructions for processing financial transactions. Financial institutions accept, collect, and process a variety of payment instruments and can participate in a variety of clearing and settlement systems.

For decades, many communities with two or more banks organized local clearinghouse associations which adopted rules governing the exchange of checks. Clearings were also processed through regional associations, correspondent banks, or the Federal Reserve. Physical items such as checks (typically submitted in batches) were often processed on proof and sorting machines that facilitated an institution's ability to verify the accuracy of individual documents, separate items by pre-identified categories, provide balance verifications for transaction types (proof), and send cash items drawn on other banks for collection (transit). Proof machines had paper handling mechanisms that fed checks, deposit slips, and other items into the system. As each item went into the system, a proof operator read and entered the courtesy amount of the check (the face value of the check). The proof machine then printed the face value on the bottom of the item in Magnetic Ink Character Recognition (MICR) ink so the transaction information could be processed electronically. Most proof machines also had a MICR reader that allowed them to read the bank and item number from pre-encoded MICR information.

Legislative changes and advances in technology now allow banks to process clearing items, or have items processed by a servicer, on equipment that captures images of items, reads the information, including MICR data, and stores images and data in a computerized file. The file can then be transmitted electronically for settlement. Similarly, institutions are now able to use remote deposit capture systems. With remote deposit capture, instead of physically transporting checks to a banking facility, customers are able to scan checks on devices maintained in their own offices and transmit information electronically to a financial institution or its service provider.

Although institutions can process clearing items such as checks quickly and efficiently using modern technologies, in many situations, checks are no longer the most convenient payment instruments for consumers. Often consumers use checks merely for person-to-person transactions that are not conducive to electronic payments. Many consumers have shifted to using fully electronic payments through Automated Teller Machine, Point-of-Sale, and on-line bill payment systems.

No matter how transactions are initiated or processed, a bank's objective remains the same: to forward items for collection quickly so funds are available as soon as possible; to distribute checks and deposits efficiently to their destinations; to establish that deposit totals balance with the totals shown on deposit tickets; to prove subsidiary and general ledger entries and other transactions; to collect data for computing customer's service charges and available funds; and to accomplish the functions accurately, securely, and efficiently.

Cash Items

Cash items are checks or other items in process of collection payable in cash upon presentation. A separate control account of all such items is generally maintained on the bank's general ledger and supported by a subsidiary record of individual amounts and other pertinent data. Cash items and related records usually are in the custody of one employee at each banking office who is designated as the collection, or exchange, teller.

In normal daily operations, all banks have items which are charged to demand deposits but which cannot be charged to individual accounts because of insufficient funds, a lack of information, unknown accounts, etc. Such items include return items, rejects, or unposted debits and may consist of checks, loan payments, or other debit memos. In some banks, such items are separated and an entry is made reclassifying them to a separate asset account. Other banks include the items in a subsidiary control account in the individual demand deposit ledgers. In that case, the account would have a debit balance that would be credited when the bank returns the checks to their sources.

Cash items not in process of collection should be carried in a noncash account and reported as other assets. These include items payable upon presentation that a bank has elected to accumulate until forwarding to payers on a periodic basis. Items not immediately payable in cash upon presentation, or items that were not paid when presented and require further collection efforts should also be included in an appropriate account, such as suspense, and shown under other assets. Many banks establish a three-day limit, after which all items not collected must be automatically transferred from cash items to a suspense account. Refer to the Other Assets section of this Manual for additional comments on cash items not in process of collection.

Due From Banks

As noted above, due from accounts enable the transfer of funds between banks. The accounts are used to facilitate the collection of cash items and cash letters, the transfer and settlement of security transactions, the transfer of participation-loan funds, the purchase or sale of Federal funds, and for many other purposes.

Due from accounts may also exist when a bank utilizes the services of another bank and maintains a minimum or compensating balance in full or partial payment for the services received. Such services may involve processing cash letters, packaging loan agreements, performing information technology or payroll services, collecting out-of-area items, or exchanging foreign currency.

Balances due from institutions cover all interest-bearing and noninterest-bearing balances whether in the form of demand, savings, or time balances, but excludes certificates of deposit held for trading.

Reciprocal balances arise when two depository institutions maintain deposit accounts with each other, i.e., when a reporting bank has both a due from and a due to balance with another depository institution. Reciprocal balances between the reporting bank and other depository institutions may be reported on a net basis when a right of set off exists. Net due from balances should be reported as deposit assets. Net due to balances should be reported as deposit liabilities.

DEPOSIT NOTES

Some banks have purchased deposit notes as investments. These instruments are a form of deposit liability somewhat similar to negotiable time certificates of deposit (CD). "Deposit notes" have been structured like corporate bonds by having a five-day corporate settlement period for purchases and semiannual interest payments calculated on a 30/360-day basis. Although maturities vary from nine months to 15 years, most "deposit notes mature in four to seven years. While the foregoing contract terms could be incorporated into a CD, certain banks, for marketing purposes, prefer to use the "deposit note" format.

Bank purchases of such notes should be made in accordance with established investment and asset/liability management policies. While these note issues tend to be rated, banks considering the purchase of a deposit note should nonetheless obtain the offering circular or other similar information to ensure that they understand the nature of such notes (including possible deposit insurance coverage) before investing. A bank's investment in a deposit note should generally be included on the balance sheet in the interest-bearing balances due from depository institutions asset category. However, if the offering circular or note instrument for a particular deposit note is available for review and it does not contain a statement to the effect that the liability represented by the note is a deposit liability of the issuing bank, the bank's investment in the note should be treated as a security or a loan based on the characteristics of the note.

Structured CDs

Structured CDs are similar to structured note investment securities in that they have customized features typically containing embedded options or having cash flows linked to various indices.

The uncertainty of the cash flows, caused by movements in interest rates or other indices, may expose banks that invest in the CDs to heightened market risk, liquidity risk, or other such risks traditionally experienced in the context of investment securities. As a result, investments in structured CDs warrant heightened supervisory attention to ensure that management understands, and has the ability to adequately monitor and manage these risks.

The risk profile of structured CDs can be very similar to that of structured notes. Certificates may include step-up features with call options, inverse floating or dual indices, or other such terms. These types of terms, in addition to severe early withdrawal penalties and the lack of an established secondary market, may result in cash flow behavior similar to that of structured notes. Proper controls for these investments include effective senior management supervision, board oversight, periodic reporting, and appropriate policies and procedures. The degree and complexity of an institution's monitoring and reporting systems should be commensurate with the volume and complexity of their investment in structured certificates.

Classification of structured CDs should be consistent with the adverse classification guidelines outline in the Securities and Derivatives section of this Manual.

EXAMINATION OBJECTIVES

When reviewing activities related to cash and due from bank accounts, examiners should consider the issues discussed below.

Primary Reserves

Cash and balances due from other banks generally represent an institution's primary liquidity reserves, except to the extent they include required reserves. Excessive cash or due from balances can have an adverse impact on earnings because they generate little or no income, while insufficient balances can contribute to a weak overall liquidity position. Examiners should review the level of primary reserves as part of the Earnings and Liquidity reviews. Some assistance in making this assessment may be obtained by referring to the UBPR. If a bank's level of cash and due from bank accounts appears considerably out of line with those of the peer group (after considering reserve requirements), or if the level changed significantly from the previous examination, or over a period of time, further investigation may be warranted.

Interbank Liabilities

All insured institutions are required to establish and maintain written policies and procedures to prevent excessive exposure to any individual correspondent, in accordance with Federal Reserve Regulation F (12 CFR Part 206), Limitations on Interbank Liabilities. This rule covers all exposure to a correspondent, including credit and liquidity risks and operational risks related to intraday and interday transactions. The regulation requires banks to establish prudent standards that consider credit, liquidity, and operational risks when selecting correspondents and terminating relationships. Where exposure is considered significant, banks must periodically review their correspondents' financial condition.

Policy standards should include exposure limits when a correspondent's financial condition, or the general level of exposure to a correspondent, creates a significant risk to a bank. Exposure limits may be fixed by amount or flexible, but should be based on the financial condition of the correspondent and the type and level of identified exposure. Regulation F provides that when exposure limits are required, banks should limit interday credit exposure to a correspondent to 25 percent of a bank's capital, unless the bank can demonstrate that its correspondent is at least adequately capitalized. When a correspondent is not at least adequately capitalized, banks should reduce their credit exposure to the 25 percent level within 120 days after the date when the current Call Report or other relevant report would be available.

Compensating Balances

Banks may be exposed to insider abuse if their officers, directors, or principal shareholders have loans at correspondent banks. For example, a correspondent bank may provide a bank insider a below-market rate loan if that officer establishes a below-market rate deposit account at the correspondent bank (in the name of their bank). In this situation the officer would be abusing their position by receiving personal gain (the below-market rate loan), and harming the bank by establishing an account at the correspondent that receives below-market returns. Therefore examiners should be alert to potential abusive relationship between executive officers, directors, and principal shareholders of a bank and that bank's correspondent banks.

Such arrangements may constitute a breach of a bank official's fiduciary obligations to the depositing bank and thus to its depositors, creditors and shareholders. In some cases, the arrangements may also involve a criminal offense.

Accordingly, if the bank maintains a correspondent account with another bank which has extended credit to any of the above persons or anyone associated with them and where there is evidence that the depositing bank may have suffered a detriment because of the loan/deposit arrangement, the situation should be thoroughly investigated. This is also the case when the bank holds a deposit from another bank and has outstanding extensions of credit to such persons in the other bank or their associates. Refer to the Bank Fraud and Insider Abuse section for further information.

Correspondent Concentration Risks

The FFIEC issued guidance (FIL-18-2010) detailing the expectation that financial institutions take actions beyond the minimum requirements established in Regulation F. The guidance clarifies that risk management practices relating to correspondent concentrations should encompasses all credit and funding exposures. In addition, management should be aware of its affiliates' exposures to individual correspondents and their affiliated entities.

A financial institution’s relationship with a correspondent can result in credit (asset) and funding (liability) concentrations. Asset concentrations may be present when an institution maintains significant due from balances; or advances, or commits to advancing, significant funds to a correspondent or their related entities. Liability concentrations may exist when an institution maintains significant due to balances; or depends on a correspondent or their related entities for a disproportionate share of its total funding.

Some correspondent concentrations may involve legitimate business purposes, such as concentrations arising when an institution maintains large due from accounts to facilitate clearing activities. However, correspondent concentrations represent diversification risks that management should consider when formulating strategic plans and risk limits. Examiners should ensure management performs appropriate due diligence procedures and adequately identifies, monitors, and manages all credit and funding concentrations.

Due Diligence

Financial institutions that maintain, or contemplate entering into, credit or funding arrangements with other financial institutions should establish correspondent risk management programs. The programs should include written investment, lending, and funding policies that incorporate appropriate risk limits. In addition, the programs should ensure institutions conduct analysis of credit transactions prior to committing to, or engaging in, the transactions. The terms of all credit and funding transactions should avoid conflicts of interest and conform to sound investment, lending, and funding practices.

Identifying Credit Concentrations

Credit concentrations involve a variety of assets and activities. For example, an institution could have due from bank accounts, Federal funds sold on a principal basis, and direct or indirect loans to or investments in a correspondent bank. When calculating credit concentration levels, institutions should aggregate all exposures, including, but not limited to:

- Due from demand and time accounts,
- Federal funds sold on a principal basis,
- Over-collateralized amounts on repurchase agreements,
- Under-collateralized portions of reverse repurchase agreements,
- Net credit exposures on derivatives contracts,
- Unrealized gains on unsettled security transactions,
- Direct or indirect loans to or for the benefit of the correspondent, and
- Investments in the correspondent, such as stocks, subordinated debts, or trust preferred securities.

Identifying Funding Concentrations

The primary risk relating to funding concentrations is that an institution may need to replace the advances on short notice or on unfavorable terms. The risks may be more pronounced if funds are credit sensitive or the party advancing the funds has a weakened financial condition. Additionally, the level of risk relating to a funding concentration is likely to vary depending on the type and maturity of the funds and the structure of the recipient's overall sources of funds. For example, a concentration in overnight unsecured funding would raise different concerns than a concentration in secured long-term funding. Also, the risks of a concentration from a particular correspondent would be more significant if the level of funds constituted a high percentage of an institution's overall funding sources.

Calculating Credit and Funding Concentrations

When identifying credit and funding concentrations, institutions should calculate both gross and net exposures to individual correspondents and to groups of affiliated correspondents. Exposures are reduced to net positions to the extent the transactions are secured by the net realizable proceeds from readily marketable collateral or are covered by valid and enforceable netting agreements.

Monitoring Correspondent Relationships

Management should maintain written policies and procedures designed to prevent excessive exposure to correspondents in relation to the correspondent's financial condition. The depth and frequency of monitoring procedures may be more or less aggressive depending on the type and level of risk exposures. Institutions should implement procedures that ensure ongoing, timely reviews of correspondent relationships, include documentation requirements, and specify when risks that meet internal criteria are to be brought to the attention of the board of directors.

In monitoring correspondent relationships, institutions should specify internal parameters relative to information, ratios, or trends that will be reviewed for each correspondent on an ongoing basis such as:

- Deteriorating trends in capital, asset quality, or earnings,
- Increasing levels of other real estate owned,
- Significant use of volatile funding sources such as large CDs or brokered deposits,
- Downgrades in its credit ratings, if publicly traded, and
- Public enforcement actions.

Managing Correspondent Concentrations

Institutions should establish prudent internal concentration limits for each correspondent, as well as ranges or tolerances for each factor being monitored. Institutions should also develop contingency plans for managing risks when internal limits, ranges, or tolerances are met, either on an individual or collective basis. However, contingency plans should not rely on temporary deposit insurance programs for mitigating concentration risks.

Contingency plans should provide for the orderly reduction of identified concentrations over reasonable timeframes. Such actions may include, but are not limited to:

- Reducing the volume of uncollateralized/uninsured funds,
- Transferring excess funds to other correspondents,
- Requiring a correspondent to serve as an agent rather than as principal for Federal funds sold,
- Modifying credit and funding limits to a correspondent, and
- Specifying timeframes to meet targeted reductions for different types of exposures.

EXAMINATION PROCEDURES

Examiners should review correspondent relationships to ascertain whether an institution’s policies and procedures appropriately manage correspondent concentrations. Examiners should also review the adequacy and reasonableness of an institution's contingency plans for managing correspondent concentrations. The Examination Documentation Modules include examination procedures regarding the evaluation of the internal controls for cash, cash items, and correspondent bank accounts. Refer to the Other Assets and Liabilities and the Internal Routine and Controls sections for additional details.

INTRODUCTION

Institutions have historically relied on a reasonable investment in premises and equipment to successfully conduct business. A financial institution's physical presence in a community can bolster its public image and competitive position, and enhance convenience for customers. Institution offices can provide a platform for gathering deposits, originating credit, and serving the financial needs of its community. However, overinvestment in facilities may tie up capital and hinder earnings. Therefore, similar to other balance sheet assets, premises and equipment can pose risks to the institution and present a range of accounting issues that require appropriate oversight.

Premises include the cost, less accumulated depreciation, of land and buildings actually owned and occupied (or to be occupied) by the institution, its branches, and consolidated subsidiaries. This includes vaults, *fixed* machinery and equipment, parking lots, and real estate acquired for future expansion. Interest costs associated with the construction of a building are capitalized as part of the cost of the building. Institution premises also include leasehold improvements. Leasehold improvements comprise two types of accounts:

- Buildings constructed on leased property, and
- Capitalized disbursements directly related to leased properties, such as vault, renovation, and fixed machinery and equipment expenses.

Non-fixed equipment includes all *movable* furniture, fixtures, and equipment of the bank, its branches, and consolidated subsidiaries, including automobiles and other vehicles used in the conduct of business.

Premises and equipment are reported in the Call Report schedule RC-Balance Sheet, Item 6, *Premises and Fixed Assets*. The institution's ownership interest in premises and equipment of non-majority-owned corporations is also included in schedule RC, Item 6.

FIXED ASSETS ACCOUNTING

Fixed Assets - Owned

Fixed assets are reported at original cost and are depreciated over their estimated useful life, except for land which is not a depreciable asset.

Interest may be capitalized as part of the historical cost of acquiring assets that need time to be brought to the condition and location necessary for their intended use. The FASB Accounting Standards Codification (ASC) 835-20, *Capitalization of Interest*, calls for capitalization of interest costs associated with the construction of a building, if material. Such interest costs include both the actual interest incurred when the construction funds are borrowed and the interest costs imputed to internal financing of a construction project. The rate used to capitalize interest on internally financed projects in a reporting period shall be the rate(s) applicable to the bank's borrowings outstanding during the period. For this purpose, a bank's borrowings include interest-bearing deposits and other interest-bearing liabilities. The interest capitalized shall not exceed the total amount of interest cost incurred by the bank during the reporting period.

Fixed Assets - Leased

Institutions often lease premises and equipment. Lease obligations, which essentially reflect an extension of credit between the lessee and lessor may reflect material investments and can significantly, affect a bank's earnings.

ASC 840, *Leases*, is the current lease accounting standard for non-public entities and entities that have not adopted ASC 842, *Leases*. ASC 842 is effective for public business entities (as defined in U.S. GAAP) and will become effective for banks that are not public business entities, for fiscal years beginning after December 15, 2020, and interim reporting periods within fiscal years beginning after December 15, 2021. As such, a calendar year end non-public entity's first reporting period will be December 31, 2021. Early adoption is permitted.

In general, under ASC 840, a *capital lease* is recorded on the balance sheet (with interest and depreciation expensed on the income statement). An *operating lease*, on the other hand, is not reported on the balance sheet (it is disclosed in the footnotes of financial statements). Under ASC 840, operating leases are expensed using the straight-lined method on the income statement.

Under ASC 842, lessees are required to classify a lease as either a *finance lease* or an operating lease and, in most cases, identify and report them on the balance sheet. Although the term finance lease replaced the term capital lease that was previously used in ASC 840, the substance of recording and reporting the transactions remains the same.

Lease Accounting – ASC 840

In accordance with ASC 840, any lease entered into by a lessee institution, which at its inception meets <u>one or more</u> of the following four criteria must be accounted for as a property acquisition financed with a debt obligation, i.e., a capitalized lease. The criteria are:

- Ownership of the property is transferred to the lessee at the end of the lease term;
- The lease contains a bargain purchase option;
- The lease term represents at least 75 percent of the estimated economic life of the leased property; and
- The present value of the minimum lease payments at the beginning of the lease term is 90 percent or more of the fair value of the leased property to the lessor at the inception of the lease, less any related investment tax credit retained by or expected to be realized by the lessor.

If none of the criteria listed above is met, the lease should be accounted for as an operating lease. Normally, rental payments should be charged to expense as they become payable over the term of the operating lease.

Capitalized leases are to be reported in the Premises and Fixed Assets category of the Call Report. The amount capitalized equals the present value of the minimum required payments over the non-cancellable term as defined by the lease (plus the present value of payments required under a bargain purchase option, if any) less any portion of payments representing administrative expenses (such as insurance, maintenance, and taxes to be paid by the lessor). The property should be amortized according to the institution's normal depreciation policy (except, if appropriate, the amortization period should be the lease term) unless the lease involves land only, which is not a depreciable asset.

Lease Accounting – ASC 842

The core principle of ASC 842 is that a lessee should recognize the assets and liabilities that arise from leases. Under ASC 842, institutions are required to report a right-of-use (ROU) asset and a lease liability for most finance and operating leases. The ROU asset reflects the lessee's control over the leased item's economic benefits during the lease term. The measurement of the ROU asset includes the initial present value of lease payments plus certain third party, initial direct costs minus any lease incentives. The lessee records a related lease liability equal to the present value of the unpaid future lease payments.

The discount rate used to estimate the present value should be the rate implicit in the lease, or if that rate cannot be readily determined, the lessee's incremental borrowing rate (IBR). Many times a lessee may not have the necessary information, (such as the residual value estimate of the lessor or the initial direct cost incurred by the lessor) to determine the rate implicit in the lease. In such cases, the lessee may use its IBR.

While most leases will be reported on the balance sheet, ASC 842 permits a lessee to make an accounting-policy election to exempt leases with a term of one year or less (at the commencement date) from on-balance sheet recognition. The lease term generally includes the non-cancellable period of a lease as well as purchase options and renewal options that are reasonably certain to be exercised by the lessee, renewal options controlled by the lessor, and any other economic incentive for the lessee to extend the lease, which may include a related-party commitment.

Classification of Leases by the Lessee

ASC 842 requires a lessee to classify a lease (at the commencement date) as either a finance lease or an operating lease. When lease terms effectively transfer control of the underlying asset, the substance of the transaction is reflective of a sale, and the lease is classified as a finance lease by the lessee. Leases between related parties, such as a holding company and its financial institution are classified in the same manner as a lease with unrelated parties, i.e., the classification is based on the terms of the contract without considering the related party relationship. ASC 842 has five criteria for determining if a lease is a finance lease or an operating lease for the lessee.

A lessee is required to classify a lease as a finance lease when <u>one or more</u> of five criteria are met:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term;
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise;
- The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion is not used for purposes of classifying the lease;
- The present value of the sum of the lease payments and any residual guarantee by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset; or
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

If none of the five criteria are met and the lease is not a short-term lease in which the institution has elected the short-term lease policy election, the lessee is to classify the lease as an operating lease.

While the initial reporting of the ROU asset and lease liability will be the same regardless how the lease is classified (i.e., finance or operating lease), the reporting in the income statement differs. For a finance lease, a lessee is required to report interest expense on the lease liability using the effective interest method separately from the amortization expense on the ROU asset, typically on a straight-line basis. For an operating lease, a lessee is required to report a single lease cost. The lease expense is recorded on a straight-line basis over the lease term by adding the interest expense on the lease liability to the amortization of the ROU asset.

If a lease is not being correctly reported, appropriate comments should be included in the Report of Examination. The comments should remind management of the responsibility for accurate reporting and include the recommendation that competent outside assistance be obtained if the bank lacks satisfactory accounting expertise. In addition, if the amount incorrectly reported is significant, amended Call Reports may be necessary. Examiners are to verify whether bank decisions on how to report a lease are be fully supported and documented.

Sale-Leaseback Transactions

Sale-leaseback transactions occur when the owner of a property sells the property and subsequently leases it back from the buyer. The seller-leasee transfers legal ownership of the property to the buyer-lessor in exchange for consideration and then makes periodic rental payments to the buyer-lessor to retain use of the property.

Sale-Leaseback Accounting - ASC 840-40

If an institution sells premises or fixed assets and leases back the property, the lease shall be treated as a capital lease if it meets any one of the four capitalization criteria in ASC 840. Otherwise, the lease shall be accounted for as an operating lease. ASC 840-40, *Leases – Sale-Leaseback Transactions* provides guidance on the treatment of any gain or loss. A loss must be recognized immediately for any excess of net book value over fair value at the time of sale. In the event a bank sells a property for an amount less than its fair value, (for example, in order to obtain more favorable lease terms), the difference between the sale proceeds and fair value represents an additional loss that must be deferred and amortized over the life of the lease. Any gain resulting from a sale-leaseback transaction is generally deferred and amortized over the life of the lease. Accordingly, the general rule on deferral does not permit the recognition of all or part of the gain in income at the time of sale. Exceptions to the general rule do permit full or partial recognition of a gain at the time of the sale if the leaseback covers less than substantially all of the property that was sold or if the total gain exceeds the minimum lease payments.

Sale-Leaseback Accounting – ASC 842-40

For a sale-leaseback transaction to qualify for sales treatment under ASC 842, the transfer of the asset must meet the requirements for a sale in ASC 606, *Revenue from Contracts with Customers*. If the transaction qualifies as a sale in accordance with ASC 606 and the transaction would not be considered a failed sales-leaseback (as described below), any gain or loss on the sale is recognized immediately. However, an option for the seller-lessee to repurchase the asset would preclude accounting for the transfer of the asset as a sale unless both of the following criteria are met:

- The exercise price of the option is the fair value of the asset at the time the option is exercised, and
- There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

The classification of a lease can affect whether a sale has occurred. In the event a leaseback is classified as a finance lease by the seller-lessee, or a sales-type lease by the buyer-lessor, then a sale has not occurred since a finance lease is essentially the purchase of an asset and a sales-type lease is essentially a sale of an asset. As such, the transaction would be considered a failed sales-leaseback.

If the transaction would not meet the conditions for a sale under ASC 606, or when the leaseback would not be classified as an operating lease (i.e., a failed sales-leaseback), the transaction would be accounted for as a financing arrangement. The transferor would not derecognize the asset and will continue to depreciate the asset as the legal owner. Any sales proceeds received would be reported as a liability.

For sale and leaseback transactions accounted for under ASC 840, the transition guidance does not require an entity to reassess whether the transaction would have qualified as a sale and a leaseback under ASC 842.

The accounting requirements for leases and sales of real estate are complex; and examiners who have questions on lease accounting or sale-leaseback transactions should refer to appropriate accounting resources or contact their regional accounting specialist.

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ANALYSIS OF FIXED ASSETS

From an accounting standpoint, an investment in fixed assets is an essential cost of doing business. Attention should be focused on the adequacy of depreciation, the reasonableness of the overall commitment, and the current and prospective utilization of fixed assets in serving the present and future anticipated banking needs. Only under exceptional circumstances, such as the contemplated abandonment of institution premises, gross under-utilization due to obsolescence, closed bank situations, or other extreme circumstances, do market value considerations assume any significance in the analysis of fixed assets.

Depreciation Costs

Depreciation is an overhead cost of doing business as the item being depreciated will have to be replaced when it ceases to have utility. An acceptable depreciation program allocates the original cost of the fixed asset over its estimated useful life. Failure to follow a realistic schedule of fixed asset depreciation distorts both the balance sheet and income statement.

Institutions carry premises and equipment at cost less accumulated depreciation, and adjust the carrying amount for permanent impairments of value. Any method of depreciation or amortization conforming to accounting principles that are generally acceptable for financial reporting purposes may be used. However, depreciation for premises and fixed assets may be based on a method used for federal income tax purposes if the results would not be materially different from depreciation based on the asset's estimated useful life. Under normal circumstances, examiners should not need to prepare detailed depreciation schedules in accordance with the generally accepted accounting principles. In instances where tax depreciation and book depreciation are the same, and depreciation is accelerated for tax purposes only, detailed analysis of book values may be necessary to determine whether fixed assets are being appropriately depreciated.

Depreciation can result in a taxable, temporary difference if an institution uses the straight-line method to determine the amount of depreciation expense to be reported for book purposes but uses an accelerated method for tax purposes. In the early years, tax depreciation under the accelerated method will typically be larger than book depreciation under the straight-line method. During this period, a taxable, temporary difference originates. Tax depreciation will be less than book depreciation in the later years when the temporary difference reverses. Therefore, in any given year, the depreciation reported on the books will differ from that reported in the bank's tax returns. However, total depreciation taken over the useful life of the asset will be the same under either method.

Overinvestment

An over commitment in equipment and facilities can adversely affect earnings. A review of pertinent Uniform Bank Performance Report schedules will reveal how an institution compares to its peers in terms of total assets invested in premises and equipment, and the percent of operating income absorbed by occupancy expense. This information, though not in itself conclusive, can be a useful starting point in the analysis. Other considerations include the bank's business model and strategy. However, as long as commitments conform to state banking regulations and aggregate direct and indirect investments, including lease obligations, appear reasonable in relation to the institution's earnings performance and capacity, the decision as to what constitutes an appropriate fixed asset commitment should generally be left to management's discretion.

Fixed Asset Investments

A reasonable investment in premises and equipment is essential to conducting institution business. However, overinvestment in facilities or equipment may encumber capital and burden earnings. Consequently, many states impose limits on fixed asset investments. In order to keep their investments within statutory limits, some institutions have engaged in a variety of alternative arrangements, such as the organization of subsidiary or affiliate realty corporations, sale-leaseback transactions, and lease-purchase contracts. These arrangements are most common in connection with institution buildings, but in some instances are also used in connection with equipment.

The realty corporation arrangement typically calls for investment in a subsidiary corporation and capitalization by the bank of an amount within state limitations, with the subsidiary corporation financing the additional cost of banking facilities in the mortgage market. The facilities are then leased to the bank by the subsidiary corporation at a rent rate that usually coincides with the mortgage payments. In one type of affiliate setup, a group of the bank's directors may form a corporation to hold title to the property and lease it to the bank.

Examiners should determine whether any arrangements or transactions concerning fixed assets involve insiders and, if so, that such transactions are on substantially the same terms as those prevailing at the time for comparable transactions with non-insiders and do not involve more than normal risk or present other unfavorable features to the institution. In addition, examiners should consider whether insiders' use of institution owned/leased facilities and equipment (including vehicles) is prudent and in accordance with banking laws and employment agreements.

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FIXED ASSET INSURANCE

Basic insurance policies and extended coverage endorsements typically provide coverage of risks caused by fire, lightning, explosion, windstorm, hail, civil unrest, aircraft or vehicle damage, etc. Broad form property insurance includes coverage for the risks identified in basic policies and adds additional coverage for falling objects, weight of ice, sleet, or snow, and accidental water damage.

The most common form of property insurance is special coverage, or *all risk* insurance. Special coverage policies may provide the best overall risk protection; however, the number and type of items excluded from coverage can be numerous. Typical exclusions include damage caused by government action, nuclear hazard, wars, floods, fungus, and pollution.

Regardless of the type of property insurance policies a bank carries, examiners should assess whether management thoroughly understands, periodically reviews, and documents their analysis of the adequacy of their institution's insurance coverage.

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EXAMINATION PROCEDURES

The Other Assets and Liabilities Examination Documentation Module includes examination procedures regarding the evaluation of the reasonableness of investment in premises and equipment.

OTHER REAL ESTATE

Other real estate (ORE) consists of real property held for reasons other than to conduct bank business. Banks usually acquire ORE through foreclosure after a borrower defaults on a loan secured by real estate. Most states have laws governing the acquisition and retention of such assets.

Examiners should ensure management establishes appropriate policies and procedures for acquiring, holding, and disposing of ORE. Management should establish policies and procedures that:

- Protect a bank's interests in ORE while mitigating the impact on surrounding property values,
- Ensure ORE is accounted for in conformance with generally accepted accounting principles and Call Report Instructions, and
- Assure the institution's compliance with federal and state laws pertaining to holding ORE.

For regulatory reporting purposes, ORE includes:

- All real estate, other than bank premises, actually owned or controlled by the bank and its consolidated subsidiaries, including real estate acquired through foreclosure or deed in lieu of foreclosure, even if the bank has not yet received title to the property;
- Real estate collateral in a bank's possession, regardless of whether formal foreclosure proceedings have been initiated;
- Property originally acquired for future expansion but no longer intended for that purpose; and
- Foreclosed real estate sold under contract and accounted for under the deposit method of accounting.

Maintaining Other Real Estate

Part 364, Appendix A of the FDIC Rules and Regulations, Interagency Guidelines Establishing Standards for Safety and Soundness, requires institutions to identify problem assets and prevent deterioration in those assets. Institutions should maintain and protect ORE from deterioration to maximize recovery values. Typical expenses incurred during the ORE holding period relate to maintenance, tax, insurance, and miscellaneous costs.

Management should maintain ORE in a manner that complies with local property and fire codes. Other requirements, such as homeowner association covenants, may also require careful attention. Efforts to ensure an ORE property is maintained in a marketable condition not only improve an institution's ability to obtain the best price for the property, but also minimize liability and reputation risks.

Real estate taxes on ORE should be paid in a timely manner to avoid unnecessary penalties and interest.

Management should periodically review general insurance policies to determine if adequate hazard and liability coverage for ORE exists. If adequate general coverage is not in place, management should consider obtaining policies on each parcel of ORE. If an institution decides to self-insure, the decision should be board approved and appropriately documented.

Management should implement reasonable procedures for managing other miscellaneous expenses the institution may incur during the ORE holding period. These expenses could include, but are not limited to, sewer and water fees, utility charges, property management fees, and interest on prior liens.

OTHER REAL ESTATE ACCOUNTING

The accounting and reporting standards for foreclosed real estate are set forth in ASC 310-40, Receivables – Troubled Debt Restructurings by Creditors (formerly FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*), and ASC 360, Property, Plant, and Equipment (formerly FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*). The disposition of ORE is addressed in ASC 360-20, Property, Plant, and Equipment – Real Estate Sales (formerly FAS 66, *Accounting for Sales of Real Estate*). For regulatory reporting purposes, certain provisions of former AICPA Statement of Position (SOP) No. 92-3, *Accounting for Foreclosed Assets*, have been incorporated into the Call Report Instructions even though SOP 92-3 was rescinded subsequent to the issuance of FAS 144. Institutions must follow these provisions of SOP 92-3 when preparing their Call Reports.

Carrying Value

Call Report Instructions provide that foreclosed real estate received in full or partial satisfaction of a loan be recorded at the fair value less cost to sell the property. This fair value (less cost to sell) becomes the "cost" of the foreclosed real estate. If the recorded amount of the loan exceeds the "cost" of the property, the difference is a loss which must be charged to the Allowance for Loan and Lease Losses (ALLL) at the time of foreclosure or repossession. However, if an asset is sold shortly after it is received in a foreclosure or repossession, it may be appropriate to substitute the value received in the sale (net of the cost to sell the property) for the fair value, with any adjustments made to losses previously charged against the ALLL.

The recorded amount of a loan at the time of foreclosure is the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest. An asset received in partial satisfaction of a loan should be accounted for at its fair value less cost to sell, and the recorded amount of the loan should be reduced by the fair value (less cost to sell) of the asset at the time of foreclosure. Legal fees and other direct costs incurred by the bank in a foreclosure should be expensed as incurred.

After foreclosure, each foreclosed real estate parcel must be carried at the lower of (1) the fair value of the real estate minus the estimated costs to sell the real estate or (2) the “cost” of the real estate. If the real estate’s fair value minus the estimated costs to sell the real estate is less than its “cost,” the deficiency must be recognized as a valuation allowance against the real estate which is created through a charge to expense. The valuation allowance should thereafter be increased or decreased (but not below zero) for changes in the real estate’s fair value or estimated selling costs.

FINANCED SALES OF ORE

ASC 360-20, which applies to all transactions in which the seller provides financing to the buyer of real estate, establishes five different methods of accounting for dispositions of real estate. Failure to apply the correct method may result in misstating ORE and earning assets (i.e., loans). The deposit method is the only one of five methods where disposition of ORE and financing by the seller of real estate does not result in a sale and corresponding recognition of a loan. Brief descriptions of the five accounting methods for seller-financed dispositions of ORE are listed below. Refer to ASC 360-20 for more detailed definitions.

Full Accrual Method

Under this method, the disposition is recorded as a sale. Any resulting profit is recognized in full and the seller-financed asset is reported as a loan. The following conditions must be met in order to utilize this method.

- A sale has been consummated,
- The receivable is not subject to future subordination,
- The usual risks and rewards of ownership have been transferred, and
- The buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property.

Guidelines for meeting the minimum down payment are set forth in Appendix A to ASC 360-20. These vary from five to 25 percent of the property sales value. These guideline percentages vary by type of property and are primarily based on the inherent risk assumed for the type and characteristics of the property. To meet the continuing investment criteria, the contractual loan payments must be sufficient to repay the loan over the customary loan term for the type of property involved. For instance, the customary repayment term for a loan secured by a single-family residential property could range up to 30 years.

Installment Method

This method recognizes a sale and corresponding loan. Profits are recognized as the bank receives payments. Interest income is recognized on an accrual basis, when appropriate.

The installment method is used when the down payment is not adequate to allow for use of the full accrual method, but recovery of the cost of the property is reasonably assured in the event of buyer default. Reasonable assurance of cost recovery may be achieved despite a small down payment if there is recourse to borrowers who have verifiable net worth, liquidity, and income levels, or if there is additional collateral pledged.

Cost Recovery Method

This method also recognizes a sale and corresponding loan and may apply when dispositions do not qualify under the full accrual or installment methods. No profit or interest income is recognized until either the aggregate payments exceed the recorded amount of the loan or a change to another accounting method is appropriate. The loan is maintained on nonaccrual status while this method is used.

Reduced-Profit Method

This method is appropriate in those situations where the bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements of the full accrual method. Like the installment method, any profit is recognized as payments are received. However, profit recognition is based on the present value of the lowest level of periodic payments required under the loan agreement. This method is seldom used in practice because sales with adequate down payments are generally not structured with inadequate loan amortization requirements.

Deposit Method

The deposit method is used in situations where a sale of the real estate has not been consummated. It may also be used for dispositions that could be accounted for under the cost recovery method. Under this method a sale is not recorded and the asset continues to be reported as ORE. Furthermore, no profit or interest income is recognized. Payments received from the borrower are reported as a liability until sufficient payments or other events have occurred which allow the use of one of the other methods.

VALUATIONS AND CLASSIFICATION

Many states require institutions to obtain ORE appraisals or valuations when acquiring, holding, and/or disposing of real estate. Management should obtain ORE appraisals or valuations as required to ensure assets are reported at appropriate values and any material change in market conditions or physical property aspects is periodically recognized. If an institution is selling and financing the sale of an ORE parcel, Part 323 of the FDIC Rules and Regulations, Appraisals, and some state laws require updated appraisals or evaluations.

Examiners can test the general validity of appraised values by comparing the sale prices and appraised values of properties previously held. The fact of foreclosure is presumptive, but not conclusive, evidence that takeover value exceeds market or appraised value. Therefore, each parcel of ORE is to be reviewed and classified on its own merits.

Often a reliable appraisal may not be available or the appraisal on file may be suspect for various reasons. Nevertheless, a careful evaluation of all the relevant factors should enable the examiner to make an accurate and reliable judgment about a property's fair value less cost to sell with regard to classification. Any portion of the carrying value in excess of fair value less cost to sell should be classified Loss. The remaining carrying value should then be evaluated and adversely classified, if appropriate. Regulatory definitions of Substandard, Doubtful, and Loss (as discussed in the Loans section) should be utilized in the analysis of ORE holdings.

ORE VALUATION ALLOWANCE

As previously mentioned, a valuation allowance is established for each parcel of ORE during the holding period when the real estate's fair value minus the estimated costs to sell the real estate is less than the real estate's "cost." Call Report Instructions clarify that valuation allowances must be determined on an asset-by-asset basis. As a result, the individual valuation allowance should be subtracted from the related asset's "cost" to determine the property's carrying value, which is the amount subject to classification.

Valuation allowances on foreclosed properties being held for sale are not recognized as a component of regulatory capital. The risk-based capital standards permit only the "allowance for loan and lease losses" to be included in Tier 2 capital up to a maximum of 1.25% of risk-weighted assets.

INTRODUCTION

Assets and liabilities that are not reported in major balance sheet categories are generally reported in other asset or other liability categories. Although these items are listed in "other" categories, it does not mean the accounts are of less significance than items detailed in major categories. Intangible assets lack physical substance and are also reported separately on the balance sheet. The following pages include descriptions of common other assets, intangible assets, and other liabilities. Additional guidance and information is included in the Call Report Instructions and the Examination Documentation (ED) Module - Other Assets and Liabilities.

OTHER ASSETS

Accrued Income

All banks, regardless of size, shall prepare the Call Report on an accrual basis. Accrued income represents the amount of interest earned or accrued on earning assets and applicable to current or prior periods that has not yet been collected. Examples include accrued interest receivable on loans and investments. When income is accrued but not yet collected, a bank debits a receivable account and credits an applicable income account. When funds are collected, cash or an equivalent is debited, and the receivable account is credited.

The degree to which accrual accounts and practices are reviewed during an examination should be governed by the examination scope. When scoping examination procedures, examiners should consider the adequacy of a bank's internal control structure and the extent to which accrual accounting procedures are analyzed during audits.

When reviewing accrual accounts and practices, examiners should assess the general accuracy of the accrual accounting system and determine if accruals relate to items in default or to items where collection is doubtful. If accrued income accounts are materially overstated, examiners should consider the impact to overall profitability levels, classify overstated amounts as Loss, and recommend management amend Call Reports.

Tax Assets

Banks must estimate the amount of the current income tax liability (or receivable) to be reported on its tax returns. Estimating this liability (or receivable) may involve consultation with the bank's tax advisers, a review of the previous year's tax returns, the identification of significant expected differences between items of income and expense reflected on the Call Report and on the tax returns, and the identification of expected tax credits.

Deferred tax assets and liabilities represent the amount by which taxes receivable (or payable) are expected to increase or decrease in the future as a result of temporary differences and net operating losses or tax credit carryforwards that exist at the reporting date. When determining the current and deferred income tax assets and liabilities to be reported in any period, a bank's income tax calculation will contain an inherent degree of uncertainty surrounding the realizability of the tax positions included in the calculation.

A net deferred tax asset is reported if a debit balance results after offsetting deferred tax assets (net of valuation allowance) and deferred tax liabilities measured at the report date for a particular tax jurisdiction. If the result for a particular tax jurisdiction is a net credit balance, then a net deferred tax liability is reported. A bank may report a net deferred tax debit, or asset, for one tax jurisdiction, such as for federal income tax purposes, and also report at the same time a net deferred tax credit, or liability, for another tax jurisdiction, such as for state or local income tax purposes.

Temporary differences arise when an institution recognizes income or expense items on the books during one period, but records them for tax purposes in another period. For example a deductible temporary difference is created when a provision for loan and lease losses is expensed in one period for financial reporting purposes, but deferred for tax purposes until the loans are charged off in a subsequent period.

A bank sustains an operating loss when deductions exceed income for federal income tax purposes. An operating loss in a year following periods when the bank had taxable income may be carried back to recover income taxes previously paid. Banks may carry back operating losses for two years. Generally, an operating loss that occurs when loss carrybacks are not available (e.g., when losses occur in a year following periods of losses) becomes an operating loss carryforward. Banks may carry operating losses forward 20 years.

Tax credit carryforwards are tax credits that cannot be used for tax purposes in the current year, but which can be carried forward to reduce taxes payable in a future period.

Deferred tax assets are recognized for operating loss and tax credit carryforwards just as they are for deductable temporary differences. However, a bank can only recognize the benefit of a net operating loss, or a tax credit carryforward, to the extent the bank determines that a valuation allowance is not necessary. A valuation allowance must be recorded, if needed, to reduce the amount of deferred tax assets to an amount that is more likely than not to be realized. Examiners should obtain management's analysis and support for any deferred tax asset and valuation allowance reported for financial reporting purposes. Examiners should refer to the Call Report Glossary for guidance on income taxes and may contact the regional accounting specialist for further guidance in cases involving significant amounts of net deferred tax assets.

Part 325 of the FDIC Rules and Regulations, Capital Maintenance (Part 325), establishes limitations on the amount of deferred tax assets that can be included in Tier 1 capital. The maximum allowable amount is limited to the lesser of: the amount of deferred tax assets dependent upon future taxable income expected to be realized within one year of the calendar quarter-end date, based on projected future taxable income for that year; or ten percent of the amount of Tier 1 capital that exists before certain deductions. Refer to Part 325 for more details.

Interest-Only Strips

Accounting standards for interest-only strips receivable are set forth in ASC 860, Transfers and Servicing (formerly FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as amended by FAS 156, Accounting for Servicing of Financial Assets, FAS 166, Accounting for Transfers of Financial Assets, and certain other standards). ASC 860 defines interest-only strips receivable as the contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset.

Financial assets such as interest-only strips receivable, that can contractually be prepaid or otherwise settled in such a way that the holder of the financial asset would not recover substantially all of its recorded investment do not qualify to be accounted for at amortized cost. Interest-only strips subsequently measured at fair value like available-for-sale securities are reported as other assets. Alternatively, interest-only strips may be reported as trading securities. Refer to the Call Report Instructions for additional details.

Equities without Readily Determinable Fair Values

An equity security does not have a readily determinable fair value if sales or bid-and-asked quotations are not currently available on a securities exchange registered with the Securities and Exchange Commission and are not publicly reported by the National Association of Securities Dealers Automated Quotations or the National Quotation Bureau. Equity securities that do not have readily determinable fair values may have been purchased by a bank or acquired for debts previously contracted, and may include items such as paid-in stock of a Federal Reserve Bank, stock of a Federal Home Loan Bank, and stock of a bankers' bank. Refer to the Call Report Instructions for additional details.

Bank-Owned Life Insurance Policies

The purchase of bank-owned life insurance (BOLI) can be an effective way for institutions to manage exposures arising from commitments to provide employee compensation and pre- and post-retirement benefits, and to protect against the loss of key persons.

Consistent with safe and sound banking practices, institutions must understand the risks associated with BOLI and implement a risk management process that provides for the identification and control of such risks. A sound pre-purchase analysis, meaningful ongoing monitoring program, reliable accounting process and accurate assessment of risk-based capital requirements are all components of a comprehensive risk management process.

The ability of state chartered banks to purchase life insurance is governed by state law. The safe and sound use of BOLI depends on effective senior management and board oversight. An institution's board of directors must understand the complex risk characteristics of the institution's insurance holdings and the role this asset plays in the institution's overall business strategy.

Each institution should establish internal policies and procedures governing its BOLI holdings, including guidelines that limit the aggregate cash surrender value (CSV) of policies from, any one insurance company, as well as the aggregate CSV of policies from all insurance companies. In general, it is not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25 percent of its Tier 1 capital. Therefore, an institution that plans to acquire BOLI in an amount that results in an aggregate CSV in excess of this concentration limit, or any lower internal limit, should gain prior approval from its board of directors or the appropriate board committee. In this situation, management is expected to justify that any increase in BOLI resulting in an aggregate CSV above 25 percent of Tier 1 capital does not constitute an imprudent capital concentration.

Management should conduct a thorough pre-purchase analysis to help ensure that the institution understands the risks, rewards, and unique characteristics of BOLI. The nature and extent of this analysis should be commensurate with the size and complexity of the potential BOLI purchases and should take into account existing BOLI holdings.

A comprehensive assessment of BOLI risks on an ongoing basis is especially important for an institution whose aggregate BOLI holdings represent a capital concentration. Management should analyze the financial condition of BOLI insurance carriers, review the performance of BOLI products, and report their findings to the board at least annually. More frequent reviews may be necessary if management anticipates additional BOLI purchases, a decline in an insurance carrier's financial condition, policy surrenders, or changes in tax laws that could affect BOLI products or performance.

Examiners should review the Interagency Statement on the Purchase and Risk Management of Life Insurance (Interagency Statement) when assessing an institution's BOLI program. Examiners should closely scrutinize risk management policies and controls associated with BOLI assets when an institution holds BOLI in an amount that approaches or exceeds 25 percent of Tier 1 capital. An institution holding life insurance in a manner inconsistent with safe and sound banking practices is subject to supervisory action. Where ineffective controls over BOLI risks exist, or the exposure poses a safety and soundness concern, supervisory action against the institution, may include requiring the institution to divest affected policies, irrespective of potential tax consequences.

ASC 325-30, Investments-Other – Investments in Insurance Contracts (formerly FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance, and Emerging Issues Task Force Issue No. 06-5, Accounting for Purchases of Life Insurance – Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4) addresses the accounting for BOLI. Only the amount that could be realized under an insurance contract as of the balance sheet date (that is, the CSV reported by the carrier, less any applicable surrender charges not reflected in the CSV) is reported as an asset. If a bank records amounts in excess of the net CSV of the policy, then the excess should be classified Loss.

For risk-based capital purposes, an institution that owns general account permanent insurance should apply a 100 percent risk weight to its claim on the insurance company. If an institution owns a separate account policy and can demonstrate that it meets certain requirements, it may choose to apply a look-through approach to the underlying assets to determine the risk weight. Refer to Call Report Instructions, the ED Module - Bank-Owned Life Insurance (BOLI), and the Interagency Statement for further details.

MISCELLANEOUS ASSETS

Miscellaneous assets that are not reported in major Balance Sheet or Other Asset categories should be reported separately under all other assets in the Call Report. Examples include derivative instruments held for purposes other than trading that have a positive fair value, computer software, and bullion. Some of the more common miscellaneous assets are described below.

Prepaid Expenses

Prepaid expenses are the costs that are paid for goods and services prior to the periods in which the goods or services are consumed or received. When the cost is prepaid, the payment is recorded as an asset because it represents a future benefit to the bank. In subsequent periods the asset is reduced (expensed) as the goods or services are used or rendered. At the end of each accounting period, the bank makes adjusting entries to reflect the portion of the cost that has expired during that period. The prepayment is often for a service for which the benefit is spread evenly throughout the year. As the service is provided, the prepaid expense is amortized to match the cost to the period it benefits. Examples of prepaid expenses include premiums paid for insurance, advance payments for leases or asset rentals, payments for stationery or other supplies that will be used over several months, and retainer fees paid for legal services to be provided over a specified period.

Examiners should ensure management accurately adjusts prepaid expenses to reflect exhausted purchased goods or services. Prepaid expenses that are recorded and amortized in accordance with generally accepted accounting principles should not be adversely classified. However, any prepaid expense that is overstated should be classified Loss.

Repossessed Personal Property

Repossessed personal property such as automobiles, boats, equipment, and appliances, represents assets acquired for debts previously contracted. A bank that receives assets from a borrower in full satisfaction of a loan, such as a receivable from a third party, an equity interest in the borrower, or another type of asset (except a long-lived asset that will be sold), will account for the asset at its fair value. An asset received in partial satisfaction of a loan should be accounted for as described above and the recorded amount of the loan should be reduced by the asset's fair value less the cost to sell. .Examiners should assess repossessed assets individually for possible adverse classification.

Suspense Accounts

Suspense accounts, also known as interoffice or clearing accounts, are temporary holding accounts in which items are carried until they can be identified and their disposition to the proper account is made. For example, items are included in suspense accounts when a transaction is coded incorrectly and cannot be processed immediately, when an account number is missing on a loan or deposit transaction, or when a check drawn on a deposit account at the bank is not properly endorsed. Most suspense items are researched and cleared the following day. The balances of suspense accounts as of the report date should not automatically be reported as Other Assets or Other Liabilities. Rather, the items included in these accounts should be reviewed and material amounts should be reported appropriately in the Call Report. Moreover, banks should regularly reconcile suspense accounts. Stale suspense items should be charged off when it is determined that they are uncollectible and should be classified Loss in the report of examination.

Cash Items Not In Process Of Collection

In contrast to those cash items that are in process of collection, cash items that are not paid when presented are referred to as cash items that are not in the process of collection. In general, cash items that are not in the process of collection occur when the paying bank has refused payment after being presented with the cash item. Once payment has been refused, the cash item immediately becomes not in process of collection and is reclassified as an Other Asset. Cash items not in the process of collection are frequently kept in a suspense account. Although collection efforts will continue, when it becomes clear that the cash item will not be paid, the bank should promptly charge off the cash item. It is common for the payee bank to refuse payment if the customer's deposit account had insufficient funds, the check was improperly endorsed, the checking account on which the check is drawn has been closed, or for some other acceptable reason.

Other Accrued Interest Receivables

Accrued interest on securities purchased (if accounted for separately from accrued interest receivable in the bank's records) and retained interests in accrued interest receivable related to securitized credit cards is reported in all other assets in the Call Report. Accrued interest receivable amounts that are overstated should be classified Loss.

In a typical credit card securitization, an institution transfers a pool of receivables and the right to receive the future collections of principal (credit card purchases and cash advances), finance charges, and fees on the receivables to a trust. If a securitization transaction qualifies as a sale, then the selling institution removes the receivables that were sold from its reported assets and continues to carry any retained interests in the transferred receivables on its balance sheet. An institution should treat this accrued interest receivable asset as a retained (subordinated) beneficial interest. Accordingly, it should be reported in all other assets in the Call Report and not as a loan receivable.

For further guidance refer to the Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations and the Call Report Instructions.

Indemnification Assets

Indemnification assets represent the carrying amount of the right to receive payments from the FDIC for losses incurred on specified assets acquired from failed insured depository institutions or otherwise purchased from the FDIC that are covered by loss-sharing agreements. Despite the linkage between them, the acquired covered assets and the indemnification asset, are treated as separate units of account. Each covered asset is reported in the appropriate category on the balance sheet. The indemnification asset is recorded at its acquisition-date fair value and is reported in all other assets in the Call Report.

Examiners should ensure the acquiring institution's financial and regulatory reporting is appropriate for the covered assets and the indemnification asset. Refer to the Call Report Instructions for further details.

INTANGIBLE ASSETS

Goodwill and Other Intangible Assets

Goodwill is an intangible asset that is commonly recognized as a result of a business combination. .Other intangible assets resulting from a business combination, such as core deposit intangibles, purchased credit card relationships, servicing assets, favorable leasehold rights, trademarks, trade names, internet domain names, and non-compete agreements, should be recognized as an asset separately from goodwill. This discussion will focus on intangible assets acquired through business combinations.

Goodwill represents the excess of the cost of a company over the sum of the fair values of the tangible and identifiable intangible assets acquired less the fair value of liabilities assumed in a business combination accounted for in accordance with ASC 805, Business Combinations (formerly FAS 141 (revised 2007), Business Combinations).

Push down accounting is the establishment of a new accounting basis for a bank in its separate financial statements as a result of it becoming substantially wholly owned via a purchase transaction or a series of purchase transactions. When push down accounting is applied, any goodwill is reflected in the separate financial statements of the acquired bank as well as in any consolidated financial statements of the bank's parent.

When measuring Tier 1 capital for regulatory capital purposes, institutions generally must deduct goodwill and other intangible assets (other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital). Refer to Part 325 for further information on the regulatory capital treatment of goodwill and intangible assets.

Accounting for Goodwill

After initial recognition, goodwill must be accounted for in accordance with ASC 350, Intangibles-Goodwill and Other (formerly FAS 142, Goodwill and Other Intangible Assets), which requires that goodwill be tested for impairment at least annually.

Goodwill is considered impaired when the amount of goodwill exceeds its implied fair value at the reporting unit level. An impairment loss must be recognized in earnings. After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill shall be its new accounting basis. Subsequent reversal of a previously recognized goodwill impairment loss is prohibited once the measurement of that loss is completed. Goodwill of a reporting unit must be tested for impairment annually and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Examples of such events or circumstances include a significant adverse change in the business climate, unanticipated competition, a loss of key personnel, and an expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed. In addition, goodwill must be tested for impairment after a portion of goodwill has been allocated to a business to be disposed.

A bank may not remove goodwill from its balance sheet, for example, by selling or upstreaming this asset to its parent holding company or another affiliate.

Other intangible assets that have indefinite useful lives should not be amortized but must be tested at least annually for impairment. Intangible assets that have finite useful lives must be amortized over their useful lives and must be reviewed for impairment.

Refer to the Call Report Instructions for further details.

Servicing Assets

The right to service assets is represented by the contractual obligations undertaken by one party to provide servicing for mortgage loans, credit card receivables, or other financial assets for another. Servicing includes, but is not limited to, processing principal and interest payments, maintaining escrow accounts for the payment of taxes and insurance, monitoring delinquencies, and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicers typically receive certain benefits from the servicing contract and incur the costs of servicing the assets.

Servicing is inherent in all financial assets; however, it becomes a distinct asset or liability only when contractually separated from the underlying financial assets by sale or securitization with servicing retained or by a separate purchase or assumption of the servicing rights and responsibilities. Whenever an institution undertakes an obligation to service financial assets, a servicing asset or liability must be recognized unless the institution securitizes the assets, retains all of the resulting securities, and classifies the securities as held-to-maturity.

Accounting

Accounting and reporting standards for asset and liability servicing rights are set forth in ASC 860-50, Transfers and Servicing – Servicing Assets and Liabilities (formerly FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as amended by FAS 156, Accounting for Servicing of Financial Assets, and FAS 166, Accounting for Transfers of Financial Assets), and ASC 948, Financial Services-Mortgage Banking (formerly FAS 65, Accounting for Certain Mortgage Banking Activities, as amended by FAS 140).. Servicing assets result from contracts to service financial assets for which the servicing benefits (revenues from contractually specified servicing fees, late charges, and other ancillary sources) are expected to more than adequately compensate the servicer. Contractually specified servicing fees are all amounts that, per contract, are due to a servicer in exchange for servicing the financial assets and which would no longer be received by a servicer if the contract for servicing were shifted to another servicer.

A bank must recognize and initially measure at fair value a servicing asset or a servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in either of the following situations:

- The bank's transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset that meets the requirements for sale accounting; or
- An acquisition or assumption of a servicing obligation that does not relate to financial assets of the bank or its consolidated affiliates included in the Call Report.

If a bank sells a participating interest in an entire financial asset, it only recognizes a servicing asset or servicing liability related to the participating interest sold.

A bank should subsequently measure each class of servicing assets and servicing liabilities using either the amortization method or the fair value measurement method. Once a bank elects the fair value measurement method for a class of servicing, that election must not be reversed.

Under the amortization method, all servicing assets or servicing liabilities in the class should be amortized in proportion to, and over the period of, estimated net servicing income for assets (servicing revenues in excess of servicing costs) or net servicing loss for liabilities (servicing costs in excess of servicing revenues). The servicing assets or servicing liabilities should be assessed for impairment or increased obligation based on fair value at each quarter-end Call Report date. The servicing assets within a class should be stratified into groups based on one or more of the predominant risk characteristics of the underlying financial assets. If the carrying amount of a stratum of servicing assets exceeds its fair value, the bank should separately recognize impairment for that stratum by reducing the carrying amount to fair value through a valuation allowance for that stratum. The valuation allowance should be adjusted to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. For the servicing liabilities within a class, if subsequent events have increased the fair value of the liability above the carrying amount of the servicing liabilities, the bank should recognize the increased obligation as a loss in current earnings.

Under the fair value measurement method, all servicing assets or servicing liabilities in a class should be measured at fair value at each quarter-end report date. Changes in the fair value of these servicing assets and servicing liabilities should be reported in earnings in the period in which the changes occur.

Institutions that sell only a limited number of financial assets with servicing retained and do not otherwise actively purchase or sell servicing rights may determine that the servicing activity is immaterial. Typically, these institutions will have a relatively low volume of financial assets serviced for others and the value of any servicing assets and liabilities would likewise be immaterial. Management must provide a reasonable basis for not reporting servicing activity. Refer to the Servicing Liabilities section below and the Call Report Instructions for further details.

Valuation

The fair value of servicing assets and liabilities is determined in accordance with ASC 820, Fair Value Measurements and Disclosures (formerly FAS 157, Fair Value Measurements) that defines fair value and establishes a framework for measuring fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the asset's or liability's principal (or most advantageous) market at the measurement date. This value is often referred to as an exit price. ASC 820 establishes a three level fair value hierarchy that prioritizes inputs used to measure fair value based on observability. The highest priority is given to Level 1 (observable, unadjusted) and the lowest priority to Level 3 (unobservable).

Valuation techniques consistent with the market approach, income approach, and/or cost approach should be used to measure fair value, as follows:

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.

The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multi period excess earnings method.

The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

When the discounted cash flow approach is used to measure the fair value of servicing assets, a number of factors and assumptions are considered when projecting the potential income stream (net of servicing costs) generated by the servicing rights. This income stream is present valued using appropriate market discount rates to determine the estimated fair value of the servicing rights. These factors and assumptions, which should be adequately documented, include:

- Average loan balance and coupon rate,
- Average portfolio age and remaining maturity,
- Contractual servicing fees,
- Estimated income from escrow balances,
- Expected late charges and other possible ancillary income,
- Anticipated loan balance repayment rate (including estimated prepayment speeds),
- Direct servicing costs and appropriate allocations of other costs, as well as the inflation rate effect, and
- Delinquency rate and estimated out-of-pocket foreclosure and collection costs that will not be recovered.

Regulatory Capital

Part 325 provides information on the regulatory capital treatment of mortgage servicing assets and nonmortgage servicing assets.

For purposes of calculating Tier 1 capital, the balance sheet assets for mortgage servicing assets and nonmortgage servicing assets will each be reduced to an amount equal to the lesser of:

- 90 percent of the fair value of these assets; or
- 100 percent of the remaining unamortized book value of these assets (net of any related valuation allowances).

The total amount of mortgage servicing assets, nonmortgage servicing assets, along with purchased credit card relationships recognized for regulatory purposes (i.e., not deducted from assets and capital) is limited to no more than 100 percent of Tier 1 capital. In addition to the aggregate limitation on such assets, the maximum allowable amount of purchased credit card relationships and nonmortgage servicing assets, when combined, is limited to 25 percent of Tier 1 capital. These limitations are calculated before the deduction of any disallowed servicing assets, disallowed purchased credit card relationships, disallowed credit-enhancing interest-only strips, disallowed deferred tax assets, and any nonfinancial equity investments. In addition, banks may elect to deduct disallowed servicing assets on a basis that is net of any associated deferred tax liability.

Servicing Risk

Examiners should be aware of the risks that can affect an institution from the failure to follow the servicing rules related to securitized assets. While credit risk may appear to be of little or no concern, the mishandling of procedures in these transactions can affect a holder's ability to collect. Financial institutions perform roles as sellers, buyers, servicers, trustees, etc., in these types of transactions. Examiners should evaluate the potential risks that might arise from one or more of these roles. In most cases, the government agency that provided the guarantee or insurance against ultimate default will also impose guidelines and regulations for the servicer to follow. If the servicer or others involved in the servicing function fail to follow these rules and guidelines, then the government agency that is providing the guarantee or insurance may refuse to honor its commitment to insure all parties against loss due to default. It is necessary for the financial institution to have adequate policies and procedures in place to control and limit the institution's liability and exposure in this regard.

Examination Procedures

When assessing asset quality during onsite examinations and when reviewing merger applications, examiners and supervisory personnel should review the valuation and accounting treatment of servicing assets. The ED Module - Mortgage Banking contains various examination procedures and references for reviewing mortgage servicing assets.

OTHER LIABILITIES

Other Borrowed Money

Mortgages, liens, and other encumbrances on premises and other real estate owned, and obligations under capitalized leases, which the bank is legally obligated to pay, are reported as other borrowed money in the Call Report. Regardless of the mortgage amount outstanding on bank premises, the asset should be carried on the general ledger at historical cost net of accumulated depreciation. ASC 840 establishes generally accepted accounting principles regarding lease transactions that must be accounted for as a property acquisition financed with a debt obligation

Additional information on premises and leases is included in the Premises and Equipment section of this Manual.

Accrued Expenses

Expenses are also reported in the Call Report on the accrual basis of accounting that records revenues when realized or realizable and earned, and expenses when incurred. This attempt to match expenses incurred during a period to the revenues that they helped generate is known as the matching principle. At the end of each reporting period, but no less frequently than quarterly, bank management needs to make appropriate entries to record accrued expenses. Interest on deposits accrued through charges to expense during the current or prior periods, but not yet paid or credited to a deposit account, are reported as other liabilities in the Call Report. Likewise, the amount of income taxes, interest on nondeposit liabilities, and other expenses accrued through charges to expense during the current or prior periods, but not yet paid, are reported as other liabilities.

Servicing Liabilities

As noted under Servicing Assets, servicers typically receive certain benefits from a servicing contract and incur costs of servicing the assets. The accounting and reporting standards addressing servicing rights (i.e., assets and liabilities) are set forth in ASC 860-50. Servicing liabilities result from contracts to service financial assets for which the benefits of servicing are not expected to adequately compensate the servicer. Banks must initially measure a servicing liability at fair value and subsequently measure each class of servicing liabilities using either the amortization method or the fair value measurement method. The election of the subsequent measurement method should be made separately for each class of servicing liabilities. Refer to the Call Report Instructions for further details.

Deferred Tax Liabilities

As noted under Tax Assets, a net deferred tax liability is reported if a net credit balance results after offsetting deferred tax assets (net of valuation allowance) and deferred tax liabilities measured at the report date for a particular tax jurisdiction. A bank may report a net deferred tax debit, or asset, for one tax jurisdiction, and also report at the same time a net deferred tax credit or liability, for another tax jurisdiction.

Deferred tax liabilities are recognized for taxable temporary differences. For example, depreciation can result in a taxable temporary difference if a bank uses the straight-line method to determine the amount of depreciation expense to be reported in the Call Report but uses an accelerated method for tax purposes. In the early years, tax depreciation under the accelerated method will typically be larger than book depreciation under the straight-line method. During this period, a taxable temporary difference originates. Tax depreciation will be less than book depreciation in the later years when the temporary difference reverses. Other taxable temporary differences include the undistributed earnings of unconsolidated subsidiaries and associated companies and amounts funded to pension plans that exceed the recorded expense.

Allowance for Off-Balance Sheet Exposures

Each bank should maintain, as a separate liability account, an allowance at a level that is appropriate to cover estimated credit losses associated with off-balance sheet credit instruments such as loan commitments, standby letters of credit, and guarantees. This separate allowance should be reported as an other liability, not as part of the allowance for loan and lease losses. The allowance for credit losses on off-balance sheet exposures should meet the criteria for accrual of a loss contingency set forth in generally accepted accounting principles.

All Other Miscellaneous Liabilities

Examiners will encounter other miscellaneous liabilities not reported in major Balance Sheet or Other Liability categories that should be reported separately in all other liabilities in the Call Report. Examples include accounts payable, deferred compensation payable, dividends declared but not yet paid, and derivative instruments held for purposes other than trading that have a negative fair value.

INTRODUCTION

Off-balance sheet activities include items such as loan commitments, letters of credit, and revolving underwriting facilities. Institutions are required to report off-balance sheet items in conformance with Call Report Instructions. The use of off-balance sheet activities may improve earnings ratios because earnings generated from the activities are included in the income numerator, while the balance of total assets included in the denominator remains unchanged.

Examiners should review the risks and controls associated with off-balance sheet activities during examinations. Reviews should consider the adequacy of items such as:

- Policies, practices, and internal controls;
- Conformance with applicable laws and internal bank guidelines;
- Credit quality and collectability of off-balance-sheet credit items; and
- Board oversight and audit activities.

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OFF-BALANCE SHEET LENDING ACTIVITIES

When reviewing off-balance sheet lending activities, examiners should apply the same general examination techniques they use when evaluating a direct loan portfolio. For example, examiners should consider the adequacy of internal controls and board-approved policies at banks with a material level of off-balance sheet lending activities. Comprehensive policies generally address issues such as underwriting standards, documentation and file maintenance requirements, collection and review procedures, officer lending limits and customer borrowing limits, board and loan committee approval requirements, and board reporting requirements. Generally, overall limits on contingent liabilities and specific sub-limits on various types of off-balance sheet lending activities, either as a dollar amount or as a relative percentage (such as a percent of total assets or capital), are also often addressed.

When evaluating individual credit lines, examiners should review all of a customer's borrowing arrangements with the bank (e.g., direct loans, letters of credit, and loan commitments). Other factors analyzed during direct loan reviews, such as collateral protection and the borrower's financial condition, repayment history, and ability/willingness to pay are also applicable when reviewing contingent liabilities such as letters of credit and loan commitments.

When analyzing off-balance sheet lending activities, examiners should evaluate the probability that lines will be funded and, if applicable, whether loss allowances adequately reflect off-balance sheet credit risks. Such allowances should not be included as part of the general allowance for loan and lease losses (ALLL). Credit exposures on financial instruments with off-balance sheet credit risk should be recorded separate from the ALLL related to a recognized financial instrument (i.e., an on-balance sheet financial asset). Allowances for off-balance sheet credit exposures are reported in Call Report Schedule RC-G - Other Liabilities.

Examiners should also consider standby letters of credit when determining legal limitations on loans to one borrower and compliance with Section 337.2(b) of the FDIC Rules and Regulations.

Letters of Credit

A letter of credit (LOC) is a document issued by a bank on behalf of its customer authorizing a third party to draw drafts on the bank up to a stipulated amount under specific terms and conditions. A letter of credit is a conditional commitment (except when prepaid by the account party) on the bank's part to pay drafts drawn in accordance with the document's terms. There are four basic types of letters of credit: travelers, sold for cash, commercial, and standby.

Travelers – A travelers letter of credit is addressed by the bank to its correspondents authorizing drafts by the person named in accordance with specified terms. These letters are generally sold for cash.

Sold for Cash – When a letter of credit is sold for cash, the bank receives funds from the account party at the time of issuance. This letter is not reported as a contingent liability, but rather as a demand deposit.

Commercial – A commercial letter of credit is issued to facilitate trade or commerce. Generally, drafts are drawn upon when the underlying transaction is consummated as intended. Commercial letters of credit not sold for cash represent contingent liabilities. Refer to the International Banking section of this Manual for further details on commercial letters of credit.

Standby – A standby letter of credit (SBLC) is an irrevocable commitment on the part of the issuing bank to make payment to a designated beneficiary. Payments to a beneficiary are guaranteed in exchange for an ongoing, periodic fee throughout the life of the letter. An SBLC can be either financial-oriented, where the account party is to make payment to the beneficiary, or performance-oriented, where a service is to be performed by the account party. SBLCs are issued for a variety of purposes, such as to improve the credit rating of a beneficiary, to assure performance under construction contracts, and to ensure the beneficiary satisfies financial obligations payable to major suppliers.

ASC Topic 460, Guarantees, clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. ASC Topic 460 applies to standby letters of credit, both financial and performance. Commercial letters of credit and other loan commitments, commonly thought of as funding guarantees, are not included in the scope of ASC Topic 460 because those instruments do not guarantee payment of a money obligation and do not provide for payment in the event of default by the account party.

While no particular form is required, SBLC documents generally contain certain descriptive information. The first item generally includes a separate binding agreement wherein the account party agrees to reimburse the bank for any payments made under the SBLC. The actual letter is often labeled as a standby letter of credit, specifies a stipulated amount, covers a specific period, and details relevant information that must be presented to the bank before any draws will be honored due to the account party's failure to perform. Most SBLCs are carefully worded so that the bank is not involved in making any determinations of fact or law at issue between the account party and the beneficiary.

The primary risks relative to SBLCs are credit risk (the possibility of default on the part of the account party), and funding risk (the potential inability of the bank to fund a large draw from normal sources). An SBLC is a potential extension of credit and should be evaluated in a manner similar to direct loans. The credit risk could be significant under an SBLC given its irrevocable nature, especially if the SBLC is written for an extended period. Generally, a bank can rescind a direct loan commitment to a customer if the customer's financial condition deteriorated and the loan commitment contained an adverse-change clause. However, such would not be applicable with an SBLC since it is an irrevocable agreement between the bank and the beneficiary.

An SBLC can be participated or syndicated. Unlike loans, however, the sale of SBLC participations does not diminish the total contingent liability of the issuing bank. The name of the issuing bank is on the actual letter of credit, and the bank must therefore honor all drafts whether or not the participants are willing or able to disburse their pro rata share. Syndications, on the other hand, represent legal apportionments of liability. If one bank fails to fulfill its obligation under the SBLC, the remaining banks are not liable for that bank's share.

Section 337.2(d) of the FDIC Rules and Regulations requires banks to maintain adequate controls and subsidiary records of SBLCs, comparable to records maintained on direct loans, so that a bank's total liability may be determined at all times. Banks are also required to reflect all SBLCs on published financial statements. Consistent with Section 337.2(d) credit files should reflect the current status of SBLCs, and adequate reports regarding the types and volume of SBLCs should be maintained. These reports enable management and the board to monitor credit risks and identify potential concentrations so that appropriate action can be taken, if needed, to reduce undue exposure.

Examiners should assess the need to adversely classify or designate as Special Mention an SBLC if draws under the facility are probable and credit weaknesses exist. For example, deterioration in the account party's financial condition could jeopardize performance under the letter of credit and result in a draw by the beneficiary. If a draw occurs, the offsetting loan to the account party may become a collection problem, especially if it is unsecured.

Loan Commitments

A loan commitment is a written agreement, signed by the borrower and bank, detailing the terms and conditions under which the bank will fund a loan. The commitment will specify a funding limit and have an expiration date. For agreeing to make the accommodation, the bank may require a fee and/or maintenance of a stipulated compensating deposit balance from the customer. A commitment can be irrevocable (like an SBLC facility) and operate as a contractual obligation by the bank to lend when requested by the customer. Generally, commitments are conditioned on the customer maintaining a satisfactory financial position and the absence of defaults in other covenants. A bank may also enter into an agreement to purchase loan commitments from another institution, which should be reflected as off-balance sheet items, until the sale is consummated. Loan commitments related to mortgage loans that will be held for sale are discussed in the Mortgage Banking Section below.

Some types of commitments are expected to be drawn upon, such as a revolving working capital line to fund operating expenses or a term loan facility for equipment purchases or developing a property. Other commitments serve as backup facilities, such as for commercial paper, whereby draws would not be anticipated unless the customer is unable to retire or roll over the issue at maturity.

Less detailed than a formal loan commitment, is a line of credit, which expresses to the customer, usually by letter, a willingness by the bank to lend up to a certain amount over a specified period. This type of facility is disclosed to the customer and referred to as *advised* or *confirmed* lines, in contrast to *guidance* lines, which are not made known to the customer, but are merely used by the bank as lending guidelines for internal control or operational purposes. Many lines of credit are cancelable if the customer's financial condition deteriorates, while others are simply subject to cancellation at the bank's option.

Disagreements can arise as to what constitutes a legally binding commitment on the part of the bank. For example, a credit arrangement could be referred to as a *revocable line of credit*, but at the same time, it may be a legally binding commitment to lend if consideration has been given by the customer and the terms of the agreement between the parties result in a contract. When appropriate, examiners should consider the extent of the bank's legal obligation to fund commitments designated as revocable to ensure that obligations are properly documented and legally defensible should the bank need to cancel a loan commitment.

Credit documentation often contains a *material adverse change* (MAC) clause, which is intended to allow the bank to terminate the commitment or line of credit arrangement if the customer's financial condition deteriorates. The extent to which a MAC clause is enforceable depends on whether a legally binding relationship continues if specific financial covenants are violated. Although the enforceability of MAC clauses may be subject to some uncertainty, such clauses may provide the bank with leverage in negotiations with the customer over issues such as requests for additional collateral or personal guarantees.

Whether a bank will fund a loan commitment or line of credit cannot always be easily determined; therefore, careful analysis is often necessary. A MAC clause may allow the bank to decline funding to a borrower that defaulted on a loan covenant. Some banks may decline funding requests if any covenant is broken, whereas others might be more accommodative and make advances unless a borrower appears likely to file bankruptcy. The procedures followed by the bank, in acceding to or denying funding requests involving adverse conditions commonly factor in a borrower's financial condition, credit history, and repayment prospects. These factors are also important considerations in the examiner's overall evaluation of credit risk.

Examiners should consider the type, volume, and anticipated funding of loan commitments and lines of credit when assessing a bank's funds-management program and rating the liquidity position. Examiners should review internal management reports estimating the amount of commitments that require funding over various periods. For further information, refer to the Liquidity and Funds Management section of this Manual.

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TRANSFERS OF FINANCIAL ASSETS

Mortgage Banking

Commitments to originate mortgage loans that will be held for sale often include interest rate lock commitments. In general, rate lock commitments are agreements to extend credit to a borrower at a specified interest rate. The agreements, which can involve fixed or floating rate commitments, protect borrowers from rising interest rates while loan applications are being processed.

Interest rate lock commitments on mortgage loans that will be held for sale are derivatives and must be recorded at fair value *on* the balance sheet as either an asset or liability. The commitments are reported as over-the-counter written options on schedule RC-L, Derivatives and Off-Balance Sheet Items, along with its notional amount.

Banks often enter into an agreement with an investor to sell mortgage loans that are originated under mandatory-delivery or best-efforts contracts. Mandatory-delivery and best-efforts contacts that meet the definition of a derivative are reported on the balance sheet at fair value and on schedule RC-L as forward loan sales commitments. In lieu of entering into a best efforts or mandatory-delivery contract, a bank may use the securitization market as a facility for selling originated mortgage loans.

A bank may not offset derivatives with negative fair values (liabilities) against those with positive fair value (assets), unless the criteria for *netting* under U.S. GAAP have been satisfied. Further, a bank may not offset the fair value of forward loan sales commitments against the fair value of derivative loan commitments of mortgage loans held for sale because the commitments typically have different counterparties.

Commitments to originate mortgage loans that will be held for investment purposes and commitments to originate other types of loans require evaluation to determine whether the commitments meet the criteria of a derivative. Often, these commitments to lend will not meet the net settlement requirement under ASC Topic 815 and would not be considered derivatives. Unused portions of loan commitments not considered derivatives are reported as off-balance sheet items if the aggregate amount individually exceeds 10 percent of the bank's equity capital.

The accounting and reporting standards for derivative activities are set forth in ASC Topic 815, Derivatives and Hedging and in ASC Topic 948, Financial Services - Mortgage Banking. ASC Topic 815 requires all derivatives to be recognized on the balance sheet as either assets or liabilities at their fair value. Additional information is available in the Capital Markets Handbook, the Call Report Glossary, and the instructions for RC-L, Derivatives and Off-Balance Sheet Items.

Financial Assets Sold Without Recourse

Financial assets sold without recourse, where the bank has surrendered control and meets the other conditions of a sale under ASC Topic 860, are accounted for as loan sales. In the case of loan participations, the transfer of a portion of an entire financial asset must meet the definition of a participating interest. If the transfer of a portion of a financial asset qualifies as a participating interest, and the other conditions for sale are met, the bank is required to allocate the previous carrying amount of the loan between the participating interest sold and the participating interest it continues to hold based on relative fair values as of the date of transfer. Further discussion of loan participations is contained in the Loans section of this Manual.

If, as a result of a change in circumstances, a selling bank regains control of a transferred financial asset that was previously accounted for as a sale, the change should generally be accounted for in the same manner as a purchase of a transferred financial asset from the purchaser in exchange for the liability assumed. If a transfer of the financial asset does not meet the conditions for sale treatment, the transferring bank and the acquiring transferee shall account for the transfer as a secured borrowing with pledge of collateral.

Financial Assets Sold With Recourse

Financial assets transferred with recourse may or may not qualify for sales treatment under U.S. GAAP. In some circumstances, recourse provisions could mean that the transferred financial asset(s) have not been isolated beyond the reach of the transferring bank or its consolidated affiliates, i.e., the first criteria under ASC 860 for sales treatment. For example, when an insured bank transfers loan participation with recourse, the participation generally will not be considered isolated from the selling bank in the event of FDIC receivership. Section 360.6 of FDIC Rules and Regulations limits the Corporation's ability to reclaim loan participations *without recourse* as defined in the regulation, but does not limit the Corporation's ability to reclaim loan participations *with recourse*. Recourse provisions in loan participations sold prior to January 1, 2002, do not necessarily preclude sale accounting for the transfer. Refer to Manual Section 3.2 - Loans for additional information.

If the financial asset transfer, e.g., a loan sale, qualifies as a sale under ASC Topic 860, the bank shall remove the transferred asset from the balance sheet, recognize and initially measure the fair value of the servicing asset or liability (if applicable) and any other asset obtained or liability incurred, before recognizing the gain or loss on the sale. Transfers of financial assets not meeting sales treatment are accounted for as secured borrowings.

If an asset transfer that qualifies for sale treatment under U.S. GAAP contains certain recourse provisions, the transaction would be treated as an asset sale with recourse for purposes of reporting risk-based capital information in Schedules RC-R and RC-S within the Call Report. When reviewing assets sold with recourse, examiners should consider the recourse attributes when calculating risk-based capital. For further information, refer to the Call Report Glossary under Transfers of Financial Assets, ASC Topic 860, and Part 324 of the FDIC Rules and Regulations.

Recourse and Direct Credit Substitutes

A recourse obligation or direct credit substitute may arise when a bank transfers assets in a sale and retains an obligation to repurchase the assets or absorb losses. The repurchase or absorption of losses may be due to a default of principal or interest or any other deficiency in the performance of the underlying obligor. Recourse may also exist implicitly where a bank provides credit enhancements beyond any contractual obligation to support assets it sold.

When an examiner encounters recourse arrangements or direct credit substitutes (commonly found in securitization and mortgage banking operations), they should refer to the Call Report instructions, Part 324 of the FDIC Rules and Regulations, and ASC Topics 815 and 860.

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OFF-BALANCE SHEET CONTINGENT LIABILITIES

Bankers Acceptances

The following discussion refers to the roles of accepting and endorsing banks in bankers acceptances. It does not apply to banks purchasing other banks' acceptances for investment purposes, which is described in the Other Assets and Liabilities section of this Manual. Bankers acceptances may represent either a direct or a contingent liability of the bank. If the bank creates the acceptance, it constitutes a direct liability that must be paid on a specified future date. If a bank participates in funding an acceptance created by another bank, the liability resulting from such endorsement is only contingent in nature. In analyzing the degree of risk associated with these contingent liabilities, the financial strength and repayment ability of the accepting bank should be considered. Further discussion of bankers acceptances is contained in the International Banking section of this Manual under the heading Forms of International Lending and in the Glossary of the Instructions for the Call Report.

Revolving Underwriting Facilities

A revolving underwriting facility (RUF) (also referred to as a note issuance facility) is a commitment by a group of banks to purchase, at a fixed spread over some interest rate index, the short-term notes that the issuer/borrower is unable to sell in the Euromarkets, at or below the predetermined rate. In effect, the borrower anticipates selling the notes as funds are needed at money market rates, but if unable to do so, has the assurance that credit will be available under the RUF at a maximum spread over the stipulated index. A lead bank generally arranges the facility and receives a one-time fee, and the RUF banks receive an annual commitment or underwriting fee. When the borrower elects to draw down funds, placement agents arrange for a sale of the notes and normally receive compensation based on the amount of notes placed. The notes usually have a maturity range of 90 days to one year and the purchasers bear the risk of any default on the part of the borrower. There are also standby RUFs, which are commitments under which Euronotes are not expected to be sold in the normal course of the borrower's business.

An inability to sell notes in the Euromarkets could result from financial deterioration of the borrower, or from volatile, short-term market conditions, which precipitate a call by the borrower on the participating banks for funding under the RUF arrangement. The evaluation of RUFs by the examiner should follow the same procedures used for reviewing loan commitments. An adverse classification should be accorded if it is determined that a loan of inferior quality will be funded under a RUF.

Standby LOC Issued By Another Depository Institution

Standby letters of credit issued by another depository institution (such as a correspondent bank), a Federal Home Loan Bank (FHLB), or another entity on behalf of a bank are potential future obligations for the bank that are reported as other off-balance sheet liabilities. Often, an FHLB will offer SBLC products to secure uninsured public deposits (i.e., deposit balances from public entities exceeding FDIC insurance limits, which may require additional protection due to state laws). Banks may choose this option as an alternative to pledging liquid assets such as U.S. Treasury securities. However, this does not mean the bank is free of asset encumbrance. As part of the SBLC agreement, the FHLB agreements may require collateral, but from a wider variety of assets, such as loans or other types of securities.

It is important to assess the implications for pledging requirements and contingent funding availability when a bank uses SBLCs to meet public deposit collateral requirements. The Call Report can serve as an initial source to gauge an institution’s involvement in this activity. Schedule RC-L, item 9.c requires banks to report SBLCs if the total amount is greater than 25 percent of total equity capital (reported in Schedule RC, item 27.a).

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ADVERSELY CLASSIFIED CONTINGENT LIABILITIES

Category I contingent liabilities are defined as liabilities that will give rise to a corresponding increase in bank assets if the contingencies convert into actual liabilities. Such contingencies should be evaluated for credit risk and if appropriate, listed for Special Mention or adverse classification. This examination treatment does not apply to Category II contingent liabilities where there will be no equivalent increase in assets if a contingency becomes a direct liability. Examination treatment of Category II contingencies is covered under Contingent Liabilities in the Capital section of this Manual.

The classification of Category I contingencies is dependent upon two factors: the likelihood of the liability becoming direct and the credit risk of the potential acquired asset. Examiners should refer to the Report of Examination Instructions and the Bank of Anytown contained in this Manual for Report of Examination treatment when considering to list contingent liabilities as special mention or to assign adverse classifications.

Adverse classification and Special Mention definitions for direct loans are set forth in the Loans section of this Manual. The following adverse classification and Special Mention criteria should be viewed as a supplement to those definitions when evaluating contingent liability credit risk.

Special Mention – The chance of the contingency becoming an actual liability is at least reasonably possible, and the potentially acquired assets are considered worthy of Special Mention. An example would be the undrawn portion of a poorly supervised accounts receivable line where the drawn portion is listed for Special Mention.

Substandard – The chance of the contingency becoming an actual liability is at least reasonably possible, and the potentially acquired assets are considered no better than Substandard quality. Undisbursed loan funds in a speculative real estate venture in which the disbursed portion is classified Substandard and the probability of the bank acquiring the underlying property is high, would be an example of a Substandard contingency.

Doubtful – The chance of the contingency becoming an actual liability is probable, and the potentially acquired assets are considered of Doubtful quality. Undisbursed loan funds on an incomplete construction project wherein cost overruns or diversion of funds will likely result in the bank sustaining significant loss from disposing the underlying property could be an example of a Doubtful contingency.

Loss – The chance of the contingency becoming an actual liability is probable, and the potentially acquired assets are not considered of bankable quality. A letter of credit on which the bank will probably be forced to honor draws that are considered uncollectible is an example of a Loss contingency. A Loss classification normally indicates that a balance sheet liability (specific reserve) should be established to cover the estimated loss. For further information as to when a contingency should be reflected as a direct liability on the balance sheet, refer to ASC Subtopic 450-20, Contingencies, Loss Contingencies.

INTRODUCTION

The quality of management is probably the single most important element in the successful operation of a bank. For purposes of this section, management includes both the board of directors, which is elected by the shareholders, and executive officers, who are appointed to their positions by the board. In the complex, competitive, and rapidly changing environment of financial institutions, it is extremely important for all members of bank management to be aware of their responsibilities and to discharge those responsibilities in a manner which will ensure stability and soundness of the institution, so that it may continue to provide to the community the financial services for which it was created.

The extreme importance of a bank director's position is clearly emphasized by the fact that bank directors can, in certain instances, be held personally liable. Also, Congress has placed great emphasis on the role of bank management by passing legislation which allows regulatory authorities to utilize "cease and desist" actions against individuals (instead of solely against the institution) to assess civil money penalties (CMPs), and even remove an officer, director, or other person participating in the affairs of the bank when their gross negligence or disregard for safety and soundness considerations threatens the financial safety of the bank.

The board of directors is the source of all authority and responsibility. In the broadest sense, the board is responsible for formulation of sound policies and objectives of the bank, effective supervision of its affairs, and promotion of its welfare. On the other hand, the primary responsibility of executive management is implementation of the board's policies and objectives in the bank's day-to-day operations. While selection of competent executive management is critical to the successful operation of any bank, the continuing health, viability, and vigor of the bank are dependent upon an interested, informed and vigilant board of directors. Therefore, the main thrust of this section is devoted to the powers, responsibilities, and duties vested in bank directors.

MANAGEMENT/DIRECTORS

Selection and Qualifications of Directors

Being selected to serve as a bank director is generally regarded as an honor, for it often denotes an individual's reputation as being successful in business or professional endeavors, public spirited, and entitled to public trust and confidence. It is this latter attribute and the public accountability implicit therein that distinguishes the office of bank director from directorships in most other corporate enterprises. Bank directors are not only responsible to the stockholders who elected them, but must also be concerned with the safety of depositors' funds and the influence the bank exercises on the community it serves.

Various laws governing the election of board members emphasize the importance of a director's position. Statutory or regulatory qualifications usually include taking an oath of office, unencumbered ownership of a specific amount of the bank's capital stock, and residential and citizenship requirements. Other laws also pertain to the qualification and selection of directors. There are, for example, certain restrictions, prohibitions, and penalties relating to: interlocking directorates; purchases of assets from or sales of assets to directors; commissions and gifts for procuring loans; and criminal activities such as embezzlement, abstraction, willful misapplication, making false entries, and improper political contributions. These qualifications and restrictions have no counterpart in general corporate law and both illustrate and emphasize the quasi-public nature of banking, the unique role of the bank director, and the grave responsibilities of that office. The position of bank director is one, therefore, not to be offered or entered into lightly.

Aside from the legal qualifications, each director should bring to the position particular skills and experience which will contribute to the composite judgment of the group. Directors should have ideas of their own and the courage to express them, sufficient time available to fulfill their responsibilities, and be free of financial difficulties which might tend to embarrass the bank. The one fundamental and essential attribute, which all bank directors must possess without exception, is personal integrity. Its presence usually gives assurance of a well-intentioned, interested and responsible director capable of assuming the important fiduciary responsibilities of the office and representing fairly and equitably the diverse interests of stockholders, depositors and the general public. The Statement Concerning the Responsibilities of Bank Directors and Officers states that the duties of loyalty (to administer the affairs of the bank with candor, personal honesty and integrity) and care (to act as prudent and diligent business persons in conducting the affairs of the bank) are among the most important responsibilities of bank directors. Other desirable personal characteristics include: knowledge of the duties and responsibilities of the office; genuine interest in performing those duties and responsibilities to the best of their ability; capability to recognize and avoid potential conflicts of interest, or the appearance of same, which might impair their objectivity; sound business judgment and experience to facilitate understanding of banking and banking problems; familiarity with the community and trade area the bank serves and general economic conditions; and an independence in their approach to problem solving and decision making.

Powers, Duties and Responsibilities of Directors

The powers, duties and responsibilities of the board of directors are usually set forth in the applicable banking statutes and the bank's charter and bylaws. Generally speaking, the powers and responsibilities of bank directors include but are not limited to those discussed below.

Regulating the Manner in Which All Business of the Bank is Conducted

Directors must provide a clear framework of objectives and policies within which executive officers operate and administer the bank's affairs. These objectives and policies should, at a minimum, cover investments, loans, asset/liability and funds management, profit planning and budgeting, capital planning, internal routine and controls, audit programs, conflicts of interest, code of ethics, and personnel. Specialty areas, such as the Bank Secrecy Act (BSA), Information Technology (IT), Trust Department activities, and consumer compliance should also be subject to similar appropriate oversight and internal guidelines. Objectives and policies in most instances should be written and reviewed periodically to determine that they remain applicable. Examiners may encounter situations (often in smaller banks with control vested in one or a few individuals) where written policies have not been developed for these operational functions, and management is reluctant to do so on the grounds that such written guidelines are unnecessary. To a considerable degree, the necessity for written policies may be inferred from the results achieved by management. That is, if the examiner's assessment of the bank reflects that it is sound and healthy in virtually every important respect, it may be difficult to convince management of the need for formalized written policies. However, when deficiencies are noted in one or more aspects of a bank's operations, it is nearly always the case that absence of written and clearly defined objectives, goals, performance standards, and limits of authority is an important contributing factor. There are few better means of ensuring that directors are properly supervising the bank's affairs than by their direct participation in devising, enforcing, and modifying the institution's written guidelines on such matters as investments, loans, marketing, capital and profit planning. Moreover, it is recognized that the depth and detail of written policies may properly vary among banks, depending on the nature, scope and complexity of their operations. Therefore, it remains the FDIC's strongly held belief that all banks should have written policies which are readily understood by all affected parties, kept up-to-date, and relevant to the institution's needs and circumstances. While it is acceptable for a bank to obtain written policies from an outside source, it is the responsibility of management to ensure that the policies are suited to their bank and that the policies accurately describe the bank's practices. The board of directors should give final approval of the substantial content of policies.

The policies and objectives of the directorate should include provisions for adherence to the Interagency Guidelines Establishing Standards for Safety and Soundness set forth in Part 364, Appendix A, of the FDIC Rules and Regulations. These standards set specific guidelines for the safe operation of banks in the following areas: internal controls and information systems; internal audit system; loan documentation; credit underwriting; interest rate exposure; asset growth; asset quality; earnings; and compensation, fees, and benefits. The specific provisions for each area are discussed in further detail within the appropriate sections of this DSC Risk Management Manual of Examination Policies (Manual). Conformance to these standards may help identify emerging problems and correct deficiencies before capital becomes impaired. The standards, which should be viewed as minimum requirements, establish the objectives of proper operations and management, but leave specific methods of achieving these objectives to each institution.

Examiners should review the bank’s conformance to the safety and soundness standards at each examination. The nature, scope and risk of the institution’s activities should be considered when evaluating the adequacy of controls in each of the respective areas. Material deficiencies should be documented in appropriate sections of the Report of Examination.

Corporate Planning

A vital part of the responsibilities of directors is to set the future direction of the bank. Planning, organizing, and controlling are three fundamental dimensions of management. Planning, however, had not been a priority concern for a large part of the banking industry. This may have been due in part to the fact that the industry has historically been highly regulated and somewhat insulated from competitive pressures and sudden change. Dramatic changes in the structure, volatility and technology associated with the financial services market altered this situation and led to an emphasis on deregulating financial institutions. Increased competition and innovation consequently produced an environment characterized by uncertainty.

Sound planning is indispensable in dealing with this uncertainty and rapid change. In order to be effective, planning must be dynamic, carefully attended to, and well supported. Projections must be revised periodically as circumstances change and new strategies devised to meet stated objectives. An increasingly competitive marketplace suggests that an inadequate or ill-conceived planning process may be as much the cause of bank failure as poor loans.

The adequacy of a bank's planning process may be judged by considering questions such as:

- How formal is the bank's planning process?
- Who is involved? The board? Middle management?
- Is the plan based on realistic assumptions regarding the bank's present and future market area(s) and nontraditional competitive factors?
- Does the bank monitor actual performance against its plan?
- Does the bank consider alternative plans in response to changing conditions?

Although the focus must be on an evaluation of the process, the plan itself cannot be ignored if, in the examiner's judgment, the plan is predicated on assumptions which are inappropriate or unrealistic. This assessment must take into account the personnel and financial resources and operating circumstances and conditions unique to the bank being examined. It is emphasized that plotting the future direction of the institution is, properly, the responsibility of the board of directors and not examiners. However, when the goals and objectives chosen by directors are likely to result in significant financial harm to the bank, examiners must identify the deficiencies in the plan and attempt to effect necessary changes.

Absence of a satisfactory planning process or glaring weaknesses in the plan itself must be considered in the appraisal of bank management.

Appointing, Dismissing at Pleasure, and Defining the Duties of Officers

It is a primary duty of a board of directors to select and appoint executive officers who are qualified to administer the bank's affairs effectively and soundly. It is also the responsibility of the board to dispense with the services of officers who prove unable to meet reasonable standards of executive ability and efficiency.

Personnel Administration

Recruiting, training, and personnel activities are vital to the development and continuity of a quality staff. Some features of good personnel administration are a designated organization structure, detailed position descriptions, carefully planned recruiting, appropriate training and developmental activities, a performance appraisal system, quality salary administration, and an effective communications network.

Honestly and Diligently Administering the Affairs of the Bank

The board of directors is charged with the responsibility of conducting the affairs of the bank. It is not expected to directly carry out details of the bank's business; these may be delegated to senior officers. But they may not be delegated and forgotten. The power to manage and administer carries with it the duty to supervise; therefore, directors must periodically examine the system of administration they have established to see that it functions properly. Should it become obsolete, it should be modernized, or should the bank's officers fail to function as intended, the cause(s) should be determined and corrections made.

Observance of Applicable Laws

It is important for directors to ensure that executive management is cognizant of applicable laws and regulations; develop a system to effect and monitor compliance, which will likely include provisions for training and retraining personnel in these matters; and, when violations do occur, make correction as quickly as possible. Board members cannot be expected to be personally knowledgeable of all laws and regulations, but they should make certain that compliance with all laws and regulations receives high priority and violations are not knowingly committed by themselves or anyone the bank employs.

Avoiding Self-Serving Practices

Although somewhat independent from the responsibility to provide effective direction and supervision, the need for directors to avoid self-serving practices and conflicts of interest is of no less importance. Bank directors must place performance of their duties above personal concerns. Wherever there is a personal interest of a director that is adverse to that of the bank, the situation clearly calls for the utmost fairness and good faith in guarding the interests of the bank. Accordingly, directors must never abuse their influence with bank management for personal advantage, nor wrongfully employ confidential information concerning the bank's clients. The same principles with respect to self-serving practices and conflicts of interest apply to the executive management of the bank.

Paying Such Dividends as May Properly Be Paid

The board of directors has the responsibility of maintaining an adequately capitalized bank, and once this responsibility has been satisfied, the payment of dividends can and should receive consideration. Dividends represent the distribution of bank earnings to owners. Establishing the medium, rate, and date of payment must be based on the directors' overall assessment of the bank's financial condition.

Appropriate Internal Control System and Adequate Auditing Program

A sound framework of internal controls and a reliable and objective audit function are essential tools for bank directors. The existence of such enable directors to remain well informed of the adequacy, effectiveness, and efficiency of accounting, operating, and administrative controls and provide an assessment of the quality of ongoing operations. Establishment and oversight of such controls is the responsibility of the board of directors. Refer to the Internal Routines and Controls section for a complete discussion of these vital areas.

Management Information System (MIS)

The critical need for and dependence on information involves a concern and responsibility for the integrity of not only the specific information furnished, but the system that supplies it as well. Advances in technology have helped banks improve both information availability and models for analysis and decision making. Regardless of the technology employed, management is responsible for developing and implementing an information system that facilitates managerial activities. Review of these reports should be undertaken during onsite examinations to ascertain the accuracy of the information being provided.

An effective MIS is comprised of information from a number of sources, and the information must serve a number of users, each having various needs. The MIS must selectively update information and coordinate it into meaningful and clear formats. One possible approach would be to combine information from the bank's accounting system with other internal sources, such as personnel records, and include information from external sources regarding economic conditions, characteristics of the marketplace and competition, technology, and legal regulatory requirements. Quality, quantity and timeliness are factors that determine the effectiveness of management information systems.

Supervision by Directors

Supervision by directors does not necessarily indicate a board should be performing management tasks, but rather ensuring that its policies are being implemented and adhered to and its objectives achieved. It is the failure to discharge these supervisory duties, which has led to bank failures and personal liability of directors for losses incurred.

Directors' supervisory responsibilities can best be discharged by establishing procedures calculated to bring to their attention relevant and accurate information about the bank in a consistent format and at regular intervals. From this critical point, the remainder of a director's job unfolds. Directors who keep abreast of basic facts and statistics such as resource growth, capital growth, loan-to-deposit ratios, deposit mix, liquidity position, general portfolio composition, loan limits, loan losses and recoveries, delinquencies, etc., have taken a first, indispensable step in discharging their responsibilities. It is essential, therefore, that directors insist on receiving pertinent information about the bank in concise, meaningful and written form, and it is one of executive management's most important responsibilities to make certain directors are kept fully informed on all important matters and that the record clearly reflects this.

Directors' meetings that are conducted in a businesslike and orderly manner are a significant aid to fulfillment of the board's supervisory responsibilities. This requires, among other things, regular attendance (whether by actual or audio, video or other remote access). Absence without just cause is, like ignorance, not a valid defense. Moreover, a director's attendance should be an informed and intelligent one, and the record should reflect this. If directors dissent from the majority, they should, for their own protection, insist upon their negative vote being recorded along with reasons for their action.

Careful and consistent preparation of an agenda for each board meeting not only assists in the conduct of such meetings, but also provides board members reasonable assurance that all important matters are brought to their attention. Agenda items will vary from bank to bank depending on asset size, type of business conducted, loan volume, trust activities and so forth. In general, the agenda should include reports on income and expense; new, overdue, renewed, insider, charged-off and recovered loans; investment activity; personnel; and individual committee actions.

To carry out its functions, the board of directors may appoint and authorize committees to perform specific tasks and supervise certain phases of operations. In most instances, the name of the committee, such as loan, investment, examination, and, if applicable, trust, identifies its duties. Of course, utilization of the committee process does not relieve the board of its fundamental responsibilities for actions taken by those groups. Review of the minutes of these committees' meetings should be a standard part of the board meeting agenda.

Communication of facts to a board of directors is essential to sound and effective supervision. However, with the ever-broadening scope of modern banking and the increased complexity of banking operations, the ability of a board of directors to effectively supervise is becoming more difficult. Because of this, the use of outside personnel to provide management supervision is relatively common. While this does not release the board from its legal and implied responsibilities, it does provide an opportunity for management improvement through the use of these external sources. The bank holding company can play a very large role in the supervision of its individual banks. Bank holding companies which control a number of banks may be able to provide individual banks' boards with lending and investment counseling, audit and internal control programs or services, profit planning and forecasting, personnel efficiency reports, electronic data processing services, marketing strategy and asset appraisal reports. Banks that do not operate within a holding company organization are also able to obtain management assistance from various firms offering the above services. In the interest of quality supervision by a bank's board of directors, the use of outside advisors, while not releasing the board from its responsibilities, can be a valuable management tool.

Legal Liabilities of Directors

In general, directors and other corporate officers of a bank may be held personally liable for: a breach of trust; negligence which is the proximate cause of loss to the bank; ultra vires acts, or acts in excess of their powers; fraud; and misappropriation or conversion of the bank's assets. From the standpoint of imposing directors' liability where the facts evidence that fraud, misappropriation, conversion, breach of trust or commission of ultra vires acts is clearly shown, a relatively simple situation presents itself. Difficulties usually arise, however, in cases involving negligence (or breach of duty) which fall short of breach of trust or fraud.

Directors' liability for negligent acts is premised on common law for failure to exercise the degree of care prudent individuals would exercise under similar circumstances, and/or noncompliance with applicable statutory law, either or both of which cause loss or injury to the bank. Statutory liability is reasonably well defined and precise. Common law liability is somewhat imprecise since failure to exercise due care on the part of a director depends on the facts and circumstances of the particular case.

A director's duty to exercise due care and diligence extends to the management, administration and supervision of the affairs of the bank and to the use and preservation of its assets. Perhaps the most common dereliction of duty by bank directors is the failure to maintain reasonable supervision over the activities and affairs of the bank, its officers and employees. The actions and inactions listed below have been found to constitute negligence on the part of directors.

- An attitude of general indifference to the affairs of the bank, such as failing to hold meetings as required by the bylaws, obtain a statement of the financial condition of the bank, or examine and audit the books and records of the bank to determine its condition.
- Failure to heed warnings of mismanagement or defalcations by officers and employees and take appropriate action.
- Failure to adopt practices and follow procedures generally expected of bank directors.
- Turning over virtually unsupervised control of the bank to officers and employees relying upon their supposed fidelity and skill.
- Failure to acquaint themselves with examination reports showing the financial condition of a company to which excessive loans had been made.
- Assenting to loans in excess of applicable statutory limitations.
- Permitting large overdrafts in violation of the bank's internal policies or permitting overdrafts to insiders in violation of law.
- Representing certain assets as good in a Report of Condition when such assets were called to the directors' attention as Loss by the primary regulator and directions were given for their immediate collection or removal from the bank.

In the final analysis, liability of bank directors for acts of negligence rests upon their betrayal of those who placed trust and confidence in them to perform the duties of their office honestly, diligently and carefully. While applicable principles involving directors' negligence (or breach of duty) are easy enough to state, their application to factual situations presents difficulties. In essence, the courts have judged the conduct of directors "not by the event, but by the circumstance under which they acted" (Briggs v. Spaulding, 141 U.S. 132, 155(1890), 35L. Ed. 662, 672). Courts also have generally followed what may be called the rule of reason in imposing liability on bank directors, "lest they should, by severity in their rulings, make directorships repulsive to the class of men whose services are most needed; or, by laxity in dealing with glaring negligences, render worthless the supervision of director's over...banks and leave these institutions a prey to dishonest executive officers" (Robinson v. Hall, 63 Fed. 222, 225-226 (4th Cir. 1894)).

The following quotation represents a brief recapitulation of the law on the subject (Rankin v. Cooper, 149 Fed. 1010, 1013 (C.C.W.D. Ark. 1907) :

> "(1) Directors are charged with the duty of reasonable supervision over the affairs of the bank. It is their duty to use ordinary diligence in ascertaining the condition of its business, and to exercise reasonable control and supervision over its affairs. (2) They are not insurers or guarantors of the fidelity and proper conduct of the executive officers of the bank, and they are not responsible for losses resulting from their wrongful acts or omissions, provided they have exercised ordinary care in the discharge of their own duties as directors. (3) Ordinary care in this matter as in other departments of the law, means that degree of care which ordinarily prudent and diligent men would exercise under similar circumstances. (4) The degree of care required further depends upon the subject to which it is to be applied and in each case must be determined in view of all circumstances. (5) If nothing has come to their knowledge to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, upon the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required, and a want of that care makes them responsible. Directors cannot, in justice to those who deal with the bank, shut their eyes to what is going on around them. (6) Directors are not expected to watch the routine of every day's business, but they ought to have a general knowledge of the manner in which the bank's business is conducted, and upon what securities its larger lines of credit are given, and generally to know of and give direction to the important and general affairs of the bank. (7) It is incumbent upon bank directors in the exercise of ordinary prudence, and as a part of their duty of general supervision, to cause an examination of the condition and resource of the bank to be made with reasonable frequency."

FEDERAL BANKING LAWS AND REGULATIONS PRIMARILY PERTAINING TO BANK DIRECTORS

Section 18(k) of the Federal Deposit Insurance Act (FDI Act) - Authority to Regulate or Prohibit Certain Forms of Benefits to Institution Affiliated Parties

Part 359 of the FDIC Rules and Regulations - Golden Parachutes and Indemnification Payments

Part 359, pursuant to Section 18(k), permits the FDIC to prohibit or limit, by regulation or order, golden parachute payments or indemnification payments. Refer to "Other Issues" within this section for additional information.

Section 39(c) of the FDI Act - Compensation Standards

This statute requires the FDIC to prohibit excessive compensation to executive officers, employees, directors, and principal shareholders as an unsafe and unsound practice. The definition of excessive compensation, as well as the specific prohibition required by Section 39(c), is found in Section III of Appendix A to Part 364, Standards for Safety and Soundness. Refer to "Other Issues" within this section for further information.

Section 32 of the FDI Act - Agency Disapproval of Directors and Senior Executive Officers of Insured Depository Institutions or Depository Institution Holding Companies

A troubled insured depository institution or troubled depository institution holding company may not add any individual to the board of directors or employ any individual as a senior executive officer if the appropriate Federal banking agency issues a notice of disapproval of such addition or employment before the end of the 90-day period beginning on the date the agency receives the required notice.

Section 19 of the FDI Act - Penalty for Unauthorized Participation by Convicted Individual

Section 19 of the FDI Act prohibits, without the prior written consent of the FDIC, a person convicted of any criminal offenses involving dishonesty or breach of trust or money laundering, or who has entered into a pretrial diversion or similar program in connection with a prosecution for such offense, from becoming or continuing as an institution-affiliated party (IAP), owning or controlling, directly or indirectly, an insured institution, or otherwise participating, directly or indirectly, in the conduct of the affairs of an insured institution.

The intent of Section 19 is not punitive. Rather, the purpose is to provide the applicant an opportunity to demonstrate that a person is fit to participate in the conduct of the affairs of an institution without posing a risk to its safety and soundness or impairing public confidence in that institution. The FDIC's policy is to approve applications in which this risk is absent. For additional guidance, refer to the FDIC Statement of Policy for Section 19 of the FDI Act.

Section 22(g) and 22(h) of the Federal Reserve Act - Loans to Executive Officers of Banks and Extensions of Credit to Executive Officers, Directors and Principal Shareholders of Member Banks

The Federal Reserve Board's Regulation O – Loans to Executive Officers, Directors and Principal Shareholders of Member Banks

Section 337.3 of the FDIC Rules and Regulations – Limits on Extensions of Credit to Executive Officers, Directors and Principal Shareholders of Insured Nonmember Banks

Sections 22(g) and 22(h) are incorporated into the FDI Act via Section 18(j)(2) and pertain to loans and extensions of credit by both member and nonmember banks to their executive officers, directors, principal shareholders and their related interests. Section 18(j)(2) does not apply to any foreign bank in the United States but does apply to the insured branch itself. It is a very important statute in the examination and supervisory process because it is aimed at prevention and detection of insider abuse, a common characteristic of failed or failing banks.

Part 215 of the Federal Reserve Board's Regulation O was issued pursuant to Sections 22(g) and 22(h) of the Federal Reserve Act. It requires that extensions of credit to executive officers, directors, principal shareholders or their related interests be made on substantially the same terms and follow credit underwriting procedures that are not less stringent than those prevailing at the time for comparable transactions with persons not covered by the regulation. Aggregate lending limits and prior approval requirements are also imposed by Regulation O. Moreover, payment of overdrafts of directors or executive officers is generally prohibited unless part of a written, preauthorized interest bearing, extension of credit plan or by transfer of funds from another account at the bank. The requirements, prohibitions and restrictions of Regulation O are important and examiners should be fully familiar with them. The complete text of the regulation is contained in the FDIC Rules and Regulations.

Section 337.3 of the FDIC Rules and Regulations makes Regulation O applicable to state nonmember banks and sets forth requirements for approval of extensions of credit to insiders. Specifically, prior approval of the bank's board of directors is necessary if an extension of credit or line of credit to any of the bank's executive officers, directors, principal shareholders, or to any related interest of any such person, exceeds the amount specified in the regulation when aggregated with the amount of all other extensions of credit or lines of credit to that person. This approval must be granted by a majority of the bank's directors and the interested party(ies) must abstain from participating directly or indirectly in the voting.

Any nonmember insured bank which violates or any officer, director, employee, agent or other person participating in the conduct of the affairs of a nonmember insured bank who violates any provision of Section 22(g) or 22(h) of the Federal Reserve Act may be subject to a CMP. In determining the amount of the penalty, the FDIC takes into account the financial resources and good faith of the bank or person charged, gravity of the violation, history if any of previous violations, and such other matters as justice may require. Examiners are reminded violations of Regulation O must be evaluated in accordance with the 13 factors specified in the Interagency Policy Regarding the Assessment of Civil Money Penalties by the Federal Financial Institutions Regulatory Agencies.

Part 348 of the FDIC Rules and Regulations - Management Official Interlocks

This act is contained in 12 U.S.C. 1823(k) and its general purpose is to foster competition. It prohibits a management official of one depository institution or depository holding company from also serving in a similar function in another depository institution or depository holding company if the two organizations are not affiliated and are located in the same area or if the two organizations are not affiliated and are very large, as defined in the regulation.

A number of exceptions allowing interlocking relationships for certain organizations and their affiliates are detailed in Part 348 of the Rules and Regulations. Under Section 8(e) of the FDI Act, the FDIC may serve written notice of intention to remove a director or officer from office whenever, in its opinion, such director or officer of an insured bank has violated the Depository Institution Management Interlocks Act.

Section 7(j) of the FDI Act and the Change in Bank Control Act of 1978

Section 7(j) of the FDI Act prohibits any person, acting directly or indirectly or through or in concert with one or more other persons, from acquiring control of any insured depository institution through a purchase, assignment, transfer, pledge, or other disposition of voting stock of the insured bank unless the appropriate Federal banking agency has been given 60-days prior written notice of the proposed acquisition. An acquisition may be made prior to the expiration of the disapproval period if the agency issues written notice of its intent not to disapprove the action. The term "insured depository institution" includes any bank holding company or any other company which has control of any insured bank. The term "control" is defined as the power, directly or indirectly, to direct the management or policies of an insured bank or to vote 25% or more of any class of voting securities of an insured bank. Willful violations of this statute are subject to civil money penalties of up to $1 million per day. This statute gives the FDIC important supervisory powers to prevent or minimize the adverse consequences that almost invariably occur when incompetent or dishonest individuals obtain positions of authority and influence in banks.

Section 737 of the Gramm-Leach-Bliley Act – Bank Officers and Directors as Officers and Directors of Public Utilities

This section of the Gramm-Leach-Bliley Act amends the Federal Power Act to preclude persons from serving both as an officer or director of a public utility and a bank except in certain circumstances. Dual service is permissible when the individual does not participate in any deliberations involved in choosing a bank to underwrite or market the securities of the utility, when the bank is chosen by competitive procedures, or when the issuance of securities by the public utility have been approved by all appropriate regulatory agencies.

Section 8 of the FDI Act

Among other things, Section 8 of the FDI Act provides the Federal banking agencies with the authority to take action to remove from office or prohibit an IAP from any further participation in the conduct of the affairs of any depository institution. Specifically, Section 8(e) and Section 8(g) are utilized in such proceedings. Actions taken under this authority represent serious charges with significant potential consequences. Therefore, outstanding guidelines should be closely followed during the examination process. For additional guidance, refer to Section 8 the FDI Act and the Formal Administrative Actions section of this Manual.

OTHER ISSUES

Indebtedness of Directors, Officers and Their Interests

The position of director or officer gives no license to special credit advantages or increased borrowing privileges. Loans to directors, officers and their interests must be made on substantially the same terms as those prevailing at the time for comparable transactions with regular bank customers. Therefore, management loans should be evaluated on their own merits. Their business operations will, in many instances, necessitate bank loans, and these will ordinarily be among a bank's better assets. Since directors usually maintain a deposit relationship with their bank, this carries with it an obligation to meet their reasonable and prudent credit requirements.

On the other hand, there have been many instances where improper loans to officers, directors, and their interests resulted in serious losses. Unfortunately, when the soundness of a management loan becomes questionable, an embarrassing situation usually results. That is, management loans frequently may not be subject to the same frank discussion accorded other loans. Bank directors may assent to such loans, despite knowledge that they are unwarranted, rather than oppose a personal or business friend or associate. Moreover, directors who serve on the board in order to increase their opportunities for obtaining bank credit are reluctant to object to credit extensions to their colleagues. Problems that occur with management loans have received considerable legislative attention and laws have been passed to curb abuses associated with the position of director or officer (i.e. Regulation O). However, while steps have been taken to reduce the potential for problems in this area, a review of the board's policies and actual practices regarding insider loans remains an important part of the examination process.

Conflicts of Interest

Examiners should be especially alert to any insider involvement in real estate projects, loans or other business activities that pose or could pose a conflict of interest with their fiduciary duties of care and loyalty to the bank. On occasion, loans are advanced to business associates involved in apparently unrelated projects where an insider nevertheless benefited. The involvement of bank insiders in these projects is sometimes not apparent since ownership is held in the form of "business trusts" or other entities without disclosure of the identity or personal guarantees of the principals. In order to help uncover these types of situations, examiners should routinely inquire of senior management, through incorporation in the "first day" letter or request, whether any of the following situations exist:

- Loans or other transactions existing at the bank in which an officer, director or principal stockholder (or immediate family member of each) of the bank holds a beneficial interest.
- Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) of another depository institution holds a beneficial interest.

- Loans or other transactions at any other depository institution in which a bank officer, director, or principal stockholder (or immediate family member of each) holds a beneficial interest, either direct or indirect.
- Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) has no direct interest but which involve parties with whom an insider has other partnership or business associations.
- Loans extended personally by officers, directors or principal stockholders (or immediate family member of each) to parties who are also borrowers from the bank or loans extended personally by any borrowing customers to an officer, director or principal stockholder of the bank.

If any of this information is not readily available, management should be requested to survey their officers, directors and principal stockholders, as necessary, to obtain it.

Examiners are also reminded to inquire into bank policies and procedures designed to bring conflicts of interest to the attention of the board of directors when they are asked to approve loans or other transactions in which an officer, director or principal stockholder may be involved. Where such policies and procedures are lacking or insufficient to reveal insider involvement before action is taken by the board, the bank should be strongly encouraged to remedy the deficiency. The board should also be encouraged to act specifically on any loan or other transaction in which insiders or their associates may be involved, either directly or indirectly, or because of business associations outside the loan or transaction in question. Moreover, the results of board deliberations on any matter involving a potential conflict of interest should be noted clearly in the minutes.

Examiners are also reminded to carefully scrutinize any loan or other transaction in which an officer, director or principal stockholder is involved. Such loans or other transactions should be sound in every respect and be in full compliance with applicable laws and regulations and the bank's own policies. Any deficiencies in credit quality or other aspects of the transaction should receive critical comment not only from an asset quality perspective but from a management perspective as well. More specifically, if a director has a personal financial interest in a loan or other transaction subject to adverse classification, the board should be urged to require that director to strengthen the credit sufficiently to remove the adverse classification within a reasonable time frame or resign from the board. In the event a principal stockholder or an officer who is not a director is involved in an adversely classified loan or other transaction, the board should be urged to assume special oversight over the loan or activity, either directly or through a committee of outside directors, with a view towards limiting any further exposure and moving aggressively to secure or collect any exposed balances as the circumstances may permit. There should be concern that these types of situations not only tend to compromise the credit standards of the lending institution and eventually may lead to losses, but that they can also lead to violations of civil and criminal laws.

Nonbanking Activities Conducted on Bank Premises

Many banks conduct nonbanking activities on bank premises by selling insurance (e.g. credit life, accident and health) in conjunction with loan transactions of the bank. When these nontraditional banking activities take the form of establishment of a new department or subsidiary of the bank, the benefit and profit is directly realized by the bank and its shareholders. However, when these activities are conducted on bank premises for the benefit of others, a bank may be deprived of corporate opportunity and profit. The FDIC has long taken the position that when nonbanking activities are conducted on bank premises either by bank personnel or others and when the benefit and profit do not flow directly to the bank, certain disclosures, approvals, and reimbursements must be made.

In all cases, the bank's directors and shareholders should be fully informed regarding the nonbanking activity conducted on bank premises. The operation should be approved by the bank's shareholders, and expenses incurred by the bank in connection with these operations formally approved by the board of directors annually. The bank should be adequately compensated for any expenses it incurs in furnishing personnel, equipment, space, etc. to this activity. It is recommended that bank management disclose completely to its bonding company any such nonbanking activity conducted on its premises. Management would also be well advised to obtain acknowledgement from the bonding company that such activities do not impair coverage under the fidelity bond. Finally, the conduct of nonbanking activity must be in conformance with applicable State statutes and regulations.

Situations where the bank is being deprived of corporate opportunity through the diversion of opportunity or profit, or inadequately compensated for the utilization of its resources should be discussed with bank management and commented upon in the Risk Management Assessment and the Examination Conclusions and Comments pages, if appropriate. Additionally, the absence of disclosure and approval to the bank's directors, shareholders, and bonding company should be discussed with management and covered in the aforementioned schedule(s). Finally, in those instances where the examiner believes, based on known facts, that a violation of applicable statutes or regulations has occurred, or where there is no question that a criminal violation has been committed, the matter should be handled in accordance with guidelines prescribed in other sections of this Manual.

Directors of Banks with Dominant Management Officials

Examiners should carefully consider the risks associated with institutions controlled by an official that dominates virtually all decisions involving the bank's policies and operations. A dominant official or policymaker is defined as an individual, or group of persons with close business dealings or otherwise acting together, that exerts an influential level of control or policymaking authority. The definition applies regardless of whether the individual or individuals involved have an executive officer title or receive compensation from the bank. The term is commonly used to describe situations where the institution's principal officer or shareholder dominates virtually all phases of the bank's policies and operations.

Examiners should not automatically view the presence of a dominant official negatively or as a supervisory concern. For example, in a small bank with limited staff, a dominant official may emerge because no one else at the bank has the skills or experience to operate the bank. However, the presence of a dominant official coupled with other risk factors such as ineffective internal controls, inadequate board oversight, or high-risk business strategies irrespective of established board policies, are a supervisory concern.

Situations involving dominant officials often involve boards that simply put their trust in the dominant officer and do not provide adequate oversight or effective challenge to management. This lack of effective challenge by boards may arise for various reasons. In particular, when first elected some directors may have a limited understanding of banking operations or of their oversight responsibilities and therefore feel dependent on operating management with more banking experience. Also, directors nominated by dominant officials may believe they owe allegiance to those dominant officials.

Operational risks inherent in these situations include the circumventing of internal controls by a dominant official. For example, a dominant official may simultaneously fulfill roles with conflicting responsibilities, such as chief executive officer (CEO) and chief financial officer, or serving as CEO and simultaneously chairing the audit committee. Situations involving dominant officials often involve boards that simply put their trust in the dominant officer and do not provide adequate oversight or effectively challenge management. This lack of effective challenge by boards may arise for various reasons.

Other risks inherent in these situations include dependence on a dominant, yet highly qualified official that is core to the operation of the institution. For example, the loss or incapacitation of the dominant official may deprive the bank of critical institutional knowledge and competent management. The loss of a dominant official may also result in short- or long-term business disruptions, productivity losses, or negatively affect profitability. Further, the process to replace a dominant official can be expensive and lengthy.

If examiners identify dominant officials at an institution, they should assess the official's level of influence. Such influence, along with other risk factors and risk management controls designed to mitigate these risks, should be considered during on-site examinations, off-site monitoring, and in the evaluation of management in connection with the regulatory and supervisory processes.

In addition to assessing internal controls the institution established to mitigate risks associated with dominant management officials, examiners should evaluate the effectiveness of compensating controls that protect the institution from the loss of the dominant official. Compensating controls include items such as key-person life insurance, business-continuity and succession planning, and cross-training programs.

When examiners encounter situations that involve dominant management officials, they should review the risk profile and control environment of the bank and assess whether:

- An appropriate segregation of duties and responsibilities is achieved or alternative actions are taken to mitigate the level of control exercised by the dominant individual;
- Director involvement in the oversight of policies and objectives of the bank is at an appropriate level;
- Board composition provides the bank with a range of knowledge and expertise, including, but not limited to, banking, accounting, and the major lending areas of the bank's target markets;
- There are a sufficient number of outside and independent directors;
- Committees of major risk areas exert a proper level of function, responsibility, and influence, and the value of the committees is exhibited in the decision-making process;
- A proper level of independence has been achieved for board committees of major risk areas, including, but not limited to, audit committees;

- An adequate audit committee has been established with only, or at least a majority of, outside directors;
- A need exists for the performance of annual financial audits by an independent certified public accounting firm if not already required under Part 363;
- A qualified, experienced, and independent internal auditor is in place;
- A proper segregation of the internal audit function is achieved from operational activities;
- An appropriate rationale is established regarding any changes to a bank's external auditors, including, but not limited to, a review of the audit committee minutes or a review of auditor notifications[1];
- An adequate written code of conduct, ethics, and conflict of interest policies have been established;
- A need exists for the bank's board to perform and report on an annual conflicts of interest and ethics review;
- A need exists for a bank to engage outside consultants to conduct an external loan review; and
- A proper segregation of the internal loan review process is established.

Report of Examination (ROE) Treatment

If a dominant official or policymaker is identified during an examination, examiners should describe related risks in the ROE. ROE comments should identify the dominant official and describe the official's influence and effect on the bank. Comments should also describe the level of board independence and oversight and the effectiveness of any mitigating controls. Supervisory recommendations relating to a dominant official, such as non-compatible duties or pursuit of high-risk business strategies, or concerns relating to ineffective board oversight or other mitigating controls should also be included in ROE comments.

Examiners should consider how identified weaknesses might affect the institution when assigning component and composite ratings. Concerns should not be disregarded when assigning ratings simply because the bank's current financial condition is satisfactory. Forward-looking supervisory practices require that examiners consider how current practices may affect the future condition of the bank. Additionally, the extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority must be considered when assigning the Management rating. And finally, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution.

When warranted, supervisory concerns should be addressed with informal or formal corrective programs. When concerns are particularly elevated or prior supervisory actions do not effect corrective actions, consideration should be given, after consultation with the regional office, to recommending changes to board composition or management to reduce a dominant official's impact on material decisions.

Advisory Directors

A naturally sensitive situation develops where the value of a director diminishes due to extensive outside commitments, illness, etc. Often such individuals do not wish to relinquish their position and the bank may be hesitant to request they do so. Some banks have met this situation by establishing a position of honorary director (or similar title) for persons who are no longer able to effectively fulfill the demanding duties of bank director. Generally, the honorary director attends board meetings as desired and offers advice on a limited participation basis, but has no formal voice or vote in proceedings, nor the responsibilities or liabilities of the office, except where there may be a continuing connection with a previous breach of duty as an official director.

Restrictions on Golden Parachute Payments and Indemnification Payments

Golden Parachute Payments

- The rule (Part 359) limits and/or prohibits, in certain circumstances, insured depository institutions, their subsidiaries, and their affiliated depository institution holding companies from agreeing to make or making golden parachute payments when the entity making the payment is "troubled," as defined in Section 303.101 of the FDIC Rules and Regulations.
- The rule does not restrict the payment of golden parachutes by healthy institutions, except that depository institution holding companies (including healthy ones) are prohibited from making golden parachute payments to IAPs of troubled subsidiary banks and savings associations.
- Several exceptions to the prohibition are included in the regulation; some are required by statute, others have been added by the FDIC. These exceptions are as follows:
  - Bona-fide deferred compensation plans.

[1] If the bank recently changed external auditors, examiners should assess the board/audit committee's rationale and review committee minutes and "change-in-auditor" notifications for possible opinion shopping and any other safety and soundness issues.

- Nondiscriminatory severance payment plans (for personnel reductions in force).
- Qualified pension or retirement plans.
- Payments pursuant to employee welfare benefit plans.
- Payments made by reason of termination caused by death or disability.
- Payments required by State statute or foreign law.

The final three listed exceptions require the approval of both the appropriate Federal banking agency and the FDIC:

- A troubled institution hiring new management .
- Severance payment in the event of an unassisted change in control.
- Any others on a case-by-case basis with the regulators' approval.

Indemnification Payments

- With regard to indemnification payments, Part 359 limits the circumstances under which an insured depository institution, its subsidiary, or affiliated depository institution holding company may indemnify institution affiliated parties IAPs for expenses incurred in administrative or civil enforcement actions brought by bank regulators. The circumstances where indemnification may be permitted are as follows:

  1. The institution's board of directors determines in writing that these four criteria are satisfied:

     - The IAP acted in good faith and in a manner believed to be in the best interests of the institution.
     - The payment will not materially adversely affect the safety and soundness of the institution.
     - The payment is limited to expenses incurred in an administrative proceeding or civil action instituted by a Federal financial institution's regulator.
     - The IAP agrees to reimburse the institution if he/she is found to have violated a law, regulation, or other fiduciary duty.

  2. An insurance policy or fidelity bond may pay the cost of defending an administrative proceeding or civil action. It may not pay a penalty or judgement.

- Under no circumstances may an institution or an insurance policy of the institution indemnify an IAP for any judgment or civil money penalty imposed in an action where the IAP is assessed a civil money penalty, is removed from office or prohibited from participating in the affairs of the institution, or is required to cease and desist from or take any affirmative action pursuant to section 8(b) of the FDI Act. However, partial indemnification is allowed for charges that are found in the IAP's favor as explained below under "Issues."

Issues

Generally speaking, the essence of Part 359 lies in its definitions of terms such as: golden parachute payment, bona fide deferred compensation plan, and prohibited indemnification payment, as well as certain significant exceptions to the general prohibitions.

The following are additional discussions on several issues encompassed in the regulation.

- The rule does not apply to contracts and agreements entered into prior to the effective date of the rule (April 1, 1996). However, the FDIC put institutions and their IAPs on notice in the proposed rule (March 29, 1995) that the FDIC will look unfavorably upon any golden parachute agreement which was entered into after the proposal, but before the date of the final rule, that attempts to circumvent the regulation. Appropriate orders should be pursued in such cases.

- With regard to indemnification payments, the majority of administrative or civil enforcement cases end in a settlement and no indemnification payment will be permitted unless charges are dropped. The parties concerned will have to factor in this cost of no indemnification in their decisions to settle or not.

  However, there are situations when an individual has been charged with several significant items of misconduct, etc., and then during the process a settlement is reached where only some of the infractions are admitted. The rule permits partial indemnification in those cases. There is a special case-by-case exception to allocate costs to the sets of charges with indemnification permitted for those that are dropped.

  Partial indemnification is not permitted in cases where an IAP is removed from office and/or prohibited from participating in the affairs of the institution.

  It is recognized that in many cases the appropriate amount of any partial indemnification will be difficult to ascertain with certainty. Although no prior regulatory consent is required, obviously the regulators are part of the settlement process. The process provides the opportunity for the regulators to give "non-objections" at the time of settlement, prior to the indemnification being made. As part of the settlement process, the bank should be required to provide from the attorney a statement containing a description of specifically attributable expenses. Concern should focus on the reasonableness of the allocations.

- If a golden parachute is prohibited to an individual leaving the institution, it is prohibited forever, even if the institution returns to health (after the individual has left the institution). There are ample exceptions and procedures for an individual who is leaving a troubled institution to avoid the prohibition if that individual has not contributed significantly to the demise of the institution. If an individual does not qualify for one of these exceptions, that individual should not benefit due to the institution reversing its course and returning to health after that individual has left the institution.

- Troubled institutions cannot apply for an exception to offer "white knight" parachutes to their current officers to not leave the institution. Rather it is to entice new management to join the institution by compensating for the uncertainty of joining a troubled institution. It is considered illogical for the FDIC to provide an exception to permit a troubled institution to offer a buyout to current management to get them to stay. The regulation does not prohibit an institution from offering golden parachutes to their current officers. It only prohibits the payment of a golden parachute if the individual leaves while the institution is troubled. On the contrary, it is believed to be of greater incentive that the only way the current officers' golden parachutes will be of value is if they stay and work to return the institution to health.

- Approval is required for a severance payment in the event of an unassisted change in control. A maximum payment of 12 months salary is permitted under this exception. Any requests for payments in excess of this amount (12 months salary) would have to be considered for approval under the general case-by-case exception.

  This exception is provided in recognition of the need for current management to be motivated to seek out acquirers. This exception is believed appropriate for cases where the IAP may not clearly demonstrate that all the factors for the general exception are evident, yet an acquisition of the troubled institution has been arranged and the acquirer is willing to make the otherwise prohibited golden parachute payment. On the other hand, if after consideration of the factors for the general case-by-case exception, the appropriate Federal banking agency and/or the FDIC determines it inappropriate to make the severance payment, an exception should not be approved.

Excessive Compensation

Section III of Part 364, Appendix A, prohibits the payment of excessive compensation, as well as compensation that could lead to material financial loss to an institution, as an unsafe and unsound practice. Furthermore, Section II of Part 364, Appendix A, urges institutions to maintain safeguards that prevent excessive compensation or compensation that could subject the institution to material financial loss. Excessive compensation is defined as when amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder. The following items should be considered when determining whether compensation is excessive:

- The combined value of all cash and noncash benefits provided to an individual;
- The compensation history of the individual and other individuals with comparable expertise;
- The financial condition of the institution;
- Compensation practices at comparable institutions, based on such factors as asset size, location, and the complexity of the loan portfolio or other assets;
- For post-employment benefits, the projected total cost and benefit to the institution;
- Any connection between the individual and any instance of fraud or insider abuse occurring at the institution; and
- Any other factors determined to be relevant.

The FDIC does not seek to dictate specific salary levels or ranges for directors, officers, or employees. In fact, Section 39 of the FDI Act prohibits establishing guidelines that set a specific level or range of compensation for bank insiders. The criteria listed above are designed to be qualitative rather than quantitative in order to grant an institution's directors reasonable discretion when structuring a compensation program.

Examiners should review the information used by the board to establish the compensation structure of the institution. The information should adequately explain the rationale for the system in place and should enable the board to consider the above items that determine whether compensation is excessive.

Gaining Access to Bank Records and Employees

Section 10(b)(6) of the FDI Act provides authority for examiners to make a thorough examination of any insured depository institution and to complete a full and detailed report of the institution's condition. In most instances, the executive officers of insured depository institutions cooperate with the requests of examiners. However, there are rare occasions when executive officers are extremely uncooperative, or refuse to provide access to bank records and employees that are essential to the evaluation of the condition of the institution. In such cases, this pattern of behavior by executive officers may be indicative of serious problems in the bank, including fraud, mismanagement, or insolvency. The Regional Office should be consulted when executive officers restrict access to bank records or employees.

Bank Owned Life Insurance (BOLI)

A number of banks use BOLI as a means of protecting against the loss of key employees or hedging employee compensation and benefit plans. However, the purchase of life insurance is subject to supervisory considerations and life insurance holdings must be consistent with safe and sound banking practices. Bankers should complete a thorough analysis before purchasing BOLI. Associated risks, minimum standards for pre-purchase analysis and basic guidelines are detailed in the Other Assets and Liabilities section of this Manual.

EVALUATION OF MANAGEMENT

A bank's performance with respect to asset quality and diversification, capital adequacy, earnings performance and trends, liquidity and funds management, and sensitivity to fluctuations in market interest rates is, to a very significant extent, a result of decisions made by the bank's directors and officers. Consequently, findings and conclusions in regard to the other five elements of the CAMELS rating system are often major determinants of the management rating. More specific considerations are detailed in the Basic Examination Concepts and Guidelines section of this Manual. However, while a bank's overall present condition can be an indicator of management's past effectiveness, it should not be the sole factor relied upon in rating management. This is particularly true when there is new management or when the bank's condition has been significantly affected by external factors versus internal decisions.

When significant problems exist in a bank's overall condition, consideration must be given to management's degree of responsibility. However, appropriate recognition should also be given to the extent to which weaknesses are caused by external problems (such as a severely depressed local economy). A distinction should be made between problems caused by bank management and those largely due to outside influences. Management of a bank whose problems are related to the economy would warrant a higher rating than management believed substantially responsible for a bank's problems, provided that prudent planning and policies are in place and management is pursuing realistic resolution of the problems. Management's ability becomes more critical in problem situations, and it is important to note management's policies and acts of omission or commission in addressing problems.

The extent to which mismanagement has contributed to areas of weakness is particularly relevant to the management evaluation. Similarly, positive economic conditions may serve to enhance a bank's condition despite weak or undocumented policies and practices. At a minimum, the assessment of management should include the following considerations:

- Whether or not insider abuse is in evidence;
- Existing management's past record of performance in guiding the bank;
- Whether loan losses and other weaknesses are recognized in a timely manner;
- Past compliance with supervisory agreements, commitments, orders, etc.; and
- Capability of management to develop and implement acceptable plans for problem resolution.

Assessment of new management, especially in a problem situation, is difficult. Performance by individuals at their former employment, if known to the examiner, may be helpful, but the examiner should assess each situation based on its particular circumstances. The management rating should generally be consistent with any recommended supervisory actions. A narrative statement supporting the management rating and reconciling any apparent discrepancies between the assigned rating and any recommended supervisory actions (or lack of recommended actions) should be included on the confidential pages of the examination report.

Examination procedures regarding the evaluation of management are included in the Examination Documentation Modules.

RATING THE MANAGEMENT FACTOR

Uniform Financial Institutions Rating System

The Federal Deposit Insurance Corporation and the other Federal Financial Institutions Examination Council (FFIEC) member agencies adopted a uniform interagency system for rating the condition and soundness of the nation's banks. The Uniform Financial Institutions Rating System involves an assessment of six critical aspects of a bank's condition and operations. Management and administration is one of those critical dimensions.

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of oversight and support of all institution activities by the board of directors and management.
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products.
- The adequacies of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile.
- The adequacy of audits and internal controls to: promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies.
- Compliance with laws and regulations.
- Responsiveness to recommendations from auditors and supervisory authorities.
- Management depth and succession.
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority.
- Reasonableness of compensation policies and avoidance of self-dealing.
- Demonstrated willingness to serve the legitimate banking needs of the community.
- The overall performance and risk profile of the institution.

Ratings

A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

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INTRODUCTION

Internal controls include the policies and procedures that financial institutions establish to reduce risks and ensure they meet operating, reporting, and compliance objectives. The board of directors is responsible for ensuring internal control programs operate effectively. Their oversight responsibilities cannot be delegated to others within the institution or to outside parties. The board may delegate operational activities to others; however, the board must ensure effective internal control programs are established and periodically modified in response to changes in laws, regulations, asset size, organizational complexity, etc.

Internal control programs should be designed to ensure organizations operate effectively, safeguard assets, produce reliable financial records, and comply with applicable laws and regulations. Internal control programs should address five key components:

- Control environments,
- Risk assessments,
- Control activities,
- Information and communication, and
- Monitoring.

These components must function effectively for institutions to achieve internal control objectives. This overview of internal control is described further in a report by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) titled *Internal Control-Integrated Framework*. Institutions are encouraged to evaluate their internal control program against this COSO framework.

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INTERNAL CONTROL SYSTEMS

Part 364 of the FDIC Rules and Regulations establishes safety and soundness standards that apply to insured state nonmember banks and state-licensed, insured branches of foreign banks. Appendix A to Part 364 includes, among other things, general standards for internal controls, information systems, and audit programs. The standards require all financial institutions to have controls, systems, and programs appropriate for their size and the nature, scope, and risk of their activities. Internal controls and information systems should ensure:

- An organizational structure that defines clear lines of authority and responsibilities for monitoring adherence to established policies;
- Effective risk assessments;
- Timely and accurate financial, operational, and regulatory reports;
- Adequate procedures to safeguard and manage assets; and
- Compliance with applicable laws and regulations.

Many internal controls are programmed directly into software applications as part of data input, processing, or output routines. Other controls involve procedural activities standardized in an institution's policies. The relative importance of an individual control, or lack thereof, must be viewed in the context of other controls. Every bank is unique, and one set of internal procedures cannot be prescribed for all institutions. However, all internal control programs should include effective control environments, risk assessments, control activities, information systems, and monitoring programs.

If examiners determine internal routines or controls are deficient, they should discuss the deficiencies with the chief executive officer and the board of directors, and include appropriate comments in the report of examination (ROE).

Key Control System Components

Control Environment

The control environment begins with a bank's board of directors and senior management. They are responsible for developing effective internal control systems and ensuring all personnel understand and respect the importance of internal controls. Control systems should be designed to provide reasonable assurance that appropriately implemented internal controls will prevent or detect:

- Materially inaccurate, incomplete, or unauthorized transactions;
- Deficiencies in the safeguarding of assets;
- Unreliable financial and regulatory reporting; and
- Deviations from laws, regulations, and internal policies.

Risk Assessments

Risk assessments require proper identification, measurement, analysis, and documentation of significant business activities, associated risks, and existing controls. Financial risk assessments focus on identifying control weaknesses and material errors in financial statements such as incomplete, inaccurate, or unauthorized transactions. Risk assessments are conducted in order to identify, measure, and prioritize risks so that attention is placed first on areas of greatest importance. Risk assessments should analyze threats to all significant business lines, the sufficiency of mitigating controls, and any residual risk exposures. The results of all assessments should be appropriately reported, and risk assessment methodologies should be updated regularly to reflect changes in business activities, work processes, or internal controls.

Control Activities

Control activities include the policies and procedures institutions establish to manage risks and ensure pre-defined control objectives are met. Preventative controls are designed to deter the occurrence of an undesirable event. Detective controls are designed to identify operational weaknesses and help effect corrective actions. Control activities should cover all key areas of an organization and address items such as organizational structures, committee compositions and authority levels, officer approval levels, access controls (physical and electronic), audit programs, monitoring procedures, remedial actions, and reporting mechanisms.

Information and Communication

Reliable information and effective communication are essential for maintaining control over an organization's activities. Information about organizational risks, controls, and performance must be quickly communicated to those who need it. Technology systems and organizational procedures should facilitate the effective distribution of reliable operational, financial, and compliance-related reports. Clearly defined procedures should be developed that make it easy for individuals to report risks, errors, or fraud through formal and informal means. The procedures should include appropriate mechanisms for communicating, as needed, with external parties such as customers, regulators, shareholders, and investors.

Monitoring

Internal control systems must be monitored to ensure they operate effectively. Monitoring may consist of periodic control reviews specifically designed to ensure the sufficiency of key program components, such as risk assessments, control activities, and reporting mechanisms. Monitoring the effectiveness of a control system may also involve ongoing reviews of routine activities. The effectiveness of a periodic review program is enhanced when people with appropriate skills and authority are placed in key monitoring roles.

Control Standards

The control environment begins with the board of directors, which must establish appropriate control standards. The board of directors or an audit committee, preferably consisting entirely of outside directors (directors independent of operational duties), must monitor adherence to established directives.

Boards should establish policy standards that address issue such as decision-making authorities, segregation of duties, employee qualifications, and operating and recording functions. Key internal controls are described below.

Director Approvals

The board of directors should establish limits for all significant matters (such as lending and investment authorities) delegated to relevant committees and officers. Management should regularly provide financial and operational reports to the board, including standardized reports that detail policy exceptions, new loans, past due credits, concentrations, overdrafts, security transactions, etc. The board or a designated board committee should periodically review all authority levels and material actions. The key control objective is that the board is regularly informed of all significant matters.

Sound Personnel Policies

Sound personnel policies are critical components of effective control programs. The policies should require boards and officers to check employment references, hire qualified officers and competent employees, use ongoing training programs, and conduct periodic performance reviews.

Management should check the credit and previous employment references of prospective employees. The FBI is available to check the fingerprints of current and prospective employees and to supply institutions with criminal records, if any, of those whose fingerprints are submitted. Some insurance companies that write bankers' blanket bonds also offer assistance in screening officers and employees.

Pursuant to Section 19 of the Federal Deposit Insurance Act (FDI Act), the FDIC's written consent is needed in order for individuals to serve in an insured bank as a director, officer, or employee if they have been convicted of a criminal offense involving dishonesty, breach of trust, or money laundering.

Segregation of Duties

The possibility of fraud diminishes significantly when two or more people are involved in processing a transaction. A segregation of duties occurs when two or more individuals are required to complete a transaction. The segregation of duties allows one person's work to verify that transactions initiated by another employee are properly authorized, recorded, and settled. When establishing segregation-of-duty standards, management should assign responsibilities so that one person cannot dominate a transaction from inception to completion. For example, a loan officer should not perform more than one of the following tasks: make a loan, disburse loan proceeds, or accept loan payments. Individuals having authority to sign official checks should not reconcile official check ledgers or correspondent accounts, and personnel that originate transactions should not reconcile the entries to the general ledger. Additionally, information technology (IT) personnel should not initiate and process transactions, or correct data errors unless corrections are required to complete timely processing. In this situation, corrections should be pre-authorized, when possible, and authorized personnel should review and approve all corrections as soon as practical after the corrections are processed, regardless of any pre-authorizations.

Automated controls that act similar to manual segregation-of-duty controls can be written into software programs. For example, automated holds can be placed on customer accounts requiring special attention, such as dormant accounts or accounts with large uncollected funds. An automated hold allows tellers or customer service representatives to access an account for a customer, but requires the approval of a second person to authorize a transaction. In addition, certain modifications of data, such as master file changes, should require action from two authorized people before data is altered. When a hold on an account is added or removed, or when an action requiring supervisory approval occurs, exception reports should be automatically printed and reviewed by a designated person who is not involved with the activity. When properly designed, automated control methods are generally considered superior to manual procedures.

Joint Custody

Joint custody (a.k.a. *dual control*) refers to a procedure where two or more persons are equally accountable for the physical protection of items or records. For example, two keys or split combinations or passwords, under the separate control of different individuals, must be used in order to obtain access to vaults, files, or other storage devices. These custodial responsibilities should be clearly assigned and communicated to all affected employees. For the system to be effective, persons exercising control must guard their key, combination, or password carefully. If this is done, only collusion can bypass this control feature. Examples of items that should be under joint custody include reserve cash, negotiable collateral, certificated securities, trust assets, safekeeping items, reserve supplies of official checks, unissued electronic debit or credit cards, and unissued traveler's checks. Other examples include spare locks, keys, or combinations to night depositories, automated teller machines, safe deposit boxes, and tellers' cash drawers.

Vacation Policies

Banks should have a policy that requires all officers and employees to be absent from their duties for an uninterrupted period of not less than two consecutive weeks. Absence can be in the form of vacation, rotation of duties, or a combination of both activities. Such policies are highly effective in preventing embezzlements, which usually require a perpetrator's ongoing presence to manipulate records, respond to inquiries, and otherwise prevent detection. The benefits of such policies are substantially, if not totally, eroded if the duties normally performed by an individual are not assumed by someone else.

Where a bank's policies do not conform to the two-week recommended absence, examiners should discuss the benefits of this control with senior management and the board of directors and encourage them to annually review and approve the bank's actual policy and any exceptions. In cases where a two-week absent-from-duty policy is not in place, the institution should establish appropriate compensating controls that are strictly enforced. Any significant deficiencies in an institution's vacation policy or compensating controls should be discussed in the ROE and reflected in the Management component of the Uniform Financial Institutions Rating System (UFIRS).

Note: Management should consider suspending or restricting an individual's normal IT access rights during periods of prolonged absence, especially for employees with remote or high-level access rights. At a minimum, management should consider monitoring and reporting remote access during periods of prolonged absence.

Rotation of Personnel

Personnel rotations can provide effective internal controls and be a valuable part of overall training and business-continuity programs. The rotations should be planned by auditors and senior officers to ensure maximum effectiveness, but should not be announced ahead of time to the involved personnel. The rotations should be of sufficient duration to permit disclosure of irregularities due to error or fraud.

Pre-numbered Documents

Financial institutions should use sequentially numbered instruments wherever possible for items such as official checks and unissued stock certificates. In addition, institutions should maintain board meeting minutes on pre-numbered pages. Pre-numbered documents aid in proving, reconciling, and controlling used and unused items. Number controls should be monitored by a person who is detached from the particular operation; and unissued, pre-numbered instruments should be maintained under joint custody.

Cash Controls

Institutions should provide tellers with a separate cash drawer to which they have sole access. Common cash funds should not be used. An inability to fix responsibility in the event of a discrepancy could unnecessarily embarrass an employee or result in improper termination. Random cash drawer audits are also a fundamental control process.

Reporting Irregularities and Shortages

Management should develop procedures for the prompt reporting and investigation of irregularities and identified shortages. The results of investigations should be regularly reported to management and internal auditors, and when appropriate to fidelity insurers, regulators, and law enforcement agencies.

Business Continuity Plans

Business continuity planning requires banks to consider the impact of disruptions from natural disasters, technical problems, malicious activities (such as cyber attacks), pandemic incidents, etc. Directors and senior managers must develop business continuity plans to protect physical assets, safeguard financial records, and minimize operational interruptions.

Management should develop continuity plans for all significant operational areas based on the potential impact and probable occurrence of business disruptions. Disruptions include those with a high probability of occurrence and low impact to an institution, such as brief power interruptions, and to disruptions with a lower probability of occurrence but higher impact to an institution, such as tornadoes.

Business continuity plans should define key roles, responsibilities, and succession plans for various operational areas. Independent internal or external auditors should review the adequacy of the plans at least annually. Management should establish adequate training programs, periodically test the continuity plans, and report the test results and any recommendations for improvements to the board.

For additional details, refer to the FFIEC IT Examination Handbook titled Business Continuity Planning.

Accounting Systems

Efficient banking operations cannot be conducted without recordkeeping systems that generate accurate and reliable information and reports. Such systems are necessary to keep directors well informed and help officers manage effectively. Properly documented records are also necessary for meeting the needs of customers, shareholders, supervisory agencies, tax authorities, and courts of law.

Accounting systems should be designed to facilitate the preparation of internal reports that correspond with the responsibilities of individual supervisors and key employees. Records should be updated daily and reflect each day's activities separately from other days. Subsidiary records, such as those pertaining to deposits, loans, and securities, should balance with general ledger accounts.

While it is expected that records and systems will differ between banks, the books of every institution should be kept in accordance with well-established accounting and banking principles. In each instance, a bank's records and accounts should accurately reflect financial conditions and operating results. The following characteristics should be present in all accounting systems.

Audit Trail

Recordkeeping systems should be designed to enable the tracing of any transaction as it passes through accounts. Some of the more common recordkeeping deficiencies encountered during examinations include:

- General ledger entries are outdated or fail to contain adequate transaction descriptions;
- Customer loan records are incorrect, incomplete, or nonexistent;
- Cash item, overdraft, and suspense account records are deficient;
- Teller cash records are inadequately detailed;
- Security registers (electronic or manual) do not include all necessary information;
- Correspondent bank account reconcilements are outdated, lack complete descriptions, or fail to reflect the status of outstanding items;
- Account overage or shortage descriptions lack sufficient details;
- Letters of credit or other contingent liability records are inadequate; and
- Inter-office or intra-branch accounts are not properly controlled or monitored.

Accounting Manual

The uniform handling of monetary transactions is essential to the production of reliable financial reports. Management should establish accounting manuals and data processing guides that help employees consistently process and record transactions. Data processing guides are often provided by a servicer and supplemented by procedures written by bank personnel. The guides normally include instructions for compiling and reconciling source documents (such as checks and transaction tickets), instructions for processing the documents internally or transmitting them to a servicer for processing, and instructions for distributing output reports. Many systems allow employees to image source documents and transmit electronic files to a servicer for final posting. Regardless of the method used to process financial transactions, banks should have clear instructions for recording transactions and controlling the movement of documents and data between customers, the bank, and data processors.

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AUDIT

Internal control and internal audit are related, but separate concepts. Internal control involves the systems, policies, and procedures that institutions design to control risks, safeguard assets, and achieve objectives. Internal audits help directors and officers evaluate the adequacy of internal control systems by providing independent assessments of internal controls, bank activities, and information systems.

Appropriately structured and monitored audit programs substantially lessen financial and operational risks, and all banks should adopt adequate audit programs. Ideally, such programs include ongoing internal audits and periodic external audits.

Internal Audit

The board of directors and senior management are responsible for ensuring internal control systems operate effectively. Internal audits provide a systematic way for institutions to assess the effectiveness of risk-management and internal-control processes. When properly structured and conducted, internal audits provide vital information about risks and controls so management can promptly address any identified weaknesses.

When examiners identify weaknesses in internal auditing programs, they should discuss their concerns with management and the board and include appropriate recommendations in the ROE.

General Standards

As noted previously, Appendix A to Part 364 of the FDIC Rules and Regulations includes general standards for internal controls, information systems, and audit programs. Internal audit programs should be appropriate for the size of an institution and the nature and scope of its activities, and provide for:

- Adequate monitoring of the internal control system;
- Independence and objectivity;
- Qualified personnel;
- Adequate testing and review of information systems;
- Adequate documentation of tests, findings, and corrective actions;
- Verification and review of management's actions to address material weaknesses; and
- Review by the audit committee or board of directors of the effectiveness of the internal audit function.

The 2003 Interagency Policy Statement on the Internal Audit Function and its Outsourcing discusses:

- Board and management responsibilities,
- Key characteristics of the internal audit function,
- Considerations at small institutions,
- Outsourcing arrangements,
- Independence considerations when external auditors also provide internal audit services,
- Independence requirements relating to public and non-public companies,
- Annual audit and reporting requirements based on an institution's size, and
- Examiner reviews of internal audit functions and related matters.

As previously noted, directors and senior management should have reasonable assurance that the internal control system prevents or detects inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial reporting; and deviations from laws, regulations, and internal policies.

To ensure the internal audit program is appropriate for the institution's current and planned activities, directors should consider whether their institution's internal audit activities are conducted in accordance with professional standards, such as the Institute of Internal Auditors' (IIA), *Standards for the Professional Practice of Internal Auditing*. These standards provide criteria to address independence, professional proficiency, scope of work, performance of audit work, management of internal audits, and quality assurance reviews. Furthermore, directors and senior management should ensure the internal audit program adequately reflects key functional characteristics regarding organizational structure; management, staffing, and audit quality; scope; communication; and contingency planning.

Organizational Structure - The internal audit function should be positioned so the board has confidence that internal auditors will act impartially and not be unduly influenced by senior officers or operation managers. The audit committee should oversee the internal audit function, evaluate performance, and assign responsibility for the internal audit function to an internal audit manager or a member of management. If the responsibility is assigned to a member of management, the individual should not be involved in daily operations to avoid potential conflicts of interest. The internal audit manager should understand the internal audit function and have no responsibility for operating the system of internal control. Ideally, the internal audit manager should report directly and solely to the audit committee regarding audit issues and administrative matters such as resources, budget, appraisals, and compensation. If the internal audit manager is placed under a dual reporting structure (reports to a senior officer and the audit committee), the board should weigh the risk of diminished independence against the benefit of reduced administrative burden. Additionally, the audit committee should document its consideration of the risk and any mitigating controls the institution has in place to maintain audit independence.

Management, Staffing, and Audit Quality - The internal audit manager is responsible for control risk assessments, audit plans, audit programs, and audit reports. Control risk assessments document the internal auditor's understanding of significant business activities and associated risks. These assessments typically analyze the risks inherent in each significant business activity, mitigating control processes, and any residual risks to the institution. Internal audit plans should be based on the findings of the control risk assessments. The plans should include a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and the resource budget. Internal audit programs should describe audit objectives and list the procedures to be performed during each internal audit review. Audit reports should generally present the purpose, scope, and results of the audit including findings, conclusions, and recommendations. Workpapers that document the work performed and support the audit report should be maintained.

Ideally, the internal audit function's only role should be to independently and objectively evaluate and report on the effectiveness of an institution's risk management, control, and governance processes. The role should not include business-line oversight of control activities, such as approving or implementing operating policies or procedures. The audit committee should ensure that any consulting type work performed (e.g., providing advice on mergers, acquisitions, new products, services, internal controls, etc.) by the internal auditor(s) does not interfere or conflict with the objectivity of monitoring the internal control system.

The internal audit function should be staffed and supervised by people with sufficient expertise to identify operational risks and assess the effectiveness of internal controls. Internal audit policies, procedures, and work programs should be commensurate with the size and complexity of the internal audit department and institution.

Scope - The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's balance sheet and off-balance sheet activities. At least annually, the audit committee should evaluate and approve internal audit's control risk assessment(s), the scope of audit plans, and how much the audit manager relies on the work of outside vendors. The audit committee should also periodically review internal audit's adherence to approved audit plans and should consider expanding internal audit work if significant issues arise or material changes occur in the institution's structure, activities, or risk exposures.

The audit committee and management are responsible for determining the extent of auditing required to effectively monitor the internal control system. The expense of having a full-time audit manager or auditing staff is likely justified at institutions with complex structures or high-risk operations. However, the cost of having a full-time audit manager or staff may be prohibitive for institutions with less complexity and risks. Nevertheless, institutions without an internal audit staff can maintain an objective internal audit function by implementing comprehensive, independent reviews of significant internal controls. To be effective, competent individuals should design review procedures, and the individuals directing or performing the reviews must not be responsible for managing or operating the controls under review. The person completing the control reviews should report findings directly to the audit committee. The audit committee should evaluate the findings and ensure senior management takes appropriate action to correct any identified deficiencies.

Communication - Directors and senior management should encourage open discussions and critical evaluations of identified control weaknesses and any proposed solutions. Internal auditors should immediately discuss internal control weaknesses or deficiencies with the appropriate level of management. Significant matters should be promptly reported directly to the board of directors or its audit committee with a copy of the written report provided to senior management. Moreover, the board or audit committee should provide internal auditors the opportunity to discuss their findings without management being present, and institutions should establish procedures for employees to submit concerns (confidentially and anonymously) about questionable accounting, control, or auditing matters.

Contingency Planning - Whether using an in-house audit staff or an outsourced arrangement, the institution should have a contingency plan to mitigate any significant discontinuity in internal audit coverage, particularly for high-risk areas.

Outsourcing Internal Audits

Outsourcing arrangements involve contracts between an institution and a vendor that provides internal audit services. The arrangements may involve vendors providing limited or extensive audit assistance. Regardless of the level of outsourced services, an institution's directors are responsible for establishing and maintaining effective internal controls and internal audit programs.

Financial institutions should consider current and anticipated business risks when establishing each party's internal audit responsibilities. Institutions should have a written contract/engagement letter that clearly distinguishes its duties and those of the outsourcing vendor. Such contracts typically include provisions that:

- Define the expectations and responsibilities of both parties;
- Set the scope, frequency, and fees of a vendor's work;
- Describe the responsibilities for providing and receiving information and reports about the contract work status;
- Establish a process for changing contract terms, such as expanding audit work if issues are found;
- State that internal audit reports are the institution's property, designated employees will have reasonable and timely access to the vendor-prepared workpapers, and the institution will receive workpaper copies if needed;
- Specify the locations of internal audit reports and related workpapers;
- Specify the period vendors must maintain the workpapers;
- State that vendor audits are subject to regulatory review and examiners will be granted full and timely access to the internal audit reports and related workpapers;
- Prescribe a process for resolving disputes and for determining who incurs the cost of consequential damages arising from errors, omissions, and negligence;
- State that the vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee; and
- State, as applicable, that the vendor will comply with independence guidance established by the American Institute of Certified Public Accountants (AICPA), U.S. Securities and Exchange Commission (SEC), Public Company Accounting Oversight Board (PCAOB), or regulatory agencies.

Management should exercise appropriate due diligence in selecting vendors and periodically review outsourcing arrangements and vendor performance thereafter.

Communication among the internal audit staff, the audit committee, and senior management should not diminish because the institution engages an outside vendor. All work should be well documented, and any identified control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report findings to directors or senior management should be the mutual decision of the internal audit manager and the outsourcing vendor. In deciding what issues should be brought to the board's attention, the concept of *materiality*, as the term is used in financial statement audits, is generally not a good indicator of which control weakness to report. For example, when evaluating an institution's compliance with laws and regulations, any exception may be important.

Accountant Independence

Accounting firms risk compromising their independence if they perform internal and external audit functions at the same financial institution. The Sarbanes-Oxley Act of 2002 prohibits accounting firms from performing external audits of a public company during the same period they provide internal audit services. Non-publicly traded institutions that engage a firm to perform internal and external audit work in the same period are encouraged to consider the risks associated with compromised independence versus potential cost savings.

External Audit

Financial institutions should design external audit programs to ensure financial statements are prepared in accordance with Generally Accepted Accounting Practices (GAAP) and to alert management of any significant deficiencies in internal controls over financial reporting.

Section 36 of the FDI Act, as implemented by Part 363 of the FDIC Rules and Regulations, establishes annual independent audit and reporting requirements for insured depository institutions with total assets of $500 million or more. The 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations (1999 Policy Statement) includes audit and reporting guidance directed at banks and savings associations with less than $500 million in total assets.

Examiners that identify weaknesses in external auditing programs should include appropriate comments and recommendations in the ROE.

Audit Committees

All banks are strongly encouraged to establish an audit committee consisting entirely of outside directors. Although it may be difficult to establish a committee that includes only outside directors in a small closely held bank, all banks should be encouraged to include outside directors on their board and appoint them to the audit committee.

At least annually, the audit committee or board should analyze the extent of external auditing coverage needed by the bank. The board or audit committee should consider the size of the institution and the nature, scope, and complexity of its operations when evaluating external auditing needs. Institutions should also consider the benefits of:

- Financial statement audits,
- Internal control reviews,
- Additional auditing procedures for specific periods, and
- Additional auditing procedures for high-risk areas or special concerns.

Decisions regarding these considerations and the reasoning supporting the decisions should be recorded in committee or board minutes. If examiners determine risks are present that require additional external auditing, they should make specific recommendations to address the issues.

External Audits of Financial Statements

External audits help boards meet their fiduciary responsibilities and provide greater assurance that financial reports are accurate and complete. The audits can benefit management by providing insight into the effectiveness of accounting and operating policies, internal controls, internal auditing programs, and management information systems.

Each bank is strongly encouraged to adopt an external audit program that includes annual audits of its financial statements by an independent public accountant (unless its financial statements are included in the audit of the parent company's consolidated financial statements). A bank that does so would generally be considered to have satisfied the objectives of the 1999 Policy Statement.

External Audit Reports

Each state nonmember bank that undergoes external auditing work, regardless of the scope, should furnish a copy of any reports by the public accountant or other external auditor, including any management letters, to the appropriate FDIC regional office, promptly after receipt. A bank whose external auditing program combines state-mandated requirements, such as completion of annual directors' audits, with additional procedures may submit a copy of the auditors' report on its state-mandated procedures that is supplemented by a report on the additional procedures. In addition, the FDIC requests each bank to notify the appropriate regional office promptly when any public accountant or other external auditor is initially engaged to perform external audit procedures and when a change in its accountant or auditor occurs.

If a bank chooses an alternative external auditing program, rather than an annual audit of the financial statements, the report produced under the alternative program should include a description of the procedures performed. For example, if the auditor's report states *procedures agreed upon with management* have been performed, the bank should be asked to supply a copy of the engagement letter or other documents that outline the agreed-upon procedures so the FDIC can determine the adequacy of the scope of the external auditing program.

Audits at Institutions Under $500 Million

Regulatory agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. However, institutions of less than $500 million (at the beginning of their fiscal year) may be able to use alternative methods (some of which may be required by individual state statutes) that include:

- *Reporting by an Independent Public Accountant on an Institution's Internal Control Structure Over Financial Reporting* - This is an independent public accountant's examination and report on management's assertion of the effectiveness of the institution's internal control over financial reporting. For a smaller institution with less complex operations, this type of engagement is often less costly than a financial statement or balance sheet audit. It should include recommendations for improving internal controls, including suggestions for compensating controls, to mitigate risks due to staffing and resource limitations. Management's assertion and the accountant's attestation should generally cover lending and investing as these activities usually present the most significant risks affecting an institution's financial reporting.

- *Balance Sheet Audit Performed by an Independent Public Accountant* - This audit involves an institution that engages an independent public accountant to examine and report only on the balance sheet. As with the financial statement audit, the balance sheet audit is performed in accordance with Generally Accepted Auditing Standards (GAAS). The cost of a balance sheet audit is often less than a financial statement audit. However, under this type of program, the accountant does not examine or report on the fairness of the presentation of the institution's income statement, statement of changes in equity capital, or statement of cash flows.

- *Agreed Upon Procedures for State Required Examinations* - Some state statutes require state-chartered depository institutions to have specific procedures performed annually by their directors or independent persons. Depending upon the engagement's scope, the cost of the agreed-upon procedures or a state required examination might be less than the cost of an audit. However, under this type of program, the independent auditor does not report on the fairness of the institution's financial statements or attest to the effectiveness of the internal control structure over financial reporting. Findings or results are usually presented to the board or the audit committee so they may draw conclusions about the quality of financial reporting or sufficiency of internal control. When choosing this type of external auditing program, the board or audit committee is responsible for determining whether the procedures meet the external auditing needs of the institution, considering the institution's size and the nature, scope, and complexity of its business activities.

If the audit committee or board, at institutions with less than $500 million in total assets, determines not to engage an independent public accountant to conduct an annual audit of the financial statements, the reason(s) to use an acceptable alternative or to have no external auditing program should be documented in meeting minutes. Examiners should determine whether the alternative audit selected is appropriate, adequately covers all high-risk areas, and is performed by a qualified independent auditor. Any identified weaknesses in the external audit program should be commented on in the ROE.

If a bank with less than $500 million in total assets chooses not to have an external audit of financial statements by an independent public accountant, examiners should, at a minimum, strongly encourage the bank to engage an independent auditor to perform an external audit. If high-risk areas are evident, examiners should recommend that the auditor review the areas, and that any other deficiencies in the auditing program be corrected, to ensure there is adequate coverage of operational risk areas.

If a bank with less than $500 million in total assets has no external auditing program, examiners should review the board minutes to determine the board's rationale. Strong internal audit programs are fundamental to the safety and soundness of a bank, but are usually an insufficient reason for not implementing an external auditing program. One program should complement the other. Typically the external audit program tests and validates (or invalidates) the strength of internal controls and the internal audit program. In such situations, examiners should discuss the benefits of external auditing programs with the board and recommend the bank reconsider its decision.

Audits at Institutions of $500 Million or More

All depository institutions should implement adequate audit programs. Institutions with total assets of $500 million or more are required to have external audit programs that conform to the audit and reporting requirements of Part 363 of the FDIC Rules and Regulations.

Institutions covered by Part 363 must:

- Prepare annual financial statements,
- Produce annual reports detailing management's responsibilities and assessing management's compliance with laws and regulations, and
- Provide appropriate report signatures.

Annual financial statements must be prepared in accordance with GAAP and audited by an independent public accountant.

Annual reports must contain a statement of management's responsibilities for:

- Preparing financial statements,
- Maintaining adequate internal controls and procedures for financial reporting, and
- Complying with safety and soundness laws and regulations.

Management's assessment of their institution's compliance with laws and regulations must state a conclusion as to whether the institution complied with applicable laws and regulations, and disclose any instances of noncompliance.

Management reports at institutions with $1 billion or more in consolidated assets must also provide an assessment of the effectiveness of the institution's internal control system and include statements that:

- Identify the internal control framework used to evaluate the effectiveness of controls,
- Indicate controls were considered during the assessment,
- Express management's conclusion as to whether the institution's internal control over financial reporting is effective as of the end of the fiscal year, and
- Disclose any material weaknesses in internal controls that were not remediated prior to the fiscal year-end.

The signature requirements for management reports are related to the type of financial statements used to meet annual reporting requirements. For example:

- If financial statements and management reports are prepared at the institution level, the management report must be signed by the chief executive officer and the chief accounting officer or chief financial officer of the institution.
- If financial statements are prepared at the holding company level and the management report is prepared at the holding company level, the management report must be signed by the chief executive officer and the chief accounting officer or chief financial officer of the holding company.
- If financial statements are prepared at the holding company level and the management report is prepared at the institution level (or if parts of the management report are prepared at the holding company level and other parts at the institution level), the management report must be signed by the chief executive officer and the chief accounting officer or chief financial officer of both the holding company and the institution. Note: The management report must clearly indicate the level (institution or holding company) at which each of its components is being satisfied.

Public Accountant Responsibilities

The independent public accountant engaged by the institution is responsible for:

- Auditing and reporting on the institution's annual financial statements in accordance with GAAS or PCAOB standards; and
- Examining, attesting to, and reporting separately on the assertions of management concerning the institution's internal control structure and procedures for financial reporting on institutions with total assets of $1 billion or more.

Reporting Requirements

Part 363 requires insured depository institutions to submit the following reports and notifications to the FDIC, the appropriate federal banking agency, and the appropriate state bank supervisor.

- An annual report must be filed within 90 days after the fiscal year-end for public institutions and 120 days after the fiscal year-end for institutions that are not a public company or a subsidiary of a public company. When required, the annual report must contain audited annual financial statements, the independent public accountant's audit report, management's statements and assessments, and the independent public accountant's attestation concerning the institution's internal control structure and procedures for financial reporting.
- Within 15 days after receipt, the institution must submit any management letter; the audit report and any qualification to the audit report; and any other report, including attestation reports, from the independent public accountant.
- Within 15 days of occurrence, the institution must provide written notice of the engagement of an independent public accountant, the resignation or dismissal of a previously engaged accountant, and the reasons for such an event.
- A written notice of late filing should be filed on or before the filing deadline if an institution is unable to timely file all or any portion of its Part 363 reporting requirements. The late filing notice shall disclose the institution's inability to file on time and the reasons in reasonable detail. It shall also state the date by which the reports will be filed.

In addition, Part 363 requires certain filings from independent public accountants. Prior to commencing any services for an insured depository institution under Part 363, the independent public accountant must have received a peer review or be enrolled in a peer review program that meets acceptable guidelines. Also, accountants must notify the FDIC and the appropriate federal banking supervisor when it ceases to be the accountant for an insured depository institution.

Audit Committee

Each institution subject to Part 363 must establish an independent audit committee of its board of directors. The members of the committee must be outside directors who are independent of management. Their duties include overseeing the internal audit function, selecting the accountant, and reviewing with management and the accountant the audit's scope and conclusions, and the various management assertions and accountant attestations. Part 363 establishes the following additional requirements for audit committees of insured depository institutions with total assets of more than $3 billion: two members of the audit committee must have banking or related financial management expertise; large customers of the institution are excluded from the audit committee; and the audit committee must have access to its own outside counsel.

Holding Company Subsidiaries

Subsidiary institutions of holding companies, regardless of size, may file the audited, consolidated financial statements of the holding company in lieu of separate audited financial statements covering only the institution. Subsidiary institutions with less than $5 billion in total assets may also elect to comply with the other requirements of Part 363 at the holding company level, provided the holding company performs services and functions comparable to those required of the institution. If the holding company performs comparable functions and services, the institution may elect to rely on the holding company's audit committee and may file a management report and accountant's attestations that have been prepared for the holding company. Subsidiary institutions with $5 billion or more in total assets may elect to comply with these other requirements of Part 363 at the holding company level only if the holding company performs services and functions comparable to those required of the institution, and the institution has a composite CAMELS rating of 1 or 2.

The institution's audit committee may be composed of the same persons as the holding company's audit committee only if such persons are outside directors of the holding company and the subsidiary and are independent of both organizations' management.

If the institution being examined is not the lead bank in the holding company, the examiner should confirm that the institution qualified for and invoked the holding company exemption. The examiner should also review the holding company reports to determine if any pertinent information about the institution was disclosed.

Mergers

Institutions subject to Part 363 that cease to exist at fiscal year-end have no responsibility under this rule. If a covered institution no longer exists as a separate entity because it merged into another institution after the fiscal year-end, but before the date its reports must be filed, institutions are not required to file a Part 363 Annual Report for the last fiscal year of its existence. An institution should consult with the Accounting and Securities Disclosure Section in Washington, DC, and its primary federal regulator if other than the FDIC, concerning the statements and reports that would be appropriate to submit under these circumstances.

Review of Compliance with Part 363

When reviewing the audit report, examiners should carefully assess any qualifications in the independent accountant's opinion and any unusual transactions. In reviewing management's report and the accountant's attestation, special attention should be given to any assessment that indicates less than reasonable assurance of effective internal controls over financial reporting, or less than material compliance with designated laws and regulations. Notices referencing a change in accountants should be reviewed for possible *opinion shopping* and any other issues that relate to safety and soundness issues.

The board's annual determination that all members of the audit committee are *independent of the management of the institution* should also be reviewed. For institutions exceeding $3 billion in total assets, the examiner should review board determinations and minutes documenting that at least two members of the audit committee have banking or related financial management expertise and that no member is a large customer of the institution. Appropriate recommendations should be made in the ROE if any determination is deemed unreasonable.

At the first examination of an institution subject to Part 363, examiners should fully discuss any apparent violations with management and the board. Based on their judgment of the situation, examiners should focus discussions on educating officers and directors and making appropriate recommendations about future compliance. The ROE should indicate the status of the institution's implementation efforts if not yet in full compliance with the rule.

Examiners should convey to the regional accountant any concerns regarding an accountant or an accounting firm's auditing, attestation, or accounting policies and procedures that may necessitate evaluating peer reviews. If the regional accountant considers a peer-review workpaper evaluation warranted, the regional accountant will confer with the Accounting and Securities Disclosure Section about conducting the review. This referral does not preclude the regional office from filing a complaint or recommending an enforcement action against the accountant. Peer-review workpaper evaluations are generally appropriate only in unusual or egregious circumstances; therefore, they should be relatively rare.

Examiners should not provide any written representations concerning Part 363 to institutions or their independent outside auditors. Examiners should refer institutions or auditors to regional accountants if they receive such requests.

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OTHER EXTERNAL AUDIT ISSUES

Communication with External Auditors

The Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners (1992 Policy Statement), includes guidelines regarding meetings between external auditors and examiners.

The FDIC encourages communication between its examiners and external auditors with the permission of an institution's management. Permission is deemed to have been given once an institution notifies the FDIC of the accountant's name or the accounting firm that it engaged as external auditor (by letter or by submitting a copy of the auditor's report to an FDIC regional office). Permission continues until the institution notifies the FDIC that its relationship with the external auditor was terminated or another auditor was engaged.

The FDIC encourages external auditors to attend exit meetings and other significant discussions at which examiners and management discuss examination findings. In addition, auditors may request a meeting to discuss relevant supervisory matters with any of the regulatory agencies involved in the institution's supervision. An auditor who determines that communication with the FDIC is warranted concerning a recent examination should contact the appropriate regional office. A regional office staff member, examiner, or field supervisor may discuss pertinent examination findings with the external auditor. Regulatory agencies will usually ask management to be represented at the meeting. However, an external auditor may request a meeting without management representation.

Requests for meetings and information can also originate with regulatory agencies. Examiners may request meetings, including confidential meetings, with an institution's external auditor if questions arise concerning matters on which the external auditor is knowledgeable. FDIC personnel should determine if the external auditor discovered any problems relevant to the FDIC. Furthermore, FDIC personnel may request copies of workpapers relating to services performed by the external auditor. In some instances, an FDIC examiner, field supervisor, or regional office staff member may determine that attending the meeting at which the audit report is discussed between an institution's auditors and its management or board of directors (or an appropriate committee) would be useful. The institution should be advised and asked to present the request to the auditor.

The 1992 Policy Statement encourages open communication between examiners and auditors, and suggests institutions should provide its external auditors a copy of certain reports and supervisory documents including: reports of condition, examination reports, regulatory correspondence, and any formal or informal regulatory agreements or actions.

Similarly, AICPA guidance suggests auditors should communicate with examiners. The guidance indicates auditors should consider reviewing communication from examiners, and when appropriate make inquiries of examiners. The AICPA guidance also indicates auditors should be responsive to examiner's requests to attend meetings between auditors and bank management, and that management's refusal to allow auditors to review regulatory material or to communicate with examiners would ordinarily be an audit scope limitation sufficient to prevent the auditor from rendering an opinion.

Workpaper Review Procedures

Examiners, in consultation with the regional accountant, may review external audit workpapers relating to audits of financial institutions or their holding companies. Workpaper reviews may enhance examiners' ability to scope an examination by identifying areas where audit work was sufficient to allow a reduction in examination procedures and by identifying higher-risk areas where examination procedures should be expanded. A workpaper review may be especially useful if an institution has asset quality problems, complex investments, aggressive accounting practices, mortgage servicing activities, or large deferred tax assets.

Before undertaking any workpaper review, examiners should coordinate activities with the state bank supervisor and primary federal regulator (if other than the FDIC) of the institution, its holding company, and any other holding company subsidiaries. No set of workpapers should be reviewed more than once by the agencies.

Examiners should review the workpapers of the independent public accountant or other auditor performing the institution's external auditing program when an FDIC-supervised institution has undergone a financial statement or balance sheet audit, and:

- Significant concerns exist regarding matters that would fall within the scope of the work performed by the institution's external auditors, or
- The institution has been, or is expected to be, assigned a UFIRS composite rating of 4 or 5.

However, when considering how best to use examination resources, examiners should exercise reasonable judgment with respect to performing an external audit workpaper review for these institutions. For example, it would be appropriate to conduct an external audit workpaper review for FDIC-supervised institutions when significant matters exist and the review is reasonably expected to provide an examination benefit. If examiners determine that a benefit would not be derived from performing an external audit workpaper review for an FDIC-supervised institution, examiners must document, and include in the examination workpapers, the reasons for not conducting the review.

Requests by the regional director for access to a public accountant's workpapers should be in writing and specify the institution to be reviewed, indicate the accountant's related policies and procedures should be available for review, and request that a staff member of the public accounting firm knowledgeable about the institution be available to answer questions. Because workpapers are often voluminous, examiners are expected to view them where they are located. Since these workpapers are highly confidential, examiners are encouraged to take notes of needed information and should request copies of only those workpapers necessary for their records. Examiners should not request copies of all workpapers.

Complaints Against Accountants

An examiner encountering possible violations of professional standards by a CPA or licensed public accountant should, if practical (after consulting with the regional office), discuss the matter with the accountant in an attempt to resolve the concern. If the concern is not resolved, the examiner should send a memorandum to the regional director, with a copy to the regional accountant, summarizing the evidence of possible violations of professional standards and the inability to resolve the matter with the accountant. After conferring with the Accounting and Securities Disclosure Section, the regional office may determine it is appropriate to inform the accountant that a complaint to the AICPA and/or state board of accountancy may be considered. Where notification of apparent violation of professional standards appears appropriate, letters should be concurrently forwarded by the regional director to the state board of accountancy in the institution's home state, the Professional Ethics Division of the AICPA (in the case of certified public accountants), the subject accountant or firm, and the RMS Accounting and Securities Disclosure Section.

In addition to violations of professional standards, complaints should also include evidence of substandard auditing work or lack of independence.

Third-Party Audits at FDIC's Request

Examiners sometimes determine an institution is involved in unique activities or complex transactions that are outside management's expertise. For example, the institution may carry certain complex financial instruments or other unusual assets on its financial statements at values management cannot adequately support and the examiner cannot confirm. Additionally, the institution may have certain internal control problems that require the expertise of an independent consultant to resolve properly.

In these situations, after receiving appropriate approval, examiners may request an institution to contract with an independent public accountant or other professional to perform specific work to address the identified concern. Such an assignment would not be included in the normal scope of work performed in external auditing programs. This additional work, when performed by an independent public accountant, may be considered an engagement to perform *agreed-upon procedures*, to issue a *special report*, or *to report on the application of accounting principles* under applicable professional standards. These latter two engagements are performed by an independent public accountant under GAAS or PCAOB standards, while agreed-upon procedures are performed under Generally Accepted Standards for Attestation Engagements (GASAE). If another type of professional is contracted to perform services for an institution, the professional may be subject to a different set of professional standards. Nevertheless, the important elements for the examiner to consider when evaluating the adequacy of the institution's contract with the professional are similar in all cases.

When the FDIC requires an institution to contract an independent public accountant or other outside professional for specific work, the regional office should ask the institution to provide the FDIC with a copy of the contract before it is signed. The regional office should review the contract to determine if it sufficiently describes the work to be performed so that the outside professional can understand the FDIC's expectations and be responsive to any specific work requirements. The contract or engagement letter should, at a minimum, include:

- A description of the work to be performed;
- The responsibilities of the accountant or other professional;

- An identification of any specific financial statement elements, accounts, or items on which the work is to be performed; the party responsible for recording them in the financial statements; and the basis of accounting of the specific elements, accounts, or items on which the work is to be performed;
- A reference to any applicable professional standards covering the work, such as auditing, attestation, and appraisal standards;
- A description of:
  - Any specific procedures to be performed,
  - Any specific information sources to be used,
  - The qualifications of employees who perform the work,
  - The time frame for completing the work,
  - Any restrictions on the use of the reported findings, and
  - A provision for examiner access to workpapers. For example:

    The workpapers for this (specify type of engagement, e.g., agreed-upon procedures, special report) are the property of (name of firm) and constitute confidential information. However, (name of firm) agrees to make the workpapers supporting this engagement available to the FDIC and other federal and state banking regulators. In addition to the workpapers, (name of firm) agrees to make any or all of the following available to the FDIC and other federal and state banking regulators:

    - The work plan or similar planning document relating to this engagement;
    - The process used for the selection of samples used in the specific work, if applicable; and
    - Other pertinent information on the firm's policies and procedures that may affect this work plan.

    Access to the workpapers will be provided at (name of firm) local office under the supervision of our personnel. Furthermore, upon the request of the FDIC or other federal and state banking regulators, we agree to provide photocopies of selected workpapers to them.

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SARBANES-OXLEY ACT

The Sarbanes Oxley Act of 2002 (SOX Act) was enacted to protect investors from fraudulent accounting activities by corporations. Protections center on annual financial disclosures and requirements that management and auditors establish internal controls and report on the adequacy of those controls.

The SOX Act is primarily directed toward companies that have a class of securities registered with the Securities and Exchange Commission or a federal banking agency. Applicability of the SOX Act to insured depository institutions depends primarily on an institution's size and whether it is a public company or a subsidiary of a public company.

Public Companies

Some FDIC supervised banks have securities registered pursuant to Part 335 of the FDIC Rules and Regulations and are therefore public companies. Other FDIC supervised banks are subsidiaries of public holding companies. Public companies and their independent public accountants must comply with the SOX Act, including provisions governing audit standards, management responsibilities, and financial disclosures.

Non-public Banks

Non-public banks generally do not fall within the scope of the SOX Act. However, existing regulatory guidance, such as Section 36 of the FDI Act and Part 363 of the FDIC Rules and Regulations, contains audit, internal control, and reporting requirements that mirror portions of the SOX Act. Although such practices are not mandatory for smaller, non-public institutions, the FDIC encourages all institutions to implement accounting, internal control, and reporting practices to the extent possible, given their size, complexity, and risk profile.

Reporting Requirements

Banks with total assets of $500 million or more at the beginning of their fiscal year are subject to the annual audit and reporting requirements of Section 36 of the FDI Act as implemented by Part 363 of the FDIC Rules and Regulations. Under certain circumstances, some institutions may satisfy Part 363 requirements by submitting audited, consolidated financial statements of their holding company. Key reporting requirements applicable to FDIC-supervised banks with $500 million or more in total assets include:

- Preparing annual financial statements in accordance with GAAP that are audited by an independent public accountant; and

- Preparing annual management reports that contain:
  - A statement of management's responsibilities for preparing financial statements, maintaining an adequate internal control structure, and complying with laws and regulations; and
  - An assessment by management of the institution's compliance with such laws and regulations during such fiscal year.

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EVALUATING AUDIT PROGRAMS

Examiners should evaluate audit and control procedures as part of their overall assessment of a bank's internal control program. Each bank presents unique situations to which common sense and technical knowledge must be applied. Examiners should consider an institution's risk profile, size, complexity, number of employees, etc., when determining the overall adequacy of an internal control program.

Recommendation Considerations

Examiners should inform management and the board if they identify material or numerous internal routine and control deficiencies. When deficiencies are considered to be of sufficient importance, appropriate comments should be included in the ROE. Examiners should make recommendations for corrective actions only after considering the following:

- Recommendations should have merit. Criticisms that could be regarded as petty or highly technical may not help improve the bank's control environment.
- The benefit to the bank of implementing a recommendation should be emphasized.
- Recommendations or criticisms should be discussed fully with management prior to bringing it to the board's attention, as the record or procedure being criticized may be more fully understood by a banker who can offer a persuasive reason for its continuance.
- Examiners should not recommend banks maintain records in a specific format, or obtain software or accounting forms from a particular vendor.
- Convincing management to implement corrective actions is best accomplished by identifying material deficiencies and recommending effective solutions. Discussing minor deficiencies with management and making verbal recommendations (which should be documented in examination workpapers) may result in more effective correction of non-critical deficiencies.
- The relative importance of an individual control or lack thereof must be viewed in the context of other related controls.

Troubled Banks

Examiners should identify banks that have not had audits performed by an independent public accountant and at which any of the following conditions exist:

- Internal controls or internal auditing procedures are inadequate,
- The directorate is generally uninformed in the area of internal controls,
- There is evidence of insider abuse,
- There are known or suspected defalcations,
- There is known or suspected criminal activity,
- It is probable that director liability for losses exists,
- Direct verification is warranted, or
- Questionable transactions with affiliates have occurred.

In these situations, the examiner and regional office staff should consider adding a provision to any contemplated administrative order that the bank obtain an audit or, if more appropriate, have an independent public accountant or other qualified independent party perform specified audit procedures. Because each situation is unique, the examiner and regional office must evaluate the type of external audit program most suitable for each troubled bank and, in conjunction with regional counsel, ascertain that the inclusion of such an external audit program as a condition in an order is appropriate. Whenever a condition requiring an audit or specified audit procedures is included in an order, it should include requirements that the bank promptly submit copies of the auditor's reports to the regional office and notify the regional office in advance of any meeting between the bank and its auditors at which audit findings are to be presented.

Management Responsibilities

Assessing internal control programs is a critical part of examinations. In most cases, examiners can assess the adequacy of a bank's internal controls by reviewing:

- The overall structure of audit and control programs, monitoring procedures, and reporting mechanisms;
- Various audit reports in conjunction with the completion of standard examination procedures; and
- A limited number of specific controls or audit procedures.

Examiners should focus on identifying and correcting systemic weaknesses when evaluating internal control programs. Serious program weaknesses may exist if management fails to:

- Delineate clear lines of authority and responsibility,

- Standardize risk assessment procedures,
- Segregate operating and recording functions,
- Provide adequate and qualified audit personnel, or
- Regularly review and respond to audit reports.

In some instances, internal controls, monitoring procedures, reporting mechanisms, or financial conditions may indicate that more extensive audit tests should be undertaken. Testing procedures that may help identify errors, fraud, or insider abuse are discussed in the Examination Techniques section below. Examiners should refer to the Bank Fraud and Insider Abuse section of this Manual if they identify material errors or irregularities.

Common Controls

The following functions and related audit procedures should be included in most audit programs. The list is not all-inclusive and deficiencies in any one area may not represent an overall inadequate control program.

Cash and Due From Audits

The primary objectives of cash and due from audits are to ensure account balances are properly recorded, cash items clear within a reasonable period, and due-from accounts are substantiated and tested.

Auditors should periodically verify cash on hand, cash items, overdrafts, and other assets or liabilities held in suspense to ensure items are properly controlled, recorded, and disposed.

Due from reconciliations should be reviewed each month by someone who does not regularly reconcile the accounts. Particular emphasis should be placed on reviewing old or recurring items. Auditors should obtain account statements from depository institutions as of the audit date, and subsequent to the audit date, for validating bank reconcilements and ensuring outstanding items are cleared. Auditors should review all return items for an appropriate period after the audit date.

Investments

The primary objectives of investment audits are to ensure:

- Physical security certificates are on hand or held in safekeeping by others;
- Book entries are properly recorded;
- Interest and dividend income and security gains or losses are properly recorded;
- Securities are properly recorded as held-to-maturity, trading, or available-for-sale;
- Personnel follow segregation-of-duty and joint-custody directives, and
- Temporary declines in value are identified.

Auditors should:

- Prove subsidiary records to the general ledger,
- Verify securities on hand or held by others for safekeeping,
- Check the gain and loss entries on securities sold or matured since the previous audit,
- Review accrued interest accounts and substantiate computations and dispositions of interest income, and
- Assess premium-amortization and discount-accretion calculations.

Loans

Auditors should periodically:

- Prove subsidiary records to the general ledger,
- Verify a sampling of loan balances on a positive or negative basis,
- Verify the existence of negotiable collateral,
- Review accrued interest accounts and confirm the computation and disposition of interest income,
- Verify leases and related balance sheet accounts,
- Test unearned discount accounts, and
- Check rebate amounts for prepaid loans.

Allowance for Loan and Lease Losses (ALLL)

Auditors should:

- Review the balance of loans with charge-offs and the debit entries to the ALLL account,
- Review the balance of loans with recoveries and the credit entries in the ALLL account,
- Check supporting documentation for loans charged off, and
- Determine compliance with GAAP regarding the ALLL methodology used to estimate credit losses on individually and collectively evaluated loans.

Bank Premises and Equipment

Auditors should:

- Review entries and documentation relative to purchases and sales of premises and equipment since the previous audit;
- Verify computations of depreciation, amortization, and impairment;
- Check computations of gains or losses on property sold; and

- Trace sale proceeds.

Other Assets and Other Liabilities

Auditors should ascertain the appropriateness of other-asset and other-liability accounts by reviewing related policies, procedures, and internal controls and ensuring transactions are properly authorized, recorded, and balanced.

Deposits

Auditors should:

- Reconcile subsidiary records to general ledger accounts,
- Verify account balances on a test basis,
- Review closed accounts and determine if the accounts were properly closed,
- Review activity in dormant accounts and insider accounts,
- Review overdrafts,
- Check the computation of service charges and trace postings to appropriate income accounts,
- Review accrued interest accounts and check the computation of interest expenses,
- Verify the numerical sequence of pre-numbered certificates of deposit and official checks,
- Reconcile and determine the validity of outstanding official checks,
- Examine documentation supporting paid official checks, and
- Test certified checks to customers' collected funds.

Borrowed Funds

Auditors should:

- Confirm borrowings were authorized in accordance with internal policies,
- Verify balances of borrowed funds,
- Ensure collateral for borrowings is properly identified and disclosed,
- Verify changes in capital notes outstanding, and
- Review related accrued interest computations and interest expense balances.

Capital Accounts and Dividends

Auditors should account for all unissued stock certificates, review capital account changes since the previous audit, check computations for dividends paid or accrued, and review board minutes to determine the propriety of dividend payments and accruals.

Other Control Accounts

Auditors should test rental income for safe deposit boxes, examine and confirm safekeeping items, and reconcile consigned items on hand.

Income and Expenses

Auditors should test income and expenses by examining supporting documentation for authenticity and proper approval, and should test accruals by either re-computing amounts or examining documents supporting such accruals.

Direct Verification

Direct verification is an effective method of confirming the accuracy and validity of certain accounts, particularly loan and deposit accounts. Direct verification should be an important part of all internal and/or external audit programs, and may be employed as an internal control separate from regularly scheduled audits.

There are two primary types of direct verification, positive and negative. When the positive method is used, the customer is asked to confirm whether the balance, as shown, is correct. When the negative method is used, a reply is not requested unless an exception is noted.

The positive method has advantages from an audit standpoint as it provides considerable assurance the customer has carefully checked the confirmation form. The negative method is less costly and provides a measure of protection in those institutions having a strong program of internal control. The positive method is recommended for loan accounts. The positive method is preferred for deposit accounts, but because of high volume and cost factors, the negative method is often employed.

It is suggested that at a minimum, large deposit accounts, public fund accounts, dormant accounts, and accounts with unusual or high volumes of activity be positively verified. Additionally, overdue loans and charged-off loans should be confirmed through positive verification.

Direct verification may be conducted for all customers within a specific account type or through an appropriate sample. The necessity for a complete verification of loans or deposits is rare. A partial verification of representative accounts is usually satisfactory.

Direct verification may be performed by bank staff or contracted to a third party. To be effective, the verification procedure (including follow-ups) must be completely controlled by someone that does not have responsibility for the accounts or records being verified.

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FRAUD AND INSIDER ABUSE

Introduction

Financial institutions are highly susceptible to fraud, embezzlements, and theft; and bank personnel at every level have opportunities to commit dishonest acts. Uncovering fraud is not the primary reason examinations are conducted; however, examiners must be able to recognize fraudulent or abusive actions.

The following items include higher-risk accounts and common methods for manipulating financial records.

Loans

Forged or fictitious notes; accommodation loans; loans to insider-related shell companies; embezzlement of principal and interest payments; failure to cancel paid notes; use of blank, signed notes; embezzlement of escrow and collection accounts; commissions and kickbacks on loans; fraudulent loans to cover cash items and overdrafts; and diverted recoveries of charged-off loans.

Loan Collateral

Loans secured by fraudulent collateral such as altered, stolen, or counterfeit securities; certificates of deposit issued by illegitimate offshore banks; and brokered loans and link-financing arrangements where underlying collateral is not properly pledged or is prematurely released.

Deposits

Unauthorized withdrawals from dormant accounts; fictitious charges to customer accounts; unauthorized overdrafts; payment of bank-personnel checks against customer accounts or fictitious accounts; manipulation of items used to reconcile deposit trial balances; unauthorized withdrawals from accounts where the employee is acting as an agent or in some other fiduciary capacity; withholding and destroying deposit tickets and checks; misappropriation of service charges; check kiting; and manipulation of certificates of deposit, money orders, and official checks.

Correspondent Bank Accounts

Concealing a shortage by unreasonably delaying the recording of cash letters; delayed remittance of cash letters; fictitious credits and debits; manipulations to prevent the detection of overstated balances, such as issuing drafts without corresponding recordation on the bank's books or credit to the account; overstatement of cash letters and return items; and false collection items.

Tellers and Cash

Lapping deposits (covering one day's shortage with the next day's receipts); theft of cash; excessive over and short activity; fraudulent checks drawn on customers' accounts; fictitious cash items; manipulation of cash items; and intentional failure to report large currency transactions or suspicious activity.

Income and Expense

Embezzlement of income; fraudulent rebates on loan interest; fictitious expense charges; overstated expenses; and misapplication of credit life insurance premiums.

Investment Securities

Collusion between a bank employee and a securities dealer to trade securities at inflated prices; concealing trading losses from bank management and examiners; and unauthorized purchases and sales of securities, futures, or forward contracts with benefits accruing to a bank employee. Improper securities trading practices include:

- Placing personal trades through bank accounts, thereby obtaining the advantage of the bank's volume discounts on commissions;
- Purchasing or selling an issue of securities prior to executing bank or trust account trades, which could be expected to change the price of the security thereby providing a personal price advantage (front-running);
- Purchasing and selling the same securities on the same day with the trader retaining the gains from any price increase, but assigning losses to trust accounts if prices decrease; and
- Buying or selling based on nonpublic, inside information, which might affect the price of securities thereby enabling the trader to benefit personally from the transaction.

Additional Risks

Numerous methods are used to defraud banks and pose an ongoing problem. While no bank is exempt from the threat of defalcations by management, employees, or outsiders, certain institutions are more vulnerable than others. Any of the following situations may indicate the need to use more comprehensive audit techniques:

- An institution has one officer with dominant control over a bank's operations.
- Audit programs are inadequate.

- Internal control deficiencies are evident, such as weak vacation policies or ineffective segregation of duties.
- Records are poorly maintained or carelessly handled.
- Close supervision by the board of directors or senior management is inadequate, especially where rapid growth has occurred or numerous inexperienced managers are employed.
- A bank has grown substantially in a short time period. (The growth may have involved the use of high deposit rates, brokered funds, fraudulent or poor quality loans, or dishonest acts to conceal the bank's true condition.)
- A bank has had limited growth or a steady decline in deposits despite general economic prosperity in their operating area or strong growth by competing institutions.
- Earnings and yields are below average and expenses are high in comparison with past operating periods with no apparent explanation for the change.
- The bank is experiencing abnormal fluctuations in individual revenue or expense accounts, either in terms of dollar amounts or in relation to other operating accounts.

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EXAMINATION TECHNIQUES

Introduction

Numerous methods for concealing fraud exist, and even comprehensive audit techniques may not expose deceptive practices. However, when necessary, examiners should conduct detailed audit procedures. The audit techniques described below are not intended to be used at every examination; however, examiners should consider using these or similar techniques when appropriate.

Examiners should consult with the regional office if fraud-related examination procedures appear warranted.

Account Reconcilements

Examiner-prepared reconcilements of asset, liability, and capital accounts help ensure entries are properly recorded and subsidiary account records balance to the general ledger.

Direct Verification

Direct verifications are rarely initiated by regulatory personnel. Typically, financial institutions perform the verifications as part of their comprehensive audit function. If examiners, in consultation with regional office personnel, determine direct verifications are necessary, it is preferred that the bank or its external auditors make the customer contacts as these parties can more efficiently verify transactions with bank customers.

However, in certain situations it may be necessary for the FDIC or another banking agency to perform direct verifications. This may be appropriate if significant unreconciled items are disclosed, or evidence of potential fraud exists. Regional director approval must be obtained before examiners initiate direct verification of bank accounts or transactions. The following basic procedures or guidelines should be used if direct verifications are performed by FDIC staff.

- Addressing, stuffing, sealing, and mailing of envelopes should be done by examination personnel only.
- Franked envelopes furnished for reply should be preaddressed to the field office, regional office, or a post office box rented for the purpose.
- Duplicate records of all items verified should be maintained for control purposes.
- Examiners should watch for borrowers with common addresses or post office box numbers and for accounts having the same addresses as bank officers and employees.
- Loan verifications should include charged-off notes; separate notices should be sent to primary obligors, co-makers, endorsers, and guarantors.
- Third-party guarantees on lines of credit or individual notes should be verified directly with guarantors, not through primary obligors.
- Deposit verifications should be considered for recently closed dormant accounts, overdrawn accounts, and pledged accounts.
- All replies should be compared against retained duplicate records. Exceptions should be fully investigated against bank records or through follow-up correspondence with customers.
- Undelivered and returned tracers, unacknowledged verifications, and unexplained differences should be discussed with the entire board, not just with officers.

Loans

Examiners should consider using the techniques discussed below during loan reviews, especially if credit administration is weak or if they identify potential irregularities.

- Compare the signature on a note with other notes or documents signed by the maker.
- Review bank records to determine who actually pays the interest and principal (and the source of the funds) on large lines of continuous credit.

- Review records for power-of-attorney agreements giving an individual other than the named borrower(s) control of loan proceeds. (The agreements may be a sign of straw/nominee loans.)
- Review records for any changes to the official signers on deposit accounts established to receive loan proceeds. This may allow individuals other than the named borrower(s) to control loan proceeds.
- Investigate weak credit lines where directors or management may be the interested party although the bank's records do not reflect their interests.
- Spot check a cross section of out-of-territory loans to verify the disbursement of loan proceeds and the source of principal and interest payments.
- Audit the interest collected on a sampling of loans. Review the loan interest account for several days and compare the total with journal figures and the amount credited to the general ledger.
- Compare collateral records to loans secured by such collateral, and compare the collateral receipt date with the date the loan was granted.
- Review charge-offs in banks with large or numerous charge-offs. Verify the amount charged off was the approved amount; determine who prepares the list of charge-offs, who collects recoveries, and the accuracy of the reporting of these items. Compare actual loan documents with the bank's records to confirm balances and signatures.
- Consider tracing the proceeds of large loans and lines of credit that are subsequently charged off. (Tracing loan proceeds involves following the trail of funds from initial and subsequent loan disbursements to determine the person or entity that ultimately received the funds and how the funds were used. Disbursements may be transmitted by cash, check, wire transfer, other electronic means, or a credit to deposit/loan accounts at the bank.) When large loans are funded or material loan losses incurred, it may be advisable to analyze credits by tracing disbursement of loan proceeds and reviewing the borrower's deposit account(s) for possible payments of commissions or fees to a bank officer.
- Consider the following when reviewing the recordkeeping and monitoring of principal and interest receipts, especially payments relating to revolving accounts-receivable (A/R) financing:
  - Review records for occurrences of lapping payments. (Lapping occurs when an employee misappropriates funds (such as a loan payment), and covers the theft with payments from another loan customer or from advance (early) payments from the same customer.)
  - Review records for occurrences of payments made through the creation of fraudulent notes or unauthorized use of dealer reserve accounts.
  - Check records for an unusually large number of advance payments or overdue loans. In suspect cases, trace a sample of transfers to and from borrowers' checking accounts.
  - Spot check a cross-section of loans for appropriate signatures, disposition of proceeds, collateral, and sources of payment (particularly if outstanding loan volumes increased substantially between examinations for no apparent reason and overdue loans are unusually low or high).
  - Review records for occurrences of loan payments that come from the proceeds of other loans. Be watchful for multiple payments made on the same date for a particular note or borrower and compare the total of the payments with new loans granted on or about the same date.
  - Spot check for adequate recordkeeping if indirect dealer-paper lines are poorly monitored.

Deposits

Risks associated with inappropriate deposit account transfers are elevated in banks with weak internal controls and audit programs. Consider the following items when investigating potentially improper activities relating to deposit accounts.

- Reconcile subsidiary and general ledger accounts and any related adjustment items such as return items, overdrafts, holdovers, or service charges.
- Review any unusual or unapproved withdrawals from inactive or dormant accounts.
- Compare cash items, rejects, and exception items to individual account records to determine if the accounts exist, have sufficient funds, or have been closed.
- Cross check the interest paid on certificates of deposit to the interest expense account to verify ownership, dates, amounts due, and amounts actually paid.
- Be alert for possible check kiting when reviewing accounts. When available, review reports on kiting suspects and uncollected funds. Kiting characteristics include a high number of daily deposits, a high percentage of deposits coming from accounts under common control of a kiting suspect, large round-dollar checks, total daily debits and credits of similar amounts, and small average balances.
- With a bank employee, reconcile incoming cash letters and local clearings, and sight-post items to demand account records to determine if there is an account for each item. If the cash letter has already been opened, compare the number of items listed on the tape accompanying the letter with actual items to ascertain whether any items have been removed.

Correspondent Bank Accounts

The following audit steps can be used when evaluating correspondent accounts:

- Reconcile subsidiary and general ledger accounts, and compare a sample of paid and cancelled drafts drawn on correspondent banks to ledger entries for the same days. Select appropriate test periods, such as the date, and for several subsequent days after, material business activities occurred or the date institutions were notified of upcoming examinations.
- Review prior internal reconcilements of cash due from correspondents and statements received from correspondents. Ensure the reconcilements identify large outstanding items, unusual activity, forced balancing, and unreasonable or ongoing delays in crediting correspondents for their charges. (Delays in remitting for cash letters can be used to cover defalcations.) Also, ensure irregular items are properly reported.
- Review entries of similar amounts and dates between correspondent accounts that may indicate possible kiting or shortages between correspondent accounts.
- Compare coin and currency transactions reflected on correspondent accounts to the bank's increase or decrease in the cash account on corresponding days.

Tellers and Cash

When warranted, tellers' daily cash records can be inspected for possible discrepancies such as mathematical errors, forced balancing, unusual charges or adjustments, and excessive total balances or number of cash items. Items drawn on or by bank personnel should always be verified as to final payment or disposition. All work can be checked for proper endorsements and dates that indicate a teller is carrying items for an excessive period.

Suspense Accounts

Suspense accounts are sometimes used to conceal shortages, worthless assets, and deposit diversions. Review suspense accounts for material, stale, or unusual items, especially noting the recurring use and aging of reconciling items.

Income and Expense Accounts

Examiners can test interest computations on a sample of loans and securities. Verify large, recurring, or unusual debits to income accounts, and test interest rebates on loans and monthly service charges on demand deposits. Finally, compare interest paid on time and savings deposits to the amount credited to respective control accounts.

General Ledger Accounts

Determine the reason for any unusual activity in general ledger accounts, or abnormal variations between various general ledger accounts, and assess the validity of any reversing or correcting entries. Select appropriate test periods, such as the date, and for several subsequent days after, material business activities occurred or the date institutions were notified of upcoming examinations. Trace all closing income entries to the undivided profits account.

Other

Be alert for any major changes, particularly growth, in asset or liability totals. In cases of rapid loan expansion, check for possible out-of-territory loans to insiders. Also, if loans and certificates of deposit have increased beyond normal expectations, check the source of certificates of deposit; check for tie-ins between new notes and new certificates of deposit as to common names, amounts, and dates; trace the proceeds and determine the source of principal and interest payments on potentially inappropriate new loans.

Secretary of State Websites

Many states have websites examiners can use to obtain useful information on an entity's corporate structure, principal shareholders, or officers and directors. The websites may also contain information on the principals' other business relationships.

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RELATED CONTROL ISSUES

Information Technology

Part 364 of the FDIC Rules and Regulations requires financial institutions to have internal controls and information systems commensurate with the size of their institution and the nature, scope, and risk of their activities. Appendix B of Part 364 requires banks to have information security programs that include administrative, technical, and physical safeguards. Program standards should be designed to:

- Ensure the security and confidentiality of customer information;
- Protect against anticipated threats to the security or integrity of such information;
- Protect against unauthorized access to, or use of, information that could result in substantial harm or inconvenience to any customer; and
- Ensure the proper disposal of consumer information.

A bank's board of directors, or an appropriate board committee, should:

- Approve a written information security program;
- Oversee the development, implementation, and maintenance of the program;
- Assign specific responsibility for implementing the program; and
- Review reports from management.

Information systems present a variety of risks that, if not adequately managed, can negatively affect the safety and soundness of the institution. Therefore, examiners should assess information technology controls and operations at every examination. If an institution's internal control systems do not meet the program standards described above, the deficiencies should be described in the ROE.

Institutions should maintain a comprehensive security plan in order to maintain the confidentiality, integrity, and reliability of information. The plan should include regular risk assessments and, at a minimum, address physical and logical security, and backup and contingency strategies.

Generally, IT risk assessments consist of the identification of hardware, software, and information; an analysis of internal and external threats to the assets; and an evaluation of existing controls. The findings can provide management valuable information regarding the security of IT assets and any controls that may need strengthening. Management should use the information to develop strategies for improving identified control weaknesses and mitigating identified risks.

The FFIEC IT Examination Handbook, which comprises a series of booklets, serves as a reference for managing and examining IT systems. The Handbook contains IT examination procedures, workprograms, and references to related laws, regulations, and examination policies. It also provides examiners with fundamental principles of internal controls applicable to information processing environments. The FFIEC procedures and workprograms are the primary tools for the examination of large, complex data centers in financial institutions and independent technology service providers.

Examiners can also use portions of the FFIEC procedures and workprograms when necessary to review complex or high-risk areas during IT reviews of less complex, well-managed institutions.

Management Information Systems

The term *management information system* (MIS) broadly refers to a comprehensive process, supported by computer-based systems, that provides the information necessary to manage an organization. An effective MIS is essential in all institutions, but becomes increasingly important for managing risks in larger institutions with diverse business lines or a wide geographic footprint. Essential components of an effective MIS include timeliness, accuracy, completeness, consistency, and relevance. Management decisions may be invalid if any one of these components is compromised.

To evaluate an MIS, and ultimately the foundation upon which management's decisions are based, examiners should scrutinize each of the essential components. First, information must be current and available in a useful format to all appropriate users. This necessitates the prompt collection and editing of data. Second, an effective system of internal controls must be in place to ensure information is accurate and complete. Third, strategies and decisions cannot be adequately monitored or measured unless the information provided is consistent. Variations in how data is collected or reported can distort its usefulness, particularly in trend analyses. Any change in information collection or reporting procedures should be clearly defined, documented, and communicated to all users. Finally, the information provided must be relevant to the user. Reports that are overly complex or include unnecessary information impede users' ability to make effective decisions. Conversely, reviewing information from numerous reports can hinder analysis; therefore, a key consideration in the adequacy of reports is that they present information in a comprehensive, yet concise format.

Payment Systems

Financial institutions process a variety of payment instruments using various clearing and settlement systems. The systems are generally differentiated as wholesale or retail systems.

Although there is no definitive division between retail and wholesale payments, retail payment systems generally involve transactions between two consumers or between consumers and businesses and have higher transaction volumes and lower average dollar values.

Key risks in payment and settlement systems include:

- Credit Risk - The possibility a counterparty will not settle an obligation for full value either when due, or anytime thereafter.
- Liquidity Risk - The possibility a counterparty will not settle an obligation for full value when due.
- Operational Risk - The possibility of loss resulting from external events or inadequate internal processes,

people, or systems. This type of risk includes physical and logical security threats.
- Legal Risk - The possibility of loss because of the unexpected application of a law or regulation, or because a contract cannot be enforced.

Risk profiles vary significantly based on the size and complexity of an institution's payment-system products and services, IT infrastructure, and dependence on third parties. All financial institutions should maintain an effective internal control environment commensurate with the level of payment products and services offered. Detailed procedures for reviewing retail and wholesale payment systems are covered in the FFIEC IT Examination Handbooks.

Lost and Stolen Securities Program

The SEC started the Lost and Stolen Securities Program in 1977 to reduce trafficking in lost, stolen, missing, and counterfeit security certificates. Security certificates are documents representing, or claiming to represent, ownership in a security.

A security may be certificated or uncertificated. Ownership of a certificated security is represented by a security certificate. Ownership of an uncertificated security is not represented by a physical document, but simply by registration on financial records (book entries). The vast majority of securities are held in book entry form with a custodian.

Banks may acquire certificated securities when investing, holding securities as trust assets or collateral for loans, or through transfer agent activities. In each situation, a bank might acquire a security certificate that was reported as lost, stolen, counterfeit, missing, or otherwise encumbered.

The SEC implemented Rule 17f-1 to govern the reporting and recordkeeping of securities as a means for reducing trafficking in lost, stolen, missing, and counterfeit securities. The Securities Information Center (SIC) operates the SEC's Lost and Stolen Securities Program. The SIC may be contacted at the Securities Information Center, Inc., P.O. Box 55151, Boston, MA 02205-5151 or at www.secic.com.

Registration

All registered FINRA[1] broker dealers, FDIC-insured banks, and transfer agents that handle physical certificates must be registered with the SIC in order to report securities to the SIC database, or make database inquiries. Banks that did not handle certificated securities within the last six months do not need to be registered.

Registration can be direct or indirect. Banks registered as direct inquirers are allowed to make inquiries against the SIC database. Banks registered as indirect inquirers must have an agreement with a direct inquirer who makes inquiries on their behalf. In either event, institutions may inquire of the SIC whether a certificate has been reported as lost, stolen, counterfeit, missing, or otherwise encumbered (restricted, cancelled, escheated, etc.).

Inquiries

Insured depository institutions are required to make inquiries by the end of the fifth business day after a securities certificate comes into their possession, provided that such inquiries shall be made before the certificate is sold, used as collateral, or sent to another reporting institution (which includes broker dealers, transfer agents, and clearing agencies). Inquiries are not required if the securities certificate:

- Was received directly from the issuer or issuing agent at the time it was issued;
- Was received from another reporting institution or Federal Reserve bank or branch;
- Was received from a bank customer and is registered in the name of the customer or its nominee, or was previously sold to the customer as verified by internal bank records;
- Was part of a transaction having an aggregate face value of $10,000 or less in the case of bonds, or an aggregate market value of $10,000 or less in the case of stocks; or
- Was received directly from a drop that is affiliated with a reporting institution for the purposes of receiving or delivering certificates on behalf of the reporting institution.

Reporting

Reporting requirements vary based upon the type of issue being reported and the type of entity doing the reporting. In general, banks should report:

- Stolen security certificates (or the loss of any securities where criminal activity is suspected), to the SIC and the registered transfer agent for the issue, within one business day of the discovery. If the certificate numbers of the securities cannot be determined within one business day, they should be reported as soon as possible. Stolen securities must also be promptly reported to the Federal Bureau of Investigation.

1 The Financial Industry Regulatory Authority (FINRA) is an independent regulator for securities firms doing business in the U.S.

- Security certificates missing or lost for a period of two business days, to the SIC and the registered transfer agent, within one business day of the discovery. Certificates lost, missing, or stolen while in transit shall be reported by the delivering institution.
- Counterfeit securities to the SIC, transfer agent, and Federal Bureau of Investigation within one business day of the discovery.
- Otherwise impaired security certificates on a voluntary basis. The SEC encourages institutions to report on and inquire about encumbered certificates that are not specifically subject to Rule 17f-1, such as restricted, cancelled, or escheated certificates.

Banks that recover a lost, missing, or stolen securities certificate must report recoveries to the SIC and registered transfer agents within one business day of recovery. The recovery of certificates that were reported lost, missing or stolen and involved allegations of criminality must also be reported to the Federal Bureau of Investigation.

Banks must report lost, stolen, or counterfeit items on SEC Form X-17F-1A. Reports to the Federal Bureau of Investigation may be made on SEC Form X-17F-1A or Suspicious Activity Reports.

Note: Institutions must file a Suspicious Activity Report (SAR) with the Financial Crimes Enforcement Network within 30 days of discovery for:

- Insider abuse involving any amount,
- Transactions aggregating $5,000 or more where a suspect can be identified, or
- Transactions aggregating $25,000 or more regardless of potential suspects.

Refer to 17 CFR Part 240, Rule 17f-1 for a complete description of all reporting requirements.

Exemptions

The following types of securities are not subject to the SEC's inquiry and reporting requirements:

- Security issues not assigned CUSIP numbers,
- Bond coupons,
- Uncertificated securities,
- Global securities issues, and
- Any securities issue for which a negotiable securities certificate cannot be obtained.

Examination Considerations

Examiners should periodically:

- Ensure banks are directly or indirectly registered, or exempt from SEC registration requirements;
- Discuss Rule 17f-1 with bank personnel to evaluate their understanding of the rule;
- Review documentation relating to inquiries and reporting to ensure compliance with the rule; and
- Assess the adequacy of audit procedures covering the lost and stolen securities program.

Examiners should cite noncompliance with SEC Rule 240.17f-1 as an apparent violation on the Violations of Laws and Regulations page.

Improper and Illegal Payments

The Foreign Corrupt Practices Act (FCPA) and the Federal Election Campaign Act (FECA) cover improper and illegal payments by banks and bank holding companies. The FCPA prohibits bribes to foreign government officials to obtain or keep business.

The FECA prohibits national banks from making contributions relating to elections to any political office, including local, state, and federal offices. State-chartered institutions are also prohibited from contributing to any federal office, but may make contributions connected to state and local elections if authorized under their state's laws. However, all contributions must be properly authorized and recorded.

Improper methods for making political contributions may involve falsified expense accounts, below-market rate loans, providing equipment or services without charge, and paying bonuses to employees or excessive fees and salaries to officers that are then contributed to a campaign. These methods involve unacceptable accounting practices, and, if identified, reflect unfavorably on management and internal control and audit programs.

Examiners should consider the following items when evaluating the effectiveness of an institution's controls over political contributions.

1. Determine whether the bank has a policy prohibiting improper or illegal payments, bribes, kickbacks, loans, etc., relating to domestic and foreign governments or political campaigns.

2. If the bank has such a policy, review and analyze it for adequacy, and determine if it is appropriately communicated to officers, employees, and agents of the bank.

3. Review any audits or reports that evaluate policies or operations relating to funds or services provided in

connection with political campaigns. In addition, review any investigative reports generated by other government agencies.

4. Review and analyze any internal or external audit programs relating to political contributions and determine if the programs include appropriate procedures for discovering and reporting improper practices or illegal payments. Determine whether the programs remind auditors to be alert to any unusual entries or charges that might involve improper or illegal payments, and review the results of any related audits.

5. Analyze the general adequacy of internal controls to determine whether there is sufficient protection against improper or illegal payments under the aforementioned statutes.

6. If examination analysis indicates political-contribution audit programs or internal controls are inadequate, examiners should consider performing additional analysis, such as:

   - Reviewing income and expense account entries (and supporting documentation) since the last examination for large or unusual items.
   - Reviewing bank-controlled accounts, such as dealer reserves and cash/collateral accounts, to determine the validity of entries and adequacy of customer notifications. With respect to official bank checks, review copies of the checks and supporting documentation for unusual items or checks to political organizations or related individuals.
   - Reviewing charged-off loan files to determine the appropriateness of any charge-offs to government officials, or political candidates or political organizations.
   - Review new loan and time deposit relationships with public entities and municipalities that originated since the prior examination. Inquire about the nature and source of the new relationship(s). If inquiries raise suspicions, review credit underwriting documents and trace loan proceeds to resolve outstanding questions or concerns. Similar procedures should be conducted for customers identified as Politically Exposed Persons.

7. When performing routine examination procedures, examiners should be alert for any transactions, or the use of any bank services or equipment, that might involve bribes, political campaigns, or inappropriate political activities. The activities may be identified through the review of items such as:

   - Loans or lines of credit;
   - Income and expense entries;
   - Director, officer, and employee deposit accounts or overdrafts; and
   - Official checks and escrow accounts.

References:

- FFIEC IT Examination Handbooks
- Manual Section 9.1, Bank Fraud and Insider Abuse

DEFINITIONS AND AUTHORITIES

Sections 23A and 23B of the Federal Reserve Act (FR Act), as applied by the Federal banking agencies under various Federal banking statutes, govern transactions between banks and affiliated business organizations. The Gramm-Leach-Bliley Act (GLBA) amended many laws governing the affiliation of banks and other financial service providers. Among other laws, the GLBA amended the Banking Act of 1933, the Bank Holding Company Act of 1956, (BHC Act), the Interstate Banking and Branching Efficiency Act of 1994, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, the International Banking Act of 1978, the FR Act, the Federal Deposit Insurance Act (FDI Act), and the Home Owners' Loan Act.

Section 18(j) of the FDI Act extends the provisions of Sections 23A and 23B of the FR Act to state nonmember banks. Section 23A regulates transactions between a bank and its "affiliates," as that term is specifically defined in Section 23A. Section 23B of the FR Act was enacted as part of the Competitive Equality Banking Act of 1987 to expand the range of restrictions on transactions with affiliates. Section 10(b)(4) of the FDI Act authorizes FDIC examiners in the course of examining insured banks "to make such examinations of the affairs of any affiliate of any depository institution as may be necessary to disclose fully --- (i) the relationship between such depository institution and any such affiliate; and (ii) the effect of such relationship on the depository institution." "Affiliate" is defined in Section 3(w)(6) of the FDI Act as having the same meaning as the definition of that term in Section 2(k) of the BHC Act.

FDIC's enforcement authority also extends to certain parents and affiliates which are not bank holding companies. Section 3(u) of the FDI Act defines "institution affiliated parties" to include the controlling stockholder of an insured depository institution, or any shareholder or person who participates in the conduct of the affairs of an insured depository institution, or any independent contractor who participates in certain acts which cause significant adverse affect on an insured depository institution. This would include the parent companies of Industrial Loan Companies and other "non-bank" charters. Under Section 8(b) of the FDI Act, the FDIC can issue Orders against institution affiliated parties.

This section of the Manual discusses affiliates and subsidiaries, including the restrictions on transactions between affiliates and insured banks, exceptions to those restrictions, and the examination authority of the FDIC with respect to affiliates of nonmember insured banks. It also discusses the major provisions of the GLBA as affecting such transactions and the statutory implications for the FDIC examination process.

GRAMM-LEACH-BLILEY ACT (GLBA)

The passage of the GLBA significantly expanded the powers of bank subsidiaries of bank holding companies to engage in "financial activities," including offering insurance and securities products. The GLBA added Section 46 of the FDI Act that prescribes the circumstances in which an insured state bank may engage in financial activities as principal that may be conducted by a national bank only through a financial subsidiary. The GLBA also repealed the restrictions on banks affiliating with securities firms which were contained in Section 20 of the Glass-Steagall Act and repealed the prohibition on interlocking directors between banks and securities firms contained in Section 32.

Financial Holding Company

The GLBA authorizes the organization of a "financial holding company" (FHC) under Section 4 of the BHC Act. A FHC can engage in any activity, and may acquire shares of any company engaged in any activity, that the Board of Governors of the Federal Reserve System (the FRB) determines to be either financial in nature or incidental to such financial activity, or complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

The GLBA identifies some specific activities which are determined to meet this test and prescribes a consultative process involving the shared input of both the FRB and the Secretary of the Treasury for future definition of activities determined to meet the test.

Section 4(k)(4) of the BHC Act identifies a list of specific activities deemed "financial in nature" for these purposes. Qualifying FHCs may engage in such activities without regulatory approval provided notice is given to the FRB within 30 days after the activity is commenced. The listed activities include:

- Lending, exchanging, transferring, investing for others, or safeguarding money or securities,
- Insuring, guaranteeing or indemnifying against loss or illness, or issuing or providing annuities, as principal, agent or broker,

- Providing various forms of financial, investment or economic advisory services, including advising investment companies,
- Issuing and selling instruments representing interests in pools of assets permissible for a bank to hold directly,
- Securities underwriting, dealing and market making,
- Engaging in activities that have been determined to meet the “closely related” and “proper incident” tests under Section 4(c)(8) of the BHC Act,
- Engaging in activities in the United States that the FRB has previously authorized bank holding companies and their subsidiaries to conduct abroad under Section 4(c)(13) of the BHC Act,
- Certain merchant banking activities, and
- Certain “insurance company portfolio investment” activities.

Conditions Precedent to New Activities:

The following guidelines exist relative to a bank holding company entering into new activities:

- All depository institution subsidiaries of the bank holding company must be “well capitalized” and “well managed.”
- A “satisfactory” or better CRA rating must have been received by all of the depository institution subsidiaries at their most recent examination.
- The bank holding company must file with the FRB an election to become a financial holding company.
- There is a grandfather provision for certain non-conforming activities of a company that is not now a bank holding company but then becomes one to continue to engage in commercial activities in an amount not to exceed 15 percent of its consolidated annual gross revenues, excluding bank subsidiaries. The grandfather provision will expire ten years after the date of enactment, unless extended by the FRB for an additional five years.

The FRB is the umbrella supervisor for FHC’s. As such, the FRB assesses the FHC’s overall financial condition and the systems for monitoring risks for the entity as a whole.

Financial Subsidiaries

Implementing Section 121 of the GLBA as it pertains to state nonmember banks, the FDIC added Subpart E to Part 362 of its regulations. For purposes of Subpart E, a “financial subsidiary” is defined as a subsidiary that is controlled by a state nonmember bank and engages as principal in activities which may be conducted by a national bank only through a financial subsidiary. Most activities that were identified in the GLBA as being financial in nature are already permissible for a national bank to conduct directly.

The statutory criteria that must be satisfied in order to engage in activities through a financial subsidiary are:

- The state nonmember bank and each insured depository institution affiliate of the state nonmember bank must be and continue to be well capitalized after deducting the bank’s investment, including retained earnings, in all financial subsidiaries.
- The state nonmember bank must disclose the capital deduction and the separate assets and liabilities of the subsidiary in any published financial statement.
- The state nonmember bank must comply with the ongoing financial and operational safeguards required by Section 5136A(d) of the Revised Statures of the United States, which requires operational safeguards to separate the bank from the risks of the subsidiary.
- The state nonmember bank must comply with the amendments to Sections 23A and 23B of the FR Act made applicable by Section 121(b) of the GLBA that require certain ongoing transactional restrictions.
- The state nonmember bank and all of its insured depository affiliates must have received a CRA rating of not less than a “satisfactory record of meeting community credit needs” in its most recent CRA examination.

Functional Regulation

The GLBA also provides for the functional regulation of securities and insurance activities. This means that similar activities should be regulated by the same regulator so as to promote regulatory efficiencies and eliminate burden and duplication. Accordingly, banking activities are to be regulated by bank regulators, securities activities by securities regulators and insurance activities by State insurance departments. In order for functional regulation to be effective, certain consultation and information-sharing requirements are also contained in the statute.

The BHC Act was amended to restrict the authority of the FRB to require reports, conduct examinations, impose capital requirements or take any other direct or indirect action with respect to any functionally regulated affiliate of a depository institution. Section 45 was added to the FDI Act, which made these restrictions applicable to the FDIC.

It is still necessary to determine the significance of the activities conducted by the functionally regulated subsidiaries and determine whether the level of such activities could pose a material risk to the insured depository institution. This functional regulation concept does not, however, alter the Corporation's authority under Section 10(b)(4) of the FDI Act to examine affiliates "as may be necessary to disclose fully (i) the relationship between the depository institution and the affiliate; and (ii) the effect of such relationship on the depository institution."

A functionally regulated entity under the GLBA means a company:

- Engaged in insurance activities (as agent or principal) supervised by State insurance commissioners;
- Registered with the Securities and Exchange Commission (SEC) as an investment company under the Investment Company Act of 1940;
- Registered as an investment adviser either with the SEC or any State; or
- Engaged in commodity activities regulated by the Commodities Futures Trading Commission.

EXAMINATION AUTHORITY

The authority of examiners to examine all affiliates of State nonmember banks is contained in Section 10(b) and 10(c) of the FDI Act. In exercising the authority to examine State nonmember insured banks and their affiliates, examiners are empowered by Section 10(b) to make a thorough examination of all of the affairs of the bank and its affiliates and are directed to make a full and detailed report of condition of the bank to the FDIC. The authority to examine affiliates extends to those entities set forth in Section 23A of the FR Act.

The manner in which such examinations are conducted, and the format of the reporting on their condition, are not specified by either regulation or specific policy guidance. This is the case for two reasons. First, the type of affiliate and the nature of transactions with the insured institution can vary significantly; requiring sometimes more or less review, and typically a far different type of analysis than would be conducted for financial institution affiliates. Second, the risk presented by the activities of affiliates to the insurance fund is likely to be indirect, especially for those not engaged in direct transactions with the insured institution. Examinations under the FDIC's 10(b) authority will need to be tailored to the level of risk to which the insured institution is exposed as a result of transactions between, and the operations of, the relevant affiliates.

In addition, Section 10(c) of the FDI Act empowers the FDIC to issue, in the course of an examination, subpoenas and to take and preserve testimony under oath related to any matter in respect to the affairs or ownership of any such institution or affiliate. Accordingly, individuals, corporations, partnerships, or other entities which in any way affect the bank's affairs or ownership may be subpoenaed and required to produce documents under the FDIC's Section 10(c) powers.

Proper use of Section 10(c) powers can be a valuable aid to the FDIC in carrying out its supervisory responsibilities. However, the reasons why examinations of affiliates are considered advisable or necessary by the examiner should be documented, and the extent of any such examination should have prior clearance from the Regional Office. The exercise of Section 10(c) powers will require extensive legal documentation and should only be initiated following authorization from the Director, DSC.

BANK HOLDING COMPANIES

Under Section 2 of the BHC Act a "bank holding company" is defined to include any corporation, partnership, business trust, association, or similar organizations, or any long-term trust (one which extends beyond 25 years or 21 years and 10 months after the death of individuals living on the effective date of the trust) which has control over any bank or over any bank holding company. A bank, of course, is a company and, therefore, may be a bank holding company if it controls another bank or bank holding company. By virtue of amendments to the BHC Act, one-bank holding companies, partnerships, and under certain circumstances, bank trust departments are within BHC Act limits. An existing BHC may become an FHC by notifying the FRB of its election to do so. The BHC must certify that each of the FHC's insured depository institution subsidiaries is well capitalized and well managed.

Definition of Control

Under the BHC Act, a company has control over a bank or any other company (1) if it directly or indirectly owns, controls, or has the power to vote 25 percent or more of any class of voting securities of such bank or other company, (2) if it controls, in any manner, the election of a majority of the directors of such bank or other company, or (3) the FRB determines, after notice and hearing, that the company exercises a controlling influence over the management or policies of the bank or company. Shares owned or controlled by any subsidiary of a bank holding company are considered to be indirectly owned or controlled by the holding company. Shares held or controlled directly or indirectly by trustees for the benefit of a company or the shareholders or employees of a company are deemed to be controlled by the company. Refer to FRB Regulation Y, Section 225.2 for further clarification.

There is also a rebuttable presumption of control if the FRB, as authorized, finds that a company directly or indirectly exercises a controlling influence over the management or policies of the bank or bank holding company. In order to establish guidelines implementing these sections of the BHC Act, the FRB has adopted the following presumptions of control that may be rebutted by the affected company:

1. A company that owns, controls, or has power to vote more than 5 percent of the voting securities of a bank or bank holding company if; one or more of the company's directors, trustees or partners, or officers or employees with policy-making functions, serves in any of these capacities with the bank or holding company, and no other person owns, controls or has power to vote as much as 5 percent of any class of voting securities of the bank or bank holding company.
2. A company that owns, controls or has power to vote more than 5 percent of any class of voting securities of a bank or bank holding company if; additional voting securities are owned, controlled or held with power to vote by individuals or members of their immediate families (spouse, children, grandchildren, parents or their ancestors, stepchildren or stepparents, all whether natural or adopted) who are directors, officers, trustees or partners of the company (or own directly or indirectly 25 percent or more of any class of voting securities of the company) and such holdings together with the company's holdings aggregate 25 percent or more of any class of voting securities of the bank or bank holding company. The presumption does not apply under (1) and (2) where securities are held in a fiduciary capacity and the company does not have sole discretionary authority to exercise the voting rights.
3. A company that enters into any agreement or understanding with a bank or bank holding company (other than an investment advisory agreement), such as a management contract, pursuant to which the company or any of its subsidiaries exercises significant influence with respect to the general management or overall operations of the bank or bank holding company presumably controls such bank or bank holding company.
4. A company that enters into an agreement or understanding under which the rights of a holder of voting securities of a bank or other company are restricted in any manner, presumably controls the shares involved unless the agreement; is a mutual agreement among shareholders granting each other a right of first refusal with respect to their shares, is incident to a bona fide loan transaction, or relates to restrictions on transferability and continues only for such time as may reasonably be necessary to obtain from a Federal bank supervisory authority with respect to acquisition by the company of such securities.
5. A company that directly or indirectly owns securities that are convertible immediately at the option of the holder or owner into voting securities, presumably owns or controls the voting securities.

In addition to the foregoing, the FRB may, under its regulations, administratively determine that a company controls a bank or other company. Congress has apparently established 5 percent as the benchmark for determining whether or not “control" exists and the FRB has to a great extent incorporated that benchmark into its regulations dealing with the rebuttable presumption of control. Accordingly, under the BHC Act, there is a presumption that a company does not have control over a bank or other company if the company directly or indirectly owns, controls, or has the power to vote less than 5 percent of the voting securities of such bank or other company. Furthermore, a company does not have control of a bank or other company unless at the time in question that company directly or indirectly owned, controlled, or had power to vote 5 percent% or more of the voting securities of a bank or other company, or had already been found to have control by the FRB after notice and opportunity for hearing.

PARENT COMPANIES WHICH ARE NOT BANK HOLDING COMPANIES

The primary forms of insured bank whose parent company does not fall under the definition of Bank Holding Company (BHC) or Financial Institution Holding Company for the purposes of the Bank Holding Company Act (BHCA), are the Industrial Loan Company (ILC) and the Savings Bank. Both of these insured entities are otherwise defined as banks under Section 3 of the FDI Act.

ILCs are defined for the purposes of the BHCA exemption, Section 2c(2)(H), as “… an institution … which does not accept demand deposits … ; which has total assets of less than $100 million … or ; which is not acquired by any company after the … enactment of the Competitive Equality Amendments of 1987; or is an institution which does not … engage in any activity in which it was not lawfully engaged as of March 5, 1987 …” Savings Banks are defined in Section 3g of the FDI Act, and are essentially State Savings Banks.

The Competitive Equality Banking Act (CEBA) of 1987, in redefining a bank as any bank insured by the FDIC and eliminating the loophole in the BHCA for institutions that accepted demand deposits or made commercial loans but not both, also created a small group of grandfathered institutions. These "CEBA" banks are also known as "non-bank banks," have the same activity restrictions as do ILCs, and their parent companies would also not necessarily have to be Bank Holding Companies. The growth in the "non-bank bank" charter, entities sometimes called limited charter institutions, is now primarily in ILCs.

While some limited charter institutions are owned by bank holding companies, most are owned by parent companies whose limited activities and primary purpose of owning the insured institution, make these parents virtually identical to the shell bank holding company. However, ILCs can be owned by commercial parent companies. Some of these corporations are otherwise engaged in a diversity of business activities which would otherwise preclude them from owning a bank and being a bank holding company. These commercial corporations presently include some of the largest manufacturing, insurance, retail, and investment banking firms.

For more specific information regarding the various definitions, limitations, and restrictions on non-bank financial institutions, see the relevant provisions of the BHC Act, 12 U.S.C. 1843(f)(3) and Regulation Y, 12 C.F.R. 225.2 and 225.52. These are included under the Bank Holding Company Act tab in the Prentice-Hall volumes.

CEBA Credit Card Banks

CEBA credit card banks are also exempt from the BHC Act and may be owned by commercial entities. Their operations are restricted to only issuing credit cards, accepting no demand deposits, accepting only jumbo deposits ($100,000 minimum), having only one office, and not making any commercial loans.

Unitary Thrift Holding Companies

Prior to the enactment of the GLBA, any company, regardless of its activities, could acquire a single savings association if the prospective subsidiary satisfied the qualified thrift lender test (QTL).[1]

The advantages of that charter included preferential taxation, liberal branching rights, expanded subsidiary powers and virtually unlimited holding company activities. Many of the thrifts with this charter were owned by commercial entities.

The GLBA prohibits the creation of new unitary thrift holding companies that engage in commercial or other nonfinancial activities. The GLBA did, however, grandfather most unitary thrift holding companies in existence as of May 4, 1999.

Industrial Loan Companies

Industrial Loan Companies (ILCs), also known as industrial banks, are state-chartered banking institutions. While only permissible in a limited number of states, they generally have broad banking powers, and under certain circumstances ILCs may be owned by commercial entities. Specifically, an ILC that meets certain criteria is not a "bank" under the BHC Act, and any company that controls such an ILC would not be subject to FRB regulation and supervision as a bank holding company. [2] Most ILCs have Federal deposit insurance (made available under the Garn-St. Germain Depository Institutions Act of 1982 legislation) and are regulated in a similar manner to state-chartered commercial banks.

Core ILC functions are traditional financial activities that can commonly be engaged in by institutions of all charter types. An ILC can:

- offer a full range of deposits, except demand deposits (unless grandfathered);
- offer a full range of loans and other financial services to both consumer and commercial customers;
- be an original issuer of Visa or Master Card credit and debit cards;
- fund its operations with deposits and Federal Home Loan Bank (FHLB) borrowings.

If an ILC is organized as a limited purpose or credit card institution, then its products and services would be limited to specified activities.

The GLBA did not repeal the ILC exception contained in the BHC Act. As such, commercial firms may continue, as State law permits, to acquire and control ILCs without complying with the BHCA so long as the ILCs satisfy the criteria for the exception. In the case of a parent subject to the reporting requirements of another regulatory body covered under the GLBA, such as the SEC or a State insurance commissioner, the FDIC has agreements in place to share information with such functional regulators. In examining any insured depository institution, the FDIC has the authority (under 12 U.S.C. § 1820(b)(4)) to examine any affiliate of the institution, including its parent company, as may be necessary to determine the relationship between the institution and the affiliate and to determine the effect of such relationship on the institution.

Unique Characteristics of Commercial Parent Companies

Certain bank charters, such as ILCs, may have commercial parent companies in place of a traditional bank holding company or financial institution holding company. As with bank holding companies, these commercial parents can be a source of strength for their subsidiary bank by providing access to the capital and debt markets, and affording the opportunity to use a variety of technical services not always available to small or mid-size banks.

However, commercial parents also present different management challenges to the insured institution and different analytical challenges to examiners. Commercial parents may not be able to offer additional management expertise directly relevant to financial institutions. In serving the specific financial needs of a commercial company, a niche bank may be insufficiently diversified against credit or liquidity risks. Further a financial catastrophe at a parent or affiliate, unrelated to the business of the insured institution, could result in an unanticipated but immediate disruption to the earnings or operations of the insured entity.

Moreover, assessment of "extra-insured" risk factors cannot be made with the comparatively straight-forward ratio analysis used for evaluating bank holding companies. Commercial firms present more varied revenue streams and business risks. Further, while a clearly identified weakness in the insured institution will generally determine the need to conduct an assessment of the potential source of strength provided by the commercial parent, any determination of a "potential source of weakness" presented by a parent or affiliate to an otherwise healthy insured entity will be far more complex. Examiners should only undertake such an assessment following consultation and direction from the Regional Office.

For non-bank holding companies or commercial parent entities, some possible sources for financial analysis include: parent entity quarterly or annual reports, Securities and Exchange Commission filings such as 10-Ks, 10-Qs, etc., bank records on affiliates, external industry analysis sources (i.e. Moody's Standard and Poor's, etc.), internal and/or external audits, corporate press releases, newspaper articles, etc.

HOLDING COMPANY EFFECT ON SUBSIDIARY BANKS

A sound, well-managed holding company can be a source of strength for unit banks; however, if the condition of the holding company or its nonbank subsidiaries is unsound, the operation of subsidiary banks can be adversely affected.

Management

The long-term health of an institution depends on a strong, independent and attentive board. The board sets the overall tone and direction of the institution and establishes policies and procedures concerning the nature and amount of risk the institution may take.

Solid corporate governance principles recognize the following elements necessary for the successful operation of the depository affiliated institution:

Each member of the board of directors should have the skills, integrity, knowledge, and experience necessary to allow the director to fulfill his or her responsibilities to the insured institution. The qualifications should be considered in light of the institution's size, complexity and risk profile. Board membership should be considered not only on an individual basis, but also collectively such that the composition provides a well rounded set of skills, knowledge, and experience.

The board of directors is responsible for actively overseeing the affairs of the institutions. This oversight should include:

- Reviewing and approving major corporate actions and the institution's overall corporate strategies, business plans, performance objectives, risk policies and risk tolerances,
- Monitoring the institution's adherence to the strategies, plans, objectives, risk policies and risk tolerances approved by the board, including policies and standards relating to conflicts of interest management,
- Reviewing appropriate regulatory and audit reports, and
- Taking appropriate action with respect to all matters requiring board attention.

The board of directors is responsible for ensuring that the institution, its directors, management, principal shareholders, and affiliates avoid potential direct and indirect conflicts of interest and comply with Federal laws and regulations that are designed to prevent misuse of depositors' funds.

The board of directors is responsible for hiring and retaining executive officers with the skills, integrity, knowledge and expertise appropriate to the nature and scope of their responsibilities. Executive officers must have the ability to manage day-to-day operations to achieve the institution’s performance goals. They should also possess the industry expertise to assess the institution’s current performance and condition and to help the board plan for the institution’s future.

The board of directors is responsible for establishing and maintaining appropriate committees, and that written charters delineating each committee’s functions, responsibilities and membership qualifications have been adopted by the full board.

The board of directors is responsible for ensuring that the insured depository institution maintains a separate corporate existence from its affiliates. This separateness also pertains to the sound tenet that all financial and other pertinent records for the financial institution affiliate be accessible on location.

Financial Considerations

The holding company structure can provide its subsidiary bank strong financial support because of greater ability to attract and shift funds from excess capital areas to capital deficient areas. The financial support can take the form of equity capital injections and/or the funding of loans and investments. However, when the financial condition of the holding company or its nonbanking subsidiaries is tenuous, pressures can be exerted on the subsidiary banks. In order to service its debt or provide support to another nonbank subsidiary, the holding company may place inordinate financial pressure on its subsidiary banks by any of the following methods: payment of excessive dividends; pressure subsidiary banks to invest in high risk assets to increase asset yields; purchase and/or trade its high quality assets for the other affiliate's lower quality assets; purchase of unnecessary services from affiliates; or payment of excessive management or other fees.

Although no formal policy statement has been issued by the FDIC, it has long been the FDIC's position that management and other fees paid by subsidiary banks should have a direct relationship to the value of actual goods or services rendered based on reasonable costs consistent with current market values for such services. Bank files should contain adequate information to permit a determination as to what goods and services are being provided and on what basis they are being priced. Charges should not be based on resources, deposits, or earnings of the bank. In those instances when payments are large and are not or could not be justified on the basis of services received by the bank, a comment should be included in the Report of Examination.

An additional method of upstreaming funds from a bank to its parent is through the remittance of income taxes to the parent that then files a consolidated income tax return. Due to timing differences arising from the use of different accounting methods for Reports of Condition and Income (Call Reports) and for income tax purposes, a portion of taxes reflected in Reports of Income and Condition will be deferred; however, in certain instances, banks are required to remit to the holding company the entire amount of income tax expense, both current and deferred. The FDIC's Statement of Policy Income Tax Remittance by Banks to Holding Company Affiliates, indicates past transfers of this kind shall be restated on the bank's books and future tax transfers shall only include the current portion of income tax expense.

Even when the holding company is financially sound, supervisory concerns may arise as the parent issues long-term debt to fund equity capital in the subsidiaries. Although this capital raising activity, known as "double leveraging," does increase equity capital in the subsidiary, too much debt at the holding company level can generate pressure on the subsidiary to upstream additional dividends. Since the holding company often services the debt with dividends from the lead bank, holding company debt service requirements which come to exceed historical dividend payment ratios may place undue earnings pressure on the bank. Should dividends be insufficient, the holding company may attempt to create other means of generating cash, such as charging the subsidiary for management and operating expenses.

The double leverage ratio is the equity of the subsidiary, or in the case of multiple subsidiaries the combined equity of all the subsidiaries; divided by the equity of the holding company. A holding company with a ratio of 100% or less, is not using double leverage. The amount of double leverage a holding company can comfortably carry can depend on various factors; but analysis should center on the amount of earnings or cash flow which the subsidiaries, or the lead bank if the lead bank generates most of the combined company’s earnings, can upstream to the parent. Even holding companies with comparatively modest double leverage ratios can negatively affect the bank if the non-bank subsidiaries produce negative cash flow. Other leverage ratios which attempt to isolate or incorporate different segments of the holding company’s capital structure (preferred stock or minority interests for example) can be useful for assessing more complex organizations.

Fixed charge coverage is a ratio that measures the ability of the parent company to cover its interest expense. The ratio is computed by determining how many times the parent's total interest expense is "covered" by the net of parent operating income (excluding "equity in undistributed earnings") less parent operating expenses other than interest and taxes. Interest expense is defined to include one- third of parent rental expense (if any), as though premises and equipment had been mortgaged rather than leased. A bank holding company parent's position is generally considered comfortable if it shows a coverage ratio of 2 times or better. A ratio of less than 1 points to a condition of cash flow deficit, without taking debt amortization or shareholder dividends into consideration. This ratio can be misleading if there is an abnormal dividend payout from subsidiaries, the major source of income to a parent. If the payout of all subsidiaries is only 20 percent (but could be 60 percent), the coverage ratio could be very low, perhaps well under 2 times. Conversely, if the payout of earnings is an unsustainable high 90 percent, the coverage ratio could temporarily appear adequate. Therefore, it is essential to be aware of actual dividend payout from subsidiaries to the parent before final interpretation of this ratio.

Cash flow match is a more severe test of parent cash availability to meet not only interest expenses, but also operating expenses, taxes, shareholder dividends, and debt maturities. Cash "sources" are defined as all parent operating income plus tax credit (or minus taxes paid). Cash "uses" are defined as operating expenses (including interest), dividends to shareholders, and debt principal due in one year. A coverage ratio of 1.10 "times" (i.e., cash sources are 110 percent of uses) is generally considered comfortable. Many highly profitable, underleveraged BHCs reflect ratios of 1.20 times or better. Ratios under 1.00 need additional study, as the presumption is that cash flow is insufficient to maintain BHC credit, which bears upon the viability of the institution. Like the fixed-charge coverage test, this ratio also needs adjustment to be interpreted in light of subsidiaries' dividend levels. The amount of debt due in one year usually does not reflect a normalized amortization schedule, since balloon and bullet maturities create a year-to-year instability in the "amount due.” If sufficient data were available, it would be more appropriate to arbitrarily introduce a "normalized" amortization schedule based on the average life of parent debt outstanding. Finally, not all parent debt needs to be serviced from parent operating income. Much of this debt is covered or matched by advances to profitable subsidiaries, so that servicing of principal is in essence automatic. Therefore, a true cash flow test would apply only to "uncovered" parent debt and only the amortization of this portion needs to be normalized in the manner described.

These cash flow measures are the best indicators of the financial support a parent company can provide to a subsidiary bank. Asset size, capitalization, revenue or profitability; even relative to the size of the insured institution, are imperfect measures for gauging potential support.

Other ratios that can be used when analyzing holding companies are included on the Relationship with Affiliates and Holding Companies page of the Report of Examination. These ratios are generally available from the Uniform Bank Holding Company Performance Report.

Economies of Scale

The holding company structure can provide significant benefits from economies of scale in areas such as audit, and data processing services, etc. Effective review of the examination report by the holding company and implementation of recommendations contained therein should assist the FDIC in the supervision of subsidiary banks.

Dual Employees

These economies of scale could extend to the employees in the case of “dual employees” or those that perform essentially the same duties for a banking entity and the affiliated organization. The use of dual-employees can be a cost-effective manner for leveraging in-house expertise or for employees that specialize in certain core competencies. Nonetheless, the use of dual-employee arrangements may present increased risk to an insured banking entity if the institution, or its management, fails to adequately monitor the hiring, training, activities, reporting, or expertise of dual-employees.

Any dual officer or employee arrangements should be consistent with sound principles of corporate governance. All bank activities, including those performed by dual employees, should be subject to the authority of an independent board of directors. Bank officers (whether they are dual employees or direct employees) must have sufficient expertise, authority, and information to act in the best interests of the insured institution at all times, under the direction of the board. A comprehensive framework of policies, procedures, legal agreements, controls, and audit must be established to govern the activities of dual officers and employees. A formal written employee sharing agreement should be established to define the employment relationship between the banking entity and affiliate. The following factors should be addressed:

- The agreement needs to be independently reviewed by the bank's board of directors to ensure that it is fair and in the best interest of the insured bank.
- Compensation arrangements need to be clearly delineated to ensure they are equitable for both the bank and affiliated entity.
- The location where the dual employee is to perform duties needs to be established and detailed, along with reporting and authority.
- The agreement should require dual employees to avoid conflicts of interest. Additionally, the agreement should state that dual employees or officers must act in the best interest of the bank while performing any activities on behalf of the bank.
- Sanctions for noncompliance should be contained in the bank's agreement.
- The agreement should provide for a periodic determination concerning the status of a dual-employee and the factors to be considered for terminating the dual-employee relationship in favor of either full-time bank or affiliated entity employment.
- Authority for managing the dual-employee relationships should be clearly assigned.
- Lines of authority for dual employees should be established. While dual employees may have other responsibilities, they must also report through appropriate lines of authority within the banking institution. The dual employee's bank responsibilities and decision-making should take precedence over any affiliate responsibilities. All activities conducted on behalf of the bank must be subject to appropriate review and authorization by bank officers, and ultimately the bank's board of directors.

Affiliate officers and employees who conduct activities on behalf of the bank (even if not formally designated as dual employees) are subject to the same level of legal and corporate duties and liabilities as a direct officer or employee of the bank. Additionally, examiners should have reasonable access to dual employees and any other affiliate employees who perform services on behalf of the bank.

Bank officers must retain control over certain key functions, including general ledger entries, regulatory reporting, cash accounts, lending activities, and investments. While dual officers and employees can provide advice and other supporting services, bank officers must retain final decision making authority. Reasonable systems should be established to ensure that bank officers have sufficient information to oversee the activities of dual officers and employees who provide services to the bank.

The institution needs to be able to devote sufficient resources for monitoring and measuring performance under the terms of the employment sharing agreement.

The extent of the relationships, including the amount of time devoted between the bank and an affiliated entity, need to be periodically reported to the directorate or an appropriate committee.

The insured banking institution utilizing a dual-employee needs to have policies and procedures in place covering account settlement for dual-employees that stipulate the manner and timing for payment in order to ensure an unanticipated affiliated loan does not occur in contravention of Sections 23A & 23B of the FR Act.

Policies and procedures dealing with dual-employee relationships should include a mechanism to ensure compliance with 12 U.S.C 1831g (Adverse Contracts). Under that statute, an institution may not enter into a written or oral contract with any person to provide goods, products, or services to, or for the benefit of, a depository institution if the performance of such contract would adversely affect the safety and soundness of the insured institution.

Examiners should review and evaluate arrangements involving shared employees and/or management for the items discussed above.

Miscellaneous Considerations

The principal benefit of bank holding companies is the tax benefit from issuing debt at the parent company level and concurrently creating equity at the bank level. Most one bank holding companies which engage in minimal other activity aside from holding the stock of the bank, were created for this purpose. The Federal Reserve ruling permitting treatment of Trust Preferred Stock as Tier 1 capital for regulatory purposes, while simultaneously allowing the consolidated holding company to treat it as debt for tax purposes, further added to the attractions of the one bank holding company.

Many of the smaller one-bank holding companies receive infrequent inspection by the Federal Reserve. Ordinarily the holding company financial statements reflect little more than the bank investment and acquisition debt. It is expected that where debt-servicing requirements may impact bank earnings, appropriate comments will be made by the examiner in the examination report. Reference is made to the Earnings section of this Manual as well as the instructions for the preparation of the Relationships with Affiliates and Holding Company report page.

Another major benefit to an individual bank that belongs to a multi-bank holding company is that it can better serve its customers by participating loans exceeding its legal lending limit. A problem could result from this practice if the loan granted exceeds the management expertise of any of the participants.

Examiners should review and evaluate current business plans and any changes thereto since the previous examination. Business plans in most instances should be reduced to written form. It is recognized that the depth and detail of written plans may properly vary, depending on the nature, scope and complexity of their operations. Occasionally, examiners may encounter situations where written plans have not been developed. In these instances, frequent and ongoing communication with management is imperative. The necessity for a written plan may be inferred from the results achieved by management to a considerable degree.

Examiners should assess whether all service relationships provided by affiliates are governed by a written agreement. Refer to Sections 23A and 23B of the FR Act for additional information on affiliate transactions.

Examiners should also determine whether the bank should have a contingency plan for all critical business functions performed by affiliated companies. Refer to outstanding Information Technology (IT) examination guidance for specifics on contingency planning.

The Potential Impact of Holding Companies on Uniform Bank Ratings

The relationship between a bank and its parent holding company and the financial condition of the holding company could affect, to a significant degree, each of the component factors in the CAMELS rating as well as the composite rating.

The financial, technical, and managerial capacity of holding companies, commercial parents, and other affiliates can provide significant and often substantial support to a subsidiary bank. This is particularly true when the bank is a comparatively small component of a much larger corporate organization.

It will not always be necessary for examiners to conduct a detailed assessment of whether a parent company can be considered a source of strength for the subsidiary financial institution. If the subsidiary bank ratings are not dependent on the resources or support of the holding company, it will not normally be necessary to conduct a detailed assessment of the parent company or affiliates. Most bank holding companies have little financial capacity independent of the bank; and are likely to provide little independent support.

In the case where a complex commercial parent company has the potential capacity to support the subsidiary bank but does not clearly dominate the bank by virtue of size, revenues, or earnings, a more detailed examination of the parent may have to be conducted if it should become necessary to show conclusively that the bank ratings should reflect the holding company as a source of strength. However, conduct of a parent company examination should be dependent first on the independent financial condition of the insured institution, the extent of risk exposure resulting from direct transactions between the insured institution and the parent company, and the extent to which the capacity of the parent company supports the Uniform Bank Ratings assigned.

When a holding company or parent is considered a potential source of strength to the insured institution, the weight of this influence on the assigned Uniform Bank Ratings should only incorporate the actual support provided at the current examination. A potential source of strength determination should not be based on projected future resources of the parent, but rather on a current assessment of the parent's actual financial condition. Furthermore, the benefits of parental resources and the influence of these resources on the Uniform Bank Ratings will likely change if the condition of the insured institution deteriorates. In this event, evaluation of potential source of strength should incorporate not just the capacity of the parent to support the bank, but also its present willingness to do so.

Some additional factors that may be considered in assigning a rating to the financial institution subsidiary could include:

- Capital – the ability and commitment of affiliates to contribute additional capital if needed and an assessment of the pressure from the parent organization for dividends.
- Asset Quality – the quality of the assets generated through programs associated with affiliates; ability of affiliates to provide financial guarantees or collateral, purchase low quality assets, or to arrange or develop risk mitigation transactions such as credit default swaps.
- Management – independence of management and the board of directors; ability of the financial institution affiliate to make decisions independent of parent company; adequacy of audit procedures; demonstrated willingness to address examination recommendations and follow safety and soundness principles; documentation and protocols for affiliate relationships.

- Earnings - reasonable fee structure of servicing relationships; suitability of management fees paid to affiliates.
- Liquidity – access to funding sources that would not otherwise be available.
- Sensitivity – funds management strategies that are coordinated with those of affiliates; efficacy of hedging or other market activities employed by affiliates.

TYING ARRANGEMENTS

The Bank Holding Company Act Amendments of 1970 and Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 added the so-called anti-tie-in provisions to the BHC Act. (See "Tying Arrangements" under the Bank Holding Company Act tab in the Prentice-Hall volumes.) Non-bank banks, including ILCs, are subject to the anti-tying provisions of the BHC Act as well.

Essentially, the anti-tying provisions prohibit a bank from conditioning the availability or price of any of its products or services upon the customer obtaining some other product or service from the bank or an affiliate, or upon the customer providing some other product or service to the bank or an affiliate. These provisions also preclude a bank from tying its products or services to a requirement that the customer not obtain some product or service from a competitor of the bank or an affiliate. The purpose of these provisions is to prevent banks from using their ability to offer financial products, credit in particular, in a coercive manner to gain a competitive advantage in markets for nonbanking products and services. For example, a bank may not require as a necessary condition to obtaining a loan or extension of credit that the prospective borrower lease personal property or equipment from the bank's holding company or a subsidiary thereof or that the prospective borrower provide the bank, its holding company or any subsidiary thereof with office supplies or equipment.

However, it is not intended that this provision interfere with the conduct of traditional banking practices. For example, a bank may restrict the availability or vary the price of its credit, property, or services on the condition that the customer also obtains a traditional bank product from the bank or an affiliate. A "traditional bank product" is a loan, discount, deposit, and trust service. For further information regarding other exceptions and safe harbors contact Regional Office staff. For purposes of these provisions, a natural person is treated as a bank holding company if he or she controls a bank or a company that controls a bank.

Violations of these anti-tying provisions may be addressed by the bank's appropriate Federal banking agency through an enforcement action, by United States Attorneys under the direction of the Attorney General through an action for injunctive relief, or by private parties through an action for injunctive relief as well as treble damages when they have sustained damages, or are threatened by loss or damage, by reason of a violation of these provisions.

Prohibition of Preferential Loans

Title VIII essentially prohibits preferential loans to executive officers, directors, and principal shareholders of a bank from its correspondent bank. Therefore, a bank which maintains a correspondent account for another bank is precluded from making an extension of credit on preferential terms to an executive officer, director, or principal shareholder of that bank, and a bank is precluded from opening a correspondent account for another bank if such bank has outstanding an extension of credit to an executive officer, director, or principal shareholder of that bank if it is on preferential terms. Conversely, a bank which maintains a correspondent account at another bank is precluded from making an extension of credit on preferential terms to an executive officer, director, or principal shareholder of that bank, and a bank is precluded from opening a correspondent account at another bank if such bank has outstanding an extension of credit to an executive officer, director, or principal shareholder of that bank on preferential terms. Any bank that violates or any officer, director, employee, agent, or other person participating in the conduct of the affairs of such bank who violates this prohibition shall forfeit and pay a civil penalty.

CHAIN BANKING GROUPS

From a supervisory standpoint, chain-banking groups are very similar in character to multibank holding companies. They have the ability to provide many of the benefits common to multibank holding companies as well as the ability to provide the potential for unsafe and unsound banking practices. The linkage of several banks or holding companies into a chain creates a concentration of banking resources that can be susceptible to common risks. Mutually shared risks that can arise in chain banking relationships include: poor loan participation practices, common deficiencies in lending and/or investment policies, domineering or absentee ownership, insider abuses or other self-serving practices. Unfortunately, detection and correction of these problems are largely dependent on the examination process and are complicated when the chain is composed of institutions subject to different Federal and/or State regulatory agencies.

Unlike multibank holding companies, chain banking organizations do not have to report financial information on a consolidated basis, thereby making offsite monitoring difficult. In addition, they are not subject to the same types of regulations as holding companies.

A chain banking organization is defined as a group (two or more) of banks or savings and loan associations and/or their holding companies which are controlled directly or indirectly by an individual or a company acting alone or through or in concert with any other individual or company. Control is defined as: ownership, control or power to vote 25 percent or more of an organization's voting securities; the power to control in any manner of the election of a majority of the directors of an organization; or the power to exercise a controlling influence over the management or policies of an organization. These criteria are to be interpreted narrowly. For example, institutions should not be deemed to be a chain organization simply because an individual holds a title such as chairman or president unless the individual actually has control.

The control structure of a chain organization is often complex. There may be registered holding companies within the ownership or control structure of a chain organization, but it would not be deemed to be a chain if the top holder of all the insured institutions in the group is a registered holding company. One bank under a bank holding company or several banks owned by a single bank holding company are not considered a chain banking group for purposes of maintaining a list of chain banking groups.

It is the policy of the Division of Supervision and Consumer Protection to monitor and supervise banks that are a part of a chain banking organization in a manner that fully considers the consolidated chain's financial impact on the safety and soundness of the individual institution(s). The supervisory strategy for monitoring chain organizations is included in the Case Manager's Procedures Manual.

In developing an overall supervisory strategy for chain organizations, the following factors should be considered:

- The relative size and complexity of the chain's organizational structure, including the degree of centralization of operations,
- The degree and nature of control or influence being exerted over individual institutions in the chain and the managerial style and extent of direct control or influence at each institution in the chain,
- The degree of interdependence among institutions in the chain. Particular emphasis should be given to the volume and frequency of inter-institution transactions such as: loan participations or sales; purchases or sales of securities or other assets; bank holding company or bank stock loans; insider loans or transactions; and contractual obligations for services, and
- The overall condition of the institutions in the group and the condition of the chain on a consolidated basis.

AFFILIATES

The relationship of a bank with its affiliated organizations is important to the analysis of the condition of the bank itself. Because of the commonality of ownership or management that exists, transactions with affiliates may not be subject to the same sort of objective analysis that exists in transactions between independent parties. Also, affiliates offer an opportunity to engage in types of business endeavors that are prohibited to the bank itself yet those endeavors may affect the condition of the bank.

In recognition of the importance of relationships with affiliated organizations, the FDIC has been granted authority, under certain conditions, to examine affiliates in connection with its examination of a bank.

There are two primary definitions of "affiliate" which are of importance to examiners. The first is the definition set forth in Section 2(b) of the Banking Act of 1933. The second is the definition set forth in Section 23A of the Federal Reserve Act.

Affiliates as Defined in Section 23A of the Federal Reserve Act

Section 23A of the FR Act (made applicable to insured nonmember banks by Section 18(j) of the FDI Act) contains the restrictive provisions relating to transactions between banks and their affiliates.

Prior to the GLBA amendments to Sections 23A and 23B, non-bank subsidiaries of banks were not covered by the definition of "affiliate." Those sections now provide that non-bank subsidiaries of state banks are "affiliates" in the event that they qualify as "financial subsidiaries." The GLBA amendments to Sections 23A and 23B apply solely to covered transactions between a state nonmember bank and its "financial subsidiaries" as covered in Section 46 of the FDI Act.

The principal purpose of Section 23A is to safeguard the resources of banks against misuse for the benefit of organizations under common control with the bank. It was designed to prevent a bank from risking too large an amount in affiliated enterprises and to assure that extensions of credit to affiliates are properly collateralized. Section 23A, therefore, regulates loans or extensions of credit to and investments in affiliates of an insured bank in two ways; first, by restricting the amount of such loans or extensions of credit and investments, and second, by requiring that the loans or extensions of credit meet certain standards as to collateral. Four major types of affiliates are defined in Section 23A and these are discussed in the following paragraphs.

Parent Holding Company and Its Subsidiaries

The first type pertains to a parent holding company and its subsidiaries. Any company that controls the bank (holding company) as well as any other company that is controlled by the company controlling the bank (sister subsidiary) is considered to be an affiliate of the bank under Section 23A. "Control" is defined as owning, controlling, or having the power to vote (directly or indirectly) 25 percent or more of any class of voting securities; or controlling in any manner the election of a majority of the directors or trustees. The term "company" means a corporation, partnership, business trust, association, or similar organization. These definitions are very similar, although not identical, to the definitions of "control" and "company" used in the BHC Act. It is therefore possible to have a holding company-subsidiary relationship under the BHC Act that is not an affiliate relationship for the purposes of Section 23A. Control relationships existing in certain types of trusts are an example.

Section 23A grants an important exemption with respect to domestic banks that are affiliated under this definition. When a bank is 80 percent controlled by a holding company, its transactions with other banks which are also 80 percent controlled by the same holding company are largely unrestricted. The only restrictions which do apply are the general prohibitions against a bank purchasing low-quality assets from its affiliates (refer to "Restrictions on Covered Transactions with Affiliates" below for a definition of "low quality asset"), and a requirement that all transactions be consistent with safe and sound banking practices. All restrictions and limitations set forth in Section 23A are, however, applicable to transactions by a bank with its parent holding company, its non-bank subsidiaries, and its bank subsidiaries that do not meet the 80 percent exemption. They also apply to an affiliated foreign bank even where the 80 percent test is met. The rationale for the 80 percent ownership test is that it is the minimum ownership generally required for the preparation of consolidated Federal income tax returns.

Bank Subsidiaries

The second category consists of bank subsidiaries of a bank. A domestic bank, which is controlled by another bank, is an affiliate of the controlling institution for the purposes of Section 23A. Where such bank is, however, 80 percent controlled, it is granted the same exemption described above relative to sister bank affiliates in a holding company organization. Thus, the treatment of domestic bank affiliates is consistent whether the bank is affiliated through a holding company or by virtue of direct ownership or control.

A different situation exists with respect to non-bank and foreign bank subsidiaries. Directly owned subsidiaries of this type, whether majority or minority owned, are excluded from the definition of an affiliate for the purposes of Section 23A. This is in contrast to the treatment of such firms when they are holding company subsidiaries. As noted above, non-bank and foreign bank subsidiaries of a holding company are affiliates and are subject to the restrictions of Section 23A. The rationale for this contrast in treatment is that non-bank subsidiaries, when majority owned by a bank, are really an integral part of the bank and transactions between the two should not normally be restricted. With respect to minority owned nonbank subsidiaries, it is noted that most banks are restricted in their ability to own stock and several of the more common types of nonbank subsidiaries (such as bank premises and safe deposit companies) are specifically exempted anyway. While this rationale serves to mitigate concern for transactions with non-bank subsidiaries in many instances, situations may arise where a bank can be exposed to undue risk. For instance, in some states banks may be able to conduct types of businesses through a non-bank subsidiary that would be prohibited to the bank itself. While the bank's investment in such a company may be limited, there may be no restriction on the amount of loans that could be made to the affiliate to fund its operations. Where evidence exists that a particular non-bank subsidiary should be brought under the restrictions of Section 23A, this can be accomplished by specific order or regulation. Any such recommendation should be forwarded to the Regional Office accompanied by supporting information.

Interlocking Companies

The third category of affiliates may be referred to as companies interlocked with a banking organization. Any company that is interlocked with a bank or its holding company by virtue of common ownership or common directors is an affiliate of the bank for the purposes of

Section 23A. Such interlocks will arise any time that 25 percent or more of a company is owned, directly or indirectly, by or for the benefit of shareholders who have a direct or indirect ownership of 25 percent or more in either the bank or its parent holding company; or a majority of a company's board of directors also comprise a majority of the board of the bank or its parent holding company. This definition may frequently be applicable to chains of one-bank holding companies that are interlocked by ownership or board membership at the holding company level. Under this definition both the chain of holding companies and their subsidiary banks will be affiliates of a bank under examination if either of the above relevant criteria is met.

Sponsored and Advised Affiliates

The final category is comprised of sponsored and advised affiliates. For the purposes of Section 23A, a company that is sponsored and advised on a contractual basis by a bank, or by any of the bank's subsidiaries or affiliates, is an affiliate of the bank. Real estate investment trusts are an example of this type of affiliation.

Any investment company that a bank or any of its subsidiaries or affiliates serves as an investment advisor is an affiliate of the bank. An investment advisor is basically one who, pursuant to a contract, regularly furnishes advice with respect to the desirability of investing in, purchasing or selling securities, or is empowered to determine what securities shall be purchased or sold by the investment company. The rationale for the inclusion of these two types of affiliations is that banks may, in order to protect their reputation or to forestall lawsuits alleging that bad advice was given, engage in less than arms length transactions. By applying the provisions of Section 23A to such situations, a bank's potential exposure to loss can be controlled.

Additional Considerations

In addition to the four categories of affiliates defined above, Section 23A also gives to the Board of Governors of the Federal Reserve System considerable latitude in defining which companies are or are not affiliated. This can be accomplished in three ways:

1. The Board of Governors may determine that "control" exists in individual situations not coming within the control definition of the FR Act after giving notice of and opportunity for a hearing. For example, the FRB may determine that a company owning less than 25 percent of a bank's stock nonetheless exercises control over the bank and is therefore an affiliate.
2. The Board of Governors may also determine that an affiliate relationship exists in specific instances by order or regulation. For instance, the FRB may determine that the relationship between an exempted subsidiary and its parent bank is such that the potential for abusive transactions exists. The FRB may issue an order or regulation bringing transactions with such company under the provisions of Section 23A.
3. The FRB also has the power to issue an order or regulation exempting specific types of transactions or affiliate relationships from the restrictions of Section 23A, provided that it finds that such exemption is in the public interest and consistent with the purposes of the FR Act.

Two final notes relating to the definition of affiliates under Section 23A concern "control" held in a trust capacity and companies acquired for debts previously contracted.

The FR Act specifies that no company shall be deemed to own or control another company by virtue of its ownership of shares in a fiduciary capacity with two exceptions. The first relates to affiliations arising out of the "Interlocking Companies" definition. Under this definition a company is an affiliate under a trust relationship whereby a trustee controls 25 percent or more of the voting shares of a company for the benefit of shareholders who control 25 percent or more of the voting shares of a bank or its holding company. The other exception provides that ownership or control of one company by another through a business trust creates an affiliate relationship.

With respect to the acquisition of control through debts previously contracted, the FR Act specifies that such companies are not affiliates for whatever period of time applicable State or Federal law or regulation permits the bank to hold such shares. In the absence of any such law the holding period is two years from the date of acquisition upon a showing of good cause. After the expiration of the allowable holding periods, such companies are deemed affiliates.

Restrictions on "Covered Transactions" with Affiliates

Section 23A (a)(1) permits a bank to engage in covered transactions with affiliates so long as the covered transactions do not exceed, in the aggregate; (1) 10 percent of the bank's capital stock and surplus with respect to a single affiliate; (The GLBA exempted transactions between banks and their financial subsidiaries from this requirement) and (2) 20 percent of capital and surplus with respect to all affiliates. (For this maximum percentage, the GLBA provides that a bank’s investment in a financial subsidiary will not include the retained earnings of the subsidiary in the calculation). Both the FRB and the FDIC have previously interpreted capital stock and surplus to include undivided profits, capital reserves, the loan valuation reserves, and valuation reserves for securities. The GLBA added a form of “anti-evasion” protection regarding the aggregate transaction limits and collateral requirements in Section 23A and the transaction restrictions in Section 23B. Any purchase of, or investment in, the securities of a “financial subsidiary” of a bank by an affiliate of the bank will be considered a purchase of or investment in such securities by the bank.

Covered transactions are specifically described in Section 23A (b)(7)(A) through (E) but basically consist of:

- Loans to an affiliate,
- Purchase of securities issued by an affiliate,
- Purchase of nonexempt assets from an affiliate,
- Acceptance of securities issued by an affiliated company as collateral for any loan, and
- Issuance of a guarantee, acceptance, or letter of credit on behalf of (for the account of) an affiliate.

Reference is made to Section 23A (d)(2) through (7) for a listing of several types of transactions that are specifically exempted from the provisions of Section 23A. These transactions basically consist of deposit balances in bank affiliates, loans secured by U.S. or agency securities or deposit balances in the bank, readily marketable assets purchased at quoted market prices, loans purchased on a nonrecourse basis from affiliated banks, and the repurchase of loans previously sold to an affiliate with recourse.

The FR Act also contains two other important general provisions that relate to covered and exempted transactions. A bank may not purchase any "low quality asset" from an affiliate in any amount unless, pursuant to an independent credit evaluation, the bank had committed itself to purchase such asset prior to the time such asset was acquired by the affiliate. A "low quality asset" is defined as:

- An asset which was classified as "substandard," "doubtful," or "loss" or treated as "other loans especially mentioned" in the most recent report of examination or inspection of an affiliate prepared by either a State or Federal supervisory agency,
- An asset in a nonaccrual status because of deteriorating credit quality and/or past due status,
- An asset on which principal or interest payments are more than 30 days past due, or
- An asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.

This prohibition on the purchase of low quality assets also extends to bank subsidiaries. In other words, neither a bank nor any of its subsidiaries may purchase low quality assets from an affiliate. The other provision is more general but has a similar intent. This provision requires that any covered transaction between a bank and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices.

For purposes of illustration, the following loan purchase transactions provide examples of the application of Section 23A which examiners may find useful.

1. Loans Purchased from Non-Bank Subsidiaries - A bank may purchase any loan, including a classified loan, from its own non-bank subsidiaries since such companies are not considered affiliates under Section 23A. It does not matter whether the subsidiary is minority or majority owned. The only way to control such possibly objectionable activity, other than through use of Section 8 powers, would be to have the nonbank subsidiary brought under the restrictions of 23A by order or regulation.
2. Loans Purchased from Domestic Banks which are 80 Percent Owned by Either the Bank or its Parent Holding Company - A bank may purchase loans in any amount from these affiliates provided they are not "low quality" or constitute "unsound" transactions under the provisions of Section 23A. The loans may be either subject to repurchase by the affiliate or not subject to repurchase.
3. Loans Purchased from Parent Holding Company, Sister Non-Bank Affiliates, Interlocking Non-Bank Affiliates, Sponsored Affiliates and Foreign Bank Affiliates - A bank may purchase good quality loans from these affiliates subject to the 10-20 percent capital stock and surplus limitations. Other covered transactions are aggregated for purposes of applying the amount limitations. Low quality loans or loans whose terms and conditions are unsound may not be purchased in any amount. Loans secured by U.S. securities or repurchased loans which had been sold earlier by the bank to the affiliate on a with-recourse basis are exempted, however, and would be excluded in applying the amount limitations.
4. Loans Purchased from Other Domestic Bank Affiliates - These affiliates are domestic banks controlled by either the bank or its parent holding company but which are less than 80 percent owned. This also includes banks controlled by interlocking affiliates (one-bank holding company chains, for example)

whether more than or less than 80 percent owned. Loan purchase transactions with these affiliates are treated the same as loan transactions with the parent holding company, etc. (#3 above) with one exception; good quality loans may be purchased in any amount provided they are sold by the affiliated bank on a non-recourse basis.

Collateral Requirements

Loans may not be extended directly to an affiliate nor may a bank issue guarantees, acceptances, or letters of credit for the account of an affiliate unless certain collateral and margin requirements are met. Eligible collateral and margins are as follows:

- 100 percent collateral margin if the collateral consists of U.S. Government and agency securities, deposits held in the bank which are specifically segregated and earmarked, or obligations (such as notes, drafts, or acceptances) which are eligible for rediscount or purchase by a Federal Reserve Bank,
- A 110 percent margin is required if the collateral is composed of obligations of a state or political subdivision of a state,
- A 120 percent margin is required if the collateral consists of other types of debt instruments, including receivables, and
- A 130 percent margin is required if the collateral is composed of stocks, leases, or other real or personal property.

It is important to note that market value at the time of the transaction is the appropriate basis for meeting margin requirements in all instances. When any collateral is subsequently retired or amortized and the amount of the remaining collateral does not provide a sufficient margin, additional eligible collateral must be supplied in an amount sufficient to meet the collateral margin required at the inception of the transaction. Where no collateral substitutions or amortizations are involved, a shrinkage in collateral value does not create a violation so long as the margin requirement was met at the inception of the transaction.

As noted above almost any type security is acceptable (provided margin requirements are met) subject to two important limitations. First, low quality assets; as that term is defined, may not be used to meet collateral requirements and, secondly, securities issued by an affiliate of a bank may not be used to secure the obligations of that affiliate or any other affiliate of the bank.

Section 23B of the Federal Reserve Act

Section 23B of the FR Act applies to insured nonmember banks through Section 18(j) of the FDI Act. Violations of Section 23B by nonmember banks are subject to the civil money penalties of subsection (3)(A) of Section 18(j). Section 23B essentially imposes the following four restrictions:

1. A requirement that the terms of affiliate transactions be comparable to terms of similar non-affiliate transactions;
2. A restriction on the extent that a bank may, as a fiduciary, purchase securities and other assets from an affiliate;
3. A restriction on the purchase of securities where an affiliate is the principal underwriter; and
4. A prohibition on agreements and advertising providing or suggesting that a bank is responsible for the obligations of its affiliates.

Section 23B generally incorporates the definitions used in Section 23A; however, banks are not "affiliates" for purposes of Section 23B.

SUBSIDIARIES

A bank subsidiary, as defined by Section 23A of the FR Act, is any company of which 25 percent or more of any class of its voting stock is owned, controlled, or may be voted by the bank; or any company with respect to which the bank controls, in any manner, the election of a majority of its directors or trustees. While several types of subsidiaries (such as bank premises companies or safe deposit companies) have long been excluded from the provisions of Section 23A, post-GLBA, the amendments to 23A and 23B provide that non-bank subsidiaries of state banks are “affiliates” in the event that they qualify as “financial subsidiaries” under new Section 46 of the FDI Act.

The overall condition of a subsidiary can substantially affect the affairs and soundness of a bank. For example, a subsidiary in severe financial distress could precipitate a drain on the management and financial resources of the bank. To determine the overall risk that the functionally regulated entity presents to the insured depository institution as a whole, it is necessary to determine which subsidiaries are functionally regulated within the functional regulation confines (refer to applicable subsection of this chapter).

Requirements for consolidation of subsidiaries are contained in the Call Reports Instructions for essentially all majority-owned bank premises subsidiaries and other majority-owned subsidiaries, which are considered significant according to certain tests, are consolidated. Some major types of subsidiaries are addressed below:

Bank Service Corporation

A bank service corporation is defined in the Bank Service Corporation Act (BSC Act) as a corporation, whose capital stock is all owned by one or more insured banks, organized to perform "authorized services." The BSC Act limits the investment of a bank in a bank service corporation and specifies prior regulatory approval requirements. Authorized services are defined to include services such as: check and deposit sorting and posting, computation and posting of interest and other credits and charges, preparation and mailing of checks, statements, notices, and similar items, or any other clerical, bookkeeping, accounting, statistical, or similar function performed for a bank. In addition, a bank service corporation may perform any services permitted by FR regulation for a bank holding company under Section 4(c) (8) of the BHC Act.

Due to the nature of services performed by these corporations, the importance of analyzing their financial condition is obvious. In addition to authority to examine affiliates the BSC Act provides that for any bank regularly examined by a Federal supervisory agency or any subsidiary or affiliate of such bank subject to examination by that agency, which causes to be performed by contract or otherwise, any bank services for itself, whether on or off premises, such performance shall be subject to regulation and examination by such agency to the same extent as if the services were being performed by the bank itself on its own premises. The bank is also required to notify the appropriate agency of the existence of such a service relationship within 30 days after the making of the service contract or the performance of the service, whichever comes first.

Safe Deposit Corporation

A safe deposit corporation primarily performs the same functions as a safe deposit department of a bank. A primary purpose for establishing such a subsidiary is to limit the bank's liability. These corporations generally are established under applicable State statutes that may contain limits on liability of the corporation for loss to a customer in any box or compartment. The safe deposit corporation should be operated under the same set of internal procedures as a normal bank safe deposit department. Additionally, the subsidiary should be protected by a combination safe depository insurance policy to the extent State law liability limitations do not provide adequate protection.

Corporation Holding Title to Bank Premises

As the name suggests, a bank premises subsidiary holds title to the bank premises and, in most cases leases them back to the bank. Oftentimes construction/acquisition of the bank premises is financed with borrowed money and lease terms are designed to service principal and interest payments of the mortgage. State law for nonmember banks generally limits the maximum investment in a bank premises subsidiary. The amount of investment, direct or indirect, by a bank in bank premises can have a significant effect on overall net earnings. Therefore, it is essential when evaluating a bank's condition and earnings, that majority-owned bank premises subsidiaries be fully consolidated.

Securities Firm

A securities firm subsidiary is a subsidiary that:

- Engages in the sale, distribution or underwriting of stocks, bonds, debentures, notes, or other securities,
- Acts as an investment adviser to any investment company,
- Conducts any activity for which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer, or
- Engages in any other securities activity.

Small Business Investment Companies (SBIC)

A SBIC is a company, organized under the Small Business Investment Act of 1958, which provides long-term credit and equity financing for small business concerns. Section 302(b) of that Act authorizes National banks, other member banks, and nonmember insured banks (to the extent permitted by applicable State law), to invest in stock of SBICs not exceeding (in total) 5 percent of the capital and surplus of such banks. In no event may a bank acquire 50 percent or more of the shares of any class of equity securities issued by an SBIC having actual or potential voting rights.

Agricultural Credit Corporation (ACC)

These subsidiaries, established under State law, are generally a means by which a bank can obtain funding to be able to continue to service the borrowing needs of its agricultural customers. The ACC establishes a financing relationship with the Federal Intermediate Credit Bank (FICB) by buying a participation certificate in the FICB. It is then able to borrow a certain percentage of the face value of loans by discounting those loans at the FICB on a full recourse basis. The ACC is examined and regulated by the FICB and any loans classified Doubtful or Loss at the parent bank, which are discounted at the FICB, must be replaced.

Inasmuch as lending limits to ACC's may be separate from and in addition to the bank's limit; care should be taken to avoid a concentration of credit to any individual borrower. Wholly owned ACCs should be examined by the FDIC with classifications reflected in a consolidated balance sheet and analysis of capital.

Special Purpose Finance Subsidiaries

A finance subsidiary is used as a mechanism for raising funds from outside investors through the issuance of collateralized debt or preferred stock. The parent bank places certain assets in the subsidiary to collateralize or otherwise support the securities issued by the subsidiary. Properly used, a finance subsidiary may enhance a bank's efforts to restructure its assets, obtain cheaper and more widely available funding sources, and improve overall profit performance.

Finance subsidiaries can also be used solely for the purpose of generating arbitrage profits rather than for the purpose of obtaining an additional source of funds. For example, a subsidiary might issue collateralized mortgage obligations and use the proceeds to simultaneously buy the mortgage-related collateral that will secure the collateralized mortgage obligation. Thus, the parent bank would receive no additional funds since the proceeds of the securities issuance are used to purchase the underlying collateral.

Bank management has the responsibility to carefully consider the impact of finance subsidiary transactions on the bank's overall financial position. Areas requiring attention include the following:

- Consolidation Requirements. For Reports of Income and Condition filed with the FDIC, subsidiaries that meet any one of the "significance" tests set forth in the Call Report instructions must be consolidated. Thus, securities issued to outside parties by a finance subsidiary that is wholly owned by the parent bank generally would be reported as a liability on the bank's consolidated financial statements.
- Capital Adequacy Considerations. If required to be consolidated with the parent bank for Call Report purposes, these subsidiaries must also be consolidated for purposes of evaluating capital adequacy under the FDIC's Part 325 capital regulation. As a result, finance subsidiary transactions are normally reflected as additional assets and liabilities on the bank's consolidated Report of Condition balance sheet. Because the transactions generally result in an increase in total assets with no increase in capital, the potential negative impact on the capital to asset ratio effectively limits the total dollar volume of such transactions.
- In addition, banks should carefully evaluate their overall asset/liability management, funding, and liquidity management strategies prior to entering into any proposed finance subsidiary transaction. In situations where finance subsidiary transactions are concluded in an unsafe or unsound manner, examiners should seek appropriate supervisory remedies.

Corporations Engaged in International Banking Activities

Edge Act Corporation - A Federally chartered corporation organized under Section 25(a) of the FR Act and subject to Federal Reserve Regulation K. Edge Act Corporations are allowed to engage only in international banking or other financial transactions related to international business. They are chartered and regulated by the Federal Reserve System and must have a minimum capital of $2,000,000 and a minimum life of 20 years. Their purpose is to aid in financing and stimulating foreign trade. An Edge Act subsidiary is a bank's majority-owned Edge Act Corporation and is treated for purposes of Reports of Income and Condition as a "foreign office."

Agreement Corporation

A State-chartered corporation that has agreed to operate as if it were organized under Section 25 of the FR Act and has agreed to be subject to FR Regulation K (refer to the FDIC Rules and Regulations). Banks must apply to the FR for permission to acquire stock in an Agreement Corporation, which is restricted principally to international banking operations.

Foreign Bank Subsidiary of a Limited Purpose Credit Card Bank

The GLBA adds a new provision to the BHC Act, which permits a credit card bank which is not a bank under the BHC Act to control a foreign bank if the investment in the foreign bank meets the requirements of Section 25 or 25A of the FR Act and the foreign bank qualifies under such sections; the activities of the foreign bank are permissible under otherwise applicable law; and the foreign bank does not offer any products or services in the United States.

Mortgage Banking Subsidiaries

Mortgage banking subsidiaries engage in the origination and/or purchase of mortgages for sale in the secondary market and the servicing of mortgages. The major functions of a mortgage banking subsidiary are:

- Origination, which includes application processing, underwriting, and closing,
- Secondary marketing, which includes purchases and sales, warehousing, packaging and shipping, investor relationships, and risk management, and
- Servicing, which includes mortgage accounting administration, collections, customer service, and investor reporting.

Insurance Subsidiaries

There is considerable variety in the laws and regulations of the states. Some allow bank subsidiaries to engage in insurance agency or brokerage operations, while others do not. Some limit the products that may be offered. Types of insurance products include credit liability, casualty, automobile, life, health, accident, title insurance, and private mortgage insurance. The insurance departments of the various states generally regulate insurance activities.

Real Estate Subsidiaries

State laws vary with respect to permissible real estate activities that may be conducted through bank subsidiaries. A number of states permit real estate brokerage activities. Others permit equity participations, which involve passive investment roles, and some states permit bank subsidiaries to engage in real estate development and ownership in an active role. In many cases investments are limited in terms of percentages of an institution's total assets or capital.

Real estate brokerage, management, development and investment are not permitted for national banks or their subsidiaries. For state non-member banks to invest or develop real estate, this activity must be authorized under State law and approved by the FDIC under Section 24 of the FDI Act. Real estate brokerage is considered to be an agency activity, so no FDIC approval is necessary.

EXAMINATION OF SUBSIDIARIES

Unlike affiliates, whose activities may be shielded from the insured institution through the holding company structure and the provisions of Sections 23A and 23B of the FR Act, the liabilities of a subsidiary may flow directly to the insured institution if appropriate barriers between the insured institution and its subsidiaries are not in place. Even with barriers, the legal precedents are such that there is no guaranty that the liabilities of a subsidiary may not adversely impact the parent. Thus, in order to determine the true condition of the parent organization, the risk presented by the subsidiary to the parent institution needs to be evaluated.

If the subsidiary is functionally regulated, the GLBA requires the FDIC to rely to "the fullest extent possible" on the functional regulator. Therefore, examinations conducted by the appropriate Federal and State regulators of functionally regulated entities should be used, if possible, rather than a direct examination of those entities. Examinations of functionally regulated subsidiaries are generally permissible only if:

- There is a reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to the depository institution,
- That an examination is necessary to assess risk management systems, or
- The subsidiary is not in compliance with a law that the agency has specific jurisdiction to enforce against the subsidiary.

If a high-risk profile is evident, more extensive examination procedures may be required. For a functionally regulated subsidiary, the examiner should contact the Regional Office before proceeding with any direct examination of the subsidiary's records. Any records that the bank maintains, including any written policies and procedures concerning the bank's oversight of the subsidiary, should be reviewed and assessed for adequacy. The objective is for examiners to reach a level of comfort sufficient to assess the overall condition of the subsidiary and its impact on the parent.

The Examination (ED) Modules contain examination procedures for examining subsidiaries. Refer to the Related Organizations section for additional guidance in this area.

Depending on the type of subsidiary, a more in-depth evaluation will generally involve assessment of the following areas:

Asset Quality

The examiner should attempt to ascertain the quality of assets, review delinquency reports where appropriate, and evaluate bank management oversight with respect to the subsidiary and any policies in place to determine the extent of any loss.

Funding and Liquidity

A determination should be made of the types of funding necessary for the subsidiary's activities, the reliability of present funding, and the extent to which the subsidiary's activities are being funded by the bank. An excessive reliance on any one source of funding may indicate future liquidity problems or undue reliance on the parent to provide funding.

Adequacy of Capital

To the extent possible, a determination of the adequacy of the subsidiary's capital should be made after reviewing asset quality, sources of funding, earnings, and management. Capital levels should be compared to regulatory requirements or other standards considered appropriate for the type of business the subsidiary is engaged in. This capital cushion is an important insulation to protect the bank from liabilities of the subsidiary.

In reviewing the parent bank's capital adequacy, the bank's investment in its subsidiary should be deducted from both assets and capital. This analysis will indicate the effect on the parent should the subsidiary become insolvent.

Earnings

The earnings stream of the subsidiary should be reviewed to determine if there is reliance on one time gains or if there is a failure to recognize losses on a timely basis. Fees received from the bank, salary structure and overhead expenses should be reviewed to ensure that charges are in line with those that would be made to third parties.

Management

Daily management of the subsidiary should be structured so as not to create the presumption that the activities of the subsidiaries are in any way conducted by the bank. Advertising and any required disclosures should be reviewed to ensure that the public is not given the perception that subsidiary activities are guaranteed by the bank or insured by the FDIC.

Another important management consideration is “firewalls.” The term "firewalls" is used to describe a concept of separation of responsibility for entities providing different services but which are commonly owned. Firewalls generally include separate corporate formalities, management, employees, accounting, and policies. Also, the operations of the subsidiary should be physically distinct from the operations of the insured institution. Section 362.4(c)(2) of the FDIC Rules and Regulations is an example of a firewall construction designed to insulate the bank from liability of the subsidiary; compliance with Section 362.4(c)(2) should be reviewed where applicable.

EXAMINATION AND INVESTIGATION OF UNAFFILIATED THIRD PARTY SERVICERS

Situations occasionally arise where the safety and soundness of an insured depository institution is materially affected by transactions, contracts or business arrangements with parties that are not affiliated with the institution. When such situations arise, it is necessary for the FDIC to examine the other side of the transaction. The potential impact of these business relationships on the insured depository institution necessitates a complete understanding of the nature of the transaction and relationship and its effect on the insured institution.

By statute, the FDIC has authority to obtain records of unaffiliated service providers and other counterparties relating to an insured financial institution. Such authority is not unqualified but depends on particular facts and circumstances giving rise to inquiries by the FDIC. Several statutory provisions support this conclusion: Sections 10(b) and 10(c) of the FDI Act; Section 7(c) of the BSC Act; and Sections 3(w)(5) and (6) of the FDI Act. The information that the FDIC can obtain from an unaffiliated service provider or other counterparty is not limited to specific transactions with or relating to the insured depository institution but can extend to the financial books and records of the servicer or entity so long as such documents are needed in furtherance of an examination that relates to the affairs of an insured bank.

It is important that examiners are aware of material transactions, service contracts, or other business arrangements that could have a material affect on an insured bank. If it is concluded that information is needed from an unaffiliated service provider or other counterparty to the bank, then the examiner should consult with the Regional Office. The Regional Office will assist the examiner in determining whether information is needed from an unaffiliated service provider, and if so, in obtaining the appropriate information.

Examination authority covering bank service corporations is set out in Section 7 of the BSC Act.

[1] Qualified Thrift Lender test requires that at least 65% of the institution's assets be qualified thrift investments, primarily residential mortgages and related investments.

[2] Generally, an ILC is excepted from the BHC Act if (A) it was chartered under a State law that on March 5, 1987 required the ILC to have Federal deposit insurance, and (B) it meets at least one of the following conditions: (1) the institution does not accept demand deposits, (2) the institution's total assets are less than $100,000,000, or (3) control of the institution has not been acquired after August 10, 1987.

INTRODUCTION

Risk management is intended to minimize the cost associated with certain types of risk and provide prudent protection. The maintenance of appropriate levels of necessary insurance coverage is a key aspect in the risk management process. It deals with pure risks that are characterized by chance occurrence and may only result in a financial loss, as opposed to a speculative risk which affords the opportunity for financial gain or loss. Such pure risks are separated into three major exposure categories: liability, property, and personnel.

There are three stages in the risk management process: risk identification and analysis, risk control, and risk treatment. Identification and analysis requires a review of all aspects of the bank's present and prospective operations to determine where the bank is exposed to loss, including consultation with a reliable insurance professional. Risk control is primarily dependent upon the strength of the bank's internal controls, policies and procedures. Risk treatment refers to choosing the appropriate steps or methods to deal with a particular risk. The objective of this process is to minimize the probability of losses and costs associated with them, such as direct costs of loss prevention measures, insurance premiums, losses sustained, and related administrative expenses. A bank has several options in treating a particular risk. It can implement additional controls to minimize yet retain the risk (i.e. become a self-insurer), transfer the risk to another party through insurance or contractual transfer, or utilize a combination of both of these approaches. A basic tenet of risk management is that those risks which carry the potential for catastrophic or significant loss should not be retained, if avoidable. Conversely, it is not cost justified to insure losses which are relatively predictable and not severe. The board of directors must determine the maximum loss the bank is willing and able to assume, and should perform an annual review of the bank's risk and insurance management program.

The real value of insurance lies in the protection it affords against catastrophic losses. To the extent a bank does not have adequate coverage, losses deplete capital and impair the position of depositors and the FDIC. Examiner review and analysis of the adequacy of the bank's insurance program is clearly necessary. The various types of insurance coverage (delineated below) serve only as a guide and a reference of available insurance protection. The specific needs of a bank must be determined on an individual basis, and only by reviewing each policy in force, can the actual degree of coverage and protection be determined. Any material inadequacies of insurance coverage should be directed to management's attention. Lack of any significant coverage, board of director approval and review, or deficiencies in a bank's loss prevention program should be appropriately commented upon in the Report of Examination.

FIDELITY INSURANCE PROTECTION

Fidelity insurance protection is appropriate for all banks because it insures against certain risks that contain the potential for significant loss. Section 18(e) of the Federal Deposit Insurance Act (FDI Act) provides that the FDIC may require such coverage, and if it is not obtained, may contract for such protection and add the cost to the bank's deposit insurance assessment. However, such action would only be taken in rare instances, such as when a bank is able to obtain protection but refuses to do so.

If the bank is without coverage, a thorough investigation should be made to determine the reasons insurance protection is lacking. Such banks must continue diligent, good faith efforts to obtain reasonably priced coverage. Their efforts should be monitored periodically to confirm the actions being taken to obtain coverage, including steps necessary to satisfy any conditions that may have been imposed by an insurer as a prerequisite for coverage.

In some cases, a bank may offer alternate arrangements in lieu of the usual insurance bond. While it is difficult to generalize, these arrangements (i. e. having directors or owners sign personal guarantees or increasing the bank's capital) do not protect the bank against the same risks in essentially the same manner or to the same extent, and therefore, are generally not acceptable as substitutes for insurance coverage. However, each such offer should be appraised on its merits for whatever additional protection it might provide in the interim.

While a periodic review of internal and external security measures and controls is warranted in every bank, it is especially appropriate in a bank that is operating without fidelity insurance coverage. Ideally, this effort should be undertaken as a special project with responsibility fixed in a particular executive officer. Further, it should include a comprehensive review of the bank's existing programs, the design and implementation of additional security procedures and controls, and a formal report to the board of directors, with any actions taken by the board based on the report findings noted in the minutes of the meeting. Management should also consider using outside experts, as necessary, to assist in strengthening internal programs or possibly to help the bank qualify for fidelity protection where a carrier has previously cited specific deficiencies that require correction.

Providing Examination Information to an Insurance Carrier

Occasionally, a bank may ask to release all or part of an examination report to an insurance carrier. These inquiries should be discouraged. A bank should be able to demonstrate its insurability to prospective insurers without having to release confidential information from an FDIC examination report. Adequate information is available from the bank's records and from nonconfidential sources to enable an insurer to accurately assess its underwriting risk.

Protection From Both External and Internal Hazards

External hazard includes the possibility of dishonest, fraudulent, or criminal acts committed against the bank and its employees by the general public. Robbery, burglary, and forgery are the predominate acts. Banks endeavor to guard against losses from these sources by maintaining vaults and safes, reliable alarm systems, and other security devices which should, at a minimum, meet the requirements set forth in Part 326 of the FDIC's Rules and Regulations. Banks should also attempt to limit the size of such losses by keeping exposed cash and negotiable securities at a minimum.

Internal hazard, which poses a far greater risk, deals with the possibility of defalcations by the bank's own personnel. Banks should try to protect themselves against this hazard by maintaining clear records and effective systems of internal routine and controls. The maintenance of an appropriate level of insurance coverage helps to further limit the institution’s level of risk related to employee defalcations and other types of internal fraud.

Bankers Blanket Bond Insurance

The most common form of blanket bond used by commercial and savings banks is the Financial Institution Bond, Standard Form No. 24. Other forms may be encountered and should be thoroughly analyzed to determine the extent of coverage. Standard Form No. 24 has two different limits of liability--a single loss limit of liability and an aggregate limit of liability. The single loss limit applies to individual claims, whereas the aggregate limit applies to the total of all loss recoverable under the bond. For example, if there is a $500,000 single loss limit and a $1,000,000 aggregate limit, payment of the single loss reduces available coverage for further losses during the bond period to $500,000. When the aggregate limit of liability is exhausted, the bond automatically terminates regardless of the remaining term and without any refund of premium. In order to determine the remaining insurance coverage, the amounts of all prior and pending claims against the bond should be deducted from the stated aggregate limit.

Scope of Blanket Bond Coverage

Clause (A) - Fidelity

Covers losses as a result of dishonest or fraudulent acts by officers and employees, attorneys retained by the bank, and non-employee data processors while performing services for the insured. This clause generally excludes loss caused by a director, unless the director is also a salaried employee of the bank. "Dishonest or fraudulent acts" are defined as acts committed by such employee with the manifest intent to cause the insured to sustain such loss and obtain financial benefit for the employee or another party (other than salaries or other employee benefits earned in the normal course of employment). Coverage of losses resulting from loan activity is severely restricted. Such losses are covered only if the employee involved acts in collusion with another party to the transaction and the employee receives a financial benefit of at least $2,500.

Clause (B) - On Premises

Loss of property (as defined in the bond) resulting directly from (a) robbery, burglary, misplacement, mysterious unexplainable disappearance and damage thereto or destruction thereof, or (b) theft, false pretenses, common law or statutory larceny, committed by a person present in an office or on the premises of the insured, while the property is lodged or deposited within offices or premises located anywhere.

Clause (C) - In Transit

Identical coverage as that provided in Clause (B), except that the property is covered while in transit. The property must be in the custody of a person acting as a messenger of the bank while in transit. When an armored vehicle is not used by a transportation company, property is generally limited to written or electronic records, certified securities, and negotiable instruments.

Clause (D) - Forgery or Alteration

Optional coverage for loss through forgery or alteration of, on, or in checks, drafts, acceptances, and other negotiable instruments, as specified, which are received by the bank either over-the-counter or through clearings. Items received as a transmission through an electronic funds transfer system are not covered.

Clause (E) – Securities

Optional coverage for loss resulting from the insured having, in good faith, for its own account or for the account of others, acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of any original security, title document or agreement (as delineated in the bond).

Clause (F) - Counterfeit Currency

Covers loss resulting from the receipt by the insured in good faith, of any counterfeit or altered money of the United States or Canada or any foreign country in which the insured maintains a branch office.

Factors to Consider in Determining Adequate Amount of Blanket Bond Insurance

Often, the most difficult insurance problem confronting bank management is determining the amount of blanket bond coverage that should be maintained. While an estimate of money and securities which might be lost through burglary or robbery can be fairly accurately calculated, there are no ready measures for estimating potential losses that may arise from employee dishonesty.

The problem of determining an adequate amount of insurance coverage to indemnify for losses from external hazards is not a complex problem. Property values at risk can be estimated fairly accurately and the level of exposure from daily operations is also generally ascertainable. The various types and amounts of transactions routinely conducted should also be appraised and considered when determining appropriate levels of insurance coverage. For instance, it may be prudent to reduce the insurance coverage for forged securities (within Clause E) taken as collateral for a loan to the amount of the in-house bank lending limit. If that limit is never exceeded, the bank would not suffer a loss greater than that limit on any given transaction.

Determining an adequate amount of fidelity insurance on the bank's own personnel is a more difficult task that cannot be based solely on one precise factor. It requires the use of management and examiner judgment. Banking associations or the insurance industry may periodically develop schedules indicating the range of blanket bond coverage carried by banks grouped by deposit size. However, a bank's level of risk exposure is influenced by many variables, only one of which is deposit size. Therefore, an overall assessment of the effectiveness of the bank's internal operations must be considered. Other factors which may increase fidelity exposure and should be given consideration are: the amount of cash and securities normally held by the bank; the number of employees and their experience level; delegations of authority to employees; personnel turn-over rates; the extent of trust, information technology, or off-balance sheet activities; and whether an institution is experiencing rapidly expanding operations.

When the bank is a member of a holding company or other group of affiliated banks, one fidelity bond is usually purchased to cover the parent and all affiliated banks. In such situations, the examiner should determine that the policy is sufficient to cover the exposures of the subsidiary bank being examined. Further, examiners should also determine that any policy premiums the subsidiary bank pays to the parent holding company are not disproportionate to the bank's benefits from the group policy and that such premiums are consistent with the fair market requirements of Section 23B of the Federal Reserve Act.

Basis for Claims Under the Bankers Blanket Bond

It is standard procedure for insurance companies to write blanket bonds on a “claims made” or "discovery" basis. Under this method, the insurance company is liable up to the full amount of the policy for losses covered by the terms of the bond and discovered while the bond is in force, regardless of the date on which the loss was actually sustained by the bank. This applies even though lower coverage amounts or more restrictive terms might have been in effect on the date the loss was sustained. Alternatively, bonds may be written on a "loss-sustained" basis. This means the bonding company is liable only to the extent of the coverage for losses sustained during the period the bond is in force. Situations which prompt an insurer to write a blanket bond on a loss-sustained basis may arise from another insurer having cancelled or refused to renew a bank's bond (i.e. the insurer is not willing to assume the risk of any undiscovered losses which may have occurred while the bank was insured by another company); the loss record of the bank; poor internal controls; or uncertainty concerning management's abilities.

Blanket bonds require that a loss be reported to the bonding company within 30-days after discovery. Failure to file a report once management is aware of discovery, even if there is uncertainty as to reportability, could jeopardize coverage for that loss. In addition, coverage as to any employee automatically cancels as soon as the bank has knowledge of any dishonest or fraudulent act on the part of an employee. Coverage on such employee can only be assured by written affirmation of the insurer. Likewise, an appropriate written waiver from the insurance company should be in evidence for any individual who has been granted consent to serve as a director, officer or employee pursuant to Section 19 of the FDI Act.

Banks must also notify the underwriter within 30-days of receiving any notice of legal action being brought against it which could result in a claim under the bond. The underwriter may elect, at its option, to defend the insured. If timely notice is not given by the bank or if the underwriter elects not to defend the action, the underwriter is not liable for attorneys' fees and court costs, nor does any judgment against the bank determine the existence of bond coverage.

The general agreements to Standard Form No. 24 make the application for insurance coverage part of the bond. Any misrepresentation, omission, concealment or incorrect statement of material fact in the application may be grounds for recession of the bond. Due to this strong language in favor of bonding companies, banks must be absolutely truthful, accurate and thorough in responding to questions on bond applications and questionnaires. There may be instances when it is appropriate for examiners to review such applications and questionnaires for accuracy and completeness.

Under the present Standard Form No. 24, there are no rights of any parties to make claims under the bond after the termination or cancellation of the bond. Banks may no longer purchase the right to extend the discovery period. It is therefore vitally important for banks to make immediate notification to the underwriter upon discovery of loss covered by the terms of the bond. If there is any uncertainty in this regard, the matter should be investigated promptly to determine whether a loss has in fact occurred that is covered by the terms of the bond. Moreover, the results of any such investigation should be documented as the investigation proceeds. There is immediate termination of the bond upon the taking over of the insured by a receiver or other liquidator or by State or Federal officials. The FDIC is thus effectively barred from pursuing any claims against the bonding company which were not discovered by the bank prior to its closing.

It is critical that the examiner in a potential closing situation call to the attention of the bank's board of directors all known facts concerning any loss discovered during the examination, and the bond requirements that notice be given to the bonding company within 30-days of discovery.

Information Technology (IT) Coverage

IT coverage is provided in the bond for serviced banks under the definition of "employee," which is defined to mean each natural person, partnership, or corporation authorized by the insured to perform services as data processor of checks or other accounting records of the insured. Usually the only riders for IT coverage are those to eliminate it from the policy, which is not advisable. To further protect banks with electronic funds transfer systems (EFTS) and those with in-house computers that contract with outside programmers, additional coverage may be obtained by a rider or separate policy referred to as computer/computer related theft insurance. Usual coverage protects banks from criminal acts affecting data processing equipment, communication lines, data elements and program logic located in one or more of the insured's offices, at contract service bureaus (including financial institutions), and at automated clearing houses, switches or other electronic communications systems. For more detailed coverage of IT insurance, refer to the FFIEC IT Examination Handbook.

Blanket Bond Riders

Numerous riders are available to delete or supplement coverage for risks not included in the basic blanket bond. In some instances, a separate policy may be obtained. While not necessarily all inclusive, a list of common riders purchased by financial institutions is detailed below. All riders should be carefully reviewed since additions and deletions to the basic policy can have a significant impact on overall coverage.

Deductible and Self-Insurance Riders

Banks and insurance companies frequently use deductible clauses to customize the blanket bond coverage to a particular bank. The deductible amount generally ranges from $1,000 to $100,000, or higher, and is directly related to the willingness and ability of the bank to absorb risks. A bank with a history of few claims may choose to lower its premium costs by requesting a higher deductible on its blanket bond policy. On the other hand, a bank with a history of numerous losses may be required to utilize a deductible clause as a condition for continued blanket bond coverage. The use of deductibles obviously lowers the cost of insurance.

Automated Teller Machine Riders

Covers loss involving automated mechanical devices for disbursing money, accepting deposits, cashing checks or making credit card loans when such devices are not located within an office of the insured, and not permanently staffed with a bank teller.

Kidnapping, Ransom and Extortion Rider

Covers losses arising from any of the various forms of extortion whereby the physical well-being of a person(s) is or is believed to be imperiled.

Computer Systems Rider

Covers losses resulting from the fraudulent entry of data or from the change of data or programs within a computer system.

Excess Employee Fidelity Coverage

The purpose of such coverage is to extend the basic protection provided under the blanket bond in areas where the dollar volume of assets or exposure is particularly high. Such excess coverage usually is written in multiples of $1 million and either carries a deductible clause equal to the amount of the blanket bond (usually requires primary bond coverage of at least $250,000), or states that coverage will be provided for the full amount of the excess policy when losses exceed a specified amount. Any deductible in excess of underlying primary coverage should be discussed with management. The most common form of this coverage is the Excess Bank Employee Dishonesty Blanket Bond, Standard Form No. 28. The FDIC strongly recommends that all banks acquire this modest cost protection against the possibility of catastrophic fidelity losses, unless the primary blanket bond coverage is large enough to equal or exceed the protection provided by an excess fidelity bond.

Other Specialized Bank Insurance

This is not a comprehensive list of coverage available, but rather those frequently purchased.

Combination Safe Depository

Consists of two coverage sections that can be purchased together or separately. Clause (A) covers losses when the bank is legally obligated to pay for loss (including damage or destruction) of a customer's property held in safe deposit boxes. Clause (B) covers loss, damage, or destruction of property in customer's safe deposit boxes, whether or not the bank is legally liable, when such loss results from other than employee dishonesty. The policy commonly provides for reimbursement of legal fees in conjunction with defending suits involving alleged loss of property from safe deposit boxes.

Registered Mail and Express Insurance

Insures valuable property such as money or securities shipped by registered mail, registered air mail, express, and air express. Coverage is provided from the time the property leaves the bank until delivered to the addressee.

Transit Cash Letter Insurance

Covers loss of cash letter items in transit for collection or to a clearing house of which the insured bank is a member. It also includes costs for reproducing cash letter items. Generally, such policies do not cover items sent by registered mail or air express, or losses due to dishonest acts of employees.

Valuable Papers and Destruction of Records Policy

Covers the cost of reproducing records damaged or destroyed. It also provides the cost of research needed to develop the facts required to replace books of accounts and records.

OTHER DESIRABLE INSURANCE COVERAGE

The banking industry customarily utilizes forms of insurance for which the blanket bond, along with related policies, endorsements and special coverage previously noted, does not provide coverage or provides insufficient protection. Banks may also need many of the same types of insurance required by any business or individual. The following is a brief description of some of those types of coverage.

Liability Insurance

Directors and Officers Liability

These policies provide for the indemnification of directors and officers against legal and other expenses incurred in defending lawsuits brought against them by reason of the performance of their official duties. They protect, under two insuring clauses, against the expense of defending suits alleging director or officer misconduct and against damages that may be awarded. Clause (A) provides coverage directly to the directors and officers for loss resulting from claims made against them for their wrongful acts. Clause (B) reimburses a corporation for its loss when the corporation indemnifies its directors and officers for claims against them. An additional, optional coverage provides protection for the corporation and its own liability. This coverage is written at a minimum of $1 million (deductible $10,000 to $20,000) with the insurance company paying a portion of any claim over the deductible amount. This insurance does not cover criminal or dishonest acts, situations when the involved person obtained personal gain, or when a conflict of interest was apparent.

General Liability

Covers the bank from possible losses arising from a variety of occurrences. Typically, general liability insurance provides coverage against specified hazards, such as personal injury, medical payments, property damage, or other specific risks that may result in or create exposure to a suit for damages against the bank. Where offered, "comprehensive" general liability insurance covers all risks, except specific exclusions.

Automobile Liability and Physical Property Damage

Protects against property and liability losses arising from injury or death when a bank-owned, rented, or repossessed vehicle is involved. Non-ownership liability insurance should be considered if officers or employees use their own vehicles for bank business.

Umbrella Liability

Provides excess coverage over and above existing liability policies, as well as basic coverage for most known risks not covered by existing liability insurance.

Fixed Assets/Property Physical Damage

Adequate insurance should be maintained to cover loss or damage of the bank's fixed assets.

Fire or Extended Coverage

This insurance covers all loss as a direct result of a fire, including damage from smoke or water and chemicals used to extinguish the fire. Covering the building's contents for fire damage is additional, but often is written in combination with the policy on the building and permanent fixtures. Extended coverage indemnifies against losses from windstorm, hail, explosion, riot, civil commotion, aircraft, vehicles, and smoke damage. Damage caused by rising water or the malfunction of a steam boiler is usually not included. Most fire insurance policies contain "coinsurance" clauses, meaning insurance coverage must be maintained at a fixed proportion of the replacement value of the building. If a bank fails to maintain the required relationship of protection, all losses will be reimbursed at the lower ratio of the amount of the insurance carried to the amount required, applied to the actual value of the building at the time of the loss. When determining insurable value for fire insurance purposes, the typical base is the cost of replacing the property with a similar kind or quality at the time of loss.

Boiler and Machinery

Provides coverage for loss due to explosion or other forms of destruction of boilers, heating and/or cooling systems, and similar types of electrical equipment.

Fine Arts

Includes coverage for art objects on display whether owned by the bank or on loan from another source. Protection generally is all-risk and requires that an appraisal of the material be made regularly to establish its insurable value.

Extra Expense

Provides funds for the additional costs of reestablishing the bank's operations after fire or other catastrophe such as renting temporary quarters and/or equipment on an interim basis.

Business Interruption

Provides reimbursement for the gross earnings lost when the bank cannot operate because of fire or other catastrophe, often with a coinsurance clause.

Rental Income

Provides protection when a fire or other hazard renders the insured premises unfit for occupancy and a lessee ceases to pay rent. The policy will pay the building owner an amount equal to the reasonable rental income immediately before the loss, less any avoidable expenses.

Bank Owned/Leased Automobile

Standard coverage for accidental loss sustained through collision involving a bank automobile. Comprehensive coverage also is available for damage to an automobile other than through collision.

Lending Activities

Various types of insurance are available to cover certain risks in lending activities dependent upon what management considers necessary and warranted for the bank.

Mortgage Lending Activity

Mortgage Errors and Omissions

Protects the bank from loss when fire or all-risk insurance on real property held as collateral inadvertently has not been obtained or has expired. Generally, this insurance is not intended to overcome errors in judgment, such as inadequate coverage or insolvency of an original insurer.

Title Insurance

Insures marketability of title, access to the property, validity and enforcement of the mortgage and, subject to the stated exceptions, its priority. The policy also insures that the person to whom the bank is making the loan has title to the real estate pledged as security. Commitments for insurance are issued in advance of closing, outlining the scope of the coverage, stating the specific exceptions from coverage and the standard exceptions.

Mortgagor's Defaults

Contract with a third-party mortgage insurer to absorb all or part of the risk that the value of the mortgaged property will not cover the loan and costs. Government agencies (Federal Housing Administration {FHA} and Veterans Affairs {VA}) and private insurers provide mortgage protection coverage. This insurance is attractive to lenders who intend to sell mortgages in the secondary market.

Installment Lending Activity

Single Interest

This insurance covers losses to uninsured vehicles pledged as collateral for an extension of credit.

Nonfiling Insurance

Covers losses resulting from nonfiling of liens or recording appropriate instruments on personal property pledged as collateral under chattel mortgages, conditional sales contracts and other similar instruments.

Credit Life, Accident and Health

These types of insurance are written in conjunction with an extension of credit, especially an installment loan, and are designed to protect the bank against loss in the event of a debtor's inability to pay because of sickness, accident or death.

Fraudulent Accounts Receivable and Fraudulent Warehouse Receipts

Cover losses resulting from the pledging of fraudulent or nonexistent accounts receivable and warehouse receipts, or from situations in which the pledger does not have title. In addition, this insurance offers protection against loss arising from diversion of proceeds through acts of dishonesty.

Personnel Administration

Depending on the needs of an individual bank, there are various types of coverage that can be obtained to benefit employees or cover the loss of an employee.

Key Person Insurance

Insurance purchased for the benefit of the bank on the life of an officer when the death of such "key person" would be of such consequences as to affect the operation of the bank. The term "key person" is defined to mean any bank officer, regardless of title, who participates in major policy making functions of the bank and whose loss to the bank would be of consequence because of knowledge, experience and related qualifications. Many "key person" insurance programs are designed to provide a fringe benefit to the insured officer and family. The benefit accrues to the officer when, upon death, the board of directors of the bank directs payment of the proceeds to the officer's family.

Employee Benefit Insurance

An employee benefit program, to be effective, must be able to respond to the changing needs of employees; be competitive with other firms in the trade area who employ individuals similarly qualified to those employed by the bank; be of reasonable overall cost; and compare favorably to peer group statistics. Some insurance coverage is legally required, such as unemployment insurance, worker's compensation, and Social Security. Other commonly provided insurance policies are group insurance protection for life, health, accident, medical, hospitalization, vision, and dental. Other programs such as deferred compensation and salary continuance have been developed which provide additional fringe benefits to key officers and/or their designated beneficiaries. The premiums for such insurance are paid either in part or entirely by the bank, with the bank having no beneficial interest in the policy.

INTRODUCTION

Financial institutions operate within a regulatory framework based on state and federal statutes, regulations, and administrative rulings. These laws and regulations are designed to protect the public (depositors, consumers, investors, creditors, etc.) by establishing operational standards and consumer protections for the banking industry. Violations of laws and regulations can reflect negatively on a bank's board of directors and management and can expose an institution to financial and other risks. Accordingly, examiners must have a thorough knowledge of state and federal laws and regulations to ensure that violations are promptly detected and corrected.

Causes

Violations often result from management's unfamiliarity with, or misinterpretation of, governing statutes or regulations. Negligence and willful noncompliance may also lead to violations. To reduce the risk of violations, the board of directors and senior management should develop:

- Policies, procedures, and training programs designed to ensure that directors, officers, and employees are familiar with applicable laws and regulations;
- Monitoring procedures to assure compliance with laws and regulations in daily operations; and
- Procedures for detecting noncompliance, reporting it to the board and management, and correcting identified issues promptly.

Differences of opinion can arise regarding the interpretation of laws and regulations. If management disagrees with the applicability or meaning of a statute or regulation and examiners are in doubt as to its applicability or meaning, the examiners may consult with the regional office to confirm the applicability or meaning.

Willful acts of noncompliance with laws or regulations should be taken seriously and thoroughly investigated by examiners. Depending on the gravity of an offense and other factors, willful noncompliance may result in civil money penalties (CMPs), or other administrative actions under Section 8 of the Federal Deposit Insurance Act (FDI Act).

Significance

The fair and non-discriminatory treatment of stakeholders and customers should be sufficient reason for bankers to operate in accordance with laws and regulations. Bank directors and officers should be aware, however, that there are also more direct and personal reasons to conform to laws and regulations. Federal statutes and regulations (and those of some states) provide for the assessment of civil money penalties against banks and individuals for certain violations. Additionally, most state laws provide that directors can be held personally liable for a bank's losses relating to illegal loans or other nonconforming assets (assets acquired or held by the bank in violation of a law or regulation). Such losses may also prompt requests for restitution or other corrective measures. Finally, infractions of laws and regulations may prompt litigation and requests for money damages by adversely affected parties.

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SCHEDULING VIOLATIONS

Examiners should cite apparent violations on the Violations of Laws and Regulations schedule of the Report of Examination (ROE). Nonconformance with interagency guidelines that are incorporated into regulations (such as Appendix A or B of Part 364, or Appendix A of Part 365 of the FDIC Rules and Regulations) should be segregated under an appropriate subheading, listed after cited apparent violations, and include information similar to apparent violations. Detailing infractions on one schedule allows examiners to present issues to bank officials more effectively and allows readers to evaluate the type and severity of apparent violations more easily. Comments should include:

- Clear, concise headings for each violation or group of related violations;
- Descriptions of each applicable statute or regulation;
- Details of the action or inaction that caused an apparent violation;
- Names and dates of directors' approvals/dissentions;
- Management's response; and
- Commitment/timing of any promised corrective action.

When describing a law or regulation in the ROE, examiners should cite the specific section number and either quote or paraphrase the law or regulation. In controversial situations, examiners should generally quote applicable sections. In non-controversial situations, examiners may paraphrase regulations, but must ensure descriptions accurately convey a statute or regulation's main point. For example, "Section 337.3(b) prohibits banks from making large loans to directors without prior board approval."

Examiners must be accurate when describing the action or inaction that caused an apparent violation; however, it is generally unnecessary to provide lengthy explanations. For example, an infraction of Section 337.3(b) could be described as, "The $3 million loan to Director Smith funded on 12/2/18 is in apparent violation of Part 337 because it was extended without prior board approval."

Examiners may avoid lengthy descriptions of violations relating to classified assets by referencing write-ups included in other ROE schedules, such as the Items Subject to Adverse Classification.

To reflect director responsibility and possible liability, report comments must identify the directors who approved or ratified the apparently unlawful actions, the date of the approvals, and the names of any dissenting directors. Examiners should follow these procedures even if an approval consisted merely of the ratification of a group of loans, possibly identified only by numbers.

General Considerations

- Use the phrase *apparent violation* to describe infractions directly related to laws and regulations, no matter how certain the violation may appear.
- List violations in order of importance, considering the substance and severity of the violation.
- Exercise care when citing apparent violations because incorrectly cited infractions discredit the ROE.
- State if an apparent violation was corrected during the examination.
- Generally, include sample lists when violations involve numerous accounts or credits. (Detail the total number of accounts or credits in the ROE, give complete lists to management, and retain a copy of the list in the workpapers.)
- Cite the specific section or subsection of a regulation, such as Section 337.3 or Section 337.3(b), when referring to specific regulations.
- Cite a regulation's part number, such as Part 337, when referring to general regulations.

The considerations above apply similarly to citations of nonconformance with guidelines incorporated into an appendix to a regulation. Key differences being:

- Use the term *nonconformance* to describe significant deficiencies in adherence to the guidelines contained in appendices to regulations, such as the appendices to Part 364 or 365.
- List nonconformance with such guidelines after apparent violation citations and under the separate heading *Nonconformance with Guidelines Incorporated into Appendices to Regulations*.

Uncorrectable Violations

Examiners should not continue to cite previously cited violations that cannot be corrected. For example, violations of the prior approval requirements of Regulation O are not correctable and should not be cited at subsequent examinations. However, examiners should cite repeat violations (new infractions of previously cited violations), and continuing violations (violations that could have been, but were not, corrected).

Report Comments

If apparent violations of law or regulation, or nonconformance with an appendix to a regulation, are cited in the ROE, the Examination Conclusions and Comments (ECC) page must include, at a minimum, a brief summary comment and reference to the Violations of Laws and Regulations page. References to other report pages may also be necessary if related issues, such as internal control or policy weaknesses, are detailed elsewhere in the ROE.

Examiners should not refer to the FDIC's authority to impose CMPs, or to the possible amount of CMPs that may be imposed, except in serious situations. Examiners can comment that violations may be subject to CMPs if violations cited at previous examinations are repeated or not corrected.

Note: When an examiner concludes that violations detected during the examination warrant a CMP recommendation to the regional office, the home mailing addresses of all directors and any other individuals involved in the violation should be included in the Directors/Trustees and Officers section of the ROE.

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TYPES OF VIOLATIONS

The following sections describe common violations detected in safety and soundness examinations. Most examples relate to nonconforming assets.

Legal Lending Limit Violations

A borrower's debt at a bank may consist of several notes of different dates. When the total of such notes exceeds state or federal lending limits, courts have generally held that only the note(s) that created the excess above the lending limit constitutes an illegal extension. Until the note(s) are paid in full, they represent a violation for which the approving directors may be held liable. Generally, examiners should cite only the note(s) that caused the apparent violation. However, if state law or practice differs from this guidance, state law prevails.

Courts have also held that if several notes constitute a single transaction, all notes should be treated as a unit and the entire loan balance considered an illegal extension for which the approving directors may be held liable.

Note: Loans are sometimes made in conformance with statutory lending limits, but subsequently exceed lending limits due to a decline in capital levels or appraised values. Examiners should not cite violations in these situations unless indicated by state law. However, violations should be cited if the loans were renewed at levels exceeding lending limits.

Nonconforming Loans to Insiders

Bank directors and officers have responsibilities to stockholders and depositors. Their actions must be conducted in good faith and free from self-dealing or conflicts of interest. Loans to directors, officers, employees, principal shareholders, and their interests must be beyond reproach, and illegal loans must be reported and corrected as soon as possible.

Nonconforming extensions of credit to insiders and their interests may violate state laws, Federal Reserve Board Regulation O, or Section 337.3 of the FDIC Rules and Regulations. These statutes limit the dollar amount of loans banks may extend to insiders, prohibit banks from making insider loans on preferential terms or conditions, and establish recordkeeping requirements.

Nonconforming Affiliate Transactions

Sections 23A and 23B of the Federal Reserve Act govern transactions between member banks and their affiliates. Section 18(j) of the FDI Act makes Sections 23A and 23B applicable to state nonmember banks.

All infractions of Sections 23A and 23B, including nonconforming extensions of credit to, and illegal investments in, an affiliate should be cited as apparent violations.

Nonconforming Real Estate Loans

Various laws and regulations govern the extension of loans to purchase, or secured by, real estate. For example, Part 365 of the FDIC Rules and Regulations requires institutions to develop written policies that establish appropriate limits and standards for real estate related loans. Part 323 requires institutions to obtain appraisals from qualified appraisers for various real estate related financial transactions.

Generally, examiners should list the current book value of nonconforming loans if they identify violations of these or other real estate related regulations. In cases where violations involve multiple loans, only the loan(s) that created the violation should be cited.

Nonconforming Securities Securing Loans

Various statutes and regulations govern the process of collateralizing loans with securities. For example, Federal Reserve Board Regulation U restricts loans made for buying margin stock if the loans are collateralized by margin stock. Section 23A of the Federal Reserve Act prohibits banks, with certain exemptions, from securing loans to an affiliate using any affiliate's stock as collateral. Also, Treasury Department regulations prohibit the pledging of certain savings bonds as loan collateral. Where ineligible bonds are designated as collateral, examiners should not recognize the loan as secured. However, the loan itself may not be a violation and should not be included in this schedule unless collateral is required, or it is otherwise nonconforming. For example, it lacks a financial statement required by a state law for unsecured loans.

Loans collateralized in apparent violation of law or regulation should be cited at the current balance of the loans.

Securities Unlawfully Acquired or Held

Part 362 of the FDIC Rules and Regulations and many state laws restrict banks from investing in certain types of securities. For example, banks may be prohibited from acquiring common stock or other forms of equity investments. Exceptions are sometimes allowed for investments in subsidiaries holding title to bank premises, stock in bank service corporations, or securities taken in consideration of debt previously contracted (DPC). If a bank appears to have unlawfully acquired or held a security, examiners should contact the regional office and when appropriate cite the current book value as an apparent violation in the ROE.

Nonconforming Other Real Estate

State laws sometimes require banks to divest of, within defined periods, real estate acquired through foreclosure, repossession, or otherwise in satisfaction of DPC. Examiners do not need to cite violations for real estate acquired DPC and held longer than permitted by statute if the asset is carried on the books at a nominal value. However, real estate acquired illegally (as distinguished from real estate acquired DPC), should be cited as an apparent violation even if fully charged off.

Charged-Off Nonconforming Assets

Illegally held or acquired assets are violations regardless of any related charge-offs. For example, if a bank makes a loan that exceeds legal lending limits and subsequently charges off all or part of the debt, the borrower remains liable for the unpaid loan balance and the loan remains a violation at the original amount. Were this interpretation not in place, bank management, desiring to accommodate a borrower beyond the legal limit, could make excessive loans and simply charge them down to the legal limit or eliminate them from their financial records. The same general rule holds true regarding most other types of nonconforming assets.

All Other Violations

Some violations of laws and regulations are not associated with the acquisition or holding of a nonconforming asset. They include most apparent violations of the FDI Act, FDIC Rules and Regulations, Bank Holding Company Act, and other similar federal and state laws and regulations.

However, some of these apparent violations are not scheduled in the safety and soundness ROE. For example, apparent infractions of the federal criminal code are reported separately, and infractions of the Truth in Lending Act and Equal Credit Opportunity Act are excluded since they are covered in separate consumer compliance ROEs.

Nonconformance with Guidelines Incorporated into Regulations

Nonconformance with guidelines or standards that are incorporated into regulations (such as Appendix A or B of Part 364, or Appendix A of Part 365 of the FDIC Rules and Regulations) should be scheduled in the Violations of Laws and Regulations page, under a separate heading and after apparent violations of laws and regulations. Related supervisory recommendations should be summarized on the ECC page and should include at a minimum, a brief summary comment, and reference to the Violations of Laws and Regulations page, and other pages when applicable. When appropriate, the concerns should be brought forward to the Matters Requiring Board Attention schedule.

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EVALUATION OF MANAGEMENT

Examiners must consider a bank's adherence to laws, regulations, and internal policies when assigning Management and composite ratings. Compliance with statutory and regulatory provisions is more likely achieved when the board of directors and senior management recognize the importance of legally conforming behavior and maintain appropriate internal guidance. The board should establish policies, procedures, and controls designed to ensure compliance with legal and regulatory directives, prompt detection of noncompliance, timely implementation of corrective measures, and adequate training of officers and employees to prevent infractions. Deficiencies in these areas reflect negatively on management and should be appropriately recognized.

For example, regular or willful noncompliance reflects more negatively on management than a minor infraction of a technically complex statute, and examiners should tailor comments and recommendations to match the severity of all infractions of laws and regulations. However, regardless of their perceived importance, it is important that management promptly correct all apparent violations.

References:

- Manual Section 16.1, ROE Instructions
- Manual Section 4.1, Management
- Manual Section 4.3, Related Organizations

REMOTE DISBURSEMENT ACTIVITIES AND ZERO-BALANCE ACCOUNTS

In an effort to establish and/or maintain customer relationships, banks often provide cash management services to corporate accounts. Two of the more common services are remote disbursement services and zero-balance accounts. Remote disbursement is a technique that enables a customer to delay settlement of a financial transaction by taking advantage of the "float" possibilities in the check clearing system. The process occurs when the maker of a check draws the instrument payable at a bank remotely located ("remote bank") from the payee named in the instrument. Remote disbursement is often used in conjunction with zero-balance accounts that permit depositors to draw checks against accounts maintained at or near a zero-balance. A corporate customer utilizing this cash management approach generally maintains a primary deposit account relationship at a bank where the principal borrowing arrangements are maintained. This bank may be referred to as a "concentration bank" and through it the customer consolidates receipts and makes general disbursements.

Zero-balance accounts obviously cannot be considered funding sources for the remote bank. More importantly, they present a credit risk due to the fact that checks are paid on accounts with insufficient collected balances on the expectation that covering funds will be provided by the customer prior to the close of the business day. The intraday exposure to the remote bank, in the form of unsecured lending against uncollected funds, is not reflected in the bank's financial statement. However, the amounts involved may be sizeable and even exceed the bank's capital.

Examiners should analyze the bank's cash management services. If a concentration bank is involved, the focus should be on the potential volatility presented by using corporate deposits as funding sources. If a remote bank is involved, the supervisory interest centers on the exposure resulting from the practice of routinely paying checks against uncollected funds. The absence of prudent safeguards and full knowledge of the creditworthiness of the customer may expose the remote bank to large and unnecessary risks and warrants comment in the examination report and the initiation of remedial measures.

FUNDS TRANSFER SYSTEM RISK

Growth of the commercial banking industry, accompanied by greater customer demand for services, has increased the importance of wire transfer activity. Wire transfer has evolved from the use of elementary Morse code to sophisticated automated switching operations linking the Federal Reserve System with various governmental agencies and commercial banks. Functions of the wire transfer operation include daily funds transfers, securities transactions and the general communication of information.

Banks may effect transfers or related messages by mail, telephone and direct access to several telecommunications systems. The size and complexity of the operation will determine which method the bank uses. Since speed is the primary reason for many wire transfers, mail requests are infrequent. The majority of banks make transfers and execute Federal funds transactions over the telephone or teletype since their size and volume does not justify maintaining automated systems. However, the tendency to automate the operation is increasing with the advent of inexpensive computer technology.

The large-dollar networks are now an integral part of the payments and clearing mechanism. A variety of networks have been established to provide funds transfer services. They include the Federal Reserve Communications System (FedWire), the Clearing House Payments System (CHIPS) and Automated Clearing House (ACH).

The volume of funds which change hands daily in the U.S. through the electronic funds transfer environment is staggering. Present estimates place this volume at over one trillion dollars. It is therefore readily apparent why the financial institutions involved in those transactions and the regulatory authorities who supervise them are concerned with the quality of internal controls and management's awareness of the inherent risks associated with the various systems.

Risk Management

Errors and omissions and fraudulent alteration of the amount or account number to which funds are to be deposited could result in a loss to the bank. Costs can include loss of funds, loss of availability of funds, interest charges, and administrative expenses associated with recovering funds and correcting problems.

Banks are exposed to settlement risk whenever provisional funds are transferred. Provisional funds are irrevocable payments that are subject to final settlement at a later time. Two levels of risk are present:

- Credit risk to participating banks whose overdraft payments for customers (including nonsettling respondents) are not covered.

- Systemic risk to network participants when other participants fail to settle. There is no settlement risk to the recipient of a FedWire transfer. However, payments received through CHIPS are provisional and expose the recipients to settlement risk if funds are released prior to final settlement.

Intraday (or daylight) overdraft risk occurs when payments are released in expectation of the future receipt of covering funds. By definition, they represent credit exposures of a very short duration, usually a few hours. Overnight overdrafts result from failure to receive covering funds or intentional extensions of credit. In either case, a bank is exposed to risks resulting from payments made against insufficient funds or credit extensions.

The examination of funds transfer activities is designed to disclose deficiencies in the internal credit and operational controls of participating institutions and to assess the adequacy of the supervision of such activities by senior management and the boards of directors of those institutions.

Management is responsible for assessing the inherent risks in the system, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of such safeguards. Bank supervisors have the responsibility to ensure that the financial institutions have evaluated their own risks realistically and have provided for accounting records and internal controls which are adequate to keep the exposures within acceptable limits.

Effective risk management requires that:

- An adequate accounting system be in place to determine the extent of any intraday overdrafts and potential overnight overdrafts before releasing payments;
- Payments be within established credit limits and amounts in excess of such limits involving significant credit risk be properly approved by appropriate lending authorities; and
- Institutions responsible for settling the positions of others assign responsibility for monitoring respondents' accounts at an appropriate supervisory level.

To assure that prudent practices are being followed by banking institutions in their funds transfer activities, examinations should focus, with equal emphasis, on the evaluation of credit risks and operational controls. Deficiencies disclosed in either of these areas and suggestions for improvement should be discussed with management and listed in the Report of Examination. Constructive criticism by the examiners should help the institutions strengthen procedures to minimize the risks associated with funds transfer activities. Refer to the Electronic Funds Transfer (EFT) Examination Documentation module for further guidance.

INTRODUCTION

From a bank regulator's standpoint, the essential purpose of bank earnings, both current and accumulated, is to absorb losses and augment capital. Earnings is the initial safeguard against the risks of engaging in the banking business, and represents the first line of defense against capital depletion resulting from shrinkage in asset value. Earnings performance should also allow the bank to remain competitive by providing the resources required to implement management's strategic initiatives.

The analysis of earnings includes all bank operations and activities. When evaluating earnings, examiners should develop an understanding of the bank's core business activities. Core activities are those operations that are part of a bank's normal or continuing business. Therefore, when earnings are being assessed, examiners should be aware of nonrecurring events or actions that have affected bank earnings performance, positively or negatively, and should adjust earnings on a tax equivalent (TE) basis for comparison purposes. Although the analysis makes adjustments for non-recurring events, examiners should also include within their analysis the impact that these items had on overall earnings performance. Examples of events that may affect earnings include adoption of new accounting standards, extraordinary items, or other actions taken by management that are not considered part of the bank's normal operations such as sales of securities for tax purposes or for some other reason unrelated to active management of the securities portfolio.

The exclusion of nonrecurring events from the analysis allows the examiner to analyze the profitability of core operations without the distortions caused by non-recurring items. By adjusting for these distortions, examiners are better able to compare earnings performance against the bank's past performance and industry norms (e.g., peer group data) over time.

The terms level and trend are used throughout this section of the Manual. Level analysis is the process of reviewing financial statement ratios and volumes as of a specific date. Level analysis allows for a comparison of performance, for example, to industry norms or peer group data. Trend analysis is the process of assessing the general direction or prevailing tendency (i.e., increasing, decreasing, or stable) of operating ratios or volumes over several periods (i.e., generally over a five year period) using the level of each period.

The following tools are available to assist the examiner in the assessment of earnings: the Uniform Bank Performance Report (UBPR), the bank's Consolidated Reports of Condition and Income (Call Report), the bank's financial statements and subsidiary ledgers, analytical reports prepared for the bank's senior management and board of directors, and the Examination Documentation (ED) Modules.

The UBPR can be used to perform level and trend analysis of key earnings components. Bank-prepared analytical reports can serve the same purpose while also revealing those elements of earnings of strategic interest to management. In conjunction with the UBPR and any internal analytical reports, the bank's Call Report and corresponding bank financial statements and supplementary schedules should be used for more in-depth review. The information gleaned from these schedules may provide the examiner considerable insight into bank earnings. An analysis of earnings is not complete until the examiner has a full understanding of the bank's business activities and its strategic initiatives, and has discussed the bank's financial performance and strategies with management

Further, examiners should consider the bank's marketplace when assessing earnings because institutions that operate in more competitive environments must continually adapt to current national, regional, and local economic and industry conditions to remain viable over time. Also, examiners should determine whether there are any secular, cyclical, or seasonal factors that may favorably or unfavorably affect bank earnings. Current knowledge of such conditions and factors can be obtained by reviewing economic and industry information in newspapers and industrial journals.

Earnings Analysis Trail

Generally the analysis of earnings begins with the examiner reviewing each component of the earnings analysis trail. The earnings analysis trail provides a means of isolating each major component of the income statement for individual analysis. The earnings analysis trail consists of the following income statement components: net interest income, noninterest income, noninterest expense, provision for loan and lease losses, and income taxes.

Each component of the earnings analysis trail is initially reviewed in isolation. Typically, ratios are examined to determine a broad level view of the component's performance. The level of progression along the analysis trail will depend on a variety of factors including the level and trend of the ratio(s), changes since the previous examination, and the institution's risk profile.

The balance sheet composition, or structure, is determined by management. Any material shifts in the balance sheet structure will cause changes to any ratios using a numerator or denominator from the balance sheet (e.g., average assets and average earning assets). Therefore, examiners should be aware that significant changes in the balance sheet structure can materially affect earnings performance.

Ratio Analysis

Several key UBPR ratios used in the earnings analysis are shown below. Refer to additional ratios and the UBPR User's Guide as needed.

Net Income to Average Assets Ratio

This ratio is also known as the Return on Assets (ROA) ratio and consists of bottom line after-tax net income, including securities gains/losses and extraordinary items, as a percentage of average assets. The ROA is a common starting point for analyzing earnings because it gives an indication of the return on the bank's overall activities. A typical ROA level is different, depending on the size, location, activities, and risk profile of the bank. For example, a "community" bank with a few branches may regularly achieve an ROA ratio that exceeds those realized by large wholesale banks. Although the ROA provides an overall performance measure, the individual components comprising the ROA need to be reviewed. These sub-components will be discussed later in this section.

Net Income Adjusted Subchapter S to Average Assets Ratio

In general, institutions that elect to operate as Subchapter S (Sub S) corporations are treated as pass-through entities and are not subject to Federal income taxes at the corporate level Therefore, an adjustment to net income is needed to improve the comparability between banks that are taxed at the corporate level and those that are not. Refer to the UBPR User's Guide for specific information.

Various other issues specific to Sub S corporations may also exist. For instance, several states do not recognize Federal Sub S elections. Therefore, Sub S institutions may remain subject to State corporate income taxes. Refer to outstanding guidance for additional information and the potential effects of this election on the institution's overall earnings performance.

Net Interest Income (TE) to Average Assets Ratio

The ratio of Net Interest Income (NII) to Average Assets is also known as the NII ratio and measures annualized total interest income, plus the tax benefit on tax-exempt income, less total interest expense, divided by average assets.

TE adjustments are made to enable meaningful comparisons for banks that have tax-exempt income. These adjustments are discussed in detail in the UBPR User's Guide. Consideration should be given to the impact of tax-free investments and the related adjustment(s) made to the ratio(s) when material.

This ratio typically represents the bank's largest revenue component. While a higher NII ratio is generally favorable, it can also be reflective of a greater degree of risk within the asset base. For example, a high NII ratio could indicate management is making a large number of "high-interest, high-risk" loans (for example, subprime loans). Although an increase in the NII ratio would be evident, this would not necessarily be an improvement.

The NII ratio can be broken down into two sub-component ratios: Interest Income (TE) to Average Assets and Interest Expense to Average Assets. These ratios and their related components can be analyzed to determine the root cause(s) of any changes in the ratio and their subsequent effect on the ROA.

Net Interest Income (TE) to Average Earnings Assets Ratio

This ratio is also known as the Net Interest Margin (NIM). The ratio is comprised of annualized total interest income on a TE basis, less total interest expense, divided by average earnings assets. This ratio indicates how well management employed the earning asset base. The NIM is more useful than the NII for measuring the profitability of the bank's primary activities (buying and selling money) because the denominator focuses strictly on assets that generate income rather than the entire asset base.

The sub-components of the NIM - the ratios of Interest Income to Average Earnings Assets and Interest Expense to Average Earning Assets - can be analyzed to determine the root causes of NIM changes. These ratios may change for a variety of reasons, for example, management may have restructured the balance sheet, the interest rate environment may have changed, or bank loan and deposit pricing became more or less competitive.

Noninterest Income to Average Assets Ratio

This ratio is comprised of annualized income from bank services and sources other than interest-bearing assets, divided by average assets. Level, trend, and overall contribution of noninterest income to earnings performance should be analyzed. If the contribution represents a major portion of the bank's total revenue, specific sources of noninterest income need to be identified. An assessment as to whether or not these sources are core versus nonrecurring should be made.

Noninterest income is largely of a fee nature; service charges on deposits, trust department income, mortgage servicing fees, and certain types of loan and commitment fees. The results of trading operations and a variety of miscellaneous transactions are also included. In some institutions, noninterest income is being relied upon more heavily as banks are attempting to diversify their earnings streams.

Noninterest Expense to Average Assets Ratio

This ratio is also referred to as the Overhead (OH) ratio and is calculated by annualizing expenses related to salaries and employees benefits, expenses of premises and fixed assets, and other noninterest expenses, divided by average assets. Levels and trends of each component should be assessed and the types of expenses representing the largest overhead components should be determined. Examples of the type of costs that may lead to an inordinately high level of overhead expenses include: excessive salaries and bonuses, sizable management fees paid to the bank holding company, and high net occupancy expenses caused by the purchase or construction of a new bank building.

Other related ratios such as average personnel expense per employee, average assets per employee, and the efficiency ratio may provide useful information. The level of these ratios and the overall affect on earnings performance should be analyzed. If significant, specific sources of noninterest expense need to be identified. An assessment as to whether these sources are core versus nonrecurring should be considered during the earnings analysis.

The existence of unwarranted and unjust compensation of bank insiders is of particular concern, especially when those expenses are likely to result in harm to the bank and ultimately the deposit insurance fund. In this regard, the FDIC's safety and soundness standards (Appendix A to Part 364) state that both excessive compensation and compensation that could lead to material financial loss to an institution are prohibited as unsafe and unsound practices. While just and equitable employee and directorate compensation is essential for the acquisition and retention of competent management, there are instances where bank insiders profit from unwarranted compensation. Unwarranted and unjust compensation and related expenses to bank insiders should be dealt with through whatever means are necessary to cease these abuses. This is particularly critical in lower-rated banks. In such banks, the directorate should be reminded of their fiduciary responsibility for the preservation and conservation of bank funds. Additionally, management fees assessed by parent bank holding companies should be considered for appropriateness and level since they may be significant.

Provision for Loan and Lease Losses (PLLL) to Average Assets Ratio

This ratio shows the annualized percentage of PLLL in relation to average assets. Material changes in the volume of PLLL (either positively or negatively) should be investigated. Higher provisions should result if the loan mix changes significantly from loans with lower to higher historical loss experience (e.g., from one-to-four family mortgage loans to commercial loans) or if economic conditions have declined and have produced a deterioration of loan quality. In situations where the economy is improving and loan quality is stabilizing or improving, lower PLLLs may be appropriate.

When assessing the PLLL, examiners need to determine whether the level of the ALLL is appropriate to absorb estimated credit losses inherent in the loan and lease portfolio. An ALLL that is not at an appropriate level may be due to any one or a combination of reasons. For example, an ALLL that is below an appropriate level may be caused by a decline in loan quality identified during the examination, an inaccurate ALLL methodology, or an attempt by management to manipulate earnings. If the ALLL is deemed to be materially insufficient during the examination, management will be required to take an additional PLLL to bring the ALLL to an appropriate level, thereby increasing the bank's expenses and adversely affecting earnings. Earnings ratios affected by this charge to the PLLL should be adjusted and reflected in the earnings analysis..

Refer to the Loans section of this manual and the Call Report Instructions for additional information on the ALLL.

Realized Gains/Losses on Securities to Average Assets Ratio(s)

The ratio of securities gains/losses to average assets shows the annualized percentage of net realized gains or losses on available-for-sale and held-to-maturity securities in relation to average assets. The level, trend, and overall contribution that securities transactions have on earnings performance should be analyzed.

Bank management may purchase and sell securities for many reasons, but most banks limit investment activity to ensure adequate liquidity is available to meet unanticipated funding needs and to invest excess funds (i.e., when loan demand is low). Examiners should determine whether management actively engages in the sale of securities. When management actively manages their portfolio, this securities activity should be considered part of the bank's core operations. Examiners should assess management's strategies and their implementation. For example, examiners should be alert for instances where investments with unrealized gains are sold while those with unrealized losses are held and should ascertain the reasons for these transactions. Examiners should consider these types of instances when assessing earnings prospects.

While actively selling securities may not be part of a bank's core operations, there are many reasons why management may sell securities. Among the reasons for which management may sell securities that would not be part of a bank's normal operations would be when management needs to restructure the portfolio to maintain or change portfolio duration, to maintain or change portfolio diversification, or to take advantage of some tax implications or some other combination of these reasons. When not part of a bank's core operations, examiners should eliminate the gains or losses adjusted for taxes so as to not distort core operating results. The elimination of these gains or losses allows for level and trend analysis of core operations.

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Other Considerations

Income Taxes

It is important to judge whether applicable income taxes, that is, the provision for taxes, seems appropriate and whether a shift in the effective tax rate has occurred. In determining the appropriateness of income taxes, several tax ratios are provided within the UBPR. These ratios generally compare the amount of applicable taxes to net operating income. In order to ensure that only taxable income is compared to applicable income taxes, certain adjustments are necessary for income received on municipal securities and other investments which are tax-exempt in nature. If the tax ratios provided on the UBPR differ significantly from the rate of taxes that should have been paid, based upon the bank's tax bracket, further analysis is necessary to determine the reasons for such a discrepancy. For example, a bank with a high tax ratio may have invested too heavily in tax-exempt assets, with the result that the potential tax savings was not fully realized. In addition, certain tax incentives, such as investment tax credits received in connection with the acquisition of bank equipment, may have the effect of lowering the tax rate. The ability or inability to carryback or carryforward operating losses for tax purposes will also impact the bank's effective tax rate. Tax ratios may appear abnormal due to management's failure to adequately accrue for income tax expense on a current basis. Appropriate tax accruals should be made on a regular basis and at least with enough frequency to allow for the preparation of accurate Call Reports.

In almost all cases, applicable income taxes reported in the Call Report will differ from the amounts reported to taxing authorities. The applicable income tax expense or benefit that is reflected in the Call Report should include both taxes currently paid or payable (or receivable) and deferred income taxes. Deferred income tax expense or benefit is measured as the change in the net deferred tax assets or liabilities for the period reported. Deferred tax liabilities and assets represent the amount by which taxes payable (or receivable) are expected to increase or decrease in the future as a result of "temporary differences" and net operating loss or tax credit carry forwards that exist at the Call Report date. Refer to the Call Report Glossary for additional information on FAS 109, *Accounting for Income Taxes*.

A higher than normal ratio of applicable income taxes to NOI may result from upstreaming income tax payments to a bank holding company. The FDIC issued a policy statement (refer to FDIC Law, Regulation, and Related Acts) that covers income tax allocation in a holding company structure. In general, the statement requires that cash transfers paid by the bank to the holding company not exceed the amount of tax the bank would have paid had a tax return been filed on a separate return basis. In addition, any payments made to the holding company shall not be required to be remitted until such time as those payments would have been due to the taxing authority. Thus, deferred income taxes on bank's books should not be upstreamed to the holding company until such time as those taxes would be otherwise payable to the taxing authority. Holding companies and subsidiary institutions are encouraged to enter into a written, comprehensive tax allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. The policy statement was not intended to limit any tax elections under the Internal Revenue Code, and the term "separate return basis" recognizes that certain adjustments due to particular tax elections may, in certain periods, result in larger payments by the affiliated bank to the parent than would have been made by an unaffiliated bank to the taxing authority. Refer to the aforementioned policy statement for additional information.

Dividends

Earnings are also evaluated on their ability to support capital. This support includes maintaining capital, as well as increasing capital. High earnings retention increases capital more rapidly, but may or may not be necessary for the bank. If growth is low, profits high and capital strong, in relation to assets, a relatively high dividend payout ratio may be acceptable. On the other hand, if growth is rapid, profits are low, and capital is weak, a high dividend payout stands in the way of retaining needed capital. Under such circumstances, a lower payout ratio would clearly be appropriate.

The retention rate must be analyzed relative to the bank’s potential growth rate. A bank in a developing trade area may forecast substantial growth, which cannot be supported by existing capital even if cash dividends are not paid. Since most bank stocks are viewed by the investor as income generating rather than growth related, a low dividend history may hamper the bank's ability to market a new stock offering.

The bank's flexibility to reduce dividend payments should be considered when analyzing the impact of dividends upon earnings. For example, a bank that has a highly-leveraged holding company may lack flexibility to significantly lower dividend declarations, because those dividends are being used to meet debt service requirements. Another example includes institutions that have elected a Sub S status for income tax purposes. In a Sub S institution, shareholders normally pay income taxes on their proportionate share of the institution’s taxable income whether or not a dividend payment or other distribution is made. Therefore, shareholders may attempt to limit the bank’s flexibility to reduce these distributions.

In undercapitalized banks, steps should be taken to strongly discourage the continuation of cash dividends and/or other distributions. If necessary, additional steps should be taken to administratively prohibit such dividends/distributions where the bank is undercapitalized and has a high risk profile, or is substantially undercapitalized, no matter what the degree of perceived risk. There may be isolated instances where the continuation of cash dividends/distributions is warranted even under fairly severe circumstances. In such cases, the continuation of these payments without supervisory action should be fully supported.

Extraordinary Items

Extraordinary items are material events and transactions that are unusual and infrequent. Both of these conditions must exist in order for an event or transaction to be reported as an extraordinary item.

To be unusual, an event or transaction must be highly abnormal or clearly unrelated to the ordinary and typical activities of banks. An event or transaction that is beyond bank management’s control is not automatically considered to be unusual.

To be infrequent, an event or transaction should not reasonably be expected to recur in the foreseeable future. Although the past occurrence of an event or transaction provides a basis for estimating the likelihood of its future occurrence, the absence of a past occurrence does not automatically imply that an event or transaction is infrequent.

Only a limited number of events or transactions qualify for treatment as extraordinary items. Among these are losses that result directly from a major disaster such as an earthquake (except in areas where earthquakes are expected to recur in the foreseeable future), an expropriation, or a prohibition under a newly enacted law or regulation.

For further information, refer to APB Opinion No. 30, *Reporting the Results of Operations*.

Accounting Considerations

The analysis of earnings may be further complicated by the adoption of new accounting standards or changes in accounting methodologies. For instance, prior to the adoption of FAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, institutions accounted for loan origination fees and costs in different ways. When analyzing earnings, examiners should be aware of changes in accounting standards that may have materially affected related ratios and, when material, make necessary adjustments to the ratios, on a tax adjusted basis, to be able to perform trend analysis. Over time, however, adjustments will no longer need to be made as reported operating performance will reflect the implementation of the accounting changes over enough periods that trend analysis will not be affected.

FAS 91 applies to all lending and leasing transactions originated since it took effect in 1988. This accounting standard established the accounting for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or a group of loans. In general, FAS 91 specifies that:

1. Loan origination fees should be recognized over the life of the related loan as an adjustment of yield;

2. Certain direct loan origination costs should be recognized over the life of the related loan as a reduction of the loan's yield;
3. Most loan commitment fees should be deferred, except for specified exceptions; and
4. Loan fees, certain direct loan origination costs, and purchase premiums and discounts on loans shall be recognized as an adjustment of yield generally by the interest method based on the contractual term of the loan.

Prior to adopting FAS 91, banks generally could immediately recognize loan origination fees in income to the extent that they represented a reimbursement to the bank for actual origination costs incurred by the bank to originate the loan. This practice is no longer acceptable.

A more detailed discussion of FAS 91 can be found in the Call Report Glossary.

Quality of Bank Earnings

Earnings quality is the ability of a bank to continue to realize strong earnings performance. It is quite possible for a bank to register impressive profitability ratios and high dollar volumes of income by assuming an unacceptable degree of risk. An inordinately high ROA is often an indicator that the bank is engaged in higher risk activities. For example, bank management may have taken on loans or other investments that provide the highest return possible, but are not of a quality to assure either continued debt servicing or principal repayment. Short-term earnings will be boosted by seeking higher rates for earning assets with higher credit risk. Eventually, however, earnings may suffer if losses in these higher-risk assets are recognized.

In addition, certain of the bank's adversely classified and nonperforming assets, especially those upon which future interest payments are not anticipated, may need to be reflected on a nonaccrual basis for income statement purposes. If such assets are not placed on a nonaccrual status, earnings will be overstated. Similarly, material amounts of troubled debt restructured assets may have an adverse impact on earnings.

As previously discussed, an institution's asset quality has a close relationship to the analysis of earnings quality. Poor asset quality may necessitate increasing the PLLL to bring the ALLL to an appropriate level and must be reviewed for impact on earnings quality.

Additionally, short-term earnings performance can be enhanced by extraordinary items and tax strategies. For example, a bank may dispose of high-yielding assets to record gains in current periods, but may only be able to reinvest the funds at a lower rate of return. Levels and trends in earnings performance would be positive, although future income potential is sacrificed. Conversely, a bank might dispose of assets at a loss to take advantage of tax loss carryback provisions and enhance future earnings potential. Current earnings levels and trends would be poor in such a case, but funds recaptured through this strategy may greatly improve future earnings capacity. The point is that no analysis of earnings is complete without a consideration of earnings quality and a complete investigation and understanding of the strategies employed by bank management.

Planning and Budgeting

Strategic Plan

A strategic plan is a methodology that an organization uses to accomplish important goals and objectives. Regardless of the institution's size, a strategic plan can help an organization outline future goals and objectives and the steps needed to achieve such. For institutions that plan significant growth, new products, new branches, or other initiatives, strategic planning becomes even more important. Many institutions have formal, written strategic plans, while others rely on a much less formal method. If a formal, written strategic plan does not exist, this matter should be discussed with the board/management to determine the institution's overall goals, objectives, and long-term plans. Additional information on Corporate Planning is contained in the Management section of this manual. The Examination Documentation (ED) Modules also provide guidance in this area.

Profit Plan

A profit plan is an overall forecast of the income statement for the period based on management's decisions, intentions, and their estimation of economic conditions. It addresses such things as the anticipated level and volatility of interest rates, local economic conditions, funding strategies, asset mix, pricing, growth objectives, interest rate and maturity mismatches, etc. The accuracy of any such plan is susceptible to the attainability of the aforementioned assumptions.

Budget

Within the profit plan is a budget. The budget is essentially an expense control technique where management decides how much is intended to be spent during the period on individual overhead expense items. The budget should be consistent with the overall business or profit plan. All banks, regardless of size, should be encouraged to prepare a profit plan and budget that addresses the current year and the next operating year. The degree of sophistication or comprehensiveness of a budget and profit plan may vary considerably based on the size of the institution and the complexity of the assets and income sources.

The FDIC issued Part 364 entitled Standards for Safety and Soundness. Appendix A of Part 364 outlines standard procedures that banks should employ periodically to evaluate and monitor earnings, thereby ensuring that earnings are sufficient to maintain adequate capital and reserves. At a minimum, management's analysis of earnings should:

- Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution's historical results and those of its peers;
- Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;
- Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring or extraordinary income or expenses;
- Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering asset quality and growth rate; and
- Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

A bank's profit plan and budget should be reviewed for reasonableness with particular attention paid to the underlying assumptions. The forecast and assumptions should be consistent with what is known about the bank such as the volume of classified assets, nonaccrual and renegotiated debt levels, the adequacy of the ALLL, and other examination findings that have earnings implications. Comparison between the bank's forecast for the previous year to actual performance as displayed in the bank's own reports and in the UBPR can provide a reasonableness check. Any material discrepancies should be discussed with management; and, if the explanation is unreasonable, the bank's forecast may need to be adjusted to determine the effect of more reasonable assumptions.

If there is no bank plan or budget, examiners may need to develop their own forecast to aid in their judgments. In any case, it will normally be necessary to discuss future prospects with management. Care should be taken in these discussions not to present the examiner's forecast as absolute, or to recommend specific strategies or transactions to management based on an examiner's forecast. Planning is properly the function of management. Examiner efforts are only an attempt to discover any undue risk and highlight any factors that may significantly impact future performance in either a positive or negative manner.

Deficiencies in the profit plan or budget, or the lack thereof, should be documented in the appropriate section of the examination report.

EVALUATION OF EARNINGS PERFORMANCE

This rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses, or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks. The rating of an institution's earnings is based upon, but not limited to, an assessment of the following evaluation factors:

- The level of earnings, including trends and stability.
- The ability to provide for adequate capital through retained earnings.
- The quality and sources of earnings.
- The level of expenses in relation to operations.
- The adequacy of the budgeting systems, forecasting processes, and management information systems in general.
- The adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts.
- The earnings exposure to market risk such as interest rate, foreign exchange, and price risks.

Ratings

1. A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

2. A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

3. A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

4. A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

5. A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

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INTRODUCTION

Liquidity reflects a financial institution's ability to fund assets and meet financial obligations. Liquidity is essential in all banks to meet customer withdrawals, compensate for balance sheet fluctuations, and provide funds for growth. Funds management involves estimating liquidity requirements and meeting those needs in a cost-effective way. Effective funds management requires financial institutions to estimate and plan for liquidity demands over various periods and to consider how funding requirements may evolve under various scenarios, including adverse conditions. Banks must maintain sufficient levels of cash, liquid assets, and prospective borrowing lines to meet expected and contingent liquidity demands.

Liquidity risk reflects the possibility an institution will be unable to obtain funds, such as customer deposits or borrowed funds, at a reasonable price or within a necessary period to meet its financial obligations. Failure to adequately manage liquidity risk can quickly result in negative consequences for an institution despite strong capital and profitability levels. Management must maintain sound policies and procedures to effectively measure, monitor, and control liquidity risks.

A certain degree of liquidity risk is inherent in banking. An institution's challenge is to accurately measure and prudently manage liquidity demands and funding positions. To efficiently support daily operations and provide for contingent liquidity demands, banks must:

- Establish an appropriate liquidity risk management program,
- Ensure adequate resources are available to fund ongoing liquidity needs,
- Establish a funding structure commensurate with risks,
- Evaluate exposures to contingent liquidity events, and
- Ensure sufficient resources are available to meet contingent liquidity needs.

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RISK MANAGEMENT PROGRAM

An institution's liquidity risk management program establishes the liquidity management framework. Comprehensive and effective programs encompass all elements of a bank's liquidity, ranging from how the institution manages routine liquidity needs to managing liquidity during a severe stress event. Elements of a sound liquidity risk management program include:

- Effective management and board oversight;
- Appropriate liquidity management policies, procedures, strategies, and risk limits;
- Comprehensive liquidity risk measurement and monitoring systems;
- Adequate levels of marketable assets;
- Diverse mix of existing and potential funding sources;
- Comprehensive contingency funding plans;
- Appropriate plans for potential stress events; and
- Effective internal controls and independent audits.

The formality and sophistication of effective liquidity management programs correspond to the type and complexity of an institution's activities, and examiners should assess whether programs meet the institution's needs. Examiners should consider whether liquidity risk management activities are integrated into the institution's overall risk management program and address liquidity risks associated with new or existing business strategies.

Close oversight and sound risk management processes (particularly when planning for potential stress events) are especially important if management pursues asset growth strategies that rely on new or potentially volatile funding sources.

Board and Senior Management Oversight

Board oversight is critical to effective liquidity risk management. The board is responsible for establishing the institution's liquidity risk tolerance and clearly communicating it to all levels of management. Additionally, the board is also responsible for reviewing, approving, and periodically updating liquidity management strategies, policies, procedures, and risk limits. When assessing the effectiveness of board oversight, examiners should consider whether the board:

- Understands and periodically reviews the institution's current liquidity position and contingency funding plans;
- Understands the institution's liquidity risks and periodically reviews information necessary to maintain this understanding;
- Establishes an asset/liability committee (ALCO) and guidelines for electing committee members, assigning responsibilities, and establishing meeting frequencies;
- Establishes executive-level lines of authority and responsibility for managing the institution's liquidity risk;
- Provides appropriate resources to management for identifying, measuring, monitoring, and controlling liquidity risks; and
- Understands the liquidity risk profiles of significant subsidiaries and affiliates.

Management is responsible for appropriately implementing board-approved liquidity policies, procedures, and strategies. This responsibility includes overseeing the development and implementation of appropriate risk measurement and reporting systems, contingency funding plans, and internal controls. Management is also responsible for regularly reporting the institution's liquidity risk profile to the board.

Examiners should consider whether an ALCO (or similar entity) actively monitors the institution's liquidity profile. Effective ALCOs typically have sufficient representation across major functions (e.g., lending, investments, wholesale and retail funding, etc.) to influence the liquidity risk profile. The committee is usually responsible for ensuring that liquidity reports include accurate, timely, and relevant information on risk exposures.

Examiners should evaluate corporate governance by reviewing liquidity management processes (including daily, monthly, and quarterly activities), committee minutes, liquidity and funds management policies and procedures, and by holding discussions with management. Additionally, examiners should consider the findings of independent reviews and prior reports of examination when assessing the effectiveness of corrective actions.

Liquidity Management Strategies

Liquidity management strategies involve short- and long-term decisions that can change over time, especially during times of stress. Therefore, the institutions' policies often require management to meet regularly and consider liquidity costs, benefits, and risks as part of the institution's overall strategic planning and budgeting processes. As part of this process, management typically:

- Performs periodic liquidity and profitability evaluations for existing activities and strategies;
- Identifies primary and contingent funding sources needed to meet daily operations, as well as seasonal and cyclical cash flow fluctuations;
- Ensures liquidity management strategies are consistent with the board's expressed risk tolerance; and
- Evaluates liquidity and profitability risks associated with new business activities and strategies.

Collateral Position Management

Assets are a key source of funds for financial institutions as they can generate substantial cash inflows through principal and interest payments. Assets can also provide funds when sold or when used as collateral for borrowings. Financial institutions routinely pledge assets when borrowing funds or obtaining credit lines through Federal Home Loan Banks, the Federal Reserve discount window, or other banks.

Examiners should consider whether the institution established reporting systems that facilitate the monitoring and management of assets pledged as collateral for borrowed funds. At a minimum, pledged asset reports typically detail the value of assets currently pledged relative to the amount of security required and identify the type and amount of unencumbered assets available for pledging.

Examiners should also consider whether the reporting systems are commensurate with borrowing activities and the institution's strategic plans. Institutions with limited amounts of long-term borrowings may be able to monitor collateral levels adequately by reviewing monthly or quarterly reports. Institutions with material payment, settlement, and clearing activities benefit from actively monitoring short- (including intraday), medium-, and long-term collateral positions.

Effective management teams thoroughly understand all borrowing agreements (contractual or otherwise) that may require the bank to provide additional collateral, substitute existing collateral, or deliver collateral. Such requirements may be triggered by changes in an institution's financial condition. Examiners should determine whether management considers potential changes to collateral requirements in cash flow projections, stress tests, and contingency funding plans. Examiners should also determine whether management considers the operational and timing requirements associated with physically accessing collateral (such as at a custodian institution or a securities settlement location where the collateral is held).

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POLICIES, PROCEDURES, & REPORTING

Liquidity Policies and Procedures

Comprehensive written policies, procedures, and risk limits form the basis of liquidity risk management programs. All financial institutions benefit from board-approved liquidity management policies and procedures specifically tailored for their institution.

Even when operating under a holding company with centralized planning and decision-making, the bank's directors are responsible for ensuring that the structure, responsibility, and controls for managing their institution's liquidity risk are clearly documented. To fulfill their oversight responsibilities, directors regularly monitor reports that highlight bank-only liquidity factors.

While there is no reason to criticize the existence of centralized planning and decision-making, each bank's board of directors has a legal responsibility to maintain policies, procedures, and risk limits tailored to its individual bank's risk profile.

Boards that review and approve liquidity policies at least annually ensure such policies remain relevant and appropriate for the institutions' business model, complexity, and risk profile. Written policies are important for defining the scope of the liquidity risk management program and ensuring that:

- Sufficient resources are devoted to liquidity management,
- Liquidity risk management is incorporated into the institution's overall risk management process, and
- Management and the board share an understanding of strategic decisions regarding liquidity.

Effective policies and procedures address liquidity matters (such as legal, regulatory, and operational issues) separately for legal entities, business lines, and, when appropriate, individual currencies. Sound liquidity and funds management policies typically:

- Provide for the effective operation of the ALCO. ALCO policies would address responsibilities for assessing current and projected liquidity positions, implementing board-approved strategies, reviewing policy exceptions, documenting committee actions, and reporting to the board;
- Provide for the periodic review of the bank's deposit structure. Effective reviews typically include assessments of the volume and trend of total deposits, the types and rates of deposits, the maturity distribution of time deposits, and competitor rate information. Other information considered in the reviews, when applicable, includes the volume and trend of large time deposits, public funds, out-of-area deposits, potentially rate sensitive depositors, wholesale deposits, and uninsured deposits;
- Address permissible funding sources and concentration limits. Items addressed generally include funding types with similar rate sensitivity or volatility, such as brokered or Internet deposits and deposits generated through promotional offers.
- Provide a method of computing the bank's cost of funds;
- Establish procedures for measuring and monitoring liquidity. Procedures generally include static measurements and cash flow projections that forecast base case and stress scenarios;
- Address the type and mix of permitted investments. Items addressed typically include the maturity distribution of the portfolio, which investments are available for liquidity purposes, and the level and quality of unpledged investments;
- Provide for an adequate system of internal controls. Controls typically require periodic, independent reviews of liquidity management processes and compliance with internal policies, procedures, and risk limits;
- Include a contingency funding plan that identifies alternate funding sources if liquidity projections are incorrect or a liquidity crisis arises;
- Require periodic testing of liquidity lines;
- Establish procedures for reviewing and documenting assumptions used in liquidity projections;
- Define procedures for approving exceptions to policies, limits, and authorizations;
- Identify permissible wholesale funding sources;
- Define authority levels and procedures for accessing wholesale funding sources;
- Establish a process for measuring and monitoring unused borrowing capacity;
- Convey the board's risk tolerance by establishing target liquidity ratios and parameters under various time horizons and scenarios; and
- Include other items unique to the bank.

Risk Tolerances

Examiners should consider whether liquidity policies accurately reflect the board's risk tolerance and delineate qualitative and quantitative guidelines commensurate with the institution's business profile and balance sheet complexity. Typical risk guidelines include:

- Targeted cash flow gaps over discrete and cumulative periods and under expected and adverse business conditions;
- Expected levels of unencumbered liquid assets;
- Measures for liquid asset coverage ratios and limits on potentially unstable liabilities;
- Concentration limits on assets that may be difficult to convert into cash (such as complex financial instruments, bank-owned life insurance, and less-marketable loan portfolios);
- Limits on the level of borrowings, brokered funds, or exposures to single fund providers or market segments;
- Funding diversification standards for short-, medium-, and long-term borrowings and instrument types;
- Limits on contingent liability exposures such as unfunded loan commitments or lines of credit;

- Collateral requirements for derivative transactions and secured lending;
- Limits on material exposures in complex activities (such as securitizations, derivatives, trading, and international activities).

Examiners should consider whether management and the board establish meaningful risk limits, periodically evaluate the appropriateness of established limits, and compare actual results to approved risk limits. Identified policy exceptions and related corrective actions are typically noted in board or committee minutes.

Liquidity Reporting

Timely and accurate information is a prerequisite to sound funds management practices. Banks benefit from liquidity risk reports that clearly highlight the bank's liquidity position, risk exposures, and level of compliance with internal risk limits.

Examiners should consider the adequacy of liquidity reporting procedures. Typically, bank personnel tasked with ongoing liquidity administration receive liquidity risk reports at least daily. Senior officers may receive liquidity reports weekly or monthly, and the board of directors may receive liquidity risk reports monthly or quarterly. Depending on the complexity of the business mix and liquidity risk profile, institutions may increase, sometimes on short notice, the frequency of liquidity reporting.

The format and content of liquidity reports will vary depending on the characteristics of each bank and its funds management practices. Examiners should consider whether an institution's management information systems and internal reports provide accurate, pertinent information such as:

- Liquidity needs and the sources of funds available to meet these needs over various time horizons and scenarios (reports are often referred to as pro-forma cash flow reports, sources and uses reports, or scenario analyses);
- Collateral positions, including pledged and unpledged assets (and when necessary, the availability of collateral by legal entity, jurisdiction, and currency exposure);
- Public funds and other material providers of funds (including rate and maturity information);
- Funding categories and concentrations;
- Asset yields, liability costs, net interest margins, and variations from the prior month and budget (beneficial reports are detailed enough to permit an analysis of interest margin variations);
- Early warning indicators for contingency funding events;
- Policy exceptions;
- Interest rate projections and economic conditions in the bank's trade area;
- Information concerning non-relationship or higher-cost funding programs;
- The stability of deposit customers and providers of wholesale funds;
- The level of highly liquid assets;
- Stress test results; and
- Other items unique to the bank.

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LIQUIDITY RISK MEASUREMENT

To identify potential funding gaps, banks typically monitor cash flows, assess the stability of funding sources, and project future funding needs. When assessing an institution's liquidity rating, examiners should evaluate the adequacy of an institution's liquidity risk measurement and monitoring procedures.

Pro-Forma Cash Flow Projections

Historically, most financial institutions used single point-in-time (static) measurements (such as loan-to-deposit or loan-to-asset ratios) to assess their liquidity position. Static liquidity measures provide valuable information and remain a key part of banks' liquidity analysis. However, cash flow forecasting can enhance a financial institution's ability to monitor and manage liquidity risk.

Cash flow forecasts can be useful for all banks and become essential when operational areas (loans, deposits, investments, etc.) are complex or managed separately from other areas in the bank. Cash flow projections enhance management's ability to evaluate and manage these areas individually and collectively.

The sophistication of cash flow forecasting ranges from the use of simple spreadsheets to comprehensive liquidity risk models. Some vendors that offer interest rate risk (IRR) models provide options for modeling liquidity cash flows because the base information is already maintained for IRR modeling. When reviewing liquidity risk models, examiners should ensure management compares funding sources and liquidity needs, over various periods, using modeling assumptions that are appropriate for managing liquidity rather than IRR.

Cash flow projections typically forecast funding sources and uses over short-, medium-, and long-term time horizons. Non-complex community banks that are in a sound condition may forecast short-term positions monthly. More complex institutions may need to perform weekly or daily forecasts, and institutions with large payment systems and settlement activities may need to conduct intra-day measurements. All institutions benefit from having the ability to increase the frequency of monitoring and reporting during a stress event.

Effective cash flow analysis allows management to plan for tactical (short-term) and strategic (medium- and long-term) liquidity needs. Examiners should review the bank's procedures, assumptions, and information used to develop cash flow projections. For example, examiners should consider whether funding sources and uses are adequately stratified, as excessive account aggregations in liquidity analysis can mask substantial liquidity risk. Similar to measuring IRR, there are advantages to utilizing account level information. For some institutions, gathering and measuring information on specific accounts may not be feasible due to information system limitations. Although the advantages of using detailed account information may not be as evident for a non-complex institution, generally, all institutions can benefit from using more detailed account information in their liquidity models.

Examiners should carefully assess the assumptions that institutions use when projecting cash flows. The reliability of the projections is enhanced when projections are based on reasonable assumptions and reliable data. Additionally, the accuracy and reliability of cash flow projections is enhanced when projected cash flows consider contractual and expected cash flows. For example, when projecting funding requirements for construction loans, the accuracy of cash flow projections is enhanced when management includes estimates of the amount of available credit that will actually be drawn in a given period, not simply the full amount of contractual obligations. Additionally, to improve the accuracy of forecasting maturing time deposits, particularly those obtained through special rate promotions, the analysis should consider the retention rate of maturing deposits.

Modeling assumptions play a critical role in measuring liquidity risks and projecting cash flows. Therefore, institutions benefit from ensuring key assumptions are reasonable, well documented, and periodically reviewed and approved by the board. Ensuring the accuracy of assumptions is also important when assessing the liquidity risk of complex assets, liabilities, and off-balance sheet positions and can be critical when evaluating the availability of funding sources under adverse, contingent liquidity scenarios. Accurate and reliable cash flow forecasting can benefit institutions by reducing liquidity risks and allowing institutions to maintain a lower liquid asset cushion.

Back Testing

The reliability of cash flow projections may also be enhanced if institutions evaluate assumptions about customer behavior, separately estimate gross cash flows on both sides of the balance sheet, and compare modeling projections to actual results (back testing). Back testing allows management to make adjustments to cash flow models and modeling assumptions, as appropriate, to reflect changes in cash flow characteristics.

Scenario Analysis

Cash flow projections can also be used in scenario analysis and developing contingency funding plans. Institutions typically start with base case projections that assume normal cash flows, market conditions, and business operations over the selected time horizon. Management then tests stress scenarios by changing various cash flow assumptions in the base case scenario. For example, if the stress scenario assumed a change in a Prompt Corrective Action (PCA) capital category that triggered interest rate restrictions and brokered deposit limitations, management should adjust assumptions to reflect the possible limitation or elimination of access to affected funding sources. Management typically uses this information in developing funding plans to mitigate these risks.

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FUNDING SOURCES - ASSETS

The amount of liquid assets that a bank maintains is generally a function of the stability of its funding structure, the risk characteristics of the balance sheet, and the adequacy of its liquidity risk measurement program. Generally, a lower level of unencumbered liquid assets may be sufficient if funding sources are stable, established borrowing facilities are largely unused, and other risk characteristics are predictable. A higher level of unencumbered liquid assets may be required if:

- Bank customers have numerous alternative investment options,
- Recent trends show a substantial reduction in large liability accounts,
- The bank has a material reliance on less stable funding sources,
- The loan portfolio includes a high volume of non-marketable loans,
- The bank expects several customers to make material draws on unused lines of credit,
- Deposits include substantial amounts of short-term municipal accounts,
- A concentration of credits was extended to an industry with existing or anticipated financial problems,

- A close relationship exists between individual demand accounts and principal employers in the trade area who have financial problems,
- A material amount of assets is pledged to support wholesale borrowings, or
- The institution's access to capital markets is impaired.

A bank's assets provide varying degrees of liquidity and can create cash inflows and outflows. Institutions generally retain a certain level of highly liquid assets to meet immediate funding needs, and hold other types of investments to provide liquidity for meeting ongoing operational needs and responding to contingent funding events. To balance profitability goals and liquidity demands, management must carefully weigh the full benefits (yield and increased marketability) of holding liquid assets against the expected higher returns associated with less liquid assets. Income derived from holding longer-term, higher-yielding assets may be offset if an institution is forced to sell the assets quickly due to adverse balance sheet fluctuations.

Cash and Due from Accounts

Cash and due from accounts are essential for meeting daily liquidity needs. Institutions rely on cash and due from accounts to fund deposit account withdrawals, disburse loan proceeds, cover cash letters, fund bank operations, meet reserve requirements, and provide compensating balances relating to correspondent bank accounts/services.

Loan Portfolio

The loan portfolio is an important factor in liquidity management. Loan payments provide steady cash flows, and loans can be used as collateral for secured borrowings or sold for cash in the secondary loan market. However, the quality of the loan portfolio can directly impact liquidity. For example, if an institution encounters asset quality issues, operational cash flows may be affected by the level of non-accrual borrowers and late payments.

For many institutions, loans serve as collateral for wholesale borrowings such as Federal Home Loan Bank (FHLB) borrowings. If asset quality issues exist, an institution may find that delinquent loans do not qualify as collateral. Also, higher amounts of collateral may be required because of doubts about the overall quality of the portfolio. These "haircuts" can be substantial and are an important consideration in stress tests.

Comprehensive liquidity analysis includes consideration of contractual requirements and customers' behavior when forecasting loan cash flows. Prepayments and renewals can significantly affect contractual cash flows for many types of loans. Customer prepayments are a common consideration for residential mortgage loans (and mortgage-backed securities) and can be a factor for commercial and commercial real estate loans (and related securities). Assumptions related to revolving lines of credit and balloon loans can also have a material effect on cash flows. For example, examiners should determine whether management's assumption for loans generating cash flow in accordance with contractual obligations is supported by historical data.

Asset Sales/Securitizations

As noted above, assets can be used as collateral for secured borrowings or sold for cash in the secondary market. Sales in the secondary market can provide fee income, relief from interest rate risk, and a funding source to the originating bank. However, for an asset to be saleable at a reasonable price in the secondary market, it must generally conform to market (investor) requirements. Because loans and loan portfolios may have unique features or defects that hinder or prevent their sale into the secondary market, institutions benefit from thoroughly reviewing loan characteristics and documenting assumptions related to loan portfolios when developing cash flow projections.

Some institutions are able to use securitizations as a funding vehicle by converting a pool of assets into cash. Asset securitization typically involves the transfer or sale of on-balance sheet assets to a third party that issues mortgage-backed securities (MBS) or asset-backed securities (ABS). These instruments are then sold to investors. The investors are paid from the cash flow from the transferred assets. Assets that are typically securitized include credit card receivables, automobile receivables, commercial and residential mortgage loans, commercial loans, home equity loans, and student loans.

Securitization can be an effective funding method for some banks. However, there are several risks associated with using securitization as a funding source. For example:

- Some securitizations have early amortization clauses to protect investors if the performance of the underlying assets does not meet specified criteria. If an early amortization clause is triggered, the issuing institution needs to begin paying principal to bondholders earlier than originally anticipated and have to fund new receivables that would have otherwise been transferred to the trust. Institutions involved in securitizations benefit from monitoring asset performance to better anticipate cash flow and funding ramifications due to early amortization clauses.
- If the issuing institution has a large concentration of residual assets, the institution's overall cash flow

might be dependent on the residual cash flows from the performance of the underlying assets. If the performance of the underlying assets is worse than projected, the institution's overall cash flow will be less than anticipated.
- Residual assets retained by the issuing institution are typically illiquid assets for which there is no active market. Additionally, the assets are not acceptable collateral to pledge for borrowings.
- An issuer's market reputation can affect its ability to securitize assets. If the bank's reputation is damaged, issuers might not be able to economically securitize assets and generate cash from future sales of loans to the trust. This is especially true for institutions that are relatively new to the securitization market.
- The timeframe required to securitize loans held for sale may be considerable, especially if the institution has limited securitization experience or encounters unforeseen problems.

Institutions that identify asset sales or securitizations as contingent liquidity sources, particularly institutions that rarely sell or securitize loans, benefit from periodically testing the operational procedures required to access these funding sources. Market-access testing helps ensure procedures work as anticipated and helps gauge the time needed to generate funds; however, testing does not guarantee the funding sources will be available or on satisfactory terms during stress events.

A thorough understanding of applicable accounting and regulatory rules is critical when securitizing assets. Accounting standards make it difficult to achieve sales treatment for certain financial assets. The standards influence the use of securitizations as a funding source because transactions that do not qualify for sales treatment require the selling institution to account for the transfer as a secured borrowing with a pledge of collateral. As such, institutions must account for, and risk weight, the transferred financial assets as if the transfer had not occurred. Accordingly, institutions should continue to report the transferred assets in financial statements with no change in the measurement of the financial assets transferred.

When financial assets are securitized and accounted for as a sale, institutions often provide contractual credit enhancements, which may involve over-collateralization, retained subordinated interests, asset repurchase obligations, cash collateral accounts, spread accounts, or interest-only strips. Part 324 of the FDIC Rules and Regulations requires the issuing institution to hold capital as a buffer against the retained credit risk arising from these contractual credit enhancements.

There can also be non-contractual support for ABS transactions that would be considered implicit recourse. The recourse may create credit, liquidity, and regulatory capital implications for issuers that provide implicit support for ABS transactions. Institutions typically provide implicit recourse in situations where management perceives that the failure to provide support, even though not contractually required, would damage the institution's future access to the ABS market. For risk-based capital purposes, institutions deemed to be providing implicit recourse are generally required to hold capital against the entire outstanding amount of assets sold, as though they remained on the books.

The federal banking agencies' concerns over the retained credit and other risks associated with such implicit support are detailed in the *Interagency Guidance on Implicit Recourse in Asset Securitizations* (See FDIC's Financial Institution Letter 52-2002).

Investment Portfolio

An institution's investment portfolio can provide liquidity through regular cash flows, maturing securities, the sale of securities for cash, or by pledging securities as collateral for borrowings, repurchase agreements, or other transactions. Institutions can benefit from periodically assessing the quality and marketability of the portfolio to determine:

- The level of unencumbered securities available to pledge for borrowings,
- The financial impact of unrealized gains and losses,
- The effect of changes in asset quality, and
- The potential need to provide additional collateral should rapid changes in market rates significantly reduce the value of longer-duration investments pledged to secure borrowings.

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FUNDING SOURCES – LIABILITIES

Deposits are the most common funding source for many institutions; however, other liability sources such as borrowings can also provide funding for daily business activities, or as alternatives to using assets to satisfy liquidity needs. Deposits and other liability sources are often differentiated by their stability and customer profile characteristics.

Core Deposits

Core deposits are generally stable, lower-cost funding sources that typically lag behind other funding sources in repricing during a period of rising interest rates. The deposits are typically funds of local customers that also have a borrowing or other relationship with the institution. Convenient branch locations, superior customer service, extensive ATM networks, and low or no fee accounts are factors that contribute to the stability of the deposits. Other factors include the insured status of the account and the type of depositor (retail, commercial, municipality, etc.).

Examiners should assess the stability of deposit accounts when reviewing liquidity and funds management practices. Generally, higher-cost, non-relationship deposits, such as Internet deposits or deposits obtained through special-rate promotions, may be considered less-stable funding sources. Brokered deposits are not considered core deposits or a stable funding source due to the brokered status and wholesale characteristics.

Core deposits are defined in the Uniform Bank Performance Report (UBPR) User's Guide as the sum of all transaction accounts, money market deposit accounts (MMDAs), nontransaction other savings deposits (excluding MMDAs), and time deposits of $250,000 and below, less fully insured brokered deposits of $250,000 and less. In some instances, core deposits included in the UPBR's core deposit definition might exhibit characteristics associated with less stable funding sources. For example, out-of-area certificates of deposit (CDs) of $250,000 or less that are obtained from a listing service may have less stability although they are included in core deposits under the UBPR definition. Management and examiners should not automatically view these deposits as a stable funding source without additional analysis. Alternatively, some deposit accounts generally viewed as volatile, non-core funds by UBPR definitions (for example, CDs larger than $250,000) might be considered relatively stable after a closer analysis. For instance, a local depositor might have CDs larger than $250,000 that may be considered stable because the depositor has maintained those deposits with the institution for several years.

While some deposit relationships over $250,000 remain stable when the institution is in good condition, such relationships might become less stable due to their uninsured status if the institution experiences financial problems. Additionally, deposits identified as stable during good economic conditions may not be reliable funding sources during stress events. Therefore, examiners should consider whether institutions identify deposit accounts likely to be unstable in times of stress and appropriately reflect such deposits in its liquidity stress testing.

Examiners should not assume that all deposits meeting the UBPR definition of *core* are necessarily stable or that all deposits defined as *non-core* are automatically volatile. Examiners should determine whether management considers the stability of deposit accounts and significant customer relationships and reflects them accordingly in the bank's liquidity monitoring and reporting systems. When analyzing the stability of deposit funding sources, UBPR accounts and ratios should be considered in light of the balance sheet composition, risk profile, deposit stability trends, and other relevant and unique characteristics of the institution.

Deposit Management Programs

The critical role deposits play in a bank's successful operation demonstrates the importance of implementing programs for retaining or expanding the deposit base. Strong competition for depositors' funds and customers' preference to receive market deposit rates also highlight the benefit of deposit management programs. Effective deposit management programs generally include:

- Regular reports detailing existing deposit types and levels,
- Projections for asset and deposit growth,
- Associated cost and interest rate scenarios,
- Clearly defined marketing strategies,
- Procedures to compare results against projections, and
- Steps to revise the plans when needed.

Deposit management programs generally take into account the make-up of the market-area economy, local and national economic conditions, and the potential for investing deposits at acceptable margins. Other considerations include management expertise, the adequacy of bank operations, the location and size of facilities, the nature and degree of bank and non-bank competition, and the effect of monetary and fiscal policies on the bank's service area and capital markets in general.

Effective deposit management programs are monitored and adjusted as necessary. The long-range success of such programs is closely related to management's ability to identify the need for changes quickly. Effective programs include procedures for accurately projecting deposit trends and carefully monitoring the potential volatility of the accounts (e.g., stable, fluctuating, seasonal, brokered, etc.).

Wholesale Funds

Wholesale funds include, but are not limited to, brokered deposits, Internet deposits, deposits obtained through listing services, foreign deposits, public funds, federal funds purchased, FHLB advances, correspondent line of credit advances, and other borrowings.

Providers of wholesale funds closely track institutions' financial condition and may cease or curtail funding, increase interest rates, or increase collateral requirements if they determine an institution's financial condition is deteriorating. As a result, some institutions may experience liquidity problems due to a lack of wholesale funding availability when funding needs increase.

The Internet, listing services, and other automated services enable investors who focus on yield to easily identify high-yield deposits. Customers who focus primarily on yield are a less stable source of funding than customers with typical deposit relationships. If more attractive returns become available, these customers may rapidly transfer funds to new institutions or investments in a manner similar to that of wholesale investors.

It is important to measure the impact of the loss of wholesale funding sources on the institution's liquidity position. The challenge of measuring, monitoring, and managing liquidity risk typically increases as the use of wholesale and nontraditional funding sources increases. Institutions that rely more heavily on wholesale funding will often need enhanced funds management and measurement processes, such as scenario modeling. In addition, contingency planning and capital management take on added significance.

Brokered and Higher-Rate Deposits

Section 29 of the FDI Act, as implemented by Part 337 of the FDIC Rules and Regulations, defines a brokered deposit as a deposit obtained through or with assistance of a deposit broker. The term deposit broker is generally defined by Section 29 as any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions.

The brokered deposit statute and regulations provide several exceptions to this definition of deposit broker. Some exceptions include an insured depository institution or its employee placing funds with that insured depository institution, certain trust departments of insured depository institutions, certain trustees and plan administrators, an agent whose primary purpose is not to place funds with insured depository institutions, and insured depository institutions acting as an intermediary or agent for a government sponsored minority or women-owned deposit program.

Listing Services

Listing service companies do not fall under the definition of a deposit broker if certain criteria are met. A listing service is a company that connects banks seeking a deposit with those seeking to place a deposit. In doing so, the listing service compiles and posts banks' deposit rate information for consideration by interested depositors. A particular company can be a listing service (compiler of information) as well as a deposit broker (facilitating the placement of deposits). In recognition of this possibility, certain criteria are considered for determining when a listing service qualifies as a deposit broker. A listing service is not a deposit broker if:

- The person or entity providing the listing service is compensated solely by means of subscription fees (fees paid by subscribers as payment for their opportunity to see the rates gathered by the listing service) and/or listing fees (fees paid by depository institutions as payment for their opportunity to list their rates). The listing service does not require a depository institution to pay for other services offered by the listing service or its affiliates as a condition precedent to being listed.
- The fees paid by depository institutions are flat fees (i.e., they are not calculated based on the number or dollar amount of deposits accepted by the depository institution as a result of the listing of the depository institution's rates).
- In exchange for fees, the listing service performs no service except the gathering and transmission of information concerning the availability of deposits.
- The listing service is not involved in placing deposits. Any funds to be invested in deposit accounts are remitted directly by the depositor to the insured depository institution and not, directly or indirectly, by or through the listing service.

Brokered Sweep Accounts

Some brokerage firms, which are investment companies that invest money in stocks, bonds, and other investments on behalf of clients, operate sweep programs in which brokerage customers are given the option to sweep uninvested cash into a bank deposit. This arrangement provides the brokerage customer with additional yield and insurance coverage on swept funds. These swept funds are generally considered brokered deposits unless the third-party brokerage firm meets the primary purpose exception. An institution must receive a favorable determination from the FDIC before it can exclude these funds from regulatory reporting of brokered deposits. Determinations are initially requested through the appropriate regional office. In determining whether the brokerage firm meets the primary purpose exception, staff considers the following criteria:

- The brokerage firm is affiliated with the bank.
- The funds are not swept into time deposit accounts.

- The amount of swept funds does not exceed 10 percent of the total amount of program assets handled by the brokerage firm (permissible ratio) on a monthly basis. When the brokerage also sweeps funds to nonaffiliated banks, which is typically done when the deposit exceeds the $250,000 deposit insurance limit, these deposits are added to the amount of swept funds for purposes of calculating the permissible ratio.
- The fees in the program are flat fees (i.e., equal per-account or per-customer fees representing payment for recordkeeping or administrative services and not representing payment for placing deposits).

Network and Reciprocal Deposits

Banks sometimes participate in networks established for the purpose of sharing deposits. In such a network, a participating bank places funds, either directly or through a third-party network sponsor, at other participating network banks in order for its customer to receive full deposit insurance coverage.

Some bank networks establish reciprocal agreements allowing participating banks to send and receive identical deposit amounts simultaneously. This reciprocal agreement allows banks to maintain the same amount of funds they had when the customer made their initial deposit while ensuring that deposits well in excess of the $250,000 deposit limit are fully insured. While reciprocal network deposits generally meet the definition of a brokered deposit, under certain conditions a limited amount of reciprocal deposits may be excepted from treatment as brokered deposits.

Section 29(i) of the FDI Act (and implemented through Section 337.6(e)(2) of the FDIC Rules and Regulations), excepts a capped amount of reciprocal deposits from treatment as brokered deposits for those insured depository institutions that qualify as an "agent" institution. The amount of reciprocal deposits that an agent institution may except from treatment as brokered deposits may not exceed the lesser of $5 billion or 20 percent of total liabilities (referred to as the general cap). To qualify as an "agent" institution, the institution must meet one of the following:

- When most recently examined, under section 10(d) of the FDI Act, was found to have a composite condition of outstanding or good, and is well capitalized; or
- Has obtained a brokered deposit waiver from the FDIC; or
- Does not receive an amount of reciprocal deposits that causes the total amount of reciprocal deposits held by the agent institution to be greater than the average of the total amount of reciprocal deposits held by the agent institution on the last day of each of the four calendar quarters preceding the calendar quarter in which the agent institution was found not to have a composite condition of outstanding or good or was determined to be not well capitalized (also referred to as the special cap).

Treatment and reporting may be impacted if an institution receives reciprocal deposits that exceed its applicable cap (general cap or special cap). Agent institutions that are in outstanding or good composite condition and are well capitalized, or have obtained a brokered deposit waiver, are subject to the general cap, and therefore would report and treat only the amount of reciprocals deposits that exceed the general cap as brokered deposits. Agent institutions that are not well capitalized or not well rated and have not received a brokered deposit waiver can only receive an amount of non-brokered reciprocal deposits up to its special cap. If an agent institution subject to the special cap receives an amount of reciprocal deposits in excess of its special cap, it is no longer an agent institution. If an institution is not an agent institution, all of its reciprocal deposits should be treated and reported as brokered deposits.

Examiners should determine whether an institution's reciprocal deposits, that are not being report as brokered, conform to the statutory and regulatory definitions under Section 29(i) of the FDI Act and Section 337.6(e) of the FDIC's Rules and Regulations.

Network member banks may receive other deposits through a network such as (1) deposits received without the institution placing into the network a deposit of the same maturity and same aggregate amount (sometimes referred to as "one-way network deposits") and (2) deposits placed by the institution into the network where the deposits were obtained, directly or indirectly, by or through a deposit broker. Such other network deposits meet the definition of brokered deposits and would not be eligible for, as previously described, the statutory and regulatory exception provided for a capped amount of reciprocal deposits.

The stability of reciprocal deposits may differ depending on the relationship of the initial customer with the institution. Examiners should consider whether management adequately supports their assessments of the stability of reciprocal deposits, or any funding source, for liquidity management and measurement purposes.

Brokered Deposit Restrictions

Section 29 of the FDI Act sets forth restrictions on the acceptance of brokered deposits based on an institutions category. Well capitalized banks may accept, renew, or roll over brokered deposits at any time. An adequately capitalized insured depository institution may not accept, renew, or roll over any brokered deposit unless the institution has applied for and been granted a waiver by the FDIC. An undercapitalized insured depository institution may not accept, renew, or roll over any brokered deposits. If a bank is under any type of formal agreement pursuant to Section 8 of the FDI Act with a directive to meet or maintain any specific capital level, it will no longer be considered well capitalized for the purposes of Part 337.

With respect to adequately capitalized institutions that have been granted a brokered deposit waiver, any safety and soundness concerns arising from the acceptance of brokered deposits are ordinarily addressed by the conditions imposed in granting the waiver application. In monitoring such conditions, it is incumbent on the examiner not only to verify compliance, but also to assess whether any unanticipated problems are being created.

Deposit Rate Restrictions

In addition to the brokered deposit restrictions noted above, Section 29 of the FDI Act also places certain restrictions on deposit interest rates for banks that are less than well capitalized. Deposit rate restrictions prevent a bank that is not well capitalized from circumventing the prohibition on brokered deposits by offering rates significantly above market in order to attract a large volume of deposits quickly. Under Section 337.6 of the FDIC's Rules and Regulations, a bank that is not well capitalized may not offer deposit rates more than 75 basis points above average national rates for deposits of similar size and maturity (referred to as the national rate cap).

The national rate is a simple average of rates paid by all banks and branches. On a weekly basis, the FDIC publishes national rate data (at www.fdic.gov) that can be used to determine conformance with the interest rate restrictions. If a bank believes that the national rate does not correspond to the actual rates in the bank's particular market, the bank is permitted to request a determination from the applicable regional office that the bank is operating in a high-rate area.

Examiners should review conformance with interest rate restrictions during examinations of banks that are not well capitalized. If a bank has not received a determination that it is operating in a high-rate area, deposit rates must not exceed the national rate caps posted on the FDIC website. If an institution receives a determination that it is operating in a high-rate area, the institution can establish its market area based on its branch locations and marketing scope. The deposit rates of all FDIC-insured institutions inside the market area must be used when calculating the prevailing rate. An institution may also include as part of its prevailing rate calculation the rates offered by credit unions that the institution competes with inside its local market area. When using the local market approach, the rate cap for local deposits cannot exceed the prevailing rate of the local market plus 75 basis points. Deposits accepted outside the market area are subject to the national rate caps, even for institutions that have received a determination they are operating in a high-rate area. While in some cases the FDIC may grant a brokered deposit waiver to a less than well-capitalized bank, the FDIC may not waive the interest rate restrictions under the brokered deposit regulations.

Brokered Deposits Use

The FDI Act does not restrict the use of brokered deposits for well-capitalized institutions, and brokered deposits can be a suitable funding source when properly managed. However, some banks have used brokered deposits to fund unsound or rapid expansion of loan and investment portfolios, which has contributed to weakened financial and liquidity positions over successive economic cycles. The overuse and failure to properly manage brokered deposits by problem institutions have contributed to bank failures and losses to the deposit insurance fund.

Examiners should consider whether an institution's policies adequately describe permissible brokered and rate-sensitive funding types, amounts, and concentration limits. Key policy considerations include procedures for assessing potential risks to earnings and capital associated with brokered and rate-sensitive deposits, and monitoring how such funds are used. Examiners should ensure management is aware of the restrictions that may apply if the institution's PCA capital category falls below well capitalized.

Examiners should determine whether management performs adequate due diligence before entering any business relationship with a deposit broker or other business partners that help provide rate-sensitive deposits, such as deposit listing services. Deposit brokers and deposit listing services are not regulated by the federal bank agencies.

While the FDI Act does not restrict the use of brokered deposits by well-capitalized institutions, the acceptance of brokered deposits by well-capitalized institutions is subject to the same considerations and concerns applicable to any type of special funding. These considerations relate to volume, availability, cost, volatility, maturity, and how the use of such special funding fits into the institution's overall liability and liquidity management plans.

When brokered deposits are encountered in an institution, examiners should consider the effect on overall funding and investment strategies and if the bank is less than well capitalized, verify compliance with Part 337. Examiners should also consider the source, stability, and use of brokered deposits or rate sensitive funding sources that support asset growth or individual loans. Appropriate supervisory action should be considered if brokered deposits or other rate sensitive funding sources are not appropriately managed as part of an overall, prudent funding strategy. Apparent violations of Part 337 or nonconformance with the Interagency Guidelines Establishing Standards for Safety and Soundness (Appendix A to Part 364) should be discussed with management and the board of directors, and appropriately addressed in the ROE.

Public Funds

Public funds are deposits of government entities such as state or local municipalities. Some states require institutions to secure the uninsured or entire balance of these accounts. Although various forms of collateral may be pledged, high-quality assets such as securities of U.S. government or government-sponsored enterprises (GSE) are most commonly pledged. Some institutions may also use standby letters of credit (SBLCs), such as those from one of the Federal Home Loan Banks (FHLB), to secure public funds.

The stability of public fund accounts can vary significantly due to several factors. Account balances may fluctuate due to timing differences between tax collections and expenditures, the funding of significant projects (e.g., school or hospital construction), placement requirements, and economic conditions. Placement requirements may include rotating deposits between institutions in a particular community, obtaining bids and placing funds with the highest bidder, and minimum condition standards for the institution receiving the deposits (such as specific capital levels or the absence of formal enforcement actions). Economic conditions can affect the volatility of public deposits since public entities may experience lower revenues during an economic downturn.

Although public deposit accounts often exhibit volatility, the accounts can be reasonably stable over time, or their fluctuations quite predictable. Therefore, examiners should closely review public deposit relationships to make informed judgments as to the stability of the balances.

Securing Public Funds with SBLCs

Some financial institutions obtain SBLCs as a supplemental funding source to accommodate public depositors, derivative counterparties, and corporate borrowing needs. Typically, institutions obtain SBLCs from their district FHLB to support uninsured public deposits and secure them with eligible loans and securities. The SBLC guarantees that the issuer will pay the beneficiary on demand if the institution fails or otherwise defaults on its obligation. When used judiciously, these standby credit facilities can complement a diversified funds management program and serve as a practical, cost-effective solution for securing a financial institution's obligations.

Certain state laws require public deposits from state, county, and municipal authorities be protected by federal deposit insurance; a pledge of obligations issued by the U.S. Treasury, U.S. government agencies, or state and local governments; or an SBLC issued by an FHLB. Some institutions prefer to obtain an SBLC rather than pledge government securities because of the standby facility's cost and balance sheet efficiency. FHLBs will accept a variety of loans and securities as collateral subject to certain collateral requirements, or "haircuts."

Similar to FHLB advances or other secured borrowings, SBLCs require collateral. Most institutions depend on eligible loans or securities as collateral. To maximize balance sheet efficiency, institutions frequently secure SBLCs with loans because they would otherwise use unencumbered securities to directly meet pledging requirements (especially for uninsured public deposits). While secured borrowings are a widely accepted form of funding that can be performed in a safe and sound manner, undiversified reliance on secured borrowings or less stable funding can sometimes result in strained liquidity. Funding diversification is important in the case of large-scale secured borrowing programs which can encumber assets that would otherwise be eligible for pledging or conversion to cash. Importantly, funding risk does not arise because of the type of secured borrowing conducted (i.e., FHLB advances or SBLCs); rather, it centers on the extent of borrowing, leveraging previously unencumbered assets, and over-reliance on non-core sources to achieve growth or earnings targets.

SBLCs are generally only exercised by public depositors if the institution fails to fund a withdrawal. If an institution does not have sufficient unencumbered liquid assets to meet a withdrawal request, it may seek a new FHLB advance and contemporaneously cancel or reduce the SBLC. The assets used to collateralize the SBLC would secure at least part of the new advance, depending on the FHLB's revised collateral terms. The FHLB can require additional collateral, possession of collateral, or limits on availability if it views an institution as troubled.

Examiners should recognize that SBLCs may present challenges in times of stress, particularly when an institution's borrowing capacity may be constrained by a large volume of pledged loans and securities. SBLCs encumber assets eligible for FHLB collateral at the time of commitment and throughout the instrument's life, meaning that pledged assets will not be as readily convertible to cash or available to use as collateral for additional borrowings. Further, if an institution's asset quality or financial condition deteriorates, the FHLB may demand more rigorous terms or additional collateral. This may occur precisely when an institution has a heightened need for on-balance sheet liquidity.

Liquidity reviews during examinations should consider the potential impact of standby credit facilities on liquidity and funds management, asset encumbrance, and the protection of uninsured public deposits. Examiners should identify SBLC or other credit facilities that require pledged collateral, followed by a review of related documentation and financial reporting. If an institution relies significantly on wholesale borrowings (such as FHLB advances and SBLCs) to fund its balance sheet, examiners should analyze how asset encumbrances might impair liquidity in a stress scenario and whether these issues are appropriately addressed in the CFP.

Secured and Preferred Deposits

Institutions are usually required to pledge securities (or other readily marketable assets) to cover secured and preferred deposits. Institutions must secure U.S. government deposits, and many states require banks to secure public funds, trust accounts, and bankruptcy court funds. In addition to strict regulatory and bookkeeping controls associated with pledging requirements, institutions often establish monitoring controls to ensure deposits and pledged assets are appropriately considered in their liquidity analysis. Accurate accounting for secured or preferred liabilities is also important if an institution fails, because secured depositors and creditors may gain immediate access to some of the institution's most liquid assets.

Large Depositors and Deposit Concentrations

For examination purposes, a large depositor is a customer or entity that owns or controls 2 percent or more of the bank's total deposits. Some large deposits remain relatively stable over long periods. However, due to the effect the loss of a large deposit account could have on an institution's overall funding position, these deposits are considered to be potentially less stable liabilities.

A large deposit account might be considered stable if the customer has ownership in the institution, has maintained a long-term relationship with the bank, has numerous accounts, or uses multiple bank services. Conversely, a large depositor that receives a high deposit rate, but maintains no other relationships with the institution, may move the account quickly if the rate is no longer considered high for the market. Therefore, examiners should consider the overall relationship between customers and the institution when assessing the stability of large deposits.

Examiners should consider whether institutions actively monitor the stability of large deposits and maintain funds management policies and strategies that reflect consideration of potentially volatile concentrations and significant deposits that mature simultaneously. Key considerations include potential cash flow fluctuations, pledging requirements, affiliated relationships, and the narrow interest spreads that may be associated with large deposits.

Negotiable Certificates of Deposit

Negotiable CDs warrant special attention as a component of large (uninsured) deposits. These instruments are usually issued by large regional or money center banks in denominations of $1 million or more and may be issued at face value with a stated rate of interest or at a discount similar to U.S. Treasury bills. Major bank CDs are widely traded, may offer substantial liquidity, and are the underlying instruments for a market in financial futures. Their cost and availability are closely related to overall market conditions, and any adverse publicity involving either a particular bank or banks in general can impact the CD market. These CDs have many features similar to borrowings and can be quite volatile.

Assessing the Stability of Funding Sources

Assessing the stability of funding sources is an essential part of liquidity risk measurement and liquidity management. Institutions may rely on a variety of funding sources, and a wide array of factors may impact the stability of those funding sources. The following factors should be considered when assessing the stability of funding sources:

- **The cost of the bank's funding sources compared to market costs and alternative funding sources:** If a bank pays significantly above local or national rates to obtain or retain deposits, the bank's deposit base may be highly cost sensitive, and depositors may be more likely to move deposits if terms become more favorable elsewhere. Examiners should determine whether the institution uses rate specials or one-time promotional offerings to obtain deposits or to retain rate-sensitive customers. Examiners should also assess how much of the deposit base consists of rate specials and determine if management measures and reports the level of such deposits.

- **Large deposit growth or large changes in deposit composition:** Strategies that rely on less stable funding sources to fund significant growth in new business lines should be carefully considered. The potential for misjudging the level of risk in new strategies is high and could be compounded with the use of volatile funding sources.
- **Stability of insured deposits and fully secured borrowings:** Insured deposits and borrowings secured by highly liquid assets are more likely to be stable than uninsured deposits or borrowings secured by non-liquid assets. Uninsured deposits should not automatically be considered volatile; however, the historical and projected stability of uninsured deposits should be assessed.
- **The current rate environment:** Depositors may be less rate sensitive in a low-rate environment due to the limited benefits (marginally higher rates) obtained by shifting deposits into longer-term investments.
- **The current business cycle:** If the national or local economy is in a downward cycle, individuals and businesses may decide to keep more cash on hand versus spending or investing it.
- **Contractual terms and conditions:** Terms and requirements related to the condition of the bank, such as the bank's PCA category, credit ratings, or capital levels can materially affect liquidity. Specific contractual terms and conditions are often associated with brokered deposits, funds from deposit listing services, correspondent bank accounts, repurchase agreements, and FHLB advances.
- **The relationship with the funding source:** Large deposits might be more stable if the deposit is difficult to move (e.g., the deposit is in a transaction account used by a payroll provider), if the depositor is an insider in the institution, or if the depositor has a long history with the institution. However, examiners should consider that depositors may withdraw funds during stress periods regardless of difficulties or the effect on the bank.

Borrowings

Stable deposits are a key funding source for most insured depository institutions; however, institutions are becoming increasingly reliant upon borrowings and other wholesale funding sources to meet their funding needs. Borrowings include debt instruments or loans that banks obtain from other entities such as correspondent lines of credit, federal funds, and FHLB and Federal Reserve Bank advances.

Generally, examiners should view borrowings as a supplemental funding source, rather than as a replacement for core deposits. If an institution is using borrowed funds to meet contingent liquidity needs, examiners should determine whether management understands the associated risks and has commensurate risk management practices. Effective practices typically include a comprehensive contingency funding plan that specifically addresses funding plans if the institution's financial condition or the economy deteriorates. Active and effective risk management, including funding-concentration management by size and source, can mitigate some of the risks associated with the use of borrowings.

Key considerations when assessing liquidity risks associated with borrowed funds include the following:

- Pledging assets to secure borrowings can negatively affect a bank's liquidity profile by reducing the amount of securities available for sale during periods of stress.
- Unexpected changes in market conditions can make it difficult for the bank to secure funds and manage its funding maturity structure.
- It may be more difficult to borrow funds if the institution's condition or the general economy deteriorates.
- Banks may incur relatively high costs to obtain funds and may lower credit quality standards in order to invest in higher-yielding loans and securities to cover the higher costs. If a bank incurs higher-cost liabilities to support assets already on its books, the cost of the borrowings may result in reduced or negative net income.
- Preoccupation with obtaining funds at the lowest possible cost, without proper consideration given to diversification and maturity distribution, intensifies a bank's exposure to funding concentrations and interest rate fluctuations.
- Some borrowings have embedded options that make their maturity or future interest rate uncertain. This uncertainty can increase the complexity of liquidity management and may increase future funding costs.

Common borrowing sources include:

- Federal funds purchased,
- Federal Reserve Bank facilities,
- Repurchase agreements,
- Dollar repurchase agreements,
- Bank investment contracts,
- Commercial Paper, and
- International funding sources.

Federal Funds

Federal funds are reserves held in an institution's Federal Reserve Bank account that can be lent (sold) by institutions with excess reserves to other institutions with an account at a Federal Reserve Bank. Institutions borrow (purchase) federal funds to meet their reserve requirements or other funding needs. Institutions rely on the Federal Reserve Bank or a correspondent bank to facilitate federal funds transactions. State non-member banks that do not maintain balances at the Federal Reserve purchase/sell federal funds through a correspondent bank.

Lending and borrowing these balances has become a convenient method for banks to avoid reserve deficiencies or invest excess reserves over a short period of time. In most instances, federal funds transactions take the form of overnight or short-term unsecured transfers of immediately available funds between banks. However, banks also enter into continuing contracts that have no set maturity but are subject to cancellation upon notice by either party to the transaction. Banks also engage in federal funds transactions of a set maturity, but these include only a small percentage of all federal funds transactions. In any event, these transactions should be supported with written verification from the lending institution.

Some institutions may access federal funds as a liability management technique to fund a rapid expansion of its loan or investment portfolios and enhance profits. In these situations, examiners should determine whether appropriate board approvals, limits, and policies are in place and should discuss with management and the board the institution's plans for developing appropriate long-term funding solutions. Liquidity risks typically decline if institutions avoid undue reliance on federal funds purchased, as the funds are usually short-term, highly credit sensitive instruments that may not be available if an institution's financial condition deteriorates.

Federal Reserve Bank Facilities

The Federal Reserve Banks provide short-term collateralized credit to banks through the Federal Reserve's discount window. The discount window is available to any insured depository institution that maintains deposits subject to reserve requirements. The most common types of collateral are U.S. Treasury securities; agency, GSE, mortgage-backed, asset-backed, municipal, and corporate securities; and commercial, agricultural, consumer, residential real estate, and commercial real estate loans. Depending on the collateral type and the condition of the institution, collateral may be transferred to the Federal Reserve, held by the borrower in custody, held by a third party, or reflected by book entry.

Types of discount window credit include primary credit (generally overnight credit to meet temporary liquidity needs), secondary credit (available to institutions that do not qualify for primary credit), seasonal credit (available to banks that demonstrate a clear seasonal pattern to deposits and assets), and emergency credit (rare circumstances).

The Federal Reserve's primary credit program was designed to ensure adequate liquidity in the banking system and is intended as a back-up of short-term funds for eligible institutions. In general, depository institutions are eligible for primary credit if they have a composite CAMELS rating of 1, 2, or 3 and are at least adequately capitalized.

Since primary credit can serve as a viable source of back-up, short-term funds, examiners should not automatically criticize the occasional use of primary credit. At the same time, over-reliance on primary credit borrowings or any one source of short-term contingency funds may indicate operational or financial difficulties. Examiners should consider whether institutions that use primary credit facilities maintain viable exit strategies.

Secondary credit is available to depository institutions that do not qualify for primary credit and is extended on a very short-term basis at a rate above the primary credit rate. This program entails a higher level of Reserve Bank administration and oversight than primary credit.

If a bank's borrowing becomes a regular occurrence, Federal Reserve Bank officials will review the purpose of the borrowing and encourage the bank to initiate a program to eliminate the need for such borrowings. Appropriate reasons for borrowing include preventing overnight overdrafts, loss of deposits or borrowed funds, unexpected loan demand, liquidity and cash flow needs, operational or computer problems, or a tightened federal funds market.

The Federal Reserve will not permit banks that are not viable to borrow at the discount window. Section 10B(b) of the Federal Reserve Act limits Reserve Bank advances to not more than 60 days in any 120-day period for undercapitalized institutions or institutions with a composite CAMELS rating of 5. This limit may be overridden only if the primary federal banking agency supervisor certifies the borrower's viability or if, following an examination of the borrower by the Federal Reserve, the Chairman of the Board certifies in writing to the Reserve Bank that the borrower is viable. These certifications may be renewed for additional 60-day periods.

Repurchase Agreements

In a securities repurchase agreement (repo), an institution agrees to sell a security to a counterparty and simultaneously commits to repurchase the security at a mutually agreed upon date and price. In economic terms, a repurchase agreement is a form of secured borrowing. The amount borrowed against the securities generally is the full market value less a reasonable discount. Typically, the securities do not physically change locations or accounting ownership; instead, the selling bank's safekeeping agent makes entries to recognize the purchasing bank's interest in the securities.

From an accounting standpoint, repurchase agreements involving securities are either reported as secured borrowings, or sales and a forward repurchase commitment based on whether the selling institution maintains control over the transferred financial asset. Generally, if the repurchase agreement both entitles and obligates the selling bank to repurchase or redeem the transferred assets from the transferee (i.e., the purchaser) the selling bank should report the transaction as a secured borrowing if various other conditions outlined in Generally Accepted Accounting Principles have been met. If the selling bank does not maintain effective control of the transferred assets according to the repurchase agreement, the transaction would be reported as a sale of the securities and a forward repurchase commitment. For further information, see the Call Report Glossary entries pertaining to Repurchase/Resale Agreements and Transfers of Financial Assets.

Examiners may encounter two types of repurchase agreements: bilateral and tri-party. Bilateral repurchase agreements involve only two parties. In tri-party repurchase agreements, an agent is involved in matching counterparties, holding the collateral, and ensuring the transactions are executed properly.

The majority of repurchase agreements mature in three months or less. One-day transactions are known as overnight repos, while transactions longer in duration are referred to as term repos. Institutions typically use repurchase agreements as short-term, relatively low cost, funding mechanisms. The interest rate paid on a repurchase agreement depends on the type of underlying collateral. In general, the higher the credit quality of the collateral and the easier the security is to deliver and hold, the lower the repo rate. Supply and demand factors for the underlying collateral also influence the repo rate.

Properly administered repurchase agreements conducted within a comprehensive asset/liability management program are not normally subject to regulatory criticism. However, repos that are inadequately controlled can expose an institution to risk of loss and may be regarded as an unsuitable investment practice. Since the fair value of the underlying security may change during the term of the transaction, both parties to a repo may experience credit exposure. Although repo market participants normally limit credit exposures by maintaining a cushion between the amount lent and the value of the underlying collateral, and by keeping terms short to allow for redemption as necessary, it is critical to conduct a thorough credit review of repo counterparties prior to the initiation of transactions. The Policy Statement on Repurchase Agreements of Depository Institutions with Securities Dealers and Others, dated February 10, 1998, provides additional information on repurchase agreements, associated policies and procedures, credit risk management practices, and collateral management practices.

A reverse repurchase agreement, which requires the buying institution to sell back the same asset purchased, is treated as a loan for Call Report purposes. If the reverse repurchase agreement does not require the institution to resell the same, or a substantially similar, security purchased, it is reported as a purchase of the securities and a commitment to sell securities.

Reverse repos can involve unique risks and complex accounting and recordkeeping challenges, and institutions can benefit from establishing appropriate risk management policies, procedures and controls. In particular, institutions can benefit from controls when relying on reverse repos that are secured with high-risk assets. The value of the underlying assets may decline significantly in a stress event, creating an undesirable amount of exposure.

Dollar Repurchase Agreements

Dollar repurchase agreements, also known as dollar repos and dollar rolls, provide financial institutions with an alternative method of borrowing against securities owned. Unlike standard repurchase agreements, dollar repos require the buyer to return substantially similar, versus identical, securities to the seller. Dealers typically offer dollar roll financing to institutions as a means of covering short positions in particular securities. Short positions arise when a dealer sells securities that it does not currently own for forward delivery. To compensate for potential costs associated with failing on a delivery, dealers are willing to offer attractive financing rates in exchange for the use of the institution's securities in covering a short position. Savings associations, which are the primary participants among financial institutions in dollar roll transactions, typically use mortgage pass through securities as collateral for the transactions.

Supervisory authorities do not normally take exception to dollar repos if the transactions are conducted for legitimate purposes and the institution has instituted appropriate controls.

Bank Investment Contracts

A bank investment contract (BIC) is a deposit contract between a bank and a customer that permits the customer to deposit funds over a period of time and obligates the bank to repay the amounts deposited plus interest at a guaranteed rate at the end of the contract term. Contract terms vary and may include maturities ranging from six months to ten years. Occasionally, BICs have been structured as non-transferable liabilities (i.e., not saleable in a secondary market). Customers for BICs are often sponsors of employee benefit plans such as pension plans or deferred compensation plans.

Examiners should consider the volume, maturity, and cost of BIC funding in relation to the bank's other deposit and non-deposit funding sources. Examiners should also be aware of the terms and conditions of the BICs. A BIC may provide specific periods and conditions under which additional deposits or withdrawals can be made to or from such accounts. The bank's liquidity planning typically estimate cash flows from BIC funding under different interest rate scenarios.

International Funding Sources

International funding sources exist in various forms. The most common source of funds is the Eurodollar market. Eurodollar deposits are U.S. dollar-denominated deposits taken by a bank's overseas branch or its international banking facility. Reserve requirements and deposit insurance assessments do not apply to Eurodollar deposits. The interbank market is highly volatile, and banks typically benefit form analyzing Eurodollar deposit activities within the same context as all other potentially volatile funding sources.

Commercial Paper

Institutions can issue commercial paper to quickly raise funds from the capital markets. Commercial paper is generally a short-term, negotiable promissory note issued for short-term funding needs by a bank holding company, large commercial bank, or other large commercial business. Commercial paper usually matures in 270 days or less, is not collateralized, and is purchased by institutional investors.

Some commercial paper programs are backed by assets referred to as asset-backed commercial paper. Some programs also involve multi-seller conduits where a special-purpose entity is established to buy interests in pools of financial assets (from one or more sellers). Entities fund such purchases by selling commercial paper notes, primarily to institutional investors.

Institutions that provide liquidity lines or other forms of credit enhancement to their own or outside commercial paper programs face the risk that the facilities could be drawn upon during a crisis situation. Prudent institutions plan for such events and include such events in stress scenario analysis and contingency plans. In addition, institutions benefit from addressing the bank's ability to continue using commercial paper conduits as a funding source in the bank's contingency funding plan.

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OFF-BALANCE SHEET ITEMS

Off-balance sheet items, such as those described below, can be a source or use of funds.

Loan Commitments

Loan commitments are common off-balance sheet items. Typical commitments include unfunded commercial, residential, and consumer loans; unfunded lines of credit for commercial and retail customers; and fee-paid, commercial letters of credit. Sound risk management practices include closely monitoring the amount of unfunded commitments that require funding over various periods and detailing anticipated demands against unfunded commitments in internal reports and contingency plans. Examiners should consider the nature, volume, and anticipated use of the institution's loan commitments when assessing and rating the liquidity position.

Derivatives

Financial institutions can use derivative instruments (financial contracts that generally obtain their value from underlying assets, interest rates, or financial indexes) to reduce business risks. However, like all financial instruments, derivatives contain risks that must be properly managed. For example, interest rate swaps typically involve the periodic net settlement of swap payments that can substantially affect an institution's cash flows. Additionally, derivative contracts may have initial margin requirements that require an institution to pledge cash or investment securities that reflect a specified percentage of the contract's notional value. Variation margin requirements (which may require daily or intra-day settlements to reflect changes in market value) can also affect an institution's cash flows and investment security levels. Examiners should consider the extent to which banks engaging in derivative activities understand and manage the liquidity, interest rate, and price risks of these instruments.

Other Contingent Liabilities

Legal risks can have a significant financial impact on institutions that may affect liquidity positions. Examiners should consider whether institutions identify these contingencies when measuring and reporting liquidity risks as exposures become more certain.

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LIQUIDITY RISK MITIGATION

There are many ways management can mitigate liquidity risk and maintain the institution's current and future liquidity positions within the risk tolerance targets established by the board. For managing routine and stressed liquidity needs, institutions typically establish diversified funding sources and maintain a cushion of high-quality liquid assets. Examiners should consider whether contingency funding plans identify back-up funding sources (and action steps to address more acute liquidity needs) and whether management tests various stress scenarios to identify risks that should be mitigated and addressed in contingency funding plans.

Diversified Funding Sources

An important component of liquidity management is the diversification of funding sources. Undue reliance on any one source of funding can have adverse consequences in a period of liquidity stress. Banks typically diversify funding across a range of retail sources and, if utilized, across a range of wholesale sources, consistent with the institution's sophistication and complexity. Institutions that rely primarily on retail deposit accounts are generally not criticized for relying on one primary funding source. However, examiners should determine whether alternative sources are identified in formal contingency plans and periodically tested.

To reduce risks associated with funding concentrations, banks generally benefit from considering the correlations between sources of funds and market conditions and having available a variety of short-, medium-, and long-term funding sources. The board is responsible for setting and clearly articulating a bank's risk tolerance in this area through policy guidelines and limits for funding diversification.

Although banks use diversified funding sources to reduce funding concentration risks, banks also consider other factors when selecting funding sources. For example, the cost of a particular funding source is a critical consideration when developing profitability strategies. Additionally, the stability and availability of a funding source are important factors when planning for asset growth. Examiners should carefully assess strategies that rely on less-stable funding sources, particularly strategies that fund significant growth in new business lines.

When assessing the diversification of funding sources, important factors to consider include:

- Internal evaluations of risks associated with funding sources (e.g., stress tests and diversification limits) and whether or not the evaluations are reasonable and well documented,
- Potential curtailment of funding or significantly higher funding costs during periods of stress,
- Time required to access funding in stressed and normal periods,
- Sources and uses of funds during significant growth periods, and
- Available alternatives to volatile funding sources.

Maintaining market access to funds is also an essential component of ensuring funding diversity. Market access can be critical, as it affects an institution's ability to raise new funds and to liquidate assets. Examiners should consider whether management actively manages, monitors, and tests the institution's market access to funds. Such efforts should be consistent with the institution's liquidity risk profile and sources of funding. For example, access to the capital markets is an important consideration for most large complex banks, whereas the availability of correspondent lines and other sources of wholesale funds are critical for community banks. Reputation risk plays a critical role in a bank's ability to access funds readily and at reasonable terms. For this reason, examiners should determine whether liquidity risk managers are aware of any information, such as an announcement of a decline in earnings, or a downgrade by a rating agency, that could affect perceptions of an institution's financial condition.

The Role of Equity

Issuing new equity is often a relatively slow and costly way to raise funds and should not be viewed as an immediate or direct source of liquidity. However, to the extent that a strong capital position helps an institution quickly obtain additional debt and economically raise funds, issuing equity can be considered a liquidity facilitator.

Cushion of Highly Liquid Assets

One of the most important components of an institution's ability to effectively respond to liquidity stress is the availability of unencumbered, highly liquid assets (i.e., assets free from legal, regulatory, or operational impediments). Unencumbered liquid assets can be sold or pledged to obtain funds under a range of stress scenarios. The quality of the assets is a critical consideration, as it significantly affects a bank's ability to sell or pledge the assets in times of stress.

When determining what type of assets to hold for contingent liquidity purposes, management typically considers factors such as:

- **Level of credit and market risk:** Assets with lower levels of credit and market risk tend to have higher liquidity profiles.
- **Liquidity during stress events:** High-quality liquid assets are generally not subject to significantly increased risk during stress events. Conversely, certain assets, such as specialty assets with small markets or assets from industries experiencing stress, are often less liquid in times of stress in the banking sector.
- **Ease and certainty of valuation:** Prices based on trades in sizeable and active markets tend to be more reliable, and an asset's liquidity increases if market participants are more likely to agree on its valuation. Formula-based pricing is less desirable than data from recent trades. If used, the pricing formula should be easy to calculate, based on active trades, and not depend heavily on assumptions or modeled prices. The inputs into the pricing formula should also be publicly available.

Institutions with high quality liquid assets are generally able to monetize the assets through the sale of the assets or the use of secured borrowings. This generally means an institution's cushion of liquid assets is concentrated in due from accounts, federal funds sold, and high-quality assets, such as U.S. Treasury securities or GSE bonds.

Occasionally, it may be appropriate to consider pledged assets as part of the highly liquid cushion, such as when a bank pledges Treasury notes as part of an unfunded line of credit. In other instances, it may be appropriate to consider an asset that has not been explicitly pledged as illiquid. For example, if an institution is required to deposit funds at a correspondent institution to facilitate operational services, it should generally exclude these funds from its liquidity reports, or denote them separately as unavailable.

Examiners should assess whether the size of the institution's liquid asset cushion is aligned with its risk tolerance and profile, and is supported by documented analysis and stress test results. Factors that may indicate a need to maintain a higher liquid asset buffer include:

- Easy customer access to alternative investments,
- Recent trends showing substantial reductions in large liability accounts,
- Significant volumes of less-stable funding,
- High levels of assets with limited marketability (due to credit quality issues or other factors),
- Expectations of elevated draws on unused lines of credit or loan commitments,
- A concentration of credit to an industry with existing or anticipated financial problems,
- Close ties between deposit accounts and employers experiencing financial problems,
- A significant volume of assets are pledged to wholesale borrowings, and
- Impaired access to funds from capital markets.

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CONTINGENCY FUNDING

Contingency Funding Plans

All financial institutions, regardless of size or complexity, benefit from a formal contingency funding plan (CFP) that clearly defines strategies for addressing liquidity shortfalls in emergency situations. Comprehensive CFPs delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. The reliability of a CFP improves if it is regularly tested and updated to ensure that it is operationally sound. Often, financial institutions coordinate liquidity risk management plans with disaster, contingency, and business planning efforts, as well as with business line and risk management objectives, strategies, and tactics.

While CFPs should be tailored to the business model, risk, and complexity of the individual institution, most CFPs require management to:

- Establish a liquidity event-management framework (including points of contact and public relation plans),
- Establish a monitoring framework,
- Identify potential contingent funding events,
- Identify potential funding sources,
- Require stress testing, and
- Require periodic testing of the CFP framework.

Contingent Funding Events

The primary goals of most CFPs are to identify risks from contingent funding events and establish an operational framework to deal with those risks. Contingent funding events are often managed based on their probability of occurrence and potential effect. CFPs generally focus on events that, while relatively infrequent, could have a high-impact on the bank's operations. Appropriate plans typically set a course of action to identify, manage, and control all significant contingent funding risks.

Stress factors that may provide early warning signs for identifying potential funding risks can be institution-specific or systemic and may involve one or more of the following:

- Deterioration in asset quality,
- Downgrades in credit ratings,
- Downgrades in PCA capital category,
- Deterioration in the liquidity management function,
- Widening of credit default spreads,
- Operating losses,
- Rapid growth,
- Inability to fund asset growth,
- Inability to renew or replace maturing funding liabilities,
- Price volatility or changes in the market value of various assets,
- Negative press coverage,
- Declining institution equity prices,
- Deterioration in economic conditions or market perceptions,
- Disruptions in the financial markets, and
- General or sector-specific market disruptions (e.g., payment systems or capital markets).

Stress events can also be caused by counterparties (both credit and non-credit exposures). For example, if a bank sells financial assets to correspondent banks for securitization and its primary correspondent exits the market, the bank may need to use a contingent funding source.

Comprehensive CFPs identify institution-specific events that may impact on- and off-balance sheet cash flows given the specific balance-sheet structure, business lines, and organizational structure. For example, institutions that securitize loans have CFPs that consider a stress event where the institution loses access to the market but must still honor its commitments to customers to extend loans.

Comprehensive CFPs also delineate various stages and severity levels for each potential contingent liquidity event. For example, asset quality can deteriorate incrementally and have various levels of severity, such as less than satisfactory, deficient, and critically deficient. The CFPs also address the timing and severity levels of temporary, intermediate-term, and long-term disruptions. For example, a natural disaster may cause temporary disruptions to payment systems, while deficient asset quality may occur over a longer term. Institutions can then use the stages or severity levels identified to establish various stress test scenarios and early-warning indicators.

Stress Testing Liquidity Risk Exposure

After identifying potential stress events, institutions often implement quantitative projections, such as stress tests, to assess the liquidity risk posed by the potential events. Stress testing helps the institution better understand the vulnerability of certain funding sources to various risks and helps to determine when and how to access alternative funding sources. Stress testing also helps institutions identify methods for rapid and effective responses, guide crisis management planning, and determine how large of a liquidity buffer should be maintained. Generally, the magnitude and frequency of stress testing is commensurate with the complexity of the financial institution and the level of its risk exposures.

Liquidity stress tests are typically based on existing cash-flow projections that are appropriately modified to reflect potential stress events (institution-specific or market-wide) across multiple time horizons. Stress tests are used to identify and quantify potential risks and to analyze possible effects on the institution's cash flows, liquidity position, profitability, and solvency. For instance, during a crisis an institution's liquidity needs can quickly escalate while liquidity sources can decline (e.g., customers may withdraw uninsured deposits, or lines of credit may be reduced or canceled). Stress testing allows an institution to evaluate the possible impact of these events and plan accordingly.

Examiners should review documented assumptions regarding the cash flows used in stress test scenarios and consider whether they incorporate:

- Customer behaviors (early deposit withdrawals, renewal/run-off of loans, exercising options);
- Prepayments on loans and mortgage-backed securities;
- Seasonality (public-fund fluctuations, agricultural credits, construction lending); and
- Various time horizons.

Effective assumptions generally incorporate both contractual and non-contractual behavioral cash flows, including the possibility of funds being withdrawn. Examples of non-contractual funding requirements that may occur during a financial crisis include supporting auction rate securities, money market funds, commercial paper programs, and structured investment vehicles. Institutions may be compelled to financially bolster shortfalls in money market funds or asset-backed paper that does not sell or roll due to market stress, and assets may be taken on balance sheet from sponsored off-balance sheet vehicles. While this financial support is not contractually required, institutions may determine that the negative press and reputation risks outweigh the costs of providing the financial support.

Effective stress testing generally assesses various stress levels and stages ranging from low- to severe-stress scenarios. To establish appropriate stress scenarios, management may use the different stages and severity levels that the institution assigned to stress events. For example, a low-stress scenario may include several events identified as low severity, while a severe stress scenario may combine several high-severity events. A severe stress scenario may include severe declines in asset quality, financial condition, and PCA category.

Management's active involvement and support is critical to the effectiveness of the stress testing process. Stress test results are typically discussed with the board, and when appropriate, management takes remedial actions to limit the institution's exposures, build up a liquidity cushion, and/or adjust its liquidity profile to fit its risk tolerance. In some situations, institutions may adjust the bank's business strategy to mitigate a contingent funding exposure.

Potential Funding Sources

Identification of potential funding sources for shortfalls resulting from stress scenarios is a key component of adequate contingency funding plans. Banks generally identify alternative funding sources and ensure ready access to the funds. The most important and reliable funding source is a cushion of highly liquid assets. Other common contingent funding sources include the sale or securitization of assets, repurchase agreements, FHLB borrowings, or borrowings though the Federal Reserve discount window. However, in a stress event, many of these liquidity sources may become unavailable or cost prohibitive. Therefore, effective stress tests typically assess the availability of contingent funding in stress scenarios.

Institutions that rely on unsecured borrowings for contingency funding normally consider how borrowing capacity may be affected by an institution-specific or market-wide disruption. Institutions that rely upon secured funding sources for contingency funding also consider whether they may be subject to higher margin or collateral requirements in certain stress scenarios. Higher margin or collateral requirements may be triggered by the deterioration in the institution's overall financial condition or in a specific portfolio.

Potential collateral values are also normally subjected to stress tests because devaluations or market uncertainties could reduce the amount of contingent funding available from a pledged asset. Similarly, stress tests often consider correlation risk when evaluating margin and collateral requirements. For example, if an institution relies on its loan portfolio for contingent liquidity, a stress test may assess the effects of poor asset quality. If loans previously securitized were of poor credit quality, the market value and collateral value of current and future loans originated by the bank could be significantly reduced.

Monitoring Framework for Stress Events

Early identification of liquidity stress events is critical to implementing an effective response. The early recognition of potential events allows the institution to position itself into progressive states of readiness as an event evolves, while providing a framework to report or communicate within the institution and to outside parties. As a result, effective CFPs typically identify early warning signs that are tailored to the institution's specific risk profile. The CFPs also establish a monitoring framework and responsibilities for monitoring identified risk factors.

Early warning indicators may be classified by management as early-stage, low-severity, or moderate-severity stress events and include factors such as:

- Decreased credit-line availability from correspondent institutions,
- Demands for collateral or higher collateral requirements from counterparties that provide credit to the institution,
- Cancelation of loan commitments or the non-renewal of maturing loans from counterparties that provide credit to the institution,
- Decreased availability of warehouse financing for mortgage banking operations,
- Increased trading of the institution's debt, or
- Unwillingness of counterparties or brokers to participate in unsecured or long-term transactions.

Testing of Contingency Funding Plans

Institutions periodically test and update the CFP to assess the plan's reliability under times of stress. Generally, management tests contingent funding sources at least annually. Testing may include both drawing on a contingent borrowing line and operational testing. Operational testing is often designed to ensure that:

- Roles and responsibilities are up to date and appropriate,

- Legal and operational documents are current and appropriate,
- Cash and collateral can be moved where and when needed, and
- Contingent liquidity lines are available.

Effective CFP testing typically includes periodically testing the operational elements associated with accessing contingent-funding sources. The tests help ensure funds are available when needed. For example, there may be extended time constraints for establishing lines with the Federal Reserve or FHLB, and often, the lines are set up in advance to establish availability and to limit the time required to pledge assets and draw on lines. However, examiners should understand that establishing lines in advance and testing the lines does not guarantee funding sources will be available within the same time frames or on the same terms during stress events.

In addition, institutions can benefit by employing operational CFP simulations to test communications, coordination, and decision making involving managers with different responsibilities, in different geographic locations, or at different operating subsidiaries. Simulations or tests run late in the day can highlight specific problems such as difficulty in selling assets or borrowing new funds at a time when the capital markets may be less active. The complexity of these tests can range from a simple communication and access test for a non-complex bank or can include multiple tests throughout the day to assess the timing of funds access.

Liquidity Event Management Processes

In a contingent liquidity event, it is critical that management's response be timely, effective, and coordinated. Therefore, comprehensive CFPs provide for a dedicated crisis management team and administrative structure, and include realistic action plans to execute the various elements of the plan for various levels of stress. The CFPs establish clear lines of authority and reporting by defining responsibilities and decision-making authority. The CFPs also address the need for more frequent communication and reporting among team members, the board of directors, and other affected parties. Critical liquidity events may also require the daily computation of regular liquidity risk reports and supplemental information, and comprehensive CFPs provide for more frequent and more detailed reporting as the stress situation intensifies.

The reputation of an institution is a critical asset when a liquidity crisis occurs, and proactive institutions maintain plans (including public relations plans) to help preserve their reputations in periods of perceived stress. Failure to appropriately manage reputation risk could cause severe damage to an institution.

And finally, comprehensive CFPs also address effective communication with key stakeholders, such as counterparties, credit-rating agencies, and customers. Smaller institutions that rarely interact with the media may benefit from having plans in place for how they will manage press inquiries and training front-line employees on how to respond to customer questions.

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INTERNAL CONTROLS

Adequate internal controls are integral to ensuring the integrity of an institution's liquidity risk management process. An effective system of internal controls promotes effective operations, reliable financial and regulatory reporting, and compliance with relevant laws and institutional policies. Effective internal control systems are designed to ensure that approval processes and board limits are followed and any exceptions to policies are quickly reported to, and promptly addressed by, senior management and the board.

Independent Reviews

A key internal control involves having an independent party regularly evaluate the various components of the liquidity risk management process. A review typically assesses the effectiveness of liquidity risk management programs, taking into account the complexity of the institution's liquidity risk profile. Institutions may achieve independence by assigning this responsibility to the audit function or other qualified individuals independent of the risk management process. To facilitate the independence of the review process, reviewers typically report key issues requiring attention (including instances of noncompliance with laws and regulations or the institution's policies) to the ALCO and audit committee for prompt action.

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EVALUATION OF LIQUIDITY

Liquidity Component Review

Under the *Uniform Financial Institutions Rating System*, a financial institution's liquidity position should be evaluated based on the current level and prospective sources of liquidity compared to funding needs, as well as the adequacy of funds management practices relative to the institution's size, complexity, and risk profile.

In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss.

In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition.
- The availability of assets readily convertible to cash without undue loss.
- Access to money markets and other sources of funding.
- The level of diversification of funding sources, both on- and off-balance sheet.
- The degree of reliance on short-term volatile funding sources (including borrowings and brokered deposits), to fund longer-term assets.
- The trend and stability of deposits.
- The ability to securitize and sell certain pools of assets.
- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

Rating the Liquidity Factor

A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

A rating of 2 indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.

A rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.

A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

A rating of 5 indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

UBPR Ratio Analysis

The UBPR is an important analytical tool that shows the impact of management's decisions and economic conditions on a bank's earnings performance and balance sheet composition. Examiners should review UBPR ratios when analyzing the institution's liquidity position. UBPR ratios should be viewed in concert with the institution's internal liquidity ratios on a level and trend basis when assessing the liquidity position. Examiners should use caution when reviewing peer group ratios as the comparisons may not be meaningful due to the varying liquidity and funding needs of different institutions.

Some of the more common ratios that examiners should review include:

- Net Non-Core Funding Dependence,
- Net Loans and Leases to Deposits,
- Net Loans and Leases to Total Assets,
- Short-Term Assets to Short-Term Liabilities,
- Pledged Securities to Total Securities,
- Brokered Deposits to Deposits, and
- Core Deposits to Total Assets.

Examiners should recognize that UBPR liquidity ratio analysis might not provide an accurate picture of the institution's liquidity position. Examiners should consider the quality, stability, and unique characteristics of asset and liability accounts before analyzing liquidity ratios. In particular, loans, securities, deposits, and borrowings should be evaluated before using UBPR ratios to draw conclusions concerning the liquidity position.

INTRODUCTION

Sensitivity to market risk reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or capital. For most community banks, market risk primarily reflects exposure to changing interest rates. Therefore, this section focuses on assessing interest rate risk (IRR). However, examiners may apply these same guidelines when evaluating foreign exchange, commodity, or equity price risks. A brief discussion of other types of market risks is included at the end of this section.

Market risks may include more than one type of risk and can quickly impact a financial institution's earnings and the economic value of its assets, liabilities, and off-balance sheet items. In order to effectively manage IRR, each institution should have an IRR management program that is commensurate with its size and the nature, scope, and risk of its activities.

The adequacy of a bank's IRR program is dependent on its ability to identify, measure, monitor, and control all material interest rate exposures. To do this accurately and effectively, institutions need:

- Appropriate IRR policies, procedures, and controls;
- Sufficiently detailed reporting processes to inform senior management and the board of IRR exposures;
- Comprehensive systems and standards for measuring and monitoring IRR; and
- Appropriate internal controls and independent review procedures.

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TYPES AND SOURCES OF INTEREST RATE RISK

IRR can arise from a variety of sources and financial transactions and has many components including repricing risk, basis risk, yield curve risk, option risk, and price risk.

Types of Interest Rate Risk

Repricing risk reflects the possibility that assets and liabilities will reprice at different times or amounts and negatively affect an institution's earnings, capital, or general financial condition. For example, management may use non-maturity deposits to fund long-term, fixed-rate securities. If deposit rates increase, the higher funding costs would likely reduce net yields on fixed-rate securities.

Basis risk is the risk that different market indices will not move in perfect or predictable correlation. For example, LIBOR-based deposit rates may change by 50 basis points while prime-based loan rates may only change by 25 basis points during the same period.

Yield curve risk reflects exposure to unanticipated changes in the shape or slope of the yield curve. It occurs when assets and funding sources are linked to similar indices with different maturities. For example, a 30-year Treasury bond's yield may change by 200 basis points, but a 3-year Treasury note's yield may change by only 50-basis points during the same time period. This risk is commonly expressed in terms of movements of the yield curve for a type of security (e.g., a flattening, steepening, or inversion of the yield curve).

Option risk is the risk that a financial instrument's cash flows (timing or amount) can change at the exercise of the option holder, who may be motivated to do so by changes in market interest rates. Lenders are typically option sellers, and borrowers are typically option buyers (as they are often provided a right to prepay). The exercise of options can adversely affect an institution's earnings by reducing asset yields or increasing funding costs.

For example, assume that a bank purchased a 30-year callable bond at a market yield of 10 percent. If market rates subsequently decline to 8 percent, the bond's issuer will be motivated to call the bond and issue new debt at the lower market rate. At the call date, the issuer effectively repurchases the bond from the bank. As a result, the bank will not receive the originally expected yield (10 percent for 30 years). Instead, the bank must re-invest the principal at the new, lower market rate.

Price risk is the risk that the fair value of financial instruments will change when interest rates change. For example, trading portfolios, held-for-sale loan portfolios, and mortgage servicing assets contain price risk. When interest rates decrease, the value of an institution's mortgage servicing rights generally decrease because the total cash flows from servicing fees decline as consumers refinance. Because servicing assets are subsequently measured at fair value, or carried at amortized cost and tested for impairment, the fair value adjustment or any impairment is reflected in current earnings.

Sources of Interest Rate Risk

Funding sources may involve repricing risk, basis risk, yield curve risk, or option risk, and examiners should carefully evaluate all significant relationships between funding sources and asset structures. Potentially volatile or market-based funding sources may increase IRR, especially when matched to a longer-term asset portfolio.

For example, long-term fixed-rate loans funded by purchased federal funds may involve repricing risk, basis risk, or yield curve risk. As a result, interest rate movements could cause funding costs to increase substantially while asset yields remain fixed.

Derivative instruments may be used for hedging but can introduce complex IRR exposures. Depending on the specific instrument, derivatives may create repricing, basis, yield curve, option, or price risk.

Mortgage banking operations may create price risk within the loan pipeline, held-for-sale portfolio, and mortgage servicing rights portfolio. Interest rate changes affect not only current values, but also future business volumes and related fee income.

Fee income businesses may be influenced by IRR, particularly mortgage banking, trust, credit card servicing, and non-deposit product sales. Changing interest rates could affect such activities.

Product pricing strategies may introduce IRR, particularly basis risk or yield curve risk. Basis risk exists if funding sources and assets are linked to different market indices. Yield curve risk exists if funding sources and assets are linked to similar indices with different maturities.

Embedded options associated with assets, liabilities, and off-balance sheet derivatives can create IRR. Embedded options are features that provide the holder with the right, but not the obligation, to buy, sell, pay down, payoff, withdraw, or otherwise alter the cash flow of the instrument. The holder of the option can be the bank, the issuer, or a counterparty. Many instruments contain embedded options that can alter cash flows and impact the IRR profile of the institution, including:

- Non-maturity deposits: Depositors have the option to withdraw funds at any time.
- Callable bonds: The issuer has the option to redeem all or part of a bond before maturity (based on contractual call dates).
- Structured notes: Options can vary by the type of instrument and may include step-up features, interest rate caps and floors, and cash flow waterfall triggers.
- Wholesale borrowings: Lenders may have a call option (requiring banks to repay borrowings), or borrowing banks may have a put option (allowing them to prepay borrowings).
- Derivatives: Derivative owners may hold an option to purchase additional securities or to exercise an existing derivative contract.
- Mortgage loans: Borrowers may have the option to partially or fully prepay the loan.
- Mortgage-backed securities (MBS): Borrowers' options to prepay individual mortgage loans included in an MBS loan pool can shorten the life of a tranche of loans within a security.

Embedded options can create various risks, such as contraction risk, extension risk, and negative convexity. Contraction risk increases when rates decline and borrowers can refinance at a lower rate, forcing the bank to reinvest those funds at a lower rate. Extension risk increases when rates rise and borrowers become less likely to prepay loans, thereby locking banks into below-market returns. Convexity measures the curvature in the relationship between certain investment prices and yields and reflects how the duration of an instrument changes as rates change.

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RISK MANAGEMENT FRAMEWORK

The IRR management framework sets forth strategies and risk tolerances as established in the institution's policies and procedures that guide the identification, measurement, management, and control of sensitivity to market risk. The framework begins with sound corporate governance and covers strategies, policies, risk controls, measurements, reporting responsibilities, independent review functions, and risk mitigation processes.

The formality and sophistication of the IRR management program should correspond with an institution's balance sheet complexity and risk profile. Less complex programs may be adequate for institutions that maintain basic balance sheet structures, have moderate exposure to embedded options, and do not employ complicated funding or investment strategies. However, all institutions should clearly document their procedures, and senior management should actively supervise daily operations.

More complex institutions need more formal, detailed IRR management programs. In such cases, management should establish specific controls and produce sound analyses that address all major risk exposures. Internal controls at complex institutions should include a more thorough independent review and validation process for the IRR models employed, as well as more rigorous requirements for separation of duties.

At all institutions, management and the board should understand the IRR implications of their business activities, products, and strategies, while also considering their potential impact on market, liquidity, credit, and operational risks.

Board Oversight

Effective board oversight is the cornerstone of sound risk management. The board of directors is responsible for overseeing the establishment, approval, implementation, and annual review of IRR management strategies, policies, procedures, and risk limits. The board should understand and regularly review reports that detail the level and trend of the institution's IRR exposure.

The board or an appropriate board committee should review sensitivity to market risk information at least quarterly. The information should be timely and of sufficient detail to allow the board to assess senior management's performance in monitoring and controlling market risks and to assess management's compliance with board-approved policies.

In order to fulfill its responsibilities in this area, the board is expected to:

- Establish formal risk management policies, strategies, and risk tolerance levels;
- Define management authorities and responsibilities;
- Communicate its risk management strategies and risk tolerance levels to all responsible parties;
- Monitor management's compliance with board-approved policies;
- Understand the bank's risk exposures and how those risks affect enterprise-wide operations and strategic plans; and
- Provide management with sufficient resources to measure, monitor, and control IRR.

Senior Management Oversight

Senior management is responsible for ensuring that board-approved IRR strategies, policies, and procedures are appropriately executed. Management should ensure that risk management processes consider the impact that various risks, including credit, liquidity, and operational risks could have on IRR.

Management is responsible for maintaining:

- Appropriate policies, procedures, and internal controls that address IRR management, including limits and controls that ensure risks stay within board-approved tolerances;
- Comprehensive systems and standards for measuring IRR, valuing positions, and assessing performance;
- Adequate procedures for updating IRR measurement scenarios and documenting key assumptions that drive IRR analysis; and
- Sufficient reporting processes for informing senior management and the board of the level of IRR exposure.

IRR reports should provide sufficient aggregate information and supporting details to enable senior management and the board to assess the impact of market rate changes and the impact of key assumptions in the IRR model.

The Asset/Liability Committee (ALCO) or a similar senior management committee should actively monitor the IRR profile. The committee should have sufficient representation across major functions (e.g., lending, investment, and funding activities) that they can directly or indirectly influence the institution's IRR exposure.

Policies and Procedures

Policies and procedures should be comprehensive and govern all material aspects of an institution's IRR management process. IRR policies and procedures should:

- Address board and senior management oversight;
- Outline strategies, risk limits, and controls;
- Define general methods used to identify risk;
- Describe the type and frequency of monitoring and reporting;
- Provide for independent reviews and internal controls;
- Ensure that significant new strategies, products, and businesses are integrated into the IRR management process;
- Incorporate the assessment of IRR into institution-wide risk management procedures so that interrelated risks are identified and addressed; and
- Provide controls over permissible risk mitigation activities, such as hedging strategies and instruments, if applicable.

Interest Rate Risk Strategies

Management should develop IRR strategies that reflect board-approved risk tolerances and do not expose the bank to excessive risk. An institution's risk profile is a function of the bank's activities and products. For example, an institution's IRR strategy may be to maintain a short-term, non-complex balance sheet. In order to implement that strategy, management may hold loans and securities with short durations and minimal embedded options and fund the assets with nonmaturity deposits and short-term borrowings.

Some institutions may conduct borrowing and investment transactions (leverage strategies) that are separate from the bank's core operations. In a typical leverage strategy, management acquires short- or intermediate-term wholesale funds or borrowings and invests those funds in longer-term bonds. Prior to implementing a leverage strategy, management should have the skills to understand, measure, and manage the risks. Management should be able to demonstrate a transaction's effect on the bank's risk profile and document that the exposure is within established risk limits.

Management should measure and document a strategy's effect on IRR exposure prior to implementation, periodically thereafter, and prior to any significant strategy changes. Institutions should consider stress testing all prospective strategies and ensure IRR exposures are within established risk limits.

Risk Limits and Controls

Risk limits should reflect the board's tolerance of IRR exposure by restricting the volatility of earnings and capital for given rate movements and applicable time horizons. Risk limits should be explicit dollar or percentage parameters. IRR exposure limits should be commensurate with the complexity of bank activities, balance sheet structure, and off-balance sheet items. At a minimum, limits should be expressed over one and two year time horizons, correspond to the internal measurement system's methodology, and appropriately address all key IRR risks and their effect on earnings and capital.

Examiners should carefully evaluate policy guidelines and board-approved risk limits. Institutions should establish limits that are neither so high that they are never breached, nor so low that exceeding the limits is considered routine and unworthy of action. Effective limits will provide management sufficient flexibility to respond to changing economic conditions, yet be stringent enough to prevent excessive risk-taking.

Policies should be in place to ensure excessive IRR exposures receive prompt attention. Controls should be designed to help management identify, evaluate, report, and address excessive IRR exposures. Policies should require management to regularly monitor risk levels, and controls should be altered as needed when economic conditions change or the board alters its risk tolerance level. Reports or stress tests that reflect significant IRR exposure should be promptly reported to the board (or appropriate board committee), and the board should review all risk limit exceptions and management's proposed actions.

Earnings-based risk limits may include volatility considerations involving:

- Net interest margin,
- Net interest income,
- Net operating income, and
- Net income.

Capital-based risk limits may include volatility considerations involving:

- Economic value of equity, and
- Other comprehensive income.

The board should provide staffing resources sufficient to ensure:

- Effective operation of measurement systems,
- Appropriate analytic expertise,
- Adequate training and staff development, and
- Regular independent reviews.

Risk Monitoring and Reporting

Management should report IRR in an accurate, timely, and informative manner. At least quarterly, senior management and the board should review IRR reports. Institutions that engage in complex or higher risk activities should assess IRR more frequently. At a minimum, IRR exposure reports should contain sufficient detail to permit management and the board to:

- Identify the source and level of IRR;
- Evaluate key assumptions, such as interest rate forecasts, deposit behaviors, and loan prepayments; and
- Determine compliance with policies and risk limits.

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INTEREST RATE RISK ANALYSIS

An effective risk management system must clearly quantify and timely report risks. Institutions should have sound IRR measurement procedures and systems that assess exposures relative to established risk tolerances. Such systems should be commensurate with the complexity of the institution. Although management may rely on third-party IRR models, they should fully understand the underlying analytics, assumptions, and methodologies of the models and ensure such systems and processes are incorporated appropriately in the strategic (long-term) and tactical (short-term) management of IRR exposures.

Management should conduct careful due diligence/pre-acquisition reviews to ensure they understand the IRR characteristics of new products, strategies, and initiatives. Management should also consider whether existing measurement systems can adequately capture new IRR exposures. When analyzing whether or not a product or activity introduces new IRR exposures, management should consider that changes to an instrument's maturity, repricing, or repayment terms can materially affect a product's IRR characteristics. Institutions may be able to run alternative scenarios in their IRR models to test the effects of new products and initiatives. If an institution is unable to run alternative scenarios using existing models, they should use other methods to estimate the risk of new products, strategies, and initiatives. All institutions should ensure that the method(s) they use to evaluate new products and initiatives (running alternative scenarios in existing models or through other means), adequately captures potential market risks.

Management should consider earnings and the economic value of capital when evaluating IRR. Reduced earnings or losses can harm capital, liquidity, and the institution's reputation. Risk-to-earnings measurements are normally derived from simulation models that estimate potential earnings variability. Economic value of equity (EVE) measurements allow for longer-term earnings and capital analysis. The analysis may be useful for long-term planning and may also indicate a need for short-term actions to mitigate IRR exposure. Long term earnings-at-risk simulations (5 to 7 years) can be a helpful supplement to EVE measures, but they are not a replacement for EVE measurements.

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INTEREST RATE RISK MEASUREMENT METHODS

Institutions are encouraged to use a variety of measurement methods to assess their IRR profile. Regardless of the methods used, a bank's IRR measurement system should be sufficient to capture all material balance sheet items and to quantify exposures to both earnings and capital. The most common types of IRR measurement systems are:

- Gap Analysis,
- Duration Analysis,
- Earnings Simulation Analysis,
- Earnings-at-Risk,
- Capital-at-Risk, and
- Economic Value of Equity.

Gap Analysis

Gap analysis is a simple IRR methodology that provides an easy way to identify repricing gaps. It can also be used to estimate how changes in rates will affect future income. However, gap analysis has several weaknesses and is generally not sufficient as a financial institution's sole IRR measurement method. Gap analysis can be a first step in identifying IRR exposures and may serve as a reasonableness check for more sophisticated forms of IRR measurement, particularly in less complex institutions with simple balance sheets.

Gap analysis helps identify maturity and repricing mismatches between assets, liabilities, and off-balance sheet instruments. Gap schedules segregate rate-sensitive assets (RSA), rate-sensitive liabilities (RSL), and off-balance sheet instruments according to their repricing characteristics. Then, the analysis summarizes the repricing mismatches for defined time horizons. Additional calculations can then estimate the effect the repricing mismatches may have on net interest income.

A basic gap ratio is calculated as:

$$\frac{\text{RSA}^{\textit{minus}}\ \text{RSL}}{\text{Average Earning Assets}}$$

Gap analysis may identify periodic, cumulative, or average mismatches, or it may show the ratio of RSA-RSL divided by average assets or total assets. However, using those denominators does not produce a standard gap ratio. They simply provide other ways of describing the degree of repricing mismatches.

A bank has a positive gap if the amount of RSAs repricing in a given period exceeds the amount of RSLs repricing during the same period. When a bank has a positive gap, it is said to be asset sensitive. Should market interest rates decrease, a positive gap indicates that net interest income would likely also decrease. If rates increase, a positive gap indicates that net interest income may also increase.

Conversely, a bank has a negative gap when the amount of RSLs exceeds the amount of RSAs repricing during the same period. When a bank has a negative gap, it is said to be liability sensitive, and a decrease in market rates would likely cause an increase in net interest income. Should interest rates increase, a negative gap indicates net interest income may decrease. While the terms asset and liability sensitive are generally used to describe gap results, they can also be used to describe the results of other models, or even the general IRR exposure of a bank.

The gap ratio can be used to calculate the potential impact on interest income for a given rate change. This is done by multiplying the gap ratio by the assumed rate change. The result estimates the change to the net interest margin.

For example, assume a bank has a 15 percent one-year average gap. If rates decline 2 percent, then the projected impact is a 30 basis point decline in the net interest margin (15 percent x 2 percent). This estimate assumes a static balance sheet and an immediate, sustained interest rate shift.

Gap analysis has several advantages. Specifically, it:

- Identifies repricing mismatches,
- Does not require sophisticated technology,
- Is relatively simple to develop and use, and
- Can provide clear, easily interpreted results.

However, the weaknesses of gap analysis often overshadow its strengths, particularly for a majority of financial institutions. For example, gap analysis:

- Generally captures only repricing risk,
- Assumes parallel rate movements in assets and liabilities,
- Generally does not adequately capture embedded options or complex instruments,
- May not identify material intra-period repricing risks, and
- Does not measure changes in the economic value of capital.

Some gap systems attempt to capture basis, yield curve, and option risk. Multiple schedules (dynamic or scenario gap analysis) can show effects from non-parallel yield curve shifts. Additionally, sensitivity factors may be applied to account categories. These factors assume that coupon rates will change by a certain percentage for a given change in a market index. The market index is designated as the driver rate (sophisticated systems may use multiple driver rates). These sensitivity percentages, also called beta factors, may dramatically change the results.

Institutions can also use sensitivity factors in their gap analysis to refine non-maturity deposit assumptions. For example, management may determine that the cost of funds for money market deposit accounts (MMDA) will increase by 75 basis points whenever the six-month Treasury bill rate increases by one percent. Thus, management might consider only 75 percent of MMDA balances as rate sensitive for gap analysis. Management may expand its analysis by preparing gap schedules that assume different market rate movements and changing customer behaviors.

As noted above, gap analysis is generally not suitable as the sole measurement of IRR for the large majority of institutions. Only institutions with very simple balance sheet structures, limited assets and liabilities with embedded options, and limited derivative instruments and off-balance sheet items should consider relying solely on gap analysis for IRR measurements.

Duration Analysis

Duration analysis measures the change in the economic value of a financial instrument or position that may occur given a small change in interest rates. It considers the timing and size of cash flows that occur before the instrument's contractual maturity. Additional information on different types of duration analysis is included below and in the glossary.

Macaulay duration calculates the weighted average term to maturity of a security's cash flows. Duration, stated in months or years, always:

- Equals maturity for zero-coupon instruments,
- Equals less than maturity for instruments with payments prior to maturity,
- Declines as time elapses,
- Is lower for amortizing instruments, and
- Is lower for instruments with higher coupons.

Modified duration, calculated from Macaulay duration, estimates price sensitivity for small interest rate changes. An instrument's modified duration represents its percentage price change given a small change in interest rates.

Modified duration assumes that interest rate shifts will not change an instrument's cash flows. As a result, it does not estimate price sensitivity with an acceptable level of precision for instruments with embedded options (e.g., callable bonds or mortgages). Institutions with significant option risk should not rely solely upon modified duration to measure IRR.

Effective duration estimates price sensitivity more accurately than modified duration for instruments with embedded options and is calculated using valuation models that contain option pricing components. First, the user must determine the instrument's current value. Next, the valuation model assumes an interest rate change (usually 100 basis points) and estimates the instrument's new value based on that assumption. The percentage change between the current and forecasted values represents the instrument's effective duration.

All duration measures assume a linear price/yield relationship. However, that relationship actually is curvilinear, which means that large shifts in rates have a greater effect than smaller changes. Therefore, duration may only accurately estimate price sensitivity for rather small (up to 100 basis point) interest rate changes. Convexity-adjusted duration should be used to more accurately estimate price sensitivity for larger interest rate changes (over 100 basis points).

Duration analysis contains significant weaknesses. Accurate duration calculations require significant analysis and complex management information systems. Further, duration only measures value changes accurately for relatively small interest rate fluctuations. Therefore, institutions must frequently update duration measures when interest rates are volatile or when any significant change occurs in economic conditions, market conditions, or underlying assumptions.

Earnings Simulation Analysis

Earnings simulation models (such as pro-forma income statements and balance sheets) estimate the effect of interest rate changes on net interest income, net income, and capital for a range of scenarios and exposures. Historically, comprehensive simulation models (both long- and short-term) were primarily used by larger, more complex institutions. Current technology allows less complex institutions to perform cost effective, comprehensive simulations of the potential impact of changes in market rates on earnings and capital.

A simulation model's accuracy depends on the use of accurate assumptions and data. Like any model, inaccurate data or unreasonable assumptions lead to inaccurate or unreasonable results.

A key aspect of IRR simulation modeling involves selecting an appropriate time horizon(s) for assessing IRR exposures. Simulations can be performed over any period and are often used to analyze multiple horizons identifying short-, intermediate-, and long-term risks. When using earnings simulation models, IRR exposures are often more accurate when projected over at least a two-year period. Using a two-year time frame better captures the full impact of important transactions, tactics, and strategies, which may be hidden by only viewing projections over shorter time horizons. Management should be encouraged to measure earnings at risk for each one-year period over their simulation horizon to better understand how risks evolve over time. For example, if the bank runs a two year simulation, one- and two-year simulation reports should be generated.

Longer-term earnings simulations of up to five to seven years may be recommended for institutions with material holdings of products with embedded options. Such extended simulations can be helpful for IRR analysis and economic value measurements. It is usually easier for an extended simulation model to identify when long-term mismatches occur (e.g., it can show that a bank is liability sensitive in years two, three, and four, but asset sensitive in years five, six, and seven), whereas EVE models aggregate the effect of such mismatches.

Institutions may vary their simulation rate scenarios based on factors such as pricing strategies, balance sheet compositions, hedging activities, etc. Simulation may also measure risks presented by non-parallel yield curve shifts.

Institutions can run static or dynamic simulations. Static models are based on current exposures and assume a constant balance sheet with no new growth. The models can also include replacement-growth assumptions where replacement growth is used to offset reductions in the balance sheet during the simulation period.

Dynamic simulation models may assume asset growth, changes in existing business lines, new business, or changes in management or customer behaviors. Dynamic simulation models can be useful for business planning and budgeting purposes. However, these simulations are highly dependent on key variables and assumptions that are difficult to project with accuracy over an extended period. Also, when management changes simulation scenarios, it may lose insights on the bank's current IRR positions. Dynamic simulations can provide beneficial information but, due to their complexity and multitude of assumptions, can be difficult to use effectively and may mask significant risks.

Projected growth assumptions in dynamic modeling often alter the balance sheet in a manner that reflects reduced IRR exposure. For example, if a liability-sensitive bank assumes significant growth in one-year adjustable rate mortgages or long-term liabilities and the growth targets are not met, management may have underestimated exposures to changing interest rates. Therefore, when performing dynamic simulations, institutions should also run static or no-growth simulations to ensure they produce an accurate, comparative description of the bank's IRR exposure.

Economic Value of Equity

Despite their benefits, both static and dynamic earnings simulations have limitations in quantifying IRR exposure. As a result, economic value methodologies should also be used to broaden the assessment of IRR exposures, particularly to capital.

Economic value methodologies attempt to estimate the changes in a bank's economic value of capital caused by changes in interest rates. A bank's economic value of equity represents the present value of the expected cash flows on assets minus the present value of the expected cash flows on liabilities, plus or minus the present value of the expected cash flows on off-balance sheet instruments.

Typically, an EVE model projects the value of a bank's economic capital for a base-case scenario, and then compares it to a stress scenario. These models go by various names and acronyms, such as EVE, MVE (Market Value of Equity), or NPV (Net Present Value).

In theory, an economic valuation approach has a broader scope than an earnings approach, since it captures all anticipated cash flows and is generally more effective in capturing embedded options. An economic valuation approach measures all estimated changes to the balance sheet and earnings, as opposed to gap models and earnings simulations, which generally measure shorter-term balance sheet and earnings projections. Economic valuation methods can be an effective supplement to short-term measures.

Many institutions can benefit from the use of economic value methods and should establish EVE risk limits and integrate economic valuation methods into their IRR measurement procedures. Because different EVE models calculate different base-case economic capital values for the same bank, limits should generally be based on the change of economic capital rather than absolute levels of economic capital. Accordingly, examiners should assess the relative changes in economic value of capital as a key indication of risk.

Most economic value models use a static approach where the analysis does not incorporate new business lines and all financial instruments are held until final payout or maturity. The analysis shows a snapshot of the risk inherent in a portfolio or balance sheet. However, this is not always the case as some models incorporate dynamic techniques that provide forward-looking estimates of economic value.

Because EVE estimates the future cash flows of the bank's financial instruments, the cash flows can be difficult to accurately quantify. This can be especially true for non-maturity deposits since the products generally have uncertain cash flows and durations. Consequently, estimating the value of these accounts can be difficult and requires the use of several assumptions. Management should be cautious when making EVE assumptions, as output errors can be more pronounced in long-term measurements. Examiners should consider the significance, accuracy, and sensitivity of underlying assumptions when assessing EVE models.

When modeling complex products with embedded options, the importance of data aggregation and stratification should not be overlooked. Complex or structured securities should be modeled on an individual basis, and homogenous balance sheet accounts should be aggregated by common IRR features. For example, loan portfolios, when possible, should be aggregated by product type, coupon, maturity, and prepayment volatility. For adjustable rate portfolios, modeling should include more IRR attributes, such as coupon reset dates and indexes; embedded caps and floors; and prepayment penalties.

Despite being different methodologies, earnings simulation and EVE models generally provide a consistent view of IRR trends. However, the two approaches may also generate divergent outcomes. In many cases, earnings simulation models provide shorter-term results and EVE models provide a much longer-term risk profile. These divergent outcomes can result from a variety of factors, such as the structure of the balance sheet, including the bank's derivative positions and off-balance sheet items, the interest rate environment, the timing of asset/liability mismatches, the sensitivity of funding sources to interest rate changes, and the volume of fixed- or floating-rate assets. Because many versions of each model type are available, management should ensure that the models used capture all significant risk factors.

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STRESS TESTING

Stress testing, which includes both scenario and sensitivity analysis, is an integral part of IRR management. Scenario analysis estimates possible outcomes given an event or series of events, while sensitivity analysis estimates the impact of change in one or only a few of a model's significant parameters.

Management should assess a range of alternative interest rate scenarios when conducting scenario analyses. The range should be sufficient to fully identify repricing, basis, and yield curve risks as well as the risk of embedded options. In many cases, static interest rate shocks consisting of parallel shifts in the yield curve of only plus and minus 200 basis points are not sufficient to adequately assess IRR exposure. Therefore, management should regularly assess a wide range of exposures across different periods, including changes in rates of greater magnitude (e.g., up and down 300 and 400 basis points). When conducting stress tests, management should give special consideration to financial instruments or markets where concentrations exist, as such positions may be difficult to unwind or hedge during periods of market stress. Management should compare stress test results against approved limits.

Management should ensure their scenarios are rigorous and consistent with the existing level of rates and the interest rate cycle. For example, in low-rate environments, scenarios involving significant declines in market rates can be deemphasized in favor of increasing the number and size of alternative rising-rate scenarios. Alternatively, there may be instances where more extreme stress tests would be desirable.

Depending on a bank's IRR profile, stress scenarios should include:

- Instantaneous and significant rate changes,
- Substantial rate changes over time,
- Changes in the relationships between key market rates, and
- Changes in the shape or slope of the yield curve.

Not all financial institutions need to use the full range of the scenarios discussed above. Non-complex institutions (for instance, institutions with limited embedded options or structured products) may be able to justify running fewer or less intricate scenarios.

Management should run repricing risk scenarios regularly. When applicable, institutions should also run scenarios for other IRR risks, such as basis and yield curve risks. Institutions should assess these risk exposures at least annually or when the risk profile of a bank changes, for example, because of acquisitions, significant new products, or new hedging programs. If a bank shows material exposure to one of these risks, an appropriate scenario should be included in monthly or quarterly IRR monitoring. If an institution has relatively non-complex exposure to basis, yield curve, or options risk, management should document that the exposure is minimal. For example, management may document its assessment with a short narrative description of what percentage of assets and liabilities are tied to various indices and a description of the potential impact of the risks. These reports should typically be reviewed by the board at least annually.

Sensitivity analysis should be included in stress testing to help determine which assumptions have the most influence on a model's output. By identifying key assumptions, management, when necessary, can refine the assumptions to increase the accuracy of their models. The most significant variables can be tested by keeping all other variables constant, changing the variable in question, and comparing the results to the base-case scenario. Additionally, sensitivity analysis can be used to determine the conditions under which key business assumptions or model parameters break down or when IRR may be exacerbated by other risks or earnings pressures. When management includes assumptions based on strategic initiatives, it is imperative that they assess the impact of not meeting projections. (Refer to Sensitivity Testing - Key Assumptions for more details.)

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INTEREST RATE RISK MEASUREMENT SYSTEMS

The IRR measurement system should be appropriate for institution's risk profile. The measurement system should capture all material sources of IRR and generate meaningful reports for senior management and the board of directors. Management should ensure risks are measured over a relevant range of interest rate changes, including meaningful stress situations. Further, the measurement system must be subject to appropriate internal controls and periodic independent reviews. The IRR measurement process should be well documented and administered by individuals with sufficient technical knowledge.

IRR measurement systems can range from simple methods to sophisticated programs that include stochastic data modeling. (Stochastic modeling involves using one or more random variables in a model.) However, all measurement systems should use generally accepted financial concepts and risk measurement techniques and have an adequate level of transparency. If a third-party model is used, management should review the adequacy and comprehensiveness of the vendor's model-validations and internal control reviews. Also, management should consider the capabilities of the software to meet the institution's future needs and the adequacy of ongoing vendor support and training.

A bank's IRR measurement system is a critical part of its overall risk management process. Examiners rely heavily on the output of the measurement systems when assessing sensitivity to market risk. Accordingly, the review of such systems and their operation is a crucial element of the examination process. The review process should address the following items:

- Capabilities of the measurement system,
- Accuracy of system inputs,
- Reasonableness and documentation of material assumptions,
- Usefulness of system output/reports, and
- Adequacy of periodic variance analysis.

Measurement System Capabilities

The IRR measurement system should capture and reliably estimate all material risk exposures. Therefore, the system should consider all significant balance sheet categories, income statement items, and risk factors. For example, if an institution has material holdings of mortgage loans or mortgage-backed securities, then its measurement system should be able to adequately incorporate prepayment projections. Likewise, if the bank has a mortgage banking operation that generates material fee income, its system should capture the rate sensitivity of this noninterest income.

When an institution develops an IRR model internally or considers acquiring a third-party model, management should assess its suitability by evaluating the model's ability to reasonably capture all relevant and material IRR exposures. Additionally, management should periodically re-evaluate the adequacy of a model in use as risk positions, strategies, and activities change.

To effectively use its IRR measurement system, management must fully understand the system's capabilities, limitations, quantitative methodologies, and use of assumptions.

System Documentation

Both purchased and internally developed systems should be supported by adequate documentation. System documentation should provide complete information regarding the factors discussed above. Management should be familiar with and retain all pertinent system documentation. Management should also review and maintain documentation of changes or upgrades to the model.

Adequacy of Measurement System Inputs

A model's accuracy depends on the assumptions and data used. Like any model, inaccurate data or unreasonable assumptions will render inaccurate results.

System data should accurately reflect the bank's current condition. When evaluating the adequacy of a model, management should consider the extent to which the model uses automated versus manual processes; whether the model has automated interfaces with the bank's core systems; and the funds, hardware, staff, and expertise needed to run and maintain the model.

Examination of the system's input process should focus on the procedures for inputting and reconciling system data, categorizing and aggregating account data, ensuring the completeness of account data, and assessing the effectiveness of internal controls and independent reviews.

The internal control process must be comprehensive enough to ensure that data inputs are accurate and complete prior to running the system and generating reports. The bank may input data manually, through data-extract programs, or a combination of both techniques. Internal control procedures should be established to ensure that input data, such as general ledger balances and contractual terms, are accurately captured. Institutions should verify system inputs by having experienced personnel reconcile the balances to the general ledger. This is often done using automated software that can identify and report exception items.

In addition to capturing account balances, institutions with complex balance sheets should use measurement systems that adequately capture the embedded market risk of all material on- and off-balance sheet activity. Most measurement systems allow for the input of the following contractual terms:

- Current balance,
- Contractual maturities,
- Principal and interest payments and frequencies,
- Coupon rates and repricing frequencies,
- Contractual caps and floors, and
- Contractual optionality (such as security or borrowing calls).

Account Aggregation

Account aggregation is the process of grouping together accounts of similar types and cash flow characteristics. This is an important component of the data input process as account aggregation improves the measurement system's efficiencies. Typically, loans of similar rate, maturity, and type (e.g., 6 percent, 30 year, residential loans) are aggregated. Grouping 6 percent, 30 year residential loans together may be appropriate, but grouping together 6 percent fixed-rate loans with 6 percent adjustable-rate loans is not.

The degree of account aggregation will vary from one institution to another. Institutions should ensure the model allows for a sufficient separation of accounts with significantly different cash flow patterns. For example, models that aggregate information based on Call Report data may not provide the granularity necessary for institutions with significant levels of embedded options. When applicable, institutions should ensure their systems have the ability to model highly structured instruments and bank-specific products.

Both contractual and behavioral characteristics should be considered when determining the cash flow patterns of accounts to aggregate. The process of determining which accounts are combined should be transparent, documented, and periodically reviewed. Furthermore, requests for changes to existing groups or new account aggregations should be formalized and documented. Institutions should maintain documentation disclosing the characteristics of aggregated assets and liabilities (including all derivative instruments), and off-balance sheet items.

Assumptions

Assessing the reasonableness of assumptions is a critical part of reviewing an IRR measurement system. It is important that assumptions accurately reflect management's expectations regarding interest rates, customer behaviors, and local and macro-economic factors. Assumptions are typically derived using a combination of internal analysis and external sources. All material assumptions should be regularly updated and supported with thorough analysis and documentation.

IRR measurement systems rely on assumptions regarding key parameters, such as:

- Projected interest rates,
- Driver rate relationships,
- Non-maturity deposits, and
- Prepayments.

It is important that material assumptions be updated regularly to reflect the current market and operating environment. Furthermore, the process for developing material assumptions should be formalized and periodically assessed (at least annually for critical assumptions). This periodic assessment of the information and processes used to generate assumptions may prompt management to reevaluate its assumptions in order to better reflect current strategies or customer behaviors.

Sensitivity Testing - Key Assumptions

Proper IRR management requires an understanding of which assumptions have the greatest impact on results. Through sensitivity testing, management can identify the assumptions that have the most effect on model results. Documentation and monitoring should reflect the relative importance of assumptions. Sensitivity testing can also be used to identify less material assumptions, where assumption documentation, monitoring, and testing are less critical. Sensitivity testing can also be used to identify weaknesses in the model. For example, if an institution tested an assumption that was expected to have a critical impact on the model result, but instead found that it had little or no influence on the model output, further investigation would be warranted.

Sensitivity testing should only be applied to one assumption at a time and should test the effects of both large and small changes in an assumption on the model's overall output. For example, if an institution wanted to test the sensitivity of non-maturity deposit decay rates, it could alter its non-maturity deposit beta assumptions incrementally (up and down) in multiple scenarios (e.g., a 10, 25, and 50 percent increase/decrease from the base-case assumption). The revised results could then be compared to the base-case scenario. If a change in the assumption disproportionately impacts the model, then management should implement more robust assumption documentation, monitoring, and testing. Another sound practice when testing assumptions is to determine how extreme changes in key assumptions impact results and whether the results approach approved tolerance levels.

Conducting sensitivity testing on an annual basis is usually adequate for many institutions. However, more frequent tests should be performed if concerns are identified. Institutions should document the results of sensitivity testing and present the results to management and the board. The results of sensitivity testing should be considered when setting various assumptions. Management should conduct thorough due diligence before changing key assumptions that can materially alter model results. Key assumption changes should be properly documented and reviewed by the board.

Projected interest rate assumptions are a critical part of measuring IRR and may be generated by internal analysis or external sources. Internal interest rate forecasts, which may be derived from implied forward yield curves, economic analysis, or historical regressions, should be documented to support the assumptions used in the analysis. Key rate assumptions that should be considered include assumptions for general market rates, repricing rates, replacement interest rates, and discount rates.

Most institutions perform scenario analysis using deterministic interest rate yield curves. With the deterministic method, all interest rate scenarios are set by the user; that is, management selects the interest rate changes to simulate in the model. The deterministic method differs from the more complex and sophisticated stochastic method where multiple scenarios are generated using random path-dependent variables. (Further discussion of deterministic and stochastic methods may be found in the glossary.)

Analysis should be performed using a base-case interest rate scenario, as well as low-probability/high-risk scenarios, so that management can better estimate the impact to earnings and capital levels in stressed interest rate scenarios. The base-case interest rate scenario should be consistent with other forecasts used in the bank's overall planning process and should remain reasonably consistent across reporting periods. Any changes in the source of interest rate forecasts between reporting periods should be justified and documented.

Driver rates are used extensively in most income simulation and EVE models. The models capture the relationship between primary market interest rates (driver rates) and the rates of bank products. While there may be no direct connection between bank rates and the driver rate, the driver rate is chosen as a proxy for management's reaction to market changes. This frees management from needing to set rates explicitly for each loan or deposit type for each projected scenario. In most cases, bank rates are set to move in relation to the driver rate. The move may be referred to as a spread (when a specified number of basis points are added to or subtracted from a driver rate), or as a beta factor (when based on a percentage change in a driver rate). For example, management might specify that the rate paid on MMDAs will increase 75 basis points if the yield on one-year Treasury bills increases 100 basis points. By designating this relationship, pricing on all products linked to the driver rate will change to reflect the relationship built into the model. More complex systems may use a variety of driver rates tailored for different products. While most systems maintain static rate relationships, more sophisticated systems can alter relationships for different interest rate environments.

Spread or beta assumptions should be based on an analysis of the relationship between the product (e.g., MMDA) and the driver rate (e.g., federal funds rate). To determine the spread or beta, management can perform correlation or regression analysis to quantify the historical relationship between the product and driver rates.

Correlation analysis may also be used to determine the level of basis risk when instruments are tied to different indices. For instance, if an institution enters into a leveraging strategy that uses borrowed funds tied to LIBOR to invest in U.S. Treasury securities, correlation analysis can be performed to determine how closely the related rates move together. Less correlated instruments present greater basis risk.

Non-maturity deposit (NMD) rate sensitivity is typically one of the most critical and most difficult assumptions that management makes when measuring IRR exposure. The potential actions of management and customers need to be considered. Just as customers have control over the level and location of their deposit accounts, management has broad control over the rates paid on these accounts. In setting rates, management must take into account a wide array of factors, including local and national competition, the bank's funding needs, and the relative costs of alternative funding sources.

The assumptions modeled for NMDs should reflect both aspects of this relationship: management's control over rates and customers' control over their funds. Consideration should be given not only to historical correlation analysis, but also to management's intentions regarding future rate movements. If the measurement system has the capacity to reflect different assumptions for rising and falling rates, management should establish rate sensitivity assumptions for both scenarios.

Non-maturity deposits present a unique problem in EVE modeling because they lack contractual maturity dates. Generally an asset or liability must have a maturity date in order to be valued under present value methods. Therefore, in order to successfully model these accounts, an EVE model must use management's assumptions regarding the maturity of the accounts. The most common of these assumptions is the decay rate assumption. The decay rate reflects the amount of nonmaturity (and other) deposits that may be withdrawn or accounts closed in a given rate environment.

Management should use NMD assumptions that reflect institution-specific factors and avoid overreliance on industry estimates or default assumptions contained in off-the-shelf IRR models. Some institutions have difficultly measuring decay rates on NMDs due to limited historical data, acquisitions, mergers, or a lack of technical expertise. Industry averages provide approximations, but are often not the most accurate estimates because they are not tailored to the bank's products, pricing strategies, market, and experience. However, management can use industry estimates as a starting point until they develop adequate data sets. Industry estimates can also serve as a benchmarking tool to test the reasonableness of internal assumptions. Management should consider modeling different decay rates under various rate scenarios and, when appropriate, should consider engaging third parties to assist in determining NMD assumptions. Examiners should recognize that NMD decay rate are often imprecise, yet significant factors in IRR analysis.

Assumptions regarding NMDs are particularly critical in market environments in which customer behaviors may be atypical, or in which institutions are subject to heightened competition for such deposits. Generally, rate-sensitive and higher-cost deposits, such as brokered and Internet deposits, reflect higher decay rates than other types of deposits. Also, institutions experiencing or projecting lower capital levels that may trigger brokered and high interest rate deposit restrictions should adjust deposit assumptions accordingly.

Prepayment assumptions are important considerations when measuring optionality risk. Prepayment risk (or conversely, extension risk) on loans and mortgage-related securities are highly influenced by the direction of interest rates. Prepayment assumptions may also be affected by factors such as loan size, geographic area, credit score, and fixed versus variable rates. It is critical that assumptions be reasonable for each rate scenario measured. For example, in an increasing rate environment, prepayment assumptions should typically reflect lower prepayments than in a declining rate environment.

Financial institutions may actively track internal prepayment data or obtain prepayment statistics from external sources. Management should consider the reliability and applicability of external data and be cognizant that market stress, externalities, or a change in the institution's condition may influence customer behaviors.

Management should ensure that assumptions are appropriate given the characteristics of the institution's various portfolios (i.e., prepayment speeds for a portfolio of five percent loans would likely differ from a portfolio of eight percent loans). In addition, proper aggregation of the assets is necessary before applying assumptions.
Documentation and support of all significant assumptions, including projected rates, spreads, customer behaviors, and NMD rates should be maintained and available for examiner review. Some measurement systems have only limited ability to change model assumptions, in which case documentation may be limited. Even in those cases, an analysis of the applicability of the embedded assumptions to the subject bank should be performed and maintained. More complex systems entail a vast array of assumptions, and thorough documentation of every assumption cannot be realistically expected. However, management should thoroughly support and document assumptions related to the most significant institution or model risks.

Measurement System Reports

Many measurement systems are capable of providing summary reports detailing key model assumptions. Examiners should review a copy of these reports when analyzing a measurement system.

Most asset/liability management systems offer an array of summary reports (such as a chart of accounts and account attribute reports) that aid management in reviewing measurement system assumptions. These reports may also provide information regarding the contractual terms and parameters that have been entered into the system for various account types and financial instruments.

If an institution is unable to provide assumption summaries, examiners should determine whether the absence of the report is due to measurement system limitations or bank personnel's lack of familiarity with system capabilities. Typically, measurement system user manuals will provide a list of reports that may be generated by the system.

Assumption summary reports are an important tool that management and examiners can use to ensure that reasonable assumptions have been entered into the measurement system. The reports can also be useful to examiners when management does not maintain adequate documentation of current assumptions. For example, when assumption summary reports are regularly produced and retained, examiners can compare current assumptions against historical assumption reports.

To ensure proper controls over significant assumption changes, management should establish procedures for reviewing the reasonableness of assumption changes and for approving those changes before they occur.

Measurement System Results

After data and assumptions have been input, the IRR measurement system performs calculations. The calculations measure the IRR in the bank's assets, liabilities, and off-balance sheet items. The measurement system should generate summary reports that highlight the bank's sensitivity to changes in market rates given various interest rate scenarios. These reports typically indicate the change in net income or net interest income and/or economic value of equity. Some systems may also provide a gap report highlighting asset/liability mismatches over various time horizons. More detailed reports may be available on some systems that can be used to test the reasonableness, consistency, and accuracy of the output. They may also assist the examiner in identifying or verifying the system's underlying assumptions.

Management should have formalized procedures in place for reviewing measurement system results and reporting to the board or a board committee. Reports provided to the board and senior management should be clear, concise, timely, and informative in order to assist the board and senior management in making decisions. The results of the measurement system should also highlight deviations from board-approved IRR exposure limits. Examiners should review follow-up actions and communication relevant to any material breaches in board-approved limits. Examiners should also review the presentations or analyses provided to senior management, board members, and the ALCO, as well as any relevant meeting minutes.

Variance Analysis

Variance analysis (also known as back-testing) can provide valuable insights into the accuracy and reasonableness of IRR models and is an integral part of the control process for IRR management. Variance analysis involves identifying material differences between actual and forecasted income statement and balance sheet amounts and ascertaining the causes of the differences. Variances can be readily identified by direct comparison of the financial statements for a particular forecast period, or by using key financial indicators, such as net interest margin, cost of funds, or asset-yield comparisons.

Variance analysis can help management understand the primary reasons for material differences between projected and actual results. It can also provide a means to improve the precision of the IRR measurement system. Periodic variance analysis helps assure management and the board that the system is accomplishing its primary goal of providing meaningful information on the level of IRR. Variance analysis provides an opportunity for a deeper understanding of both the system and its results.

Variance analysis should be done periodically and no less frequently than annually. Further, management should document their analysis, highlighting any material variances, the primary cause of identified variances, and any proposed or implemented corrective actions.

Variances resulting from errors can be broken down into three major components: input, modeling, or assumption errors. When conducting variance analysis, management should attempt to pinpoint the cause of all material variances. Mathematical flaws, while relatively rare in widely available purchased systems, can occur. Other types of modeling errors can be caused by inaccurate data input, user unfamiliarity with the model, over-aggregation of account types, or the use of a model with insufficient capabilities.

Data errors can be minimized by strong internal controls and may be identified through selective transaction testing. Many models can compare the results of historical IRR simulations with actual financial results. Significant variances can help management identify, and subsequently correct, identified issues with the model setup, such as inappropriate account aggregations or the failure to include key account characteristics.

Assumption Variance Analysis

All IRR measurement systems rely heavily on a series of assumptions, and assessing their reasonableness is critical to ensuring the integrity of the measurement system results. Just as actual financial results can be expected to vary from forecasts, the assumptions that form the basis of that forecast can be expected to vary from actual events.

Institutions should have formalized procedures for periodically identifying material differences between assumed and realized values. Formal procedures help identify the key reasons for variances. Even if material financial variances are absent, the model's significant assumptions should be compared to actual performance. Compensating differences may have masked important variances. For example, an institution with a large mortgage portfolio may find that actual prepayment speeds were significantly higher than projected, but new loan production replaced the run-off. In this case, there may only be an immaterial variance in the ending loan balance, but a significant variance in projected vs. actual prepayments.

Given the large number of assumptions inherent in most measurement systems, a thorough review of every assumption during each measurement cycle is unrealistic. However, key assumptions should be checked against actual behaviors on a regular basis. Key assumptions include those dealing with interest rate movements, driver rates, non-maturity deposits, prepayment speeds, and account aggregations. Variance analysis should be used to identify the differences attributable to rate assumptions and other factors in order to better understand how those factors influenced modeled results.

Driver rate variances occur when the expected correlation between a bank rate and its driver rate does not act as predicted. Variance analysis is used to determine the significance of the difference and should address whether the difference is due to an inaccurate correlation between the subject and driver rate, or due to inappropriate spreads or beta factors. Ideally, the relationship between subject and driver rates should be documented, and the relationship should factor in historical correlations and management's intentions regarding future movements.

Non-maturity deposit assumptions may cause significant variances. If the measurement system forecast an increasing net interest margin in a rising rate environment, while the actual margin declined, the cause may involve NMD assumptions. Many models treat NMD rates as very insensitive to yield curve changes, while actual practices are to manage the rates more actively. This can lead to model measurements that show the bank as asset sensitive or neutral, when past performance shows it to be liability sensitive. Periodic variance analysis may identify this discrepancy and allow management to more effectively use the IRR measurement tool. *Note:* Examiners should recognize that models are forward looking; therefore the usefulness of historical variance analysis may be limited.

Prepayment speed variances occur when actual prepayments do not mirror those projected. Variances are not uncommon as the cash flows are difficult to model and predict; however, management should monitor prepayments and revise related assumptions if material variances occur.

Inappropriate account aggregation can also lead to significant variances. For example, when comparing actual and modeled loan interest income, an institution may find that the model overestimated income in a falling rate environment because real estate loans with significantly different prepayment characteristics were aggregated together.

Many models measure static IRR, that is, what would happen to the current balance sheet if only interest rates changed. Other models incorporate management projections about asset and liability growth and changes in product mix. Variance analysis in the latter instance is complicated by the need to segregate variances due to balance sheet changes from those caused by rate movements.

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OTHER RISK FACTORS TO CONSIDER

Although IRR is the principal market risk taken by most financial institutions, other activities can significantly increase (or reduce) a bank's exposure and sensitivity to market risk.

Foreign exchange activities expose institutions to the price (exchange rate) risk that results from volatile currency markets. Exchange rates depend upon a variety of global and local factors that are difficult to predict, including interest rates, economic performance, central bank actions, and political developments.

Commodity activities involve using commodity contracts (including futures and options) to speculate or hedge. Commodity prices depend upon many factors and are very difficult to forecast.

Generally, institutions should only use foreign exchange or commodity activities to hedge or control specific market risks. Management, independent of the broker/dealer, should demonstrate expertise commensurate with the activities undertaken. In addition, management should produce documented analysis that clearly details the effectiveness of all foreign exchange and commodity hedging activities. The analysis should be prepared at least quarterly and presented to the board for its review. *Note:* Typical commodity hedging activities are significantly different from speculative commodity activities.

Equity trading and investing creates market risk exposure because changes in equity prices can adversely affect earnings and capital. The board and management have a responsibility to identify, measure, monitor, and control trading risks. Management should carefully monitor all equity investments, regularly evaluate the resulting market risk exposure, and provide timely reports to the board.

Foreign exchange, commodities, and equity trading requires a high level of technical and managerial expertise. The risk management and measurement systems needed to operate them effectively are likewise highly sophisticated and require rigorous monitoring and testing. Foreign exchange, commodity, or equity speculation, absent the necessary controls and sufficient capital, might be considered an unsuitable practice. When necessary, contact legal counsel or capital markets specialists in your region for additional guidance.

Interest Rate Risk Mitigation

Institutions can use several measures to mitigate IRR exposures. If risk measures fall outside approved tolerance guidelines and trigger corrective steps (which should be guided by approved policies), management might alter their balance sheet or engage in hedging activities. Hedging strategies often involve using complex derivative instruments and are not suitable for institutions lacking technical expertise. When any IRR mitigation strategy is considered, management should also consider other risks, such as credit, liquidity, and operational risks.

When implementing IRR mitigation techniques, the board and management should ensure that policies and approved strategies address:

- Analysis of market, liquidity, credit, and operating risks;
- Qualifications of personnel involved in implementing and monitoring hedging strategies;
- Permissible strategies and types of derivative contracts;
- Authority levels and titles of individuals approved to initiate hedging transactions and related authority limits;
- Risk limits for hedging activities such as position limits (gross and net), maturity parameters, and counterparty credit guidelines;
- Monitoring requirements for hedging activities, including ensuring activities fall within approved limits and management lines of authority; and
- Controls for ensuring management's compliance with technical accounting guidance that covers hedging activities.

Institutions should not use derivative instruments for hedging (whether or not hedge accounting is applied), unless the board and senior management fully understand the institution's strategy and the potential risks and benefits. Relying on outside consultants to assist with a hedging strategy does not absolve the board and senior management of their responsibility to understand and oversee the risks of the activities. Hedging strategies should be designed to limit downside earnings exposure or manage income or EVE volatility. Activities conducted solely to generate additional income should not be considered hedging.

Altering the balance sheet is the most common method institutions use to modify their IRR position. However, this strategy may take time to implement and often cannot quickly correct significant exposures. For example, if a bank is liability sensitive and therefore exposed to rising interest rates, management may decide to reduce their retention of 30-year fixed-rate mortgages. Strategies may include increased sales (possibly for securitization) of longer-term mortgage products or pricing longer-term mortgages above market rates in order to reduce the volume of new loan originations. While this strategy may reduce IRR over time, this method can be slow in correcting material IRR imbalances and may not effect a timely reduction in risk exposures.

Institutions may also attempt to address exposures to rising interest rates by increasing longer-term deposit or borrowing levels. However, several factors may hinder the success of such strategies. There may be significant competition or limited demand for longer-term time deposits, and access to longer-term wholesale funding may be limited or offered on unfavorable terms. Additionally, embedded options (e.g., calls and step-up dates) in wholesale funding sources can present measurement challenges, and the cost of such funding can make this approach prohibitive unless there is a clear productive use for the funds.

Cash flow matching and duration matching are two typical hedging strategies. The goal of these strategies is to change a bank's IRR exposure to meet specific cash flow or duration targets. These strategies can be accomplished by altering the balance sheet composition or through the use of derivatives.

Some institutions refer to cash flow matching as matched funding. The bank matches the terms (rate or maturity) of funding and assets so that cash flows will reprice or mature simultaneously and interest rate changes will not significantly influence net cash flow. Cash flow matching can be difficult for small institutions due to the wide range of cash flows in most financial assets.

With a duration matching strategy, management may attempt to match the duration of a pool of assets with the duration of a pool of liabilities. The use of interest rate derivatives or options might also be used to modify or offset the duration of an existing pool of assets or liabilities. The goal is to match the effective durations of the pools in order to limit the net changes in fair values of the pools, rather than matching the specific cash flows. Duration matching is not a perfect strategy and may result in imperfect hedging from a cash flow perspective and can cause exposure to different kinds of risk (such as yield curve and basis risk).

Derivative instruments are available to hedge IRR. These instruments include, but are not limited to, swaps, amortizing swaps, basis swaps, futures, forwards, caps, options, floor options, and collars. The most common derivatives used to hedge IRR are swaps and forwards. In a pay-fixed swap transaction, a stream of fixed interest payments from a commercial loan may be contractually exchanged for a stream of floating-rate payments. This swap effectively shortens the duration of the commercial loan portfolio by reducing the asset/liability mismatch and improves profitability in a rising-rate environment. Conversely, the bank could lengthen the effective duration of its floating-rate deposits by entering into a swap where a floating-rate stream of payments is exchanged for a fixed-rate payment stream.

Institutions that use hedging activities should understand the true impact of a hedge (whether it actually decreases risks), and understand its impact on earnings and capital. All derivatives require fair value accounting adjustments, which may result in earnings and capital volatility. While management may utilize hedges to reduce certain risks in their portfolio, analysis of the hedges should consider the impact of related accounting adjustments on earnings and capital.

Each institution using derivatives should establish an effective process for managing related risks. The level of formality in this process should be commensurate with the activities involved and the level of risk approved by senior management and the board.

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INTERNAL CONTROLS

Establishing and maintaining an effective system of internal controls and independent reviews is critical to the risk management process and the general safety and soundness of the bank. Institutions should have adequate internal controls to ensure the integrity of their IRR management process. These controls should promote reliable financial reporting and compliance with internal policies and relevant regulations. Internal control policies and procedures should address appropriate approval processes, adherence to exposure limits, reconciliations, reporting, reviews, and other mechanisms designed to provide a reasonable assurance that the bank's IRR management objectives are achieved. Internal control policies and procedures should clearly define management authorities and responsibilities and identify the individuals and committees responsible for managing sensitivity to market risk.

A sound control environment should also ensure adequate separation of duties in key elements of the risk management process to avoid potential conflicts of interest. Institutions should have clearly defined duties that are sufficiently independent from position-taking functions of the bank. Additionally, IRR exposures should be reported directly to senior management and the board of directors. The nature and scope of such safeguards should reflect the type and structure of the bank, the volume and complexity of IRR incurred by the bank, and the complexity of its transactions and commitments. More complex institutions should have an independent unit responsible for the design and administration of the bank's IRR measurement, monitoring, and control functions.

Independent Reviews

Regular independent reviews of its IRR management process are an important element of a bank's internal control system. Internal reviews of the IRR measurement system should include assessments of the assumptions, parameters, and methodologies used. Such reviews should seek to understand, test, and document the current measurement process, evaluate the system's accuracy, and recommend solutions to any identified weaknesses. The independent review should be tailored to the type and complexity of an institution's activities and encompass the standards and desirable scope discussed below. Regardless of the depth of the independent review, the findings of the review should be reported to the board no less frequently than annually, along with a summary of the bank's IRR measurement techniques and management practices.

Independent Review Standards

The purpose of an independent review is to ensure that the IRR measurement and management processes are sound. Regardless of whether the review is performed by internal staff or external entities, it is important these parties be independent of any operational responsibility for the measurement and management processes. They should not perform any of the routine internal control functions such as reconciling data inputs, developing assumptions, or performing variance analysis.

Independent reviews should be performed at least annually. The scope, responsibility, and authority for the reviews should be clearly documented and encompass all material aspects of the measurement process. The scope of the independent review should generally be defined by the internal audit staff and approved by the audit committee. However, subject to board approval, it is acceptable for another department of the bank, separate from the group that measures IRR, to define, perform, and document the independent review. A bank's review processes should meet the following minimum standards:

- Independence - Parties performing the independent review should not be involved in the day-to-day IRR measurement/management process. Institutions may use internal staff, an outsourcing arrangement, or a combination of the two to independently review the measurement system. Management may find that the internal audit department, or other staff independent of the measurement system, has the knowledge and skills to perform certain aspects of the review while using external resources for other areas. When the assessment of the measurement system is outsourced, senior management and the board should ensure that the procedures used meet the same standards required of a satisfactory internal review.
- Skills and Knowledge - Senior management and the board must ensure that individuals performing the independent review have the knowledge and skills to competently assess the measurement system and its control environment.
- Transparency - The procedures used in the independent review of the measurement system should be clearly documented, and work papers should be available to management, auditors, and examiners for review. Senior management should ensure that they have access to work papers even when external parties perform the review.
- Communication of Results - Procedures should be established for reporting independent review findings at least annually to the board or board-delegated committee.

Scope of Independent Review

Independent reviews provide a way to assess the adequacy of a bank's IRR measurement system. The level and depth of the independent reviews should be commensurate with the bank's risks and activities. More complex institutions should have a more rigorous independent review process. Less complex institutions may rely upon less formal reviews. At a minimum, each institution should have procedures in place to independently review the input process, assumptions used, and system output reports.

System-input reviews should evaluate the adequacy and appropriateness of:

- The knowledge and skills of individuals responsible for input to the measurement system;
- The reconciliation of the measurement system's data

to the bank's general ledger;
- The rules and methods of account aggregation used in the measurement system;
- The accuracy of contractual terms captured within the measurement system; and
- The source, completeness, accuracy, and procedures for external data feeds.

Assumption reviews should evaluate the following issues:

- The process of developing assumptions for all material asset, liability, and off-balance sheet exposures;
- The process for reviewing and approving key assumptions;
- The periodic review of assumptions for relevance, applicability, and reasonableness; and
- The completeness of assumption analysis and its supporting documentation.

System output and reporting assessments should include coverage of the following:

- Inclusion of a sufficiently broad range of potential rate scenarios,
- Accuracy of the IRR measurement and assurance that all material exposures are captured,
- Timeliness and frequency of reporting to management and the board,
- Compliance with operating policies and approved risk limits,
- Performance and documentation of variance analyses (back-testing), and
- Translation of model output into understandable management reports that support decision making.

Theoretical and Mathematical Validations

The degree to which calculations in an IRR model should be validated depends on the complexity of an institution's activities and IRR model. The complexity of many measurement systems demands specialized knowledge and skills to verify the mathematical equations. Less complex institutions using simpler, vendor-supplied IRR models can satisfy some, but not all, validation requirements with independent attestation reports from the vendor.

Management should periodically discuss with vendors what validation and internal control process assessments have been conducted. The vendor should provide documentation showing a credible, independent third party has performed such assessments. Vendors should be able to provide appropriate testing results to show their product works as expected. They should also clearly indicate the model's limitations, assumptions, and where the product's use may be problematic. Such disclosures, exclusive of confidential or proprietary information, should contain useful insights regarding a model's functionality and outputs. However, a certification or validation report from a vendor is only one component of a bank's independent review and should not be used as a substitute for an overall validation review. Management is still responsible for any aspect of the process under their control, such as data input, assumption changes, etc.

As part of the validation process, management should ensure that the software and mathematics of the IRR model function as intended. Many community institutions use largely standardized, vendor-provided models. In such cases, the validations provided by vendors can be used to support the accuracy of the model. For models that are customized to an individual institution or in situations where vendors are unable or unwilling to provide appropriate certifications or validations, management is responsible for validating the accuracy of the model's mathematics and soundness of the software.

Additionally, vendor models may be customized by an institution for its particular circumstances. Management should document and justify the institution's customization choices as part of the validation process. If vendors provide input data or assumptions, their relevance to the bank's situation should be evaluated and approved. Institutions should obtain information regarding the data (e.g., vendor-derived assumptions) used to develop the model and assess whether the data is representative of the institution's situation.

Complex institutions or those with significant IRR exposures may need to perform more in-depth validation procedures of the underlying mathematics. Validation practices could include constructing a similar model to test assumptions and outcomes or using an existing, well-validated benchmark model, which is often a less costly alternative. The benchmark model should have theoretical underpinnings, methodologies, and inputs that are very close to those used in the model being validated. More complex institutions have used benchmarking effectively to identify model errors that could distort IRR measurements. The depth and extent of the validation process should be consistent with the degree of risk exposures.

Model certifications and validations commissioned by vendors can be a useful part of an institution's efforts to evaluate the model's development and conceptual soundness. Although many vendors offer services for process verification, benchmarking, or back-testing, the services are usually separate engagements. Each institution should ensure these engagements meet its internal policy requirements for validations and independent reviews.

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EVALUATING SENSITIVITY TO MARKET RISK

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, consideration should be given to: management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to its level of market risk exposure.

For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates. In some larger institutions, foreign operations can be a significant source of market risk. For some institutions, trading activities are a major source of market risk.

Market risk is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchanges rates, commodity prices, or equity prices.·
- The ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile.
- The nature and complexity of interest rate risk exposure arising from nontrading positions.
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

Ratings

1. A rating of 1 indicates that market risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

2. A rating of 2 indicates that market risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

3. A rating of 3 indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

4. A rating of 4 indicates that control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

5. A rating of 5 indicates that control of market risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

Examination Standards and Goals

The following documents provide additional guidance for managing IRR:

- Joint Agency Policy Statement on Interest Rate Risk,
- Interagency Advisory on Interest Rate Risk Management, and
- Interagency Advisory on Interest Rate Risk Management Frequently Asked Questions.

Interagency Policy Statement on Interest Rate Risk

In 1996, the FDIC and the other Federal banking regulators adopted the Sensitivity to Market Risk component of the Uniform Financial Institutions Rating System and issued a Joint Agency Policy Statement on IRR (Policy Statement). The Policy Statement identifies the key elements of sound IRR management and describes prudent principles and practices for each of these elements. It emphasizes the importance of adequate oversight by a bank's board of directors and senior management as well as the importance of comprehensive risk management processes. The Policy Statement also describes the critical IRR-related factors that affect the Agencies' evaluation of an institution's capital adequacy

Interagency Advisory-Interest Rate Risk Management

In January 2010, the Agencies issued updated guidance to clarify supervisory expectations for IRR management set forth in the 1996 Policy Statement. The Interagency Advisory on Interest Rate Risk Management (Advisory) re-emphasizes the importance of effective corporate governance, policies and procedures, risk measurement and monitoring systems, stress testing, and internal controls related to IRR exposures. The Advisory indicates financial institutions should manage IRR commensurate with their complexity, risk profile, business model, and scope of operations. Additionally, the Advisory highlights that effective IRR management involves not only the identification and measurement of IRR, but also appropriate risk mitigation strategies that may be used to control IRR if exposure levels warrant corrective steps.

In January 2012, the agencies published supplemental guidance addressing Frequently Asked Questions (FAQs) on the 2010 Advisory. The FAQs provides additional clarification on topics such as determining model appropriateness; defining meaningful stress scenarios; analyzing yield curve, basis, and option risk, as well as using no-growth measurement scenarios. The FAQs also describe effective procedures for model validations and calculation of non-maturity deposit decay assumptions.

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EXAMINATION PROCESS

FDIC examination procedures follow a risk-focused framework that incorporates the guidelines outlined in the 1996 Policy Statement and the 2010 Advisory (including the FAQs guidance) to efficiently allocate examination resources. The scope of an examination should consider a bank's IRR exposure relative to earnings and capital, the complexity of on- and off-balance sheet exposures, and the strength of risk management processes.

Examiners can identify material exposures and risks by reviewing the following items (most of which are available during off-site analysis):

- Prior examination findings,
- Interest Rate Risk Standard Analysis (IRRSA),
- Net interest margin and net operating income trends,
- Board or committee minutes,
- Bank IRR analysis,
- Independent review or audit findings,
- Related bank policies and procedures,
- Balance sheet and account data,
- Strategic and business plans,
- Product pricing guidelines, and
- Derivatives activities.

Citing Examination Deficiencies

Material weaknesses in risk management processes, or high levels of IRR exposure relative to capital, require corrective action. Such actions may include recommendations or directives to:

- Raise additional capital;
- Reduce levels of IRR exposure;
- Strengthen IRR management expertise;
- Improve IRR management information and measurement systems; or
- Take other measures or combination of actions, depending on the facts and circumstances of the individual bank.

If an examiner determines that IRR weaknesses warrant the listing of a contravention of regulatory guidance in the Report of Examination, the 1996 Policy Statement should be cited as the source guidance. Examiners may reference the Advisory or the FAQs document in supporting comments. A contravention of the interagency guidelines detailed in Appendix A of Part 364 may also be warranted for institutions with seriously deficient IRR programs.

Pursuant to Appendix A (II.E.) of Part 364, an institution should:

- Manage interest rate risk in a manner that is appropriate to the size of the institution and the complexity of its assets and liabilities; and
- Provide for periodic reporting to management and the board of directors regarding interest rate risk with adequate information for management and the board of directors to assess the level of risk.

Note: Accepting a reasonable degree of IRR is a fundamental part of banking that significantly affects profitability and shareholder values. Although risks must be properly managed, exceptions to established IRR policies and limits occasionally occur. Examiners should not automatically criticize relatively minor exceptions to established policies or internal limits if an institution has appropriate, formal processes for monitoring, reviewing, and approving exceptions.

Additionally, examiners are reminded that, if weaknesses in a model or its assumptions are identified that render its results unreliable, report comments supporting the assigned rating should not rely on (or, at a minimum, should qualify any use of) the resulting data.

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MARKET RISK GLOSSARY

Deterministic Rate Scenarios

Deterministic modeling techniques allow management to specify the direction, amount, and timing of future interest rates in order to measure the potential impact the changes may have on earnings and capital. The following items are examples of commonly used deterministic interest rate scenarios:

- **Rate Shock Scenario** – In this scenario, rate changes are immediate and sustained. For example, in a plus 300 basis point scenario, the full effect of the rate increase would be administered in the first period measured and remain in effect for all periods.
- **Rate Ramp Scenario** – In this scenario, rate changes are applied gradually over the measured period. For example, when measuring the effects of a 300 basis point rate increase during a 12-month period, rates would be increased 25 basis points each month.
- **Stair Step Scenario** – In this scenario, rate changes are administered at less frequent intervals over the measured period. For instance, in a 300 basis point increasing rate environment measured over a two-year time period, rates may be increased 50 basis points each quarter of the first year and 25 basis points each quarter of the second year.

Non-parallel Yield Curve Shifts

A shift in the yield curve in which yields do not change by the same number of basis points for every maturity. When running various interest rate scenarios, management may set non-parallel shifts in a manner similar to deterministic rate scenarios (rate shock, rate ramp, or stair step). The scenarios often have a pivot point on the yield curve from which longer-term and shorter-term rates change in different amounts.

Static Models

Static simulation models are based on current exposures and assume a constant, no-growth balance sheet. In order to simulate no growth in balance sheet accounts, some static models assume that all principal cash flows from a particular account are reinvested back into that same account. This assumption is sometimes referred to as replacement growth.

Dynamic Models

Dynamic simulation models rely on detailed assumptions regarding changes in existing business lines, new business, and changes in management and customer behavior. The assumptions change the existing balance sheet to reflect expected business changes.

Stochastic Models

Stochastic modeling consists of the modeling of an uncertain variable over time using a random selection process. It recognizes that market variables, such as interest rates, exhibit a general trend (drift) and some degree of volatility around that trend. Stochastic models provide a framework for the evaluation of the impact of embedded options in financial instruments.

Constraints are usually imposed so that the model is representative of current market conditions. For example, if Treasury securities are priced using interest rate paths, a constraint may be imposed so that the average present value derived from all the paths must equal the observed market price of the Treasury securities. In such a case, the model can also be classified as a Stochastic No Arbitrage Model.

Monte Carlo Simulation

A Monte Carlo simulation randomly generates a large sample set of values from a reasonable population of variables such as an interest rate. The stochastic model provides a framework for the evolution of the variable, and a Monte Carlo simulation is an application of that stochastic model. The randomness in games of chance is similar to how Monte Carlo simulation selects values at random to simulate a model. When you turn a roulette wheel, you know that one number within a range of numbers will come up, but you do not know which number will come up for any particular turn. The same concept applies with a Monte Carlo simulation where the variables (e.g., interest rates, security prices) have a known range of values but an uncertain value for any particular time. Monte Carlo simulations can take into account returns, volatility, correlations, and other factors. Monte Carlo programs can generate millions of different scenarios by randomly changing a component for each run or iteration. Monte Carlo simulation allows the banker to simulate thousands of market-like scenarios and learn the probability of a particular outcome or a range of outcomes. Assume that the investment portfolio is run through 20,000 simulations, projecting 20,000 separate scenarios over a two-year period, and acceptable results occur 16,000 times. This means that there is an 80 percent probability that the portfolio will perform at an acceptable level. Like any financial model, the results are sensitive to underlying assumptions. The number of runs or simulations is also important. For example, a Monte Carlo model with only 500 iterations captures fewer possible scenarios than one that runs 50,000 iterations.

Spread Types

- **Static Spread –** Basis points, that when added to a set of implied forward rates, discounts the cash flows of an instrument back to its observed market value. For an instrument without embedded optionality, the static spread is the best measure of return in excess of the risk-free rates provided by that instrument. For instruments with embedded optionality, it may be useful to calculate a static spread only as a starting point for comparison with a more appropriate mark-to-market spread measure, such as the option adjusted spread.
- **Option Adjusted Spread (OAS) –** Basis points, that when added to a set of interest rates discounts the cash flows of an instrument back to its observed market value. This measure only applies to instruments with embedded optionality. The static spread applies to instruments without embedded optionality. For example, consider a mortgage-backed security, which typically contains an embedded prepayment option. Assume the static spread is 75 basis points. The OAS would be less than the static spread of 75 basis points because the volatility of interest rates reflected in an OAS framework assigns more value to the borrower's prepayment option, thus reducing the value to the MBS investor.
- **OAS Process** – In a stochastic valuation model, the average value generated by all the interest rate paths must equal the currently observed price of the security. The initial computation in the model is based on an assumed spread. The security value derived is compared to the observed.

Duration Calculations

Macaulay duration calculates the weighted average term to maturity of a security's cash flows. Assume a bond with three years remaining to maturity, bearing a 5 percent coupon rate paid annually, when a 10 percent yield is required.

Macaulay Duration Calculation
3 year bond, 5% coupon, 10% yield

Year	Payment	PV x	T	PVxT
1	$50	$45.5 x	1 =	$45.5
2	$50	$41.3 x	2 =	$82.6
3	$1,050	$788.9 x	3 =	$2,366.7
Total		$875.7		$2,494.8

T = Time period payment is received

Macaulay Duration: 2,494.8 / 875.7 = 2.85 years

Modified duration, calculated from Macaulay duration, estimates price sensitivity for small interest rate changes.

Modified Duration Calculation
3 year bond, 5% coupon, 10% yield
Macaulay Duration = 2.85 years

$$\frac{\text{Macaulay Duration}}{1 + (\text{Yield} / n)}$$
$$= 2.85 / 1.10$$

n = coupons per year

Modified Duration = 2.59%

The following formula can be used to estimate the percentage change in a bond's price:

$$\Delta\ \% = -\text{Modified Duration x } \Delta \text{ Yield x } 100$$

Note: The minus sign recognizes the inverse relationship of price and yield.

For a 100 basis point change in rates, the estimated change in price is equal to the modified duration. In other words, using a modified duration of 2.59 percent, the price of a bond would change approximately 2.6 percent for every 100 basis point change in rates. If rates changed by only 50 basis points, the bond would change approximately 1.3 percent.

$$\Delta\% = \text{Modified Duration x } \Delta \text{ Yield x } 100$$
$$= 2.59\% \text{ x } 50\text{bp x } 100$$
$$= 2.59\% \text{ x } .5$$
$$= 1.295\%$$

The following formula can be used to estimate the dollar change in price:

$$\Delta\$ = \text{minus Price x Modified Duration x } \Delta \text{ Yield x } 100$$

If the price of the bond had been $875.66, then its approximate change in value (price), if rates changed by 50bp, would be ($875.66) x 1.295% = ($11.34).

If rates fell, the estimated value would be $887.00, while if rates rose the estimated value would fall to $864.32.

Duration-based price forecasts are generally precise when used with small rate changes (1 to 5 basis points). However, the accuracy of the forecasts decline when larger rates changes (especially 100 basis points or more) are involved. The reason for the declining accuracy of price forecasts relates to the non-linear relationship between prices and yields (a.k.a., convexity).

Convexity

Option-free financial instruments display positive convexity. When rates decline, a positively convexed instrument's price increases at an increasing rate. When rates rise, a positively convexed instrument's price decreases at a decreasing rate.

Negative convexity causes the duration of a security to lengthen when rates rise and shorten when rates fall. Instruments that contain embedded options demonstrate negative convexity. When rates decline, a negatively convexed instrument's price increases at a decreasing rate. When rates rise, the price of a negatively convexed instrument will decline at an increasing rate.

For example, the value of the treasury security changes relatively less in value in comparison to the sample mortgage security, which declines more significantly. However, as yields decrease, the treasury security gains value at an increasing rate, while the mortgage security gains only modestly. As interest rates decline, the likelihood increases that borrowers will refinance (exercise prepayment option). Therefore, the value of a mortgage security does not increase at the same rate or magnitude as a decline in interest rates.

Effective Duration and Effective Convexity

Effective duration and effective convexity are used to calculate the price sensitivity of bonds with embedded options. The calculations provide an approximate price change of a bond given a parallel yield curve shift. Measures of modified duration and convexity do not provide accurate calculations of price sensitivity for bonds with embedded options. Effective duration and convexity provide a more accurate view of price sensitivity since the measures allow for cash flows to change due to a change in yield. Formula:

Effective Duration = $(V_- - V_+)/(2V_0 \times \Delta Y)$
Effective Convexity = $(V_+ + V_- - 2V_0)/(2V_0 \times \Delta Y)^2$

Where, ΔY = Change in market interest rate used to calculate new values:

V_+ = Price if yield is increased by Change Y
V_- = Price if yield is decreased by Change Y
V_0 = Initial price per \$100 of par value

Assume: a three-year callable bond's current market value is \$98.60 (V_0); that interest rates are projected to change by 100 basis points (Y); that the price of this bond given a 100 basis point increase in rates is \$96.75 (V_+); and that the price of this bond given a 100 basis point decrease in rates is \$99.98 (V_-).

To calculate effective duration and convexity:

Effective Duration =
$(99.98 - 96.75)/(2(98.60)(.01)) = 1.64$
Effective Convexity =
$96.75 + 99.98 - 2(98.60) \div (2(98.60)(.01))^2 = -23.83$

If we assume interest rates increase 100 basis points, the approximate price change due to effective duration is the following:

Percentage Price Change = -Effective Duration x Yield Change
Percentage Change in Price = $-1.64 \times .01 = -1.64\%$

The approximate price change due to effective convexity is the following:

½ x Effective Convexity x (Yield Change)²
$\frac{1}{2} \times -23.83 \times (0.01)^2 \times 100 = -0.12\%$

Thus this bond's price would be expected to decrease by about 1.76 percent given a 100 bps rise in rates:

Effective Duration	=	-1.64%
Effective Convexity	=	-0.12%
		-1.76%

INTRODUCTION TO THE BANK SECRECY ACT

The Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act of 1970 (31 U.S.C. 5311 et seq.) is referred to as the Bank Secrecy Act (BSA). The purpose of the BSA is to require United States (U.S.) financial institutions to maintain appropriate records and file certain reports involving currency transactions and a financial institution's customer relationships. Currency Transaction Reports (CTRs) and Suspicious Activity Reports (SARs) are the primary means used by banks to satisfy the requirements of the BSA. The recordkeeping regulations also include the requirement that a financial institution's records be sufficient to enable transactions and activity in customer accounts to be reconstructed if necessary. In doing so, a paper and audit trail is maintained. These records and reports have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.

The BSA consists of two parts: Title I Financial Recordkeeping and Title II Reports of Currency and Foreign Transactions. Title I authorizes the Secretary of the Department of the Treasury (Treasury) to issue regulations, which require insured financial institutions to maintain certain records. Title II directed the Treasury to prescribe regulations governing the reporting of certain transactions by and through financial institutions in excess of $10,000 into, out of, and within the U.S. The Treasury's implementing regulations under the BSA, issued within the provisions of 31 CFR Part 103, are included in the FDIC's Rules and Regulations and on the FDIC website.

The implementing regulations under the BSA were originally intended to aid investigations into an array of criminal activities, from income tax evasion to money laundering. In recent years, the reports and records prescribed by the BSA have also been utilized as tools for investigating individuals suspected of engaging in illegal drug and terrorist financing activities. Law enforcement agencies have found CTRs to be extremely valuable in tracking the huge amounts of cash generated by individuals and entities for illicit purposes. SARs, used by financial institutions to report identified or suspected illicit or unusual activities, are likewise extremely valuable to law enforcement agencies.

Several acts and regulations expanding and strengthening the scope and enforcement of the BSA, anti-money laundering (AML) measures, and counter-terrorist financing measures have been signed into law and issued, respectively, over the past several decades. Several of these acts include:

- Money Laundering Control Act of 1986,
- Annuzio-Wylie Anti-Money Laundering Act of 1992,
- Money Laundering Suppression Act of 1994, and
- Money Laundering and Financial Crimes Strategy Act of 1998.

Most recently, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (more commonly known as the USA PATRIOT Act) was swiftly enacted by Congress in October 2001, primarily in response to the September 11, 2001 terrorist attacks on the U.S. The USA PATRIOT Act established a host of new measures to prevent, detect, and prosecute those involved in money laundering and terrorist financing.

FINANCIAL CRIMES ENFORCEMENT NETWORK REPORTING AND RECORDKEEPING REQUIREMENTS

Currency Transaction Reports and Exemptions

U.S. financial institutions must file a CTR, Financial Crimes Enforcement Network (FinCEN) Form 104 (formerly known as Internal Revenue Service [IRS] Form 4789), for each currency transaction over $10,000. A currency transaction is any transaction involving the physical transfer of currency from one person to another and covers deposits, withdrawals, exchanges, or transfers of currency or other payments. Currency is defined as currency and coin of the U.S. or any other country as long as it is customarily accepted as money in the country of issue.

Multiple currency transactions shall be treated as a single transaction if the financial institution has knowledge that the transactions are by, or on behalf of, any person and result in either cash in or cash out totaling more than $10,000 during any one business day. Transactions at all branches of a financial institution should be aggregated when determining reportable multiple transactions.

CTR Filing Requirements

<u>Customer and Transaction Information</u>

All CTRs required by 31 CFR 103.22 of the Financial Recordkeeping and Reporting of Currency and Foreign

Transactions regulations must be filed with the IRS. Financial institutions are required to provide all requested information on the CTR, including the following for the person conducting the transaction:

- Name,
- Street address (a post office box number is not acceptable),
- Social security number (SSN) or taxpayer identification number (TIN) (for non-U.S. residents), and
- Date of birth.

The documentation used to verify the identity of the individual conducting the transaction should be specified. Signature cards may be relied upon; however, the specific documentation used to establish the person's identity should be noted. A mere notation that the customer is "known to the financial institution" is insufficient. Additional requested information includes the following:

- Account number,
- Social security number or taxpayer identification number of the person or entity for whose account the transaction is being conducted (should reflect all account holders for joint accounts), and
- Amount and kind of transaction (transactions involving foreign currency should identify the country of origin and report the U.S. dollar equivalent of the foreign currency on the day of the transaction).

The financial institution must provide a contact person, and the CTR must be signed by the preparer and an approving official. Financial institutions can also file amendments on previously filed CTRs by using a new CTR form and checking the box that indicates an amendment.

CTR Filing Deadlines

CTRs filed with the IRS are maintained in the FinCEN database, which is made available to Federal Banking Agencies[1] and law enforcement. Paper forms are to be filed within 15 days following the date of the reportable transaction. If CTRs are filed using magnetic media, pursuant to an agreement between a financial institution and the IRS, a financial institution must file a CTR within 25 calendar days of the date of the reportable transaction. A third option is to file CTRs using the Patriot Act Communication System (PACS), which also allows up to 25 calendar days to file the CTR following the reportable transaction. PACS was launched in October 2002 and permits secure filing of CTRs over the Internet using encryption technology. Financial institutions can access PACS after applying for and receiving a digital certificate.

Examiners reviewing filed CTRs should inquire with financial institution management regarding the manner in which CTRs are filed before evaluating the timeliness of such filings. If for any reason a financial institution should withdraw from the magnetic tape program or the PACS program, or for any other reason file paper CTRs, those CTRs must be filed within the standard 15 day period following the reportable transaction.

Exemptions from CTR Filing Requirements

Certain "persons" who routinely use currency may be eligible for exemption from CTR filings. Exemptions were implemented to reduce the reporting burden and permit more efficient use of the filed records. Financial institutions are not required to exempt customers, but are encouraged to do so. There are two types of exemptions, referred to as "Phase I" and "Phase II" exemptions.

"Phase I" exemptions may be granted for the following "exempt persons":

- A bank[2], to the extent of its domestic operations;
- A Federal, State, or local government agency or department;
- Any entity exercising governmental authority within the U.S. (U.S. includes District of Columbia, Territories, and Indian tribal lands);
- Any listed entity other than a bank whose common stock or analogous equity interests are listed on the New York, American, or NASDAQ stock exchanges (with some exceptions);
- Any U.S. domestic subsidiary (other than a bank) of any "listed entity" that is organized under U.S. law and at least 51 percent of the subsidiary's common stock is owned by the listed entity.

"Phase II" exemptions may be granted for the following:

- A "non-listed business," which includes commercial enterprises that do not have more than 50% of the business gross revenues derived from certain ineligible businesses. Gross revenue has been interpreted to reflect what a business actually earns from an activity conducted by the business, rather than the sales volume of such activity. "Non-listed businesses" must

[1] Federal Banking Agencies consist of the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), and the FDIC.

[2] Bank is defined in The U.S. Department of the Treasury (Treasury) Regulation 31 CFR 103.11.

also be incorporated or organized under U.S. laws and be eligible to do business in the U.S. and may only be exempted to the extent of its domestic operations.

- A "payroll customer," which includes any other person not covered under the "exempt person" definition that operates a firm that regularly withdraws more than $10,000 in order to pay its U.S. employees in currency. "Payroll customers" must also be incorporated and eligible to do business in the U.S. "Payroll customers" may only be exempted on their withdrawals for payroll purposes from existing transaction accounts.

Commercial transaction accounts of sole proprietorships can qualify for "non-listed business" or "payroll customer" exemption.

Exemption of Franchisees

Franchisees of listed corporations (or of their subsidiaries) are not included within the definition of an "exempt person" under "Phase I" unless such franchisees are independently exempt as listed corporations or listed corporation subsidiaries. For example, a local corporation that holds an ABC Corporation franchise is not a "Phase I" "exempt person" simply because ABC Corporation is a listed corporation; however, it is possible that the local corporation may qualify for "Phase II" exemption as a "non-listed business," assuming it meets all other exemption qualification requirements. An ABC Corporation outlet owned by ABC Corporation directly, on the other hand, would be a "Phase I" "exempt person" because ABC Corporation's common stock is listed on the New York Stock Exchange.

Ineligible Businesses

There are several higher-risk businesses that may not be exempted from CTR filings. The nature of these businesses increases the likelihood that they can be used to facilitate money laundering and other illicit activities. Ineligible businesses include:

- Non-bank financial institutions or agents thereof (this definition includes telegraph companies, and money services businesses [currency exchange, check casher, or issuer of monetary instruments in an amount greater than $1,000 to any person in one day]);
- Purchasers or sellers of motor vehicles, vessels, aircraft, farm equipment, or mobile homes;
- Those engaged in the practice of law, medicine, or accountancy;
- Investment advisors or investment bankers;
- Real estate brokerage, closing, or title insurance firms;
- Pawn brokers;
- Businesses that charter ships, aircraft, or buses;
- Auction services;
- Entities involved in gaming of any kind (excluding licensed para mutual betting at race tracks);
- Trade union activities; and
- Any other activities as specified by FinCEN.

Additional Qualification Criteria for Phase II Exemptions

Both "non-listed businesses" and "payroll customers" must meet the following additional criteria to be eligible for "Phase II" exemption:

- The entity has maintained a transaction account with the financial institution for at least twelve consecutive months;
- The entity engages in frequent currency transactions that exceed $10,000 (or in the case of a "payroll customer," regularly makes withdrawals of over $10,000 to pay U.S. employees in currency); and
- The entity is incorporated or organized under the laws of the U.S. or a state, or registered as, and eligible to do business in the U.S. or state.

The financial institution may treat all of the customer's transaction accounts at that financial institution as a single account to qualify for exemption. There may be exceptions to this rule if certain accounts are exclusively used for non-exempt portions of the business. (For example, a small grocery with wire transfer services has a separate account just for its wire business).

Accounts of multiple businesses owned by the same individual(s) are generally not eligible to be treated as a single account. However, it may be necessary to treat such accounts as a single account if the financial institution has evidence that the corporate veil has been pierced. Such evidence may include, but is not limited to:

- Businesses are operated out of the same location and/or utilize the same phone number;
- Businesses are operated by the same daily management and/or board of directors;
- Cash deposits or other banking transactions are completed by the same individual at the same time for the different businesses;
- Funds are frequently intermingled between accounts or there are unexplained transfers from one account to the other; or
- Business activities of the entities cannot be differentiated.

More than one of these factors must typically be present in order to provide sufficient evidence that the corporate veil has been pierced.

Transactions conducted by an "exempt person" as agent or on behalf of another person are not eligible to be exempted based on being transacted by an "exempt person."

Exemption Qualification Documentation Requirements

Decisions to exempt any entity should be based on the financial institution taking reasonable and prudent steps to document the identification of the entity. The specific methodology for performing this assessment is largely at the financial institution's discretion; however, results of the review must be documented. For example, it is acceptable to document that a stock is listed on a stock market by relying on a listing of exchange stock published in a newspaper or by using publicly available information through the Securities and Exchange Commission (SEC). To document the subsidiary of a listed entity, a financial institution may rely on authenticated corporate officer's certificates or annual reports filed with the SEC. Annually, management should also ensure that "Phase I" exempt persons remain eligible for exemption (for example, entities remain listed on National exchanges.)

For "non-listed businesses" and "payroll customers," the financial institution will need to document that the entity meets the qualifying criteria both at the time of the initial exemption and annually thereafter. To perform the annual reviews, the financial institution can verify and update the information that it has in its files to document continued eligibility for exemption. The financial institution must also indicate that it has a system for monitoring the transactions in the account for suspicious activity as it continues to be obligated to file Suspicious Activity Reports on activities of "exempt persons," when appropriate. SARs are discussed in detail within the "Suspicious Activity Reporting" section of this chapter.

Designation of Exempt Person Filings and Renewals

Both "Phase I" and "Phase II" exemptions are filed with FinCEN using Form TD F 90-22.53 - Designation of Exempt Person. This form is available on the Internet at FinCEN's website. The designation must be made separately by each financial institution that treats the person in question as an exempt customer. This designation requirement applies whether or not the designee has previously been treated as exempt from the CTR reporting requirements within 31 CFR 103. Again, the exemption applies only to transactions involving the "exempt person's" own funds. A transaction carried out by an "exempt person" as an agent for another person, who is the beneficial owner of the funds involved in a transaction in currency can not be exempted.

Exemption forms for "Phase I" persons need to be filed only once. A financial institution that wants to exempt another financial institution from which it buys or sells currency must be designated exempt by the close of the 30 day period beginning after the day of the first reportable transaction in currency with the other financial institution. Federal Reserve Banks are excluded from this requirement.

Exemption forms for "Phase II" persons need to be renewed and filed every two years, assuming that the "exempt person" continues to meet all exemption criteria, as verified and documented in the required annual review process discussed above. The filing must be made by March 15th of the second calendar year following the year in which the initial exemption was granted, and by every other March 15th thereafter. When filing a biennial renewal of the exemption for these customers, the financial institution will need to indicate any change in ownership of the business. Initial exemption of a "non-listed business" or "payroll customer" must be made within 30 days after the day of the first reportable transaction in currency that the financial institution wishes to include under the exemption. Form TD F 90-22.53 can be also used to revoke or amend an exemption.

CTR Backfiling

Examiners may determine that a financial institution has failed to file CTRs in accordance with 31 CFR 103, or has improperly exempted customers from CTR filings. In situations where an institution has failed to file a number of CTRs on reportable transactions for any reason, examiners should instruct management to promptly contact the IRS Detroit Computing Center (IRS DCC), Compliance Review Group for instructions and guidance concerning the possible requirement to backfile CTRs for those affected transactions. The IRS DCC will provide an initial determination on whether CTRs should be backfiled in those cases. Cases that involve substantial noncompliance with CTR filing requirements are referred to FinCEN for review. Upon review, FinCEN may correspond directly with the institution to discuss the program deficiencies that resulted in the institution's failure to appropriately file a CTR and the corrective action that management has implemented to prevent further infractions.

When a backfiling request is necessary, examiners should direct financial institutions to write a letter to the IRS at the IRS Detroit Computing Center, Compliance Review Group Attn: Backfiling, P.O. Box 32063, Detroit, Michigan, 48232-0063 that explains why CTRs were not filed. Examiners should also provide the financial institution a copy of the "Check List for CTR Filing Determination" form available on the FDIC's website. The financial institution will need to complete this form and include it with the letter to the IRS.

Once an institution has been instructed to contact IRS DCC for a backfiling determination, examiners should notify both their Regional Special Activities Case Manager (SACM) or other designees and the Special Activities Section (SAS) in Washington, D.C. Specific contacts are listed on the FDIC's Intranet website. Requisite information should be forwarded electronically via e-mail to these contacts.

Currency and Banking Retrieval System

The Currency and Banking Retrieval System (CBRS) is a database of CTRs, SARs, and CTR Exemptions filed with the IRS. It is maintained at the IRS Detroit Computing Center. The SAS, as well as each Region's SACM and other designees, has on-line access to the CBRS. Refer to your Regional Office for a full listing of those individuals with access to the FinCEN database.

Examiners should routinely receive volume and trend information on CTRs and SARs from their Regional SACM or other designees for each examination or visitation prior to the pre-planning process. In addition, the database information may be used to verify CTR, SAR and/or CTR Exemption filings. Detailed FinCEN database information may be used for expanded BSA reviews or in any unusual circumstances where examiners suspect certain forms have not been filed by the financial institution, or where suspicious activity by individuals has been detected.

Examiners should provide all of the following items they have available for each search request:

- The name of the subject of the search (financial institution and/or individual/entity);
- The subject's nine-digit TIN/SSN (in Part III of the CTR form if seeking information on the financial institution and/or Part I of the CTR form if seeking information on the individual/entity); and
- The date range for which the information is requested.

When requesting a download or listing of CTR and SAR information, examiners should take into consideration the volume of CTRs and SARs filed by the financial institution under examination when determining the date range requested. Except under unusual circumstances, the date range for full listings should be no greater than one year. For financial institutions with a large volume of records, three months or less may be more appropriate.

Since variations in spellings of an individual's name are possible, accuracy of the TIN/SSN is essential in ensuring accuracy of the information received from the FinCEN database. To this end, examiners should also identify any situations where a financial institution is using more than one tax identification number to file their CTRs and/or SARs. To reduce the possibility of error in communicating CTR and SAR information/verification requests, examiners are requested to e-mail or fax the request to their Regional SACM or other designee.

Other FinCEN Reports

Report of International Transportation of Currency or Monetary Instruments

Treasury regulation 31 CFR 103.23 requires the filing of FinCEN Form 105, formerly Form 4790, to comply with other Treasury regulations and U.S. Customs disclosure requirements involving physical transport, mailing or shipping of currency or monetary instruments greater than $10,000 at one time out of or into the U.S. The report is to be completed by or on behalf of the person requesting the transfer of the funds and filed within 15 days. However, financial institutions are not required to report these items if they are mailed or shipped through the postal service or by common carrier. Also excluded from reporting are those items that are shipped to or received from the account of an established customer who maintains a deposit relationship with the bank, provided the item amounts are commensurate with the customary conduct of business of the customer concerned.

In situations where the quantity, dollar volume, and frequency of the currency and/or monetary instruments are not commensurate with the customary conduct of the customer, financial institution management will need to conduct further documented research on the customer's transactions and determine whether a SAR should be filed with FinCEN. Please refer to the discussion on "Customer Due Diligence" and "Suspicious Activity Reporting" within this chapter for detailed guidance.

Reports of Foreign Bank Accounts

Within 31 CFR 103.24, the Treasury requires each person who has a financial interest in or signature authority, or other authority over any financial accounts, including bank, securities, or other types of financial accounts, maintained in a foreign country to report those relationships to the IRS annually if the aggregate value of the accounts exceeds

$10,000 at any point during the calendar year. The report should be filed by June 30 of the succeeding calendar year, using Form TD F 90-22.1 available on the FinCEN website. By definition, a foreign country includes all locations outside the United States, Guam, Puerto Rico, the Virgin Islands, the Northern Mariana Islands, American Samoa, and Trust Territory of the Pacific Islands. U.S. military banking facilities are excluded. Foreign assets including securities issued by foreign corporations that are held directly by a U.S. person, or through an account maintained with a U.S. office of a bank or other institution are not subject to the BSA foreign account reporting requirements. The bank is also not required to report international interbank transfer accounts ("nostro accounts") held by domestic banks. Also excluded are accounts held in a foreign financial institution in the name of, or on behalf of, a particular customer of the financial institution, or that are used solely for the transactions of a particular customer. Finally, an officer or employee of a federally-insured depository institution branch, or agency office within the U.S. of a foreign bank that is subject to the supervision of a Federal bank regulatory agency need not report that he or she has signature or other authority over a foreign bank, securities or other financial account maintained by such entities unless he or she has a personal financial interest in the account.

FinCEN Recordkeeping Requirements

Required Records for Sales of Monetary Instruments for Cash

Treasury regulation 31 CFR 103.29 prohibits financial institutions from issuing or selling monetary instruments purchased with cash in amounts of $3,000 to $10,000, inclusive, unless it obtains and records certain identifying information on the purchaser and specific transaction information. Monetary instruments include bank checks, bank drafts, cashier's checks, money orders, and traveler's checks. Furthermore, the identifying information of all purchasers must be verified. The following information must be obtained from a purchaser who has a deposit account at the financial institution:

- Purchaser's name;
- Date of purchase;
- Type(s) of instrument(s) purchased;
- Serial number(s) of each of the instrument(s) purchased; and
- Amounts in dollars of each of the instrument(s) purchased.

If the purchaser does not have a deposit account at the financial institution, the following additional information must be obtained:

- Address of the purchaser (a post office box number is not acceptable);
- Social security number (or alien identification number) of the purchaser;
- Date of birth of the purchaser; and
- Verification of the name and address with an acceptable document (i.e. driver's license).

The regulation requires that multiple purchases during one business day be aggregated and treated as one purchase. Purchases of different types of instruments at the same time are treated as one purchase and the amounts should be aggregated to determine if the total is $3,000 or more. In addition, the financial institution should have procedures in place to identify multiple purchases of monetary instruments during one business day, and to aggregate this information from all of the bank branch offices.

If a customer first deposits the cash in a bank account, then purchases a monetary instrument(s), the transaction is still subject to this regulatory requirement. The financial institution is not required to maintain a log for these transactions, but should have procedures in place to recreate the transactions.

The information required to be obtained under 31 CFR 103.29 must be retained for a period of five years.

Funds Transfer and Travel Rule Requirements

Treasury regulation 31 CFR Section 103.33 prescribes information that must be obtained for funds transfers in the amount of $3,000 or more. There is a detailed discussion of the recordkeeping requirements and risks associated with wire transfers within the "Banking Services and Activities with Greater Potential for Money Laundering and Terrorist Financing Vulnerabilities" discussion within this chapter.

Records to be Made and Retained by Financial Institutions

Treasury regulation 31 CFR 103.33 states that each financial institution must retain either the original or a microfilm or other copy/reproduction of each of the following:

- A record of each extension of credit in an amount in excess of $10,000, except an extension of credit secured by an interest in real property. The record must contain the name and address of the borrower, the loan amount, the nature or purpose of the loan, and the date the loan was made. The stated purpose can be very general such as a passbook loan, personal loan, or business loan. However, financial institutions should be encouraged to be as specific as possible when stating the loan purpose. Additionally, the purpose of a renewal, refinancing, or consolidation is not required as long as the original purpose has not changed and the original statement of purpose is retained for a period of five years after the renewal, refinancing or consolidation has been paid out.

- A record of each advice, request, or instruction received or given regarding any transaction resulting in the transfer of currency or other monetary instruments, funds, checks, investment securities, or credit, of more than $10,000 to or from any person, account, or place outside the U.S. This requirement also applies to transactions later canceled if such a record is normally made.

Required Records for Deposit Accounts

Treasury regulation 31 CFR 103.34 requires banking institutions to obtain and retain a social security number or taxpayer identification number for each deposit account opened after June 30, 1972, and before October 1, 2003. The same information must be obtained for each certificate of deposit sold or redeemed after May 31, 1978, and before October 1, 2003. The banking institution must make a reasonable effort to obtain the identification number within 30 days after opening the account, but will not be held in violation of the regulation if it maintains a list of the names, addresses, and account numbers of those customers from whom it has been unable to secure an identification number. Where a person is a nonresident alien, the banking institution shall also record the person's passport number or a description of some other government document used to verify his/her identity.

Furthermore, 31 CFR 103.34 generally requires banks to maintain records of items needed to reconstruct transaction accounts and other receipts or remittances of funds through a bank. Specific details of these requirements are in the regulation.

Record Retention Period and Nature of Records

All records required by the regulation shall be retained for five years. Records may be kept in paper or electronic form. Microfilm, microfiche or other commonly accepted forms of records are acceptable as long as they are accessible within a reasonable period of time. The record should be able to show both the front and back of each document. If no record is made in the ordinary course of business of any transaction with respect to which records are required to be retained, then such a record shall be prepared in writing by the financial institution.

CUSTOMER IDENTIFICATION PROGRAM

Section 326 of the USA PATRIOT Act, which is implemented by 31 CFR 103.121, requires banks, savings associations, credit unions, and certain non-federally regulated banks to implement a written Customer Identification Program (CIP) appropriate for its size and type of business. For Section 326, the definition of **financial institution** encompasses a variety of entities, including **banks**, agencies and branches of foreign banks in the U.S., thrifts, credit unions, private banks, trust companies, investment companies, brokers and dealers in securities, futures commission merchants, insurance companies, travel agents, pawnbrokers, dealers in precious metals, check cashers, casinos, and telegraph companies, among many others identified at 31 USC 5312(a)(2) and (c)(1)(A). As of October 1, 2003, all institutions and their operating subsidiaries must have in place a CIP pursuant to Treasury regulation 31 CFR 103.121.

The CIP rules do not apply to a **financial institution**'s foreign subsidiaries. However, **financial institutions** are encouraged to implement an effective CIP throughout their operations, including their foreign offices, except to the extent that the requirements of the rule would conflict with local law.

Applicability of CIP Regulation

The CIP rules apply to **banks**, as defined in 31 CFR 103.11 that are subject to regulation by a Federal Banking Agency and to any non-Federally-insured credit union, private bank or trust company that does not have a Federal functional regulator. Entities that are regulated by the U.S. Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) are subject to separate rulemakings. It is intended that the effect of all of these rules be uniform throughout the financial services industry.

CIP Requirements

31 CFR 103.121 requires a **bank** to develop and implement a written, board-approved CIP, appropriate for its size and type of business that includes, at a minimum, procedures for:

- Verifying a customer's true identity to the extent reasonable and practicable and defining the methodologies to be used in the verification process;
- Collecting specific identifying information from each customer when opening an account;
- Responding to circumstances and defining actions to be taken when a customer's true identity cannot be appropriately verified with "reasonable belief;"
- Maintaining appropriate records during the collection and verification of a customer's identity;
- Verifying a customer's name against specified terrorist lists; and
- Providing customers with adequate notice that the **bank** is requesting identification to verify their identities.

While not required, a **bank** may also include procedures for:

- Specifying when it will rely on another **financial institution** (including an affiliate) to perform some or all of the elements of the CIP.

Additionally, 31 CFR 103.121 provides that a **bank** with a Federal functional regulator must formally incorporate its CIP into its written board-approved anti-money laundering program. The FDIC expanded Section 326.8 of its Rules and Regulations to require each **FDIC-supervised institution** to implement a CIP that complies with 31 CFR 103.121 and incorporate such CIP into a bank's written board-approved BSA compliance program (with evidence of such approval noted in the board meeting minutes). Consequently, a **bank** must specifically provide:

- Internal policies, procedures, and controls;
- Designation of a compliance officer;
- Ongoing employee training programs; and
- An independent audit function to test program.

The slight difference in wording between the Treasury's and FDIC's regulations regarding incorporation of a bank's CIP within its anti-money laundering program and BSA compliance program, respectively, was not intended to create duplicative requirements. Therefore, an FDIC-regulated **bank** must include its CIP within its anti-money laundering program and the latter included under the "umbrella" of its overall BSA/AML program.

CIP Definitions

As discussed above, both Section 326 of the USA PATRIOT Act and 31 CFR 103.121 specifically define the terms **financial institution** and **bank**. Similarly, specific definitions are provided for the terms **person**, **customer**, and **account**. Both bank management and examiners must properly understand these terms in order to effectively implement and assess compliance with CIP regulations, respectively.

Person

A **person** is generally an individual or other legal entity (such as registered corporations, partnerships, and trusts).

Customer

A **customer** is generally defined as any of the following:

- A **person** that opens a new **account** (**account** is defined further within the discussion of CIP definitions);
- An individual acting with "power of attorney"(POA)[3] who opens a new **account** to be owned by or for the benefit of a **person** lacking legal capacity, such as a minor;
- An individual who opens an **account** for an entity that is not a legal person, such as a civic club or sports boosters;
- An individual added to an existing **account** or one who assumes an existing debt at the **bank;** or
- A deposit broker who brings new customers to the bank (as discussed in detail later within this section).

The definition of **customer** excludes:

- A financial institution regulated by a Federal Banking Agency or a bank regulated by a State bank regulator[4];
- A department or agency of the U.S. Government, of any state, or of any political subdivision of any state;
- Any entity established under the laws of the U.S., of any state, or of any political subdivision of any state, or under an interstate compact between two or more states, that exercises governmental authority on behalf of the U.S. or any such state or political subdivision (U.S. includes District of Columbia and Indian tribal lands and governments); or

[3] If a POA individual opens an account for another individual with legal capacity or for a legal entity, then the **customer** is still the account holder. In this case, the POA is an agent acting on behalf of the **person** that opens the account and the CIP must still cover the account holder (unless the person lacks legal capacity).

[4] The IRS is not a Federal functional regulator. Consequently, money service businesses, such as check cashers and wire transmitters that are regulated by the IRS are not exempted from the definition of customer for CIP purposes.

- Any entity, other than a bank, whose common stock or analogous equity interests are listed on the New York or American Stock Exchanges or whose common stock or analogous equity interests have been designated as a NASDAQ National Market Security listed on the NASDAQ Stock Market (except stock or interests listed under the separate "NASDAQ Small-Cap Issues" heading). A listed company is exempted from the definition of **customer** only for its domestic operations.

The definition of **customer** also excludes a **person** who has an existing account with a bank, provided that the bank has a "reasonable belief" that it knows the true identity of the **person**. So, if the **person** were to open an additional account, or renew or roll over an existing account, CIP procedures would <u>not</u> be required. A bank can demonstrate that is has a "reasonable belief" that it knows the identity of an existing customer by:

- Demonstrating that it had similar procedures in place to verify the identity of **persons** prior to the effective date of the CIP rule. (An "affidavit of identity" by a bank officer is not acceptable for demonstrating "reasonable belief.")
- Providing a history of **account** statements sent to the **person.**
- **Maintaining account** information sent to the IRS regarding the **person's accounts** accompanied by IRS replies that contain no negative comments.
- Providing evidence of loans made and repaid, or other services performed for the **person** over a period of time.

These actions may <u>not</u> be sufficient for existing account holders deemed to be high risk. For example, in the situation of an import/export business where the identifying information on file only includes a number from a passport marked as a duplicate with no additional business information on file, the bank should follow all of the CIP requirements provided in 31 CFR 103.121 since it does not have sufficient information to show a "reasonable belief" of the true identity of the existing account holder.

<u>Account</u>

An **account** is defined as a formal, ongoing banking relationship established to provide or engage in services, dealings, or other financial transactions including:

- Deposit accounts;
- Transaction or asset accounts ;
- Credit accounts, or any other extension of credit;
- Safety deposit box or other safekeeping services;
- Cash management, custodian, and trust services; or
- Any other type of formal, ongoing banking relationship.

The definition of **account** specifically excludes the following:

- Product or service where a formal banking relationship is NOT established with a **person**. Thus CIP is not intended for infrequent transactions and activities (already covered under other recordkeeping requirements within 31 CFR 103) such as:
  - Check cashing,
  - Wire transfers,
  - Sales of checks,
  - Sales of money orders;
- Accounts acquired through an acquisition, merger, purchase of assets, or assumption of liabilities (as these "new" accounts were not initiated by customers);[5] and
- Accounts opened for the purpose of participating in an employee benefit plan established under the Employee Retirement Income Security Act of 1974 (ERISA).

Furthermore, the CIP requirements do not apply to a **person** who does not receive banking services, such as a **person** who applies for a loan but has his/her application denied. The **account** in this circumstance is only opened when the bank enters into an enforceable agreement to provide a loan to the **person** (who therefore also simultaneously becomes a **customer**).

Collecting Required Customer Identifying Information

The CIP must contain account opening procedures that specify the identifying information obtained from each customer <u>prior</u> to opening the account. The minimum required information includes:

- Name.
- Date of birth, for an individual.

[5] Accounts acquired by purchase of assets from a third party are excluded from the CIP regulations, provided the purchase was not made under an agency in place or exclusive sale arrangement, where the bank has final approval of the credit. If under an agency arrangement, the bank may rely on the agent third party to perform the bank's CIP, but it must ensure that the agent is performing the bank's CIP program. For example, a pool of auto loans purchased from an auto dealer after the loans have already been made would not be subject to the CIP regulations. However, if the bank is directly extending credit to the borrower and is using the car dealer as its agent to gather information, then the bank must ensure that the dealer is performing the bank's CIP.

- Physical address[6], which shall be:
    - for an individual, a residential or business street address (An individual who does not have a physical address may provide an Army Post Office [APO] or a Fleet Post Office [FPO] box number, or the residential or business street address of next of kin or of another contact individual. Using the box number on a rural route is acceptable description of the physical location requirement.)
    - for a person other than an individual (such as corporations, partnerships, and trusts), a principal place of business, local office, or other physical location.
- Identification number including a SSN, TIN, Individual Tax Identification Number (ITIN), or Employer Identification Number (EIN).

For non-U.S. persons, the bank must obtain one or more of the following identification numbers:

- Customer's TIN,
- Passport number and country of issuance,
- Alien identification card number, and
- Number and country of issuance of any other (foreign) government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

When opening an account for a foreign business or enterprise that does not have an identification number, the bank must request alternative government-issued documentation certifying the existence of the business or enterprise.

Exceptions to Required Customer Identifying Information

The bank may develop, include, and follow CIP procedures for a customer who at the time of account opening, has applied for, but has not yet received, a TIN. However, the CIP must include procedures to confirm that the application was filed before the customer opens the account and procedures to obtain the TIN within a reasonable period of time after the account is opened.

There is also an exception to the requirement that a bank obtain the above-listed identifying information <u>from the customer</u> prior to opening an account in the case of credit card accounts. A bank may obtain identifying information (such as TIN) <u>from a third-party source</u> prior to extending credit to the customer.

Verifying Customer Identity Information

The CIP should rely on a **risk-focused** approach when developing procedures for verifying the identity of each customer to the extent reasonable and practicable. A bank need not establish the accuracy of every element of identifying information obtained in the account opening process, but must do so for enough information to form a "reasonable belief" that it knows the true identity of each customer. At a minimum, the **risk-focused** procedures must be based on, but not limited to, the following factors:

- Risks presented by the various types of accounts offered by the bank;
- Various methods of opening accounts provided by the bank;
- Various sources and types of identifying information available; and
- The bank's size, location, and customer base.

Furthermore, a bank's CIP procedures must describe when the bank will use **documentary verification methods**, **non-documentary verification methods**, or a **combination of both methods**.

<u>Documentary Verification</u>

The CIP must contain procedures that set forth the specific documents that the bank will use. For an individual, the documents may include:

- Unexpired government-issued identification evidencing nationality or residence, and bearing a photograph or similar safeguard, such as a driver's license or passport.

For a person other than an individual (such as a corporation, partnership, or trust), the documents may include:

- Documents showing the existence of the entity, such as certified articles of incorporation, a government-issued business license, a partnership agreement, trust instrument, a certificate of good standing, or a business resolution.

<u>Non-Documentary Verification</u>

[6] The bank MUST obtain a physical address: a P.O. Box alone is NOT acceptable. Collection of a P.O. Box address and/or alternate mailing address is optional and potentially very useful as part of the bank's Customer Due Diligence (CDD) program.

Banks are not required to use non-documentary methods to verify a customer's identity. However, if a bank chooses to do so, a description of the approved non-documentary methods must be incorporated in the CIP. Such methods may include:

- Contacting the customer,
- Checking references with other financial institution,
- Obtaining a financial statement, and
- Independently verifying the customer's identity through the comparison of information provided by the customer with information obtained from consumer reporting agencies (for example, Experian, Equifax, TransUnion, Chexsystems), public databases (for example, Lexis, Dunn and Bradstreet), or other sources (for example, utility bills, phone books, voter registration bills).

The bank's non-documentary procedures must address situations such as:

- The inability of a customer to present an unexpired government-issued identification document that bears a photograph or similar safeguard;
- Unfamiliarity on the bank's part with the documents presented;
- Accounts opened without obtaining documents;
- Accounts opened without the customer appearing in person at the bank (for example, accounts opened through the mail or over the Internet); and
- Circumstances increasing the risk that the bank will be unable to verify the true identity of a customer through documents.

Many of the risks presented by these situations can be mitigated. A bank that accepts items that are considered secondary forms of identification, such as utility bills and college ID cards, is encouraged to review more than a single document to ensure that it has formed a "reasonable belief" of the customer's true identity. Furthermore, in instances when an account is opened over the Internet, a bank may be able to obtain an electronic credential, such as a digital certificate, as one of the methods it uses to verify a customer's identity.

Additional Verification Procedures for Customers (Non-Individuals)

The CIP must address situations where, based on a risk assessment of a new account that is opened by a customer that is not an individual, the bank will obtain information about individuals with authority or control over such accounts, in order to verify the customer's identity. These individuals could include such parties as signatories, beneficiaries, principals, and guarantors. As previously stated, a risk-focused approach should be applied to verify customer accounts. For example, in the case of a well-known firm, company information and verification could be sufficient without obtaining and verifying identity information for all signatories. However, in the case of a relatively new or unknown firm, it would be in the bank's best interest to obtain and verify a greater volume of information on signatories and other individuals with control or authority over the firm's account.

Inability to Verify Customer Identity Information

The CIP must include procedures for responding to circumstances in which the bank cannot form a reasonable belief that it knows the true identity of a customer. These procedures should describe, at a minimum, the following:

- Circumstances when the bank should not open an account;
- The terms or limits under which a customer may use an account while the bank attempts to verify the customer's identity (for example, minimal or no funding on credit cards, holds on deposits, limits on wire transfers);
- Situations when an account should be closed after attempts to verify a customer's identity have failed; and
- Conditions for filing a SAR in accordance with applicable laws and regulations.

Recordkeeping Requirements

The bank's CIP must include recordkeeping procedures for:

- Any document that was relied upon to verify identity noting the type of document, the identification number, the place of issuance, and, if any, the dates of issuance and expiration;
- The method and results of any measures undertaken to perform non-documentary verification procedures; and
- The results of any substantive discrepancy discovered when verifying the identifying information obtained.

Banks are not required to make and retain photocopies of any documents used in the verification process. However, if a bank does choose to do so, it must ensure that these photocopies are physically secured to adequately protect against possible identity theft. In addition, such photocopies should not be maintained with files and documentation relating to credit decisions in order to avoid any potential problems with consumer compliance regulations.

Required Retention Period

All required customer identifying information obtained in the account opening process must be retained for five years after the account is closed, or in the case of credit card accounts, five years after the account is closed or becomes dormant. The other "required records" (descriptions of documentary and non-documentary verification procedures and any descriptions of substantive discrepancy resolution) must be retained for five years after the record is made. If several accounts are opened at a bank for a customer simultaneously, all of the required customer identifying information obtained in the account opening process must be retained for five years after the last account is closed, or in the case of credit card accounts, five years after the last account is closed or becomes dormant. As in the case of a single account, all other "required records" must be kept for five years after the records are made.

Comparison with Government Lists of Known or Suspected Terrorists

The CIP must include procedures for determining whether the customer appears on any list of known or suspected terrorists or terrorist organizations issued by any Federal government agency and designated as such by the Treasury in consultation with the other Federal functional regulators.

The comparison procedures must be performed and a determination made within a reasonable period of time after the account is opened, or earlier, as required and directed by the issuing agency. Since the USA PATRIOT Act Section 314(a) Requests, discussed in detail under the heading entitled "Special Information Sharing Procedures to Deter Money Laundering and Terrorist Activities," are one-time only searches, they are not applicable to the CIP.

Adequate Customer Notice

The CIP must include procedures for providing customers with adequate notice that the bank is requesting information to verify their identities. This notice must indicate that the institution is collecting, verifying, and recording the customer identity information as outlined in the CIP regulations. Furthermore, the customer notice must be provided prior to account opening, with the general belief that it will be clearly read and understood. This notice may be posted on a lobby sign, included on the bank's website, provided orally, or disclosed in writing (for example, account application or separate disclosure form). The regulation provides sample language that may be used for providing adequate customer notice. In the case of joint accounts, the notice must be provided to all joint owners; however, this may be accomplished by providing notice to one owner for delivery to the other owners.

Reliance on Another Financial Institution's CIP

A bank may develop and implement procedures for relying on another financial institution for the performance of CIP procedures, yet the CIPs at both entities do not have to be identical. The reliance can be used with respect to any bank customer that is opening or has opened an account or similar formal relationship with the relied-upon financial institution. Additionally, the following requirements must be met:

- Reliance is reasonable, under the circumstances;
- The relied-upon financial institution (including an affiliate) is subject to the same anti-money laundering program requirements as a bank, and is regulated by a Federal functional regulator (as previously defined); and
- A signed contract exists between the two entities that requires the relied-upon financial institution to certify annually that it has implemented its anti-money laundering program, and that it will perform (or its agent will perform) the specified requirements of the bank's CIP.

To strengthen such an arrangement, the signed contract should include a provision permitting the bank to have access to the relied-upon institution's annual independent review of its CIP.

Deposit Broker Activity

The use of deposit brokers is a common funding mechanism for many financial institutions. This activity is considered higher risk because each deposit broker operates under its own operating guidelines to bring customers to a bank. Consequently, the deposit broker may not be performing sufficient Customer Due Diligence (CDD), Office of Foreign Assets Control (OFAC) screening (refer to the detailed OFAC discussion provided elsewhere within this chapter), or CIP procedures. The bank accepting brokered deposits relies upon the deposit broker to have sufficiently performed all required account opening procedures and to have followed all BSA and AML program requirements.

Deposit Broker is Customer

Regulations contained in 31 CFR 103.121 specifically defines the term customer as a person (individual, registered corporation, partnership, or trust). Therefore, according to this definition, if a deposit broker opens an account(s), the customer is the deposit broker NOT the deposit broker's clients.

Deposit Broker's CIP

Deposit brokers must follow their own CIP requirements for their customers. If the deposit broker is registered with the SEC, then it is required to follow the same general CIP requirements as banking institutions and is periodically examined by the SEC for compliance. However, if the deposit broker does not come under the SEC's jurisdiction, they may not be following any due diligence laws or guidelines.

As such, banks accepting deposit broker accounts should establish policies and procedures regarding the brokered deposits. Policies should establish minimum due diligence procedures for all deposit brokers providing business to the bank. The level of due diligence a bank performs should be commensurate with its knowledge of the deposit broker and the broker's known business practices.

Banks should conduct **enhanced** due diligence on unknown and/or unregulated deposit brokers. For protection, the bank should determine that the:

- Deposit broker is legitimate;
- Deposit broker is following appropriate guidance and/or regulations;
- Deposit broker's policies and procedures are sufficient;
- Deposit broker has adequate CIP verification procedures;
- Deposit broker screens clients for OFAC matches;
- BSA/OFAC audit reviews are adequate and show compliance with requirements; and
- Bank management is aware of the deposit broker's anticipated volume and transaction type.

Special care should be taken with deposit brokers who:

- Are previously unknown to the bank;
- Conduct business or obtain deposits primarily in another country;
- Use unknown or hard-to-contact businesses and banks for references;
- Provide other services which may be suspect, such as creating shell corporations for foreign clients;
- Advertise their own deposit rates, which vary widely from those offered by banking institutions; and
- Refuse to provide requested due diligence information or use methods to get deposits placed before providing information.

Banks doing business with deposit brokers are encouraged to include contractual requirements for the deposit broker to establish and conduct procedures for minimum CIP, CDD, and OFAC screening.

Finally, the bank should monitor brokered deposit activity for unusual activity, including cash transactions, structuring, and funds transfer activity. Monitoring procedures should identify any "red flags" suggesting that the deposit broker's customers (the ultimate customers) are trying to conceal their true identities and/or their source of wealth and funds.

Additional Guidance on CIP Regulations

Comprehensive guidance regarding CIP regulations and related examination procedures can be found within FDIC FIL 90-2004, Guidance on Customer Identification Programs. On January 9, 2004, the Treasury, FinCEN, and the Federal Financial Institutions Examination Council (FFIEC) regulatory agencies issued joint interpretive guidance addressing frequently asked questions (FAQs) relating to CIP requirements in FIL-4-2004. Additional information regarding CIP can be found on the FinCEN website.

SPECIAL INFORMATION SHARING PROCEDURES TO DETER MONEY LAUNDERING AND TERRORIST ACTIVITIES

Section 314 of the USA PATRIOT Act covers special information sharing procedures to deter money laundering and terrorist activities. These are the only two categories that apply under Section 314 information sharing; no information concerning other suspicious or criminal activities can be shared under the provisions of Section 314 of the USA PATRIOT Act. Final regulations of the following two rules issued on March 4, 2002, became effective on September 26, 2002:

- Section 314(a), codified into 31 CFR 103.100, requires **mandatory** information sharing between the U.S. Government (FinCEN, Federal law enforcement agencies, and Federal Banking Agencies) and financial institutions.
- Section 314(b), codified into 31 CFR 103.110, encourages **voluntary** information sharing between financial institutions and/or associations of financial institutions.

Section 314(a) – Mandatory Information Sharing Between the U.S. Government and Financial Institutions

A Federal law enforcement agency investigating terrorist activity or money laundering may request that FinCEN solicit, on its behalf, certain information from a financial institution or a group of financial institutions on certain individuals or entities. The law enforcement agency must provide a written certification to FinCEN attesting that credible evidence of money laundering or terrorist activity exists. It must also provide specific identifiers such as date of birth, address, and social security number of the individual(s) under investigation that would permit a financial institution to differentiate among customers with common or similar names.

Section 314(a) Requests

Upon receiving an adequate written certification from a law enforcement agency, FinCEN may require financial institutions to perform a search of their records to determine whether they maintain or have maintained accounts for, or have engaged in transactions with, any specified individual, entity, or organization. This process involves providing a Section 314(a) Request to the financial institutions. Such lists are issued to financial institutions every two weeks by FinCEN.

Each Section 314(a) request has a unique tracking number. The general instructions for a Section 314(a) Request require financial institutions to complete a **one-time** search of their records and respond to FinCEN, if necessary, within **two weeks**. However, individual requests can have different deadline dates. Any specific guidelines on the request supercede the general guidelines.

Designated Point-of-Contact for Section 314(a) Requests

All financial institutions shall designate at least one point-of-contact for Section 314(a) requests and similar information requests from FinCEN. FDIC-supervised financial institutions must promptly notify the FDIC of any changes to the point-of-contact, which is reported on each Call Report.

Financial Institution Records Required to be Searched

The records that must be searched for a Section 314(a) Request are specified in the request itself. Using the identifying information contained in the 314(a) request, financial institutions are required to conduct a **one-time** search of the following records, **whether or not they are kept electronically (subject to the limitations below)**:

- Deposit account records;
- Funds transfer records;
- Sales of monetary instruments (purchaser only);
- Loan records;
- Trust department records;
- Securities records (purchases, sales, safekeeping, etc.);
- Commodities, options, and derivatives; and
- Safe deposit box records (but only if searchable electronically).

According to the general instructions to Section 314(a), financial institutions are NOT required to research the following documents for matches:

- Checks processed through an account for a payee,
- Monetary instruments for a payee,
- Signature cards, and
- CTRs and SARs previously filed.

The general guidelines specify that the record search need only encompass current accounts and accounts maintained by a named subject during the preceding twelve (12) months, and transactions not linked to an account conducted by a named subject during the preceding six (6) months. Any record described above that is not maintained in electronic form need only be searched if it is required to be kept under federal law or regulation.

Again, if the specific guidelines or the timeframe of records to be searched on a Section 314(a) Request differ from the general guidelines, they should be followed to the extent possible. For example, if a particular Section 314(a) Request asks financial institutions to search their records back eight years, the financial institutions should honor such requests to the extent possible, even though BSA recordkeeping requirements generally do not require records to be retained beyond five years.

Reporting of "Matches"

Financial institutions typically have a two-week window to complete the one-time search and respond, if necessary to FinCEN. If a financial institution identifies an account or transaction by or on behalf of an individual appearing on a Section 314(a) Request, it must report back to FinCEN that it has a "positive match," unless directed otherwise. When reporting this information to FinCEN, no additional details, unless otherwise instructed, should be provided other than the fact that a "positive match" has been identified. In situations where a financial institution is unsure of a match, it may contact the law enforcement agency specified in the Section 314(a) Request. Negative responses to Section 314(a) Requests are not required; the financial institution does not need to respond to FinCEN on a Section 314(a) Request if there are no matches to the institution's records. Financial institutions are to be reminded that unless a name is repeated on a subsequent Section 314(a) Request, that name does not need to be searched again.

The financial institution **must not** notify a customer that he/she has been included on a Section 314(a) Request. Furthermore, the financial institution must not tell the customer that he/she is under investigation or that he/she is suspected of criminal activity.

Restrictions on Use of Section 314(a) Requests

A financial institution may only use the information identified in the records search to report "positive matches" to FinCEN and to file, when appropriate, SARs. If the financial institution has a "positive match," account activity with that customer or entity is not prohibited; it is acceptable for the financial institution to open new accounts or maintain current accounts with Section 314(a) Request subjects; the closing of accounts is not required. However, the Section 314(a) Requests may be useful as a determining factor for such decisions if the financial institution so chooses. Unlike OFAC lists, Section 314(a) Requests are not permanent "watch lists." In fact, Section 314(a) Requests are not updated or corrected if an investigation is dropped, a prosecution is declined, or a subject is exonerated, as they are point-in-time inquiries. Furthermore, the names provided on Section 314(a) Requests do not necessarily correspond to convicted or indicted persons; rather, a Section 314(a) Request subject need only be "reasonably suspected," based on credible evidence of engaging in terrorist acts or money laundering to appear on the list.

SAR Filings

If a financial institution has a positive match within its records, it is not required to automatically file a SAR on the identified subject. In other words, the subject's presence on the Section 314(a) Request should not be the sole factor in determining whether to file a SAR. However, prudent BSA compliance practices should ensure that the subject's accounts and transactions be scrutinized for suspicious or unusual activity. If, after such a review is performed, the financial institution's management has determined that the subject's activity is suspicious, unusual, or inconsistent with the customer's profile, then the timely filing of an SAR would be warranted.

Confidentiality of Section 314(a) Requests

Financial institutions must protect the security of the Section 314(a) Requests, as they are confidential. As stated previously, a financial institution must not tip off a customer that he/she is the subject of a Section 314(a) Request. Similarly, a financial institution cannot disclose to any person or entity, other than to FinCEN, its primary Federal functional regulator, or the Federal law enforcement agency on whose behalf FinCEN is requesting information, the fact that FinCEN has requested or obtained information from a Section 314(a) Request.

FinCEN has stated that an affiliated group of financial institutions may establish one point-of-contact to distribute the Section 314(a) Requests for the purpose of responding to requests. However, the Section 314(a) Requests should not be shared with foreign affiliates or foreign subsidiaries (unless the request specifically states otherwise), and the lists cannot be shared with affiliates or subsidiaries of bank holding companies that are not financial institutions.

Notwithstanding the above restrictions, a financial institution is authorized to share information concerning an individual, entity, or organization named in a Section 314(a) Request from FinCEN with other financial institutions and/or financial institution associations in accordance with the certification and procedural requirements of Section 314(b) of the USA PATRIOT Act discussed below. However, such sharing shall not disclose the fact that FinCEN has requested information on the subjects or the fact that they were included within a Section 314(a) Request.

Internal Financial Institution Measures for Protecting Section 314(a) Requests

In order to protect the confidentiality of the Section 314(a) Requests, these documents should only be provided to financial institution personnel who need the information to conduct the search and should not be left in an unprotected or unsecured area. A financial institution may provide the Section 314(a) Request to third-party information technology service providers or vendors to perform/facilitate the record searches so long as it takes the necessary steps to ensure that the third party appropriately safeguards the information. It is important to remember that the financial institution remains ultimately responsible for the performance of the required searches and to protect the security and confidentiality of the Section 314(a) Requests.

Each financial institution must maintain adequate procedures to protect the security and confidentiality of requests from FinCEN. The procedures to ensure confidentiality will be considered adequate if the financial institution applies procedures similar to those it has established to comply with Section 501 of the Gramm-Leach-Bliley Act (15 USC 6801) with regard to the protection of its customers' non-public personal information.

Financial institutions should keep a log of all Section 314(a) Requests received and any "positive matches" identified and reported to FinCEN. Additionally, documentation that all required searches were performed is essential. The financial institution should not need to keep copies of the Section 314(a) Requests, noting the unique tracking number will suffice. Some financial institutions may choose to destroy the Section 314(a) Requests after searches are performed. If a financial institution chooses to keep the Section 314(a) Requests for audit/internal review purposes, it should not be criticized for doing so, as long as it appropriately secures them and protects their confidentiality.

FinCEN has provided financial institutions with general instructions, FAQs, and additional guidance relating to the Section 314(a) Request process. These documents are revised periodically and may be found on FinCEN's Web site.

Section 314(b) - Voluntary Information Sharing

Section 314(b) of the USA PATRIOT Act encourages financial institutions and financial institution associations (for example, bank trade groups and associations) to share information on individuals, entities, organizations, and countries suspected of engaging in possible terrorist activity or money laundering. Section 314(b) limits the definition of "financial institutions" used within Section 314(a) of USA PATRIOT Act to include only those institutions that are required to establish and maintain an anti-money laundering program; this definition includes, but is not limited to, banking entities regulated by the Federal Banking Agencies. The definition specifically excludes any institution or class of institutions that FinCEN has designated as ineligible to share information. Section 314(b) also describes the safe harbor from civil liability that is provided to financial institutions that appropriately share information within the limitations and requirements specified in the regulation.

Restrictions on Use of Shared Information

Information shared on a subject from a financial institution or financial institution association pursuant to Section 314(b) cannot be used for any purpose other than the following:

- Identifying and, where appropriate, reporting on money laundering or terrorist activities;
- Determining whether to establish or maintain an account, or to engage in a transaction; or
- Assisting in the purposes of complying with this section.

Annual Certification Requirements

In order to avail itself to the statutory safe harbor protection, a financial institution or financial institution association must annually certify with FinCEN stating its intent to engage in information sharing with other similarly-certified entities. It must further state that it has established and will maintain adequate procedures to protect the security and confidentiality of the information, as if the information were included in one of its own SAR filings. The annual certification process involves completing and submitting a "Notice for Purposes of Subsection 314(b) of the USA PATRIOT Act and 31 CFR 103.110." The notice can be completed and electronically submitted to FinCEN via their website. Alternatively, the notice can be mailed to the following address: FinCEN, P.O. Box 39, Mail Stop 100, Vienna, VA 22183. It is important to mention that if a financial institution or financial institution association improperly uses its Section 314(b) permissions, its certification can be revoked by either FinCEN or by its Federal Banking Agency.

Failure to follow the Section 314(b) annual certification requirements will result in the loss of the financial institution or financial institution association's statutory safe harbor and could result in a violation of privacy laws or other laws and regulations.

Verification Requirements

A financial institution must take reasonable steps to verify that the other financial institution(s) or financial institution association(s) with which it intends to share information has also performed the annual certification process discussed above. Such verification can be performed by reviewing the lists of other 314(b) participants that are periodically provided by FinCEN. Alternatively, the financial institution or financial institution association can confirm directly with the other party that the certification process has been completed.

Other Important Requirements and Restrictions

Section 314(b) requires virtually the same care and safeguarding of sensitive information as Section 314(a), whether the bank is the "provider" or "receiver" of information. Refer to the discussions provided above and within "Section 314(a) – Mandatory Information Sharing Between the U.S. Government and Financial Institutions" for detailed guidance on:

- SAR Filings and
- Confidentiality of Section 314(a) Requests (including the embedded discussion entitled "Internal Financial Institution Measures for Protecting Section 314(a) Requests").

Actions taken pursuant to shared information do not affect a financial institution's obligations to comply with all BSA and OFAC rules and regulations. For example, a financial institution is still obligated to immediately contact law enforcement and its Federal regulatory agency, by telephone, when a significant reportable violation requiring immediate attention (such as one that involves the financing of terrorist activity or is of an ongoing nature) is being conducted; thereafter, a timely SAR filing is still required.

FinCEN has provided financial institutions with general instructions, registration forms, FAQs, and additional guidance relating to the Section 314(b) information sharing process. These documents are revised periodically and may be found on FinCEN's website.

CUSTOMER DUE DILIGENCE (CDD)

The cornerstone of strong BSA/AML programs is the adoption and implementation of comprehensive CDD policies, procedures, and controls for all customers, particularly those that present a higher risk for money laundering and terrorist financing. The concept of CDD incorporates and builds upon the CIP regulatory requirements for identifying and verifying a customer's identity.

The goal of a CDD program is to develop and maintain an awareness of the unique financial details of the institution's customers and the ability to relatively predict the type and frequency of transactions in which its customers are likely to engage. In doing so, institutions can better identify, research, and report suspicious activity as required by BSA regulations. Although not required by statute or regulation, an effective CDD program provides the critical framework that enables the institution to comply with regulatory requirements.

Benefits of an Effective CDD Program

An effective CDD program protects the reputation of the institution by:

- Preventing unusual or suspicious transactions in a timely manner that potentially exposes the institution to financial loss or increased expenses;
- Avoiding criminal exposure from individuals who use the institution's resources and services for illicit purposes; and
- Ensuring compliance with BSA regulations and adhering to sound and recognized banking practices.

CDD Program Guidance

CDD programs should be tailored to each institution's BSA/AML risk profile; consequently, the scope of CDD programs will vary. While smaller institutions may have more frequent and direct contact with customers than their counterparts in larger institutions, all institutions should adopt and follow an appropriate CDD program.

An effective CDD program should:

- Be commensurate with the institution's BSA/AML risk profile, paying particular attention to higher risk customers,
- Contain a clear statement of management's overall expectations and establish specific staff responsibilities, and
- Establish monitoring systems and procedures for identifying transactions or activities inconsistent with a customer's normal or expected banking activity.

Customer Risk

As part of an institution's BSA/AML risk assessment, many institutions evaluate and apply a BSA/AML risk rating to its customers. Under this approach, the institution will obtain information at account opening sufficient to develop a "customer transaction profile" that incorporates an understanding of normal and expected activity for the customer's occupation or business operations. While this practice may not be appropriate for all institutions, management of all institutions should have a thorough understanding of the money laundering or terrorist financing risks of its customer base and develop and implement the means to adequately mitigate these risks.

Due Diligence for Higher Risk Customers

Customers that pose higher money laundering or terrorist financing risks present increased exposure to institutions. Due diligence for higher risk customers is especially critical in understanding their anticipated transactions and implementing a suspicious activity monitoring system that reduces the institution's reputation, compliance, and transaction risks. Higher risk customers and their transactions should be reviewed more closely at account opening and more frequently throughout the term of the relationship with the institution.

The USA PATRIOT Act requires special due diligence at account opening for certain foreign accounts, such as foreign correspondent accounts and accounts for senior foreign political figures. An institution's CDD program should include policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts that are established or maintained for non-U.S. persons. Guidance regarding special due diligence requirements is provided in the next section entitled "Banking Services and Activities with Greater Potential for Money Laundering and Enhanced Due Diligence Procedures."

BANKING SERVICES AND ACTIVITIES WITH GREATER POTENTIAL FOR MONEY LAUNDERING AND ENHANCED DUE DILIGENCE PROCEDURES

Certain financial services and activities are more vulnerable to being exploited in money laundering and terrorist financing activities. These conduits are often utilized because each typically presents an opportunity to move large amounts of funds embedded within a large number of similar transactions. Most activities discussed in this section also offer access to international banking and financial systems. The ability of U.S. financial institutions to conduct the appropriate level of due diligence on customers of foreign banks, offshore and shell banks, and foreign branches is often severely limited by the laws and banking practices of other countries.

While international AML and Counter-Terrorist Financing (CTF) standards are improving through efforts of several international groups, U.S. financial institutions will still need effective systems in their AML and CTF programs to understand the quality of supervision and assess the integrity and effectiveness of controls in other countries. Higher risk areas discussed in this section include:

- Non-bank financial institutions (NBFIs), including money service businesses (MSBs);
- Foreign correspondent banking relationships;
- Payable-through accounts;
- Private banking activities;
- Numbered accounts;
- Pouch activities;
- Special use accounts;
- Wire transfer activities; and
- Electronic banking.

Financial institutions offering these higher risk products and services must enhance their AML and CDD procedures to ensure adequate scrutiny of these activities and the customers conducting them.

Non-Bank Financial Institutions and Money Service Businesses

Non-bank financial institutions (NBFIs) are broadly defined as institutions that offer financial services. Traditional financial institutions ("banks" for this discussion) that maintain account relationships with NBFIs are exposed to a higher risk for potential money laundering activities because these entities are less regulated and may have limited or no documentation on their customers. Additionally, banks may likewise be exposed to possible OFAC violations for unknowingly engaging in or facilitating prohibited transactions through a NBFI account relationship.

NBFIs include, but are not limited to:

- Casinos or card clubs;
- Securities brokers/dealers; and
- Money Service Businesses (MSBs)
  - currency dealers or exchangers;
  - check cashers;
  - issuers, sellers, or redeemers of traveler's checks, money orders, or stored value cards;
  - money transmitters; and
  - U.S. Post Offices (money orders).

Money Service Businesses

As indicated above, MSBs are a subset of NBFIs. Regulations for MSBs are included within 31 CFR 103.41. All MSBs were required to register with FinCEN using Form TD F 90-22.55 by December 31, 2001, or within 180 days after the business begins operations. Thereafter, each MSB must renew its registration every two years.

MSBs are a major industry, and typically operate as independent businesses. Relatively few MSBs are chains that operate in multiple states. MSBs can be sole-purpose entities but are frequently tied to another business such as a liquor store, bar, grocery store, gas station, or other multi-purpose entity. As a result, many MSBs are frequently unaware of their legal and regulatory requirements and have been historically difficult to detect. A bank may find it necessary to inform MSB customers about the appropriate MSB regulations and requirements.

Most legitimate MSBs should not refuse to follow regulations once they have been informed of the requirements. If they do, the bank should closely scrutinize the MSBs activities and transactions for possible suspicious activity.

MSBs typically do not establish on-going customer relationships, and this is one of the reasons that MSB customers are considered higher risk. Since MSBs do not have continuous relationships with their clients, they generally do not obtain key due diligence documentation, making customer identification and suspicious transaction identification more difficult.

Banks with MSB customers also have a risk in processing third-party transactions through their payment and other banking systems. MSB transactions carry an inherent potential for the facilitation of layering. MSBs can be conduits for illicit cash and monetary instrument transactions, check kiting, concealing the ultimate beneficiary of the funds, and facilitating the processing of forged or fraudulent items such as treasury checks, money orders, traveler's checks, and personal checks.

MSB Agents

MSBs that are agents of such commonly known entities as Moneygram or Western Union should be aware of their legal requirements. Agents of such money transmitters, unless they offer another type of MSB activity, do NOT have to independently register with FinCEN, but are maintained on an agency list by the "actual" MSB (such as Western Union). However, this "actual" MSB is responsible for providing general training and information requirements to their agents and for aggregating transactions on a nationwide basis, as appropriate.

Check Cashers

FinCEN defines a check casher as a business that will cash checks and/or sell monetary or other instruments over $1,000 per customer on any given day. If a company, such as a local mini-market, will cash only personal checks up to $100 per day AND it provides no other financial services or instruments (such as money orders or money transmittals), then that company would NOT be considered a check casher for regulatory purposes or have to register as an MSB.

Exemptions from CTR Filing Requirements

MSBs are subject to BSA regulations and OFAC sanctions and, as such, should be filing CTRs, screening customers for OFAC matches, and filing SARs, as appropriate. MSBs cannot exempt their customers from CTR filing requirements like banks can, and banks may not exempt MSB customers from CTR filing, unless the "50 Percent Rule" applies.

The "50 Percent Rule" states that if a MSB derives less than 50 percent of its gross cash receipts from money service activities, then it can be exempted. If the bank exempts a MSB customer under the "50 Percent Rule," it should have documentation evidencing the types of business conducted, receipt volume, and estimations of MSB versus non-MSB activity.

Policies and Procedures for Opening and Monitoring NBFI and MSB Relationships

Banks that maintain account relationships with NBFIs or MSBs should perform greater due diligence for these customers given their higher risk profile. Management should implement the following due diligence procedures for MSBs:

- Identify all NBFI/MSB accounts;
- Determine that the business has met local licensing requirements;
- Ascertain if the MSB has registered or re-registered with FinCEN and obtain a copy of the filing or verify the filing on FinCEN's website;
- Determine if the MSB has procedures to comply with BSA regulations and OFAC monitoring;
- Establish the types and amounts of currencies/instruments handled, and any additional services provided;
- Note the targeted customer base;
- Determine if the business sends or receives international wires and the nature of the activity;
- Determine if the MSB has procedures to monitor and report suspicious activity; and
- Obtain a copy of the MSBs independent BSA review, if available.

Management should document in writing the responses to the items above and update MSB customer files at least annually. In addition, management should continue to monitor these higher risk accounts for suspicious activity. The FDIC does not expect the bank to perform an examination of the MSB; however, the bank should take reasonable steps to document that MSB customers are aware of and are complying with appropriate regulations.

For additional information, examiners should instruct bank management to consult the FinCEN website developed specifically for MSBs. This website contains guidance, registration forms, and other materials useful for MSBs to understand and comply with BSA regulations. Bank customers who are uncertain if they are covered by the definition of MSBs can also visit this site to determine if their business activities qualify.

Foreign Correspondent Banking Relationships

Correspondent accounts are accounts that financial institutions maintain with each other to handle transactions for themselves or for their customers. Correspondent accounts between a foreign bank and U.S. financial institutions are much needed, as they facilitate international trade and investment. However, these relationships may pose a higher risk for money laundering.

Transactions through foreign correspondent accounts are typically large and would permit movement of a high volume of funds relatively quickly. These correspondent accounts also provide foreign entities with ready access to the U.S. financial system. These banks and other financial institutions may be located in countries with unknown AML regulations and controls ranging from strong to weak, corrupt, or nonexistent.

The USA PATRIOT Act establishes reporting and documentation requirements for certain high-risk areas, including:

- Special due diligence requirements for correspondent accounts and private banking accounts which are addressed in 31 CFR 103.181.
- Verification procedures for foreign correspondent account relationships which are included in 31 CFR 103.185.
- Foreign banks with correspondent accounts at U.S. financial institutions must produce bank records, including information on ownership, when requested by regulators and law enforcement, as detailed in Section 319 of the USA PATRIOT Act and codified at 31 CFR 103.185.

The foreign correspondent records detailed above are to be provided within seven days of a law enforcement request and within 120 hours of a Federal regulatory request. Failure to provide such records in a timely manner may result in the U.S. financial institution's required termination of the foreign correspondent account. Such foreign correspondent relationships need only be terminated upon the U.S. financial institution's written receipt of such instruction from either the Secretary of the Treasury or the U.S. Attorney General. If the U.S. financial institution fails to terminate relationships after receiving notification, the U.S. institution may face civil money penalties.

The Treasury was also granted broad authority by the USA PATRIOT Act (codified in 31 USC 5318[A]), allowing it to establish special measures. Such special measures can be established which require U.S. financial institutions to perform additional recordkeeping and/or reporting or require a complete prohibition of accounts and transactions with certain countries and/or specified foreign financial institutions. The Treasury may impose such special measures by regulation or order, in consultation with other regulatory agencies, as appropriate.

Shell Banks

Sections 313 and 319 of the USA PATRIOT Act implemented (by 31 CFR 103.177 and 103.185, respectively) a new provision of the BSA that relates to foreign correspondent accounts. Covered financial institutions (CFI) are prohibited from establishing, maintaining, administering, or managing a correspondent account in the U.S. for or on behalf of a foreign shell bank.

A correspondent account, under this regulation, is defined as an account established by a CFI for a foreign bank to receive deposits from, to make payments or other disbursements on behalf of a foreign financial institution, or to handle other financial transactions related to the foreign bank. An account is further defined as any formal banking or business relationship established to provide:

- Regular services,
- Dealings, and
- Other financial transactions,

and may include:

- Demand deposits,
- Savings deposits,
- Any other transaction or asset account,
- Credit account, or
- Any other extension of credit.

A foreign shell bank is defined as a foreign bank without a physical presence in any country. Physical presence means a place of business that:

- Is maintained by a foreign bank;
- Is located at a fixed address (other than solely an electronic address or a post-office box) in a country in which the foreign bank is authorized to conduct banking activities;
- Provides at that fixed address:
  - One or more full-time employees,
  - Operating records related to its banking activities; and
- Is subject to inspection by the banking authority that licensed the foreign bank to conduct banking activities.

There is one exception to the shell bank prohibition. This exception allows a CFI to maintain a correspondent account with a foreign shell bank if it is a regulated affiliate. As a regulated affiliate, the shell bank must meet the following requirements:

- The shell bank must be affiliated with a depository institution (bank or credit union, either U.S. or foreign) in the U.S. or another foreign jurisdiction.
- The shell bank must be subject to supervision by the banking authority that regulates the affiliated entity.

Furthermore, in any foreign correspondent relationship, the CFI must take reasonable steps to ensure that such an account is not being used indirectly to provide banking services to other foreign shell banks. If the CFI discovers that a foreign correspondent account is providing indirect services in this manner, then it must either prohibit the indirect services to the foreign shell bank or close down the foreign correspondent account. This activity is referred to as "nested" correspondent banking and is discussed in greater detail below under "Foreign Correspondent Banking Money Laundering Risks."

Required Recordkeeping on Correspondent Banking Accounts

As mentioned previously, a CFI that maintains a foreign correspondent account must also maintain records identifying the owners of each foreign bank. To minimize recordkeeping burdens, ownership information is not required for:

- Foreign banks that file form FR-7 with the Federal Reserve, or
- Publicly traded foreign banks.

A CFI must also record the name and street address of a person who resides in the U.S. and who is willing to accept service of legal process on behalf of the foreign institution. In other words, the CFI must collect information so that law enforcement can serve a subpoena or other legal document upon the foreign correspondent bank.

Certification Process

To facilitate information collection, the Treasury, in coordination with the banking industry, Federal regulators and law enforcement agencies, developed a certification process using special forms to standardize information collection. The use of these forms is not required; however, the information must be collected regardless. The CFI must update, or re-certify, the foreign correspondent information at least once every three years.

For new accounts, this certification information must be obtained within 30 calendar days after the opening date. If the CFI is unable to obtain the required information, it must close all correspondent accounts with that foreign bank within a commercially reasonable time. The CFI should review certifications to verify their accuracy. The review should look for potential problems that may warrant further research or information. Should a CFI know, suspect, or have reason to suspect that any certification information is no longer correct, the CFI must request the foreign bank to verify or correct such information within 90 days. If the information is not corrected within that time, the CFI must close all correspondent accounts with that institution within a commercially reasonable time.

Foreign Correspondent Banking Money Laundering Risks

Foreign correspondent accounts provide clearing access to foreign financial institutions and their customers, which may include other foreign banks. Many U.S. financial institutions fail to ascertain the extent to which the foreign banks will allow other foreign banks to use their U.S. accounts. Many high-risk foreign financial institutions have gained access to the U.S. financial system by operating through U.S. correspondent accounts belonging to other foreign banks. These are commonly referred to as "nested" correspondent banks.

Such nested correspondent bank relationships result in the U.S. financial institution's inability to identify the ultimate customer who is passing a transaction through the foreign correspondent's U.S. account. These nested relationships may prevent the U.S. financial institution from effectively complying with BSA regulations, suspicious activity reporting, and OFAC monitoring and sanctions.

If a U.S. financial institution's due diligence or monitoring system identifies the use of such nested accounts, the U.S.

financial institution should do one or more of the following:

- Perform due diligence on the nested users of the foreign correspondent account, to determine and verify critical information including, but not limited to, the following:
    - Ownership information,
    - Service of legal process contact,
    - Country of origin,
    - AML policies and procedures,
    - Shell bank and licensing status,
    - Purpose and expected volume and type of transactions;
- Restrict business through the foreign correspondent's accounts to limited transactions and/or purposes; and
- Terminate the initial foreign correspondent account relationship.

Necessary Due Diligence on Foreign Correspondent Accounts

Because of the heightened risk related to foreign correspondent banking, the U.S. financial institution needs to assess the money laundering risks associated with each of its correspondent accounts. The U.S. financial institution should understand the nature of each account holder's business and the purpose of the account. In addition, the U.S. financial institution should have an expected volume and type of transaction anticipated for each foreign bank customer.

When a new relationship is established, the U.S. financial institution should assess the management and financial condition of the foreign bank, as well as its AML programs and the home country's money laundering regulations and supervisory oversight. These due diligence measures are in addition to the minimum regulation requirements.

Each U.S. financial institution maintaining foreign correspondent accounts must establish appropriate, specific, and, where necessary, enhanced due diligence policies, procedures, and controls as required by 31 CFR 103.181. The U.S. financial institution's AML policies and programs should enable it to reasonably detect and report instances of money laundering occurring through the use of foreign correspondent accounts.

The regulations specify that additional due diligence must be completed if the foreign bank is:

- Operating under an offshore license;
- Operating under a license granted by a jurisdiction designated by the Treasury or an intergovernmental agency (such as the Financial Action Task Force [FATF]) as being a primary money laundering concern; or
- Located in a bank secrecy or money laundering haven.

Internal financial institution policies should focus compliance efforts on those accounts that represent a higher risk of money laundering. U.S. financial institutions may use their own risk assessment or incorporate the best practices developed by industry and regulatory recommendations.

Offshore Banks

An offshore bank is one which does not transact business with the citizens of the country that licenses the bank. For example, a bank is licensed as an offshore bank in Spain. This institution may do business with anyone in the world except for the citizens of Spain. Offshore banks are typically a revenue generator for the host country and may not be as closely regulated as banks that provide financial services to the host country's citizens. The host country may also have lax AML standards, controls, and enforcement. As such, offshore licenses can be appealing to those wishing to launder illegally obtained funds.

The FATF designates Non-Cooperative Countries and Territories (NCCTs). These countries have been so designated because they have not applied the recommended international anti-money laundering standards and procedures to their financial systems. The money laundering standards established by FATF are known as the Forty Recommendations. Further discussion of the Forty Recommendations and NCCTs can be found at the FATF website.

Payable Through Accounts

A payable through account (PTA) is a demand deposit account through which banking agencies located in the U.S. extend check writing privileges to the customers of other domestic or foreign institutions. PTAs have long been used in the U.S. by credit unions (for example, for checking account services) and investment companies (for example, for checking account services associated with money market management accounts) to offer customers the full range of banking services that only a commercial bank has the ability to provide.

International PTA Use

Under an international PTA arrangement, a U.S. financial institution, Edge corporation, or the U.S. branch or agency of a foreign bank (U.S. banking entity) opens a master checking account in the name of a foreign bank operating outside the U.S. The master account is subsequently divided by the foreign bank into "sub-accounts" each in the name of one of the foreign bank's customers. Each sub-account holder becomes a signatory on the foreign bank's account at the U.S. banking entity and may conduct banking activities through the account.

Financial institution regulators have become aware of the increasing use of international PTAs. These accounts are being marketed by U.S. financial institutions to foreign banks that otherwise would not have the ability to offer their customers direct access to the U.S. banking system. While PTAs provide legitimate business benefits, the operational aspects of the account make it particularly vulnerable to abuse as a mechanism to launder money. In addition, PTAs present unique safety and soundness risks to banking entities in the U.S.

Sub-account holders of the PTA master accounts at the U.S. banking entity may include other foreign banks, rather than just individuals or corporate accounts. These second-tier foreign banks then solicit individuals as customers. This may result in thousands of individuals having signatory authority over a single account at a U.S. banking entity. The PTA mechanism permits the foreign bank operating outside the U.S. to offer its customers, the sub-account holders, U.S. denominated checks and ancillary services, such as the ability to receive wire transfers to and from sub-accounts and to cash checks. Checks are encoded with the foreign bank's account number along with a numeric code to identify the sub-account.

Deposits into the U.S. master account may flow through the foreign bank, which pools them for daily transfer to the U.S. banking entity. Funds may also flow directly to the U.S. banking entity for credit to the master account, with further credit to the sub-account.

Benefits Associated with Payable Through Accounts

While the objectives of U.S. financial institutions marketing PTAs and the foreign banks which subscribe to the PTA service may vary, essentially three benefits currently drive provider and user interest:

- PTAs permit U.S. financial institutions to attract dollar deposits from the home market of foreign banks without jeopardizing the foreign bank's relationship with its clients.
- PTAs provide fee income potential for both the U.S. PTA provider and the foreign bank.
- Foreign banks can offer their customers efficient and low-cost access to the U.S. banking system.

Risks Associated with Payable Through Accounts

The PTA arrangement between a U.S. banking entity and a foreign bank may be subject to the following risks:

- *Money Laundering risk* – the risk of possible illegal or improper conduct flowing through the PTAs.
- *OFAC risk* – the risk that the U.S. banking entity does not know the ultimate PTA customers which could facilitate the completion of sanctioned or blocked transactions.
- *Credit risk* - the risk the foreign bank will fail to perform according to the terms and conditions of the PTA agreement, either due to bankruptcy or other financial difficulties.
- *Settlement risk* - the risk that arises when the U.S. banking entity pays out funds before it can be certain that it will receive the corresponding deposit from the foreign bank.
- *Country risk* - the risk the foreign bank will be unable to fulfill its international obligations due to domestic strife, revolution, or political disturbances.
- *Regulatory risk* - the risk that deposit and withdrawal transactions through the PTA may violate State and/or Federal laws and regulations.

Unless a U.S. banking entity is able to identify adequately, and understand the transactions of the ultimate users of the foreign bank's account maintained at the U.S. banking entity, there is a potential for serious illegal conduct.

Because of the possibility of illicit activities being conducted through PTAs at U.S. banking entities, financial institution regulators believe it is inconsistent with the principles of safe and sound banking for U.S. banking entities to offer PTA services without developing and maintaining policies and procedures designed to guard against the possible improper or illegal use of PTA facilities.

Policy Recommendations

Policies and procedures must be fashioned to enable each U.S. banking entity offering PTA services to foreign banks to:

- Identify sufficiently the ultimate users of its foreign bank PTAs, including obtaining (or having the ability to obtain) substantially the same type of information on the ultimate users as the U.S. banking entity obtains for its domestic customers.
- Review the foreign bank's own procedures for identifying and monitoring sub-account holders, as

well as the relevant statutory and regulatory requirements placed on the foreign bank to identify and monitor the transactions of its own customers by its home country supervisory authorities.
- Monitor account activities conducted in the PTAs with foreign banks and report suspicious or unusual activity in accordance with Federal regulations.

Termination of PTAs

It is recommended the U.S. banking entity terminate a PTA with a foreign bank as expeditiously as possible in the following situations:

- Adequate information about the ultimate users of the PTAs cannot be obtained.
- The U.S. banking entity cannot adequately rely on the home country supervisor to require the foreign bank to identify and monitor the transactions of its own customers.
- The U.S. banking entity is unable to ensure that its PTAs are not being used for money laundering or other illicit purposes.
- The U.S. banking entity identifies ongoing suspicious and unusual activities dominating the PTA transactions.

Private Banking Activities

Private banking has proven to be a profitable operation and is a fast-growing business in U.S. financial institutions. Although the financial service industry does not use a standard definition for private banking, it is generally held that private banking services include an array of all-inclusive deposit account, lending, investment, trust, and cash management services offered to high net worth customers and their business interests. Not all financial institutions operate private banking departments, but they typically offer special attention to their best customers and ensure greater privacy concerning the transactions and activities of these customers. Smaller institutions may offer similar services to certain customers while not specifically referring to this activity as private banking.

Confidentiality is a vital element in administering private banking relationships. Although customers may choose private banking services to manage their assets, they may also seek confidential ownership of their assets or a safe, legal haven for their capital. When acting as a fiduciary, financial institutions may have statutory, contractual, or ethical obligations to uphold customer confidentiality.

Typically, a private banking department will service a financial institution's wealthy foreign customers, as these customers may be conducting more complex transactions and using services that facilitate international transactions. Because of these attributes, private banking also appeals to money launderers.

Examiners should evaluate the financial institution management's ability to measure and control the risk of money laundering in the private banking area and determine if adequate AML policies, procedures, and oversight are in place to ensure compliance with laws and regulations and adequate identification of suspicious activities.

Policy Recommendations

At a minimum, the financial institution's private banking policies and procedures should address:

- Acceptance and approval of private banking clients;
- Desired or targeted client base;
- Products and services that will be offered;
- Effective account opening procedures and documentation requirements; and
- Account review upon opening and ongoing thereafter.

In addition, the financial institution must:

- Document the identity and source of wealth on all customers requesting custody or private banking services;
- Understand each customer's net worth, account needs, as well as level and type of expected activity;
- Verify the source and accuracy of private banking referrals;
- Verify the origins of the assets or funds when transactions are received from other financial service providers;
- Review employment and business information, income levels, financial statements, net worth, and credit reports; and
- Monitor the account relationship by:
    - Reviewing activity against customer profile expectations,
    - Investigating extraordinary transactions,
    - Maintaining an administrative file documenting the customer's profile and activity levels,
    - Maintaining documentation that details personal observations of the customer's business and/or personal life, and
    - Ensuring that account reviews are completed periodically by someone other than the private banking officer.

Financial institutions should ensure, through independent review, that private banking account officers have adequate documentation for accepting new private banking account funds and are performing the responsibilities detailed above.

Enhanced Due Diligence for Non-U.S. Persons Maintaining Private Banking Accounts

Section 312 of the USA PATRIOT Act, implemented by 31 CFR 103.181, requires U.S. financial institutions that maintain private banking accounts for non-U.S. persons to establish enhanced due diligence policies, procedures, and controls that are designed to detect and report money laundering.

Private banking accounts subject to requirements under Section 312 of the USA PATRIOT Act include:

- Accounts, or any combination of accounts with a minimum deposit of funds or other assets of at least $1 million;
- Accounts established for one or more individuals (beneficial owners) that are neither U.S. citizens, nor lawful permanent residents of the U.S.; or
- Accounts assigned to or managed by an officer, employee, or agent of a financial institution acting as a liaison between the financial institution and the direct or beneficial owner of the account.

Regulations for private banking accounts specify that enhanced due diligence procedures and controls should be established where appropriate and necessary with respect to the applicable accounts and relationships. The financial institution must be able to show it is able to reasonably detect suspicious and reportable money laundering transactions and activities.

A due diligence program is considered reasonable if it focuses compliance efforts on those accounts that represent a high risk of money laundering. Private banking accounts of foreign customers inherently indicate higher risk than many U.S. accounts; however, it is incumbent upon the financial institution to establish a reasonable level of monitoring and review relative to the risk of the account and/or department.

A financial institution may use its own risk assessment or incorporate industry best practices into its due diligence program. Specific due diligence procedures required by Section 312 of USA PATRIOT Act include:

- Verification of the identity of the nominal and beneficial owners of an account;
- Documentation showing the source of funds; and
- Enhanced scrutiny of accounts and transactions of senior foreign political figures, also known as "politically exposed persons" (PEPs).

<u>Identity Verification</u>

The financial institution is expected to take reasonable steps to verify the identity of both the nominal and the beneficial owners of private banking accounts. Often, private banking departments maintain customer information in a central confidential file or use code names in order to protect the customer's privacy. Because of the nature of the account relationship with the bank liaison and the focus on a customer's privacy, customer profile information has not always been well documented.

Other methods used to maintain customer privacy include:

- Private Investment Corporation (PIC),
- Offshore Trusts, and
- Token Name Accounts.

PICs are established to hold a customer's personal assets in a separate legal entity. PICs offer confidentiality of ownership, hold assets centrally, and provide intermediaries between private banking customers and the potential beneficiaries of the PICs or trusts. A PIC may also be a trust asset. PICs are incorporated frequently in countries that impose low or no taxes on company assets and operations, or are bank secrecy havens. They are sometimes established by the financial institution for customers through their international affiliates – some high profile or political customers have a legitimate need for a higher degree of financial privacy. However, financial institutions should exercise extra care when dealing with beneficial owners of PICs and associated trusts because they can be misused to conceal illegal activities. Since PICs issue bearer shares, anonymous relationships in which the financial institution does not know and document the beneficial owner should not be permitted.

Offshore trusts can operate similarly to PICs and can even include PICs as assets. Beneficial owners may be numerous; regardless, the financial institution must have records demonstrating reasonable knowledge and due diligence of beneficiary identities. Offshore trusts should identify grantors of the trusts and sources of the grantors' wealth.

Furthermore, OFAC screening may be difficult or impossible when transactions are conducted through PICs, offshore trusts, or token name accounts that shield true identities. Management must ensure that accounts maintained in a name other than that of the beneficial owner are subject to the same level of filtering for OFAC as other accounts. That is, the OFAC screening process must include the account's beneficial ownership as well as the official account name.

Documentation of Source of Funds

Documentation of the source of funds deposited into a private banking account is also required by Section 312 of the USA PATRIOT Act. Customers will frequently transfer large sums in single transactions and the financial institution must document initial and ongoing monetary flows in order to effectively identify and report suspicious activity. Understanding how high net worth customers' cash flows, operational income, and expenses flow through a private banking relationship is an integral part of understanding the customer's wealth picture. Due diligence will often necessitate that the financial institution thoroughly investigate the customer's expected transactions.

Enhanced Scrutiny of Politically Exposed Persons

Enhanced scrutiny of accounts and transactions involving senior foreign political figures, their families and associates is required by law in order to guard against laundering the proceeds of foreign corruption.

Illegal activities related to foreign corruption were brought under the definition of money laundering by Section 315 of USA PATRIOT Act. Abuses and corruption by political officials not only negatively impacts their home country's finances, but can also undermine international government and working group efforts against money laundering. A financial institution doing business with corrupt PEPs can be exposed to significant reputational risk, which could result in adverse financial impact through news articles, loss of customers, and even civil money penalties (CMPs). Furthermore, a financial institution, its directors, officers, and employees can be exposed to criminal charges if they did know or should have known (willful blindness) that funds stemmed from corruption or serious crimes.

As such, PEP accounts can present a higher risk. Enhanced scrutiny is appropriate in the following situations:

- Customer asserts a need to have the foreign political figure or related persons remain secret.
- Transactions are requested to be performed that are not expected given the customer's account profile.
- Amounts and transactions do not make sense in relation to the PEP's known income sources and uses.
- Transactions exceed reasonable amounts in relation to the PEP's known net worth.
- Transactions are large in relation to the PEP's home country financial condition.
- PEP's home country is economically depressed, yet the PEP's home country transactions funding the account remain high.
- Customer refuses to disclose the nominal or beneficial owner of the account or provides false or misleading information.
- Net worth and/or source of funds for the PEP are unidentified.

Additional discussion of due diligence procedures for these accounts can be found in interagency guidance issued in FDIC FIL-6-2001, dated in January 2001, "Guidance on Enhanced Scrutiny for Transactions That May Involve the Proceeds of Foreign Official Corruption."

Fiduciary and Custody Services within the Private Banking Department

Although fiduciary and agency activities are circumscribed by formal trust laws, private banking clients may delegate varying degrees of authority (discretionary versus nondiscretionary) over assets under management to the financial institution. In all cases, the terms under which the assets are managed are fully described in a formal agreement, also known as the "governing instrument" between the customer and the financial institution.

Even though the level of authority may encompass a wide range of products and services, examiners should determine the level of discretionary authority delegated to private banking department personnel in the management of these activities and the documentation required from customers to execute transactions on their behalf. Private banking department personnel should not be able to execute transactions on behalf of their clients without proper documentation from clients or independent verification of client instructions.

Concerning investments, fiduciaries are also required to exercise prudent investment standards, so the financial institution must ensure that if it is co-trustee or under direction of the customer who retains investment discretion, that the investments meet prudent standards and are in the best interest of the beneficiaries of the trust accounts.

Trust agreements may also be structured to permit the grantor/customer to continue to add to the corpus of the trust account. This provides another avenue to place funds into the banking system and may be used by money launderers for that purpose.

Investment management services have many similar characteristics to trust accounts. The accounts may be discretionary or nondiscretionary. Transactions from clients through a private banking department relationship manager should be properly documented and able to be independently verified. The portfolio manager should also document the investment objectives.

Custodial services offered to private banking customers include securities safekeeping, receipts and disbursements of dividends and interest, recordkeeping, and accounting. Custody relationships can be established in many ways, including referrals from other departments in the financial institution or from outside investment advisors. The customer, or designated financial advisor, retains full control of the investment management of the property subject to the custodianship. Sales and purchases of assets are made by instruction from the customer, and cash disbursements are prearranged or as instructed, again by the customer. In this case, it is important for the financial institution to know the customer. Procedures for proper administration should be established and reviewed frequently.

Numbered Accounts

A numbered account, also known as a pseudonym account, is opened not under an individual or corporate name, but under an assigned number or pseudonym. These types of numbered accounts are typically services offered in the private banking department or the trust department, but they can be offered anywhere in the institution.

Numbered accounts present some distinct customer advantages when it comes to privacy. First, all of the computerized information is recorded using the number or pseudonym, not the customer's real name. This means that tellers, wire personnel, and various employees do not know the true identity of the customer. Furthermore, it protects the customer against identity theft. If electronic financial records are stolen, the number or pseudonym will not provide personal information. Statements and any documentation would simply show the number, not the customer's true name or social security number.

However, numbered accounts offered by U.S. financial institutions must still meet the requirements of the BSA and specific customer identification and minimum due diligence documentation should be obtained. Account opening personnel must adequately document the customer due diligence performed, and access to this information must be provided to employees reviewing transactions for suspicious activity.

If the financial institution chooses to use numbered accounts, they must ensure that proper procedures are in place. Here are some minimum standards for numbered or pseudonym accounts:

- The BSA Officer should ensure that all required CIP information is obtained and well documented. The documentation should be readily available to regulators upon request.
- Management should ensure that adequate suspicious activity review procedures are in place. These accounts are considered to be high risk, and, as such, should have enhanced scrutiny. In order to properly monitor for unusual or suspicious activities, the person(s) responsible for monitoring these accounts must have the identity of the customer revealed to them. <u>All transactions for these accounts should be reviewed at least once a month or more frequently.</u>
- The financial institution's system for performing OFAC reviews, Section 314(a) Requests, or any other inquiries on its customer databases, must be able to check the actual names and relevant information of these individuals. Typically the software will screen just the account name on the trial balance. Consequently, if the name is not on the trial balance, then it could be overlooked in this process. Management should thoroughly document how it will handle such situations, as well as each review that is performed.

Examiners should include the fact that the financial institution's policy allows for numbered accounts on the "Confidential – Supervisory Section" page of the Report of Examination. Given the high risk nature of this account type, examiners should review them at every examination to ensure that management is adequately handling these accounts.

Pouch Activities

Pouch activities involve the use of a common carrier to transport currency, monetary instruments, and other documents usually from outside the U.S. to a domestic bank account. Pouches can originate from an individual or another financial institution and can contain any kind of document, including all forms of bank transactions such as demand deposits and loan payments. The contents of the pouch are not always subject to search while in transport, and considerable reliance is placed on the financial institution's internal control systems designed to account for the contents and their transfer into the institution's accounts.

Vulnerabilities in pouch systems can be exploited by those looking for an avenue to move illegally-gained funds into the U.S. Law enforcement has uncovered money laundering schemes where pouches were used to transfer:

- Bulk currency, both U.S. and foreign, and
- Sequentially numbered monetary instruments, such as traveler's checks and money orders.

Once these illegal funds are deposited into the U.S. financial institution, they can be moved – typically through use of a wire transfer – anywhere in the world. As such, pouches are used by those looking to legitimize proceeds and obscure the true source of the funds.

Financial institutions establish pouch activities primarily to provide a service. The risks associated with a night deposit drop box (one example of pouch activity) are very different from financial institutions that provide document and currency transport from their international offices to banking offices in the U.S.

A prime benefit of having pouch services is the speed with which international transactions can be placed in the U.S. domestic banking system by avoiding clearing a transaction through several international banks in order to move the funds into the U.S. This benefit is particularly advantageous for customers in countries that do not do direct business with the U.S., including those countries that:

- May require little or no customer identification,
- Are well-known secrecy havens, or
- Are considered NCCTs.

Examination Guidance

Examiners should ascertain if a financial institution offers pouch services. If it does provide these services, examiners must verify that all pouch activity is included in AML programs and is thoroughly monitored for suspicious activity.

Examiners are strongly encouraged to be present during one or more pouch openings during the examination. By reviewing the procedures for opening and documenting items in the pouches, along with records maintained of pouch activities, examiners should be able to ascertain or confirm the degree of risk undertaken and the sufficiency of AML program in relation to the institution's pouch activity.

Special Use Accounts

Special use accounts are in-house accounts established to handle the processing of multiple customer transactions within the financial institution. These accounts are also known as concentration accounts, omnibus, or suspense accounts and serve as settlement accounts. They are used in many areas of a financial institution, including private banking departments and in the wire transfer function. They present heightened money laundering risks because controls may be lax and an audit trail of customer information may not be easy to follow since transactions do not always maintain the customer identifying information with the transaction amount. In addition, many financial institution employees may have access to the account and have the ability to make numerous entries into and out of the account. Balancing of the special use account is also not always the responsibility of one individual, although items posted in the account are usually expected to be processed or resolved and settled in one day.

Financial institutions that use special use accounts should implement risk-based procedures and controls covering access to and operation of these accounts. Procedures and controls should ensure that the audit trail provides for association of the identity of transactor, customer and/or direct or beneficial owner with the actual movement of the funds. As such, financial institutions must maintain complete records of all customer transactions passing through these special use accounts. At a minimum, such records should contain the following information:

- Customer name,
- Customer address,
- Account number,
- Dollar value of the transaction, and
- Dates the account was affected.

Wire Transfer Activities

The established wire transfer systems permit quick movement of funds throughout the U.S. banking system and internationally. Wire transfers are commonly used to move funds in various money laundering schemes. Successive wire transfers allow the originator and the ultimate beneficiary of the funds to:

- Obtain relative anonymity,
- Obfuscate the money trail,
- Easily aggregate funds from a large geographic area,
- Move funds out of or into the U.S., and
- "Legitimize" illegal proceeds.

Financial institutions use two wire transfer systems in the U.S., the Fedwire and the Clearing House Interbank Payments System (CHIPS). A telecommunications network, the Society for Worldwide Interbank Financial Telecommunications (SWIFT), is often used to send messages with international wire transfers.

Fedwire transactions are governed by the Uniform Commercial Code Article 4a and the Federal Reserve Board's Regulation J. These laws primarily facilitate business conduct for electronic funds transfers; however, financial institutions must ensure they are using procedures for identification and reporting of suspicious and unusual transactions.

Wire Transfer Money Laundering Risks

Although wire systems are used in many legitimate ways, most money launderers use wire transfers to aggregate funds from different sources and move them through accounts at different banks until their origin cannot be traced. Money laundering schemes uncovered by law enforcement agencies show that money launderers aggregate funds from multiple accounts at the same financial institution, wire those funds to accounts held at other U.S. financial institutions, consolidate funds from these larger accounts, and ultimately wire the funds to offshore accounts in countries where laws are designed to facilitate secrecy. In some cases the monies are then sent back into the U.S. with the appearance of being legitimate funds.

It can be challenging for financial institutions to identify suspicious transactions due to the:

- Large number of wire transactions that occur in any given day;
- Size of wire transactions;
- Speed at which transactions move and settle; and
- Weaknesses in identifying the customers (originators and/or beneficiaries) of such transactions at the sending or receiving banks.

A money launderer will often try to make wire transfers appear to be for a legitimate purpose, or may use "shell companies" (corporations that exist only on paper, similar to shell banks discussed above in the section entitled "Foreign Correspondent Banking Relationships"), often chartered in another country. Money launderers usually look for legitimate businesses with high cash sales and high turnover to serve as a front company.

Mitigation of Wire Transfer Money Laundering Risks

Familiarity with the customer and type of business enables the financial institution to more accurately analyze transactions and thereby identify unusual wire transfer activity. With appropriate CDD policies and procedures, financial institutions should have some expectation of the type and volume of activity in accounts, especially if the account belongs to a high-risk entity or the customer uses higher-risk products or services. Consideration should be given to the following items in arriving at this expectation:

- Type and size of business;
- Customer's stated explanation for activity;
- Historical customer activity; and
- Activity of other customers in the same line of business.

Wire Transfer Recordkeeping Requirements

BSA recordkeeping rules require the retention of certain information for funds transfers and the transmittal of funds. Basic recordkeeping requirements are established in 31 CFR 103.33 and require the maintenance of the following records on all wire transfers originated over $3,000:

- Name and address of the originator,
- Amount of the payment order,
- Execution date of the payment order,
- Payment instructions received from the originator,
- Identity of the beneficiary's financial institution, and
- As many of the following items that are received with the transfer order:
  - Name and address of the beneficiary,
  - Account number of the beneficiary, and
  - Any other specific identifier of the beneficiary.

In addition, as either an intermediary bank or a beneficiary bank, the financial institution must retain a complete record of the payment order. Furthermore, the $3,000 minimum limit for retention of this information does not mean that wire transfers under this amount should not be reviewed or monitored for unusual activity.

Funds Transfer Record Keeping and Travel Rule Regulations

Along with the BSA recordkeeping rules, the Funds Transfer Recordkeeping and Travel Rule Regulations became effective in May of 1996. The regulations call for standard recordkeeping requirements to ensure all institutions are obtaining and maintaining the same information on all wire transfers of $3,000 or more. Like the BSA recordkeeping requirements, these additional recordkeeping requirements were put in place to create a paper trail for law enforcement to investigate money laundering schemes and other illegal activities.

Industry best practices dictate that domestic institutions should encourage all foreign countries to attach the identity of the originator to wire information as it travels to the U.S. and to other countries. Furthermore, the financial institution sending or receiving the wire cannot ensure adequate OFAC verification if they do not have all of the appropriate originator and beneficiary information on wire transfers.

Necessary Due Diligence on Wire Transfer Customers

To comply with these standards and regulations, a financial institution needs to know its customers. The ability to trace funds and identify suspicious and unusual transactions hinges on retaining information and a strong knowledge of the customer developed through comprehensive CDD procedures. Financial institution personnel must know the identity and business of the customer on whose behalf wire transfers are sent and received. Wire room personnel must be trained to identify suspicious or unusual wire activities and have a strong understanding of the bank's OFAC monitoring and reporting procedures.

Review and monitoring activity should also take place subsequent to sending or receiving wires to further aid in identification of suspicious transactions. Reviewers should look for:

- Unusual wire transfer activity patterns;
- Transfers to and from high-risk countries; or
- Any of the "red flags" relating to wire transfers (refer to the "Identification of Suspicious Transactions" discussion included within this chapter.)

Risks Associated with Wire Transfers Sent with "Pay Upon Proper Identification" Instructions

Financial institutions should also be particularly cautious of wire transfers sent or received with "Pay Upon Proper Identification" (PUPID) instructions. PUPID transactions allow the wire transfer originator to send funds to a financial institution location where an individual or business does not have an account relationship. Since the funds receiver does not have an account at the financial institution, he/she must show prior identification to pick up the funds, hence the term PUPID. These transactions can be legitimate, but pose a higher than normal money laundering risk.

Electronic Banking

Electronic banking (E-Banking) consists of electronic access (through direct personal computer connection, the Internet, or other means) to financial institution services, such as opening deposit accounts, applying for loans, and conducting transactions. E-banking risks are not as significant at financial institutions that have a stand-alone "information only" website with no transactional or application capabilities. Many financial institutions offer a variety of E-banking services and it is very common to obtain a credit card, car loan, or mortgage loan on the Internet without ever meeting face-to-face with a financial institution representative.

The financial institution should have established policies and procedures for authenticating new customers obtained through E-banking channels. Customer identification policies and procedures should meet the minimum requirements of the USA PATRIOT Act and be sufficient to cover the additional risks related to customers opening accounts electronically. New account applications submitted over the Internet increase the difficulty of verifying the application information. Many financial institutions choose to require the prospective customer to come into an office or branch to complete the account opening process, while others will not. If a financial institution completes the entire application process over the Internet, it should consider using third-party databases or vendors to provide:

- Positive verification, which ensures that material information provided by an applicant matches information from third-party sources;
- Negative verification, which ensures that information provided is not linked to previous fraudulent activity; and
- Logical verification, which ensures that the information is logically consistent.

In addition to initial verification, a financial institution must also authenticate the customer's identity each time an attempt is made to access his/her private information or to conduct a transaction over the Internet. The authentication methods involve confirming one or more of these three factors:

- Information only the user should know, such as a password or personal identification number (PIN);
- An object the user possesses, such as an automatic teller machine (ATM) card, smart card, or token; or
- Something physical of the user, such as a biometric characteristic like a fingerprint or iris pattern.

Automated Clearing House Transactions and Electronic Initiation Systems

Additionally, the National Automated Clearing House Association (NACHA) has provided standards which mandate the use of security measures for automated clearing house (ACH) transactions initiated through the Internet or electronically. These guidelines include ensuring secure access to the electronic and Internet systems in conjunction with procedures reasonably designed to identify the ACH originator.

Interagency guidance on authenticating users of technology and the identity of customers is further discussed in FDIC FIL-69-2001, "Authentication in an Electronic Environment." This FIL not only identifies the risk of access to systems and information, it also emphasizes the need to verify the identity of electronic and/or Internet customers, particularly those who request account opening and new services online.

MONITORING BANK SECRECY ACT COMPLIANCE

Section 8(s) of the Federal Deposit Insurance Act, which implements 12 U.S.C. 1818, requires the FDIC to:

- Develop regulations that require insured financial institutions to establish and maintain procedures reasonably designed to assure and monitor compliance with the BSA;
- Review such procedures during examinations; and
- Describe any problem with the procedures maintained by the insured depository institution within reports of examination.

To satisfy Section 8(s) requirements, at a minimum, examiners must review BSA at each regular safety and soundness examination. In addition, the FDIC must conduct its own BSA examination at any intervening Safety and Soundness examination conducted by a State banking authority if such authority does not review for compliance with the BSA. Section 326.8 of the FDIC's Rules and Regulations establishes the minimum BSA program requirements for all state nonmember banks, which are necessary to assure compliance with the financial recordkeeping and reporting requirements set forth within the provisions of the Treasury regulation 31 CFR 103.

Part 326.8 of the FDIC's Rules and Regulations

Minimum Requirements of the BSA Compliance Program

The BSA compliance program must be in writing and approved by the financial institution's board of directors, with approval noted in the Board minutes. Best practices dictate that Board should review and approve the policy annually. In addition, financial institutions are required to develop and implement a Customer Identification Program as part of their overall BSA compliance program. More specific guidance regarding the CIP program requirements can be found within the "Customer Identification Program" discussion within this section of the DSC Risk Management Manual of Examination Policies (DSC Manual).

A financial institution's BSA compliance program must meet four minimum requirements, as detailed in Section 326.8 of the FDIC's Rules and Regulations. The procedures necessary to establish an adequate program and assure reasonable compliance efforts designed to meet these minimum requirements are discussed in detail below:

1. *A system of internal controls.* At a minimum, the system must be designed to:

    a. Identify reportable transactions at a point where all of the information necessary to properly complete the required reporting forms can be obtained. The financial institution might accomplish this by sufficiently training tellers and personnel in other departments or by referring large currency transactions to a designated individual or department. If all pertinent information cannot be obtained from the customer, the financial institution should consider declining the transaction.
    b. Monitor, identify, and report possible money laundering or unusual and suspicious activity. Procedures should provide that high-risk accounts, services, and transactions are regularly reviewed for suspicious activity.
    c. Ensure that all required reports are completed accurately and properly filed within required timeframes. Financial institutions should consider centralizing the review and report filing functions within the banking organization.
    d. Ensure that customer exemptions are properly granted, recorded, and reviewed as appropriate, including biennial renewals of "Phase II" exemptions. Exempt accounts must be reviewed at least annually to ensure that the exemptions are still valid and to determine if any suspicious or unusual activity is occurring in the account. The

BSA compliance officer should review and initial all exemptions prior to granting and renewing them.

e. Ensure that all information sharing requests issued under Section 314(a) of the USA PATRIOT Act are checked in accordance with FinCEN guidelines and are fully completed within mandated time constraints.
f. Ensure that guidelines are established for the optional providing and sharing of information in accordance with 314(b) of the USA PATRIOT Act and the written employment verification regulations (as specified in Section 355 of the USA PATRIOT Act).
g. Ensure that the financial institution's CIP procedures comply with regulatory requirements.
h. Ensure that procedures provide for adequate customer due diligence in relation to the risk levels of customers and account types. Adequate monitoring for unusual or suspicious activities cannot be completed without a strong CDD program. The CDD program should assist management in predicting the types, dollar volume, and transaction volume the customer is likely to conduct, thereby providing a means to identify unusual or suspicious transactions for that customer.
i. Establish procedures for screening accounts and transactions for OFAC compliance that include guidelines for responding to identified matches and reporting those to OFAC.
j. Provide for adequate due diligence, monitoring, and reporting of private banking activities and foreign correspondent relationships. The level of due diligence and monitoring must be commensurate with the inherent account risk.
k. Provide for adequate supervision of employees who accept currency transactions, complete reports, grant exemptions, open new customer accounts, or engage in any other activity covered by the Financial Recordkeeping and Reporting of Currency and Foreign Transactions regulations at 31 CFR 103.
l. Establish dual controls and provide for separation of duties. Employees who complete the reporting forms should not be responsible for filing them or for granting customer exemptions.

2. *Independent testing for compliance with the BSA and Treasury's regulation 31 CFR Part 103*. Independent testing of the BSA compliance program should be conducted by the internal audit department, outside auditors, or qualified consultants. Testing must include procedures related to high-risk accounts and activities. Although not required by the regulation, this review should be conducted at least annually. Financial institutions that do not employ outside auditors or consultants or that do not operate internal audit departments can comply with this requirement by utilizing employees who are not involved in the currency transaction reporting or suspicious activity reporting functions to conduct the reviews. The BSA compliance officer, even if he/she does not participate in the daily BSA monitoring and reporting of BSA, can never suffice for an independent review.

The scope of the independent testing should be sufficient to verify compliance with the financial institution's anti-money laundering program. Additionally, all findings from the audit should be provided within a written report and promptly reported to the board of directors or appropriate committee thereof. Testing for compliance should include, at a minimum:

a. A test of the financial institution's internal procedures for monitoring compliance with the BSA, including interviews of employees who handle cash transactions and their supervisors. The scope should include all business lines, departments, branches, and a sufficient sampling of locations, including overseas offices.
b. A sampling of large currency transactions, followed by a review of CTR filings.
c. A test of the validity and reasonableness of the customer exemptions granted by the financial institution.
d. A test of procedures for identifying suspicious transactions and the filing of SARs. Such procedures should incorporate a review of reports used by management to identify unusual or suspicious activities.
e. A review of documentation on transactions that management initially identified as unusual or suspicious, but, after research, determined that SAR filings were not warranted.
f. A test of procedures and information systems to review compliance with the OFAC regulations. Such a test should include a review of the frequency of receipt of OFAC updates and interviews to determine personnel knowledge of OFAC procedures.
g. A test of the adequacy of the CDD program and the CIP. Testing procedures should ensure that established CIP standards are appropriate for the various account types, business lines, and departments. New accounts from various areas in the financial institution should be sampled to

ensure that CDD and CIP efforts meet policy requirements.

h. A review of management reporting of BSA-related activities and compliance efforts. Such a review should determine that reports provide necessary information for adequate BSA monitoring and that they capture the universe of transactions for that reporting area. (For example, the incoming wire transfer logs should contain all the incoming transfers for the time period being reviewed).

i. A test of the financial institution's recordkeeping system for compliance with the BSA.

j. Documentation of the scope of the testing procedures performed and the findings of the testing.

Independent Testing Workpaper Retention

Retention of workpapers from the independent testing or audit of BSA is expected and those workpapers must be made available to examiners for review upon request. It is essential that the scope and findings from any testing procedures be thoroughly documented. Procedures that are not adequately documented will not be accepted as being in compliance with the independent testing requirement.

3. *The designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance with BSA.* To meet the minimum requirement, each financial institution must designate a senior official within the organization to be responsible for overall BSA compliance. Other individuals in each office, department or regional headquarters should be given the responsibility for day-to-day compliance. The senior official in charge of BSA compliance should be in a position, and have the authority, to make and enforce policies. This is not intended to require that the BSA administrator be an "executive officer" under the Federal Reserve Board's Regulation O.

4. *Training for appropriate personnel.* At a minimum, the financial institution's training program must provide training for all operational personnel whose duties may require knowledge of the BSA, including, but not limited to, tellers, new accounts personnel, lending personnel, bookkeeping personnel, wire room personnel, international department personnel, and information technology personnel. In addition, an overview of the BSA requirements should be given to new employees and efforts should be made to keep executives and directors informed of changes and new developments in BSA regulations.Training should be comprehensive, conducted regularly, and clearly documented. The scope of the training should include:

    - The financial institution's BSA policies and procedures;
    - Identification of the three stages of money laundering (placement, layering, and integration);
    - "Red flags" to assist in the identification of money laundering (similar to those provided within the "Identification of Suspicious Transactions" discussion within this chapter);
    - Identification and examples of suspicious transactions;
    - The purpose and importance of a strong CDD program and CIP requirements;
    - Internal procedures for CTR and SAR filings;
    - Procedures for reporting BSA matters, including SAR filings to senior management and the board of directors;
    - Procedures for conveying any new BSA rules, regulations, or internal policy changes to all appropriate personnel in a timely manner; and
    - OFAC policies and procedures.

Depending on the financial institution's needs, training materials can be purchased from banking associations, trade groups, and outside vendors, or they can be internally developed by the financial institution itself. Copies of the training materials must be available in the financial institution for review by examiners.

BSA VIOLATIONS AND ENFORCEMENT

Procedures for Citing Apparent Violations in the Report of Examination

Apparent Violations of the U.S. Department of the Treasury's regulation 31 CFR 103 - Financial Recordkeeping and Reporting of Currency and Foreign Transactions

As stated previously, Treasury's regulation 31 CFR 103 establishes the minimum recordkeeping and reporting requirements for currency and foreign transactions by financial institutions. Failure to comply with the requirements of 31 CFR 103 may result in the examiner citing an apparent violation(s). Apparent violations of 31 CFR 103 are generally for specific issues such as:

- Failure to adequately identify and report large cash transactions in a timely manner;

- Failure to report Suspicious Activities, such as deposit layering or structuring cash transactions;
- Failure to reasonably identify and verify customer identity; and
- Failure to maintain adequate documentation of financial transactions, such as the purchase or sale of monetary instruments and originating or receiving wire transfers.

All apparent violations of the BSA should be reported in the Violations of Laws and Regulations pages of the Report of Examination. When preparing written comments related to apparent violations cited as a result of deficient BSA compliance practices, the following information should be included in each citation:

- Reference to the appropriate section of the regulation;
- Nature of the apparent violation;
- Date(s) and amount of the transaction(s);
- Name(s) of the parties to the transaction;
- Description of the transaction; and
- Management's response, including planned or taken corrective action.

In preparing written comments for apparent violations of the BSA, examiners should focus solely on statements of fact, and take precautions to ensure that subjective comments are omitted. Such statements would include an examiner attributing the infraction to a cause, such as management oversight or computer error. For all violations of 31 CFR 103, the Treasury reserves the authority to determine if civil penalties should be pursued. Examiner comments on the supposed causes of apparent violations may affect the Treasury's ability to pursue a case.

Random, isolated apparent violations do not require lengthy explanations or write-ups in the Report of Examination. In such cases, the section of the regulation violated, and identification of the transaction and/or instance will suffice. Examiners are also encouraged to group violations by type. When there are several exceptions to a particular section of the regulation, for example, late CTR filing, examiners should include a minimum of three examples in the Report of Examination citation. The remainder of the violations under that specific regulation can be listed as a total, without detailing all of the information. For example, detail three late CTR filings with customer information, dates, and amounts, but list a total in the apparent violation write-up for 55 instances identified during the examination.

If an examiner chooses not to include each example in the apparent violation citation, the examiners should provide bank management with a separate list so that they can identify and, if possible, correct the particular violation. A copy of the list must also be maintained in the BSA examination workpapers.

Additionally, deficient practices may violate more than one regulation. In such circumstances, the apparent violations can be grouped together. However, all of the sections of each violated regulation must be cited. Each apparent violation must be recorded on the BSA Data Entry sheet and submitted with the Report of Examination for review and transmittal.

Apparent Violations of Section 326.8 of the FDIC Rules and Regulations

In situations where deficiencies in the BSA compliance program are serious or systemic in nature, or apparent violations result from management's inability or unwillingness to develop and administer an effective BSA compliance program, examiners should cite an apparent violation(s) of the appropriate subsection(s) of Section 326.8, within the Report of Examination. Additionally, apparent violations of 31 CFR 103 that are repeated at two or more examinations, or dissimilar apparent violations that are recurring over several examinations, may also point towards a seriously deficient compliance program. When such deficiencies persist within the financial institution, it may be appropriate for examiners to consider the overall program to be deficient and cite an apparent violation of Section 326.8.

Specifically, an apparent violation of Section 326.8(b)(1) should be cited when the weaknesses and deficiencies identified in the BSA compliance program are significant, repeated, or pervasive. Citing a Section 326.8(b)(1) violation indicates that the program is inadequate or substantially ineffective. Furthermore, these deficiencies, if uncorrected, significantly impair the institution's ability to detect and prevent potential money laundering or terrorist financing activities.

An apparent violation of Section 326.8(b)(2) should be cited when weaknesses and deficiencies cited in the Customer Identification Program mitigate the institution's ability to reasonably establish, verify and record customer identity. An apparent violation of 326.8(b)(2) would generally be associated with specific weaknesses that would be reflected in apparent violations of 31 CFR 103.121, which establishes the minimum requirements for Customer Identification Programs.

An apparent violation of Section 326.8(c) should be cited for a specific program deficiency to the extent that deficiency is attributed to internal controls, independent testing, individual responsible for monitoring day-to-day compliance, or training. If an apparent violation of Section 326.8(c) is determined to be an isolated program weakness that does not significantly impair the effectiveness of the overall compliance program, then a Section 326.8(b) should **not** be cited. If one or more program violations are cited under Section 326.8(c), or are accompanied by notable infractions of Treasury's regulation 31 CFR 103, or management is unwilling or unable to correct the reported deficiencies, the aggregate citations would likely point toward an ineffective program and warrant the additional citing of a 326.8(b) program violation, in addition to the other program, and/or financial recordkeeping violations.

When preparing written comments related to apparent violations cited as a result of deficient BSA compliance program, as defined in Section 326.8, the following information should be included in each citation:

- Nature of the violation(s);
- Name(s) of the individual(s) responsible for coordinating and monitoring compliance with the BSA (BSA officer);
- Specific internal control deficiencies that contributed to the apparent violation(s); and
- Management's response, including planned or taken corrective action.

BSA Workpapers Evidencing Apparent Violations

BSA examination workpapers that support BSA/AML apparent violation citations, enforcement actions, SARs, and CMP referrals to the Treasury should be maintained for 5 years, since they may be needed to assist further investigation or other supervisory response. Examination workpapers should not generally be included as part of a SAR, enforcement action recommendation, or Treasury referral, but may be requested for additional supporting information during a law enforcement investigation.

Civil Money Penalties and Referrals to FinCEN

When significant apparent violations of the BSA, or cases of willful and deliberate violations of 31 CFR 103 or Section 326.8 of the FDIC's Rules and Regulations are identified at a state nonmember financial institution, examiners should determine if a recommendation for CMPs is appropriate. This assessment should be conducted in accordance with existing examiner guidance for consideration of CMPs, detailed within the DSC Manual.

Civil penalties for negligence and willful violations of BSA are detailed in 31 CFR 103.57. This section states that negligent violations of any regulations under 31 CFR 103 shall not exceed $500. Willful violations for any reporting requirement for financial institutions under 31 CFR 103 can be assessed a civil penalty up to $100,000 and no less than $25,000. CMPs may also be imposed by the FDIC for violations of final Cease and Desist Orders issued under our authority granted in Section 8(s) of the Federal Deposit Insurance Act (FDI Act). In these cases, the penalty is established by Section 8(i)(2) of the FDI Act at up to $5,000 per day for each day the violation continues. Recommendations for civil money penalties for violations of Cease and Desist Orders should be handled in accordance with outstanding FDIC Directives.

Furthermore, Section 363 of the USA PATRIOT Act increases the maximum civil and criminal penalties from $100,000 to up to $1,000,000 for violations of the following sections of the USA PATRIOT Act:

- Section 311: Special measures enacted by the Treasury for jurisdictions, financial institutions, or international transactions or accounts of primary money laundering concern;
- Section 312: Special due diligence for correspondent accounts and private banking accounts; and
- Section 313: Prohibitions on U.S. correspondent accounts with foreign shell banks.

Referring Significant Violations of the BSA to FinCEN

Financial institutions that are substantially noncompliant with the BSA should be reviewed by the FDIC for recommendation to FinCEN regarding the issuance of CMPs. FinCEN is the administrator of the BSA and has the authority to assess CMPs against any domestic financial institution, including any insured U.S. branch of a foreign bank, and any partner, director, officer, or employee of a domestic financial institution for violations of the BSA and implementing regulations. Criminal prosecution is also authorized, when warranted. However, referrals to FinCEN do not preclude the FDIC from using its authority to take formal administrative action.

Factors to consider for determining when a referral to FinCEN is warranted and the guidelines established for preparing and forwarding referral documentation are detailed in examiner guidance. When examiners identify serious BSA program weaknesses at an institution, including significant apparent violations, the examiner should consult with the Regional SACM before proceeding further.

Generally, a referral should be considered when the types and nature of apparent violations of the BSA result from a nonexistent or seriously deficient BSA and anti-money laundering compliance program; expose the financial institution to a heightened level of risk for potential money laundering activity; or demonstrate a willful or flagrant disregard for the requirements of the BSA. Normally, isolated incidences of noncompliance should not be referred for penalty consideration. Even if the type of violation was cited previously, referral would not be appropriate if the apparent violations involved are genuine misunderstandings of the BSA requirements or inadvertent violations, the deficiencies are correctable in the normal course of business and proper corrective action has been taken or committed to by management.

A referral may be warranted in the absence of previous violations if the nature of apparent violations identified at the current examination is serious. An example would be failing to file FinCEN Form 104, Currency Transaction Report, on nonexemptible businesses or businesses that, while exemptible, FinCEN, as a matter of policy will not authorize the financial institution to exempt. To illustrate, the failure to file CTRs on transactions involving an individual or automobile dealer (both nonexemptible) is of greater concern to FinCEN than a failure to file CTRs on a recently opened supermarket which has not yet been added to the bank's exempt list or a golf course where the financial institution believed that it qualified for a unilateral exemption as a sports arena. This doesn't mean that the failure to file CTRs on a supermarket should never be referred. Failure to file CTRs on a supermarket that is a front for organized crime, that has no customers yet has large receipts, or that has currency transaction activity that far exceeds its expected revenues would warrant referral.

Mitigating Factors to Consider

Other considerations in, deciding whether to recommend criminal/civil penalties include the financial institution's past history of compliance, and whether the current system of policies, procedures, systems, internal controls, and training are sufficient to ensure a satisfactory level in the future. Senior management's attitude and commitment toward compliance as evidenced by their involvement and devotion of resources to compliance programs should also be considered. Any mitigating factors should be given full consideration. Mitigating factors would include:

- The implementation of a comprehensive compliance program that ensures a high level of compliance including a system for aggregating currency transactions.
- Volunteer reporting by the institution of apparent violations discovered on its own during the course of internal audits. This does not apply to situations where examiners disclose apparent violations and the institution comes forward voluntarily to head off a possible referral.
- Positive efforts to assist law enforcement, including the reporting of suspicious transactions and the filing of Suspicious Activity Reports.

It should be noted that FinCEN does not categorize violations as substantive or technical. However, FinCEN does recognize the varying nature of violations and the fact that not all violations require a referral.

Content of a Well-Developed Referral

A well-developed referral is one that contains sufficient detail to permit FinCEN to ascertain: the number, nature and severity of apparent violations cited; the overall level of BSA compliance; the severity of any weaknesses in the financial institution's compliance program; and the financial institution's ability to achieve a satisfactory level of compliance in the future.

A summary memorandum detailing these issues should be prepared by the field examiner and submitted to the Regional Office for review. At a minimum, each referral should include a copy of this memorandum, the Report of Examination pages that discuss BSA findings, and a civil monetary penalty assessment. Documents contained in the referral package need to be conclusion-oriented and descriptive with facts supporting summary conclusions. It is not sufficient to say that the financial institution has written policies and procedures or that management provides training to employees. Referrals are much more useful when they discuss the specific deficiencies identified within the compliance programs, policies and procedures, systems, management involvement, and training.

Discussing the Referral Process with Financial Institution Management

Examiners should not advise the financial institution that a civil money penalty referral is being submitted to FinCEN. If an investigation by law enforcement is warranted, it may be compromised by disclosure of this information. It is permissible to tell management that FinCEN will be notified of all apparent violations of the BSA cited. However, examiners are not to provide any oral or written communication to the financial institution passing judgment on the willfulness of apparent violations.

Criminal Penalties

Treasury regulation 31 CFR 103.59 notifies institutions that they can be subject to criminal penalties if convicted for willful violations of the BSA of not more than $1,000 and/or one year in prison. If such a BSA violation is committed to further any other Federal law punishable by more than a year in prison (such as fraud, money laundering, theft, illegal narcotics sales, etc.) then harsher penalties can be imposed. In these cases, the perpetrator, upon conviction, can be fined not more than $10,000 and/or be imprisoned not more than 5 years.

In addition, criminal penalties may also be charged against any person who knowingly makes any false, fictitious, or fraudulent statement or representation in any BSA report. Upon conviction of such an act, the perpetrator may be fined not more than $10,000 and/or imprisoned for 5 years.

Certain violations of the BSA allow for the U.S. Government to seize the funds related to the crime. The USA PATRIOT Act amended the BSA to provide for funds forfeiture in cases dealing with foreign crimes, U.S. interbank accounts, and in connection with some currency transaction reporting violations. Furthermore, the U.S. Government can seize currency or other monetary instruments physically transported into or out of the U.S. when required BSA reports go unfiled or contain material omissions or misstatements.

Supervisory Actions

The FDIC has the authority to address less than adequate compliance with the BSA through various formal or informal administrative actions. If a specific violation of Section 326.8 or 31 CFR 103 is not corrected or the same provision of a regulation is cited from one examination to the next, Section 8(s) of the FDI Act requires the FDIC to consider formal enforcement action as described in Section 8(b) or 8(c) of the FDI Act. However, the FDIC has determined that informal enforcement action, such as a Board Resolution or a Memorandum of Understanding may be a more appropriate supervisory response, given related circumstances and events, which may serve as mitigating factors.

Violations of a technical and limited nature would not necessarily reflect an inadequate BSA program; as such, it is important to look at the type and number of violations before determining the appropriate administrative action. If the Regional Office reviews a case with significant violations, it should determine whether an enforcement action is necessary. Under such circumstances, if the Regional Office determines that a Cease and Desist action is **not** appropriate, then documentation supporting that decision should be maintained at the Regional Office and a copy of that documentation submitted to the Special Activities Section in Washington, D.C.

Memoranda of Understanding (MOU) and Board Resolutions (BBR)

In certain cases, the Regional Office may determine that a BBR or a MOU is an appropriate action to deal with an institution's BSA weaknesses. BBRs should only be used in circumstances where recommendations are minor and do not affect the overall adequacy of the institution's BSA compliance program. Unlike a BBR, a MOU is a bi-lateral agreement between the financial institution and the FDIC. When the Regional Office deems that a MOU is appropriate, the examiners, reviewer, the Regional SACM, and the Regional legal department may work together to formulate the provisions of the action and obtain appropriate approvals as soon as possible after the examination.

Cease and Desist Orders

Section 8(s) of the FDI Act grants the FDIC the power to issue Cease and Desist Orders solely for the purpose of correcting BSA issues at state nonmember banks. In situations where BSA/AML program weaknesses expose the institution to an elevated level of risk to potential money laundering activity, are repeatedly cited at consecutive examinations, or demonstrate willful noncompliance or negligence by management, a Section 8(b) Order to Cease and Desist should be considered by the Regional Office. Cases referred to FinCEN for civil money penalties should also be reviewed for **formal** supervisory action.

When a Cease and Desist Order is deemed to be appropriate, the examiners, reviewer, the Regional SACM, and the Regional legal department should work together to formulate the provisions of the action and obtain appropriate approvals as soon as possible after the examination. Specific details are contained in the Formal and Informal Actions Procedures (FIAP) Manual.

Removal/Prohibition Orders

If deficiencies or apparent violations of Section 326.8 or 31 CFR 103 involve negligent or egregious action or inaction by institution-affiliated parties (IAPs), other formal actions may be appropriate. In such situations where the IAP exposes the institution to an elevated risk of, or has facilitated or participated in actual transactions involving money laundering activity, utilization of Section

8(e) of the FDI Act, a removal/prohibition action, should be considered.

In cases where apparent violations of Section 326.8 and/or 31 CFR Section 103 have been committed by an IAP(s) and appear to involve criminal intent, examiners should contact the Regional SACM or other designees about filing a SAR on the IAP(s). If the involvement of the IAP(s) in the criminal activity warrants, the Regional Office should also consider contacting the Federal Bureau of Investigation (FBI) or other Federal law enforcement agency via phone or letter to provide them a referral of the SAR and indicate the FDIC's interest in pursuit of the case.

IDENTIFICATION OF SUSPICIOUS TRANSACTIONS

Effective BSA/AML compliance programs include controls and measures to identify and report suspicious transactions in a timely manner. An institution should have in place a CDD program sufficient to be able to make an informed decision about the suspicious nature of a particular transaction. This section highlights unusual or suspicious activities and transactions that may indicate potential money laundering through structured transactions, terrorist financing, and other schemes designed for illicit purposes. Often, individuals involved in suspicious activity will use a combination of several types of unusual transactions in an attempt to confuse or mislead anyone attempting to identify the true nature of their activities.

Structuring is the most common suspicious activity reported to FinCEN. Structuring is defined as breaking down a sum of currency that exceeds the $10,000 CTR reporting level per the regulation, into a series of transactions at or less than $10,000. The transactions do not need to occur on any single day in order to constitute structuring. Money launderers have developed many ways to structure large amounts of cash to evade the CTR reporting requirements. Examiners should be alert to multiple cash transactions that exceed $10,000, but may involve other monetary instruments, bank official checks, travelers' checks, savings bonds, loans and loan payments, or even securities transactions as the offsetting entry. The transactions could also involve the exchange of small bank notes for large ones, but in amounts less than $10,000. Structuring of cash transactions to evade CTR filing requirements is often the easiest of suspicious activities to identify. It is subject to criminal and civil violations of the BSA regulations as implemented within 31 CFR 130.63. This regulation states that any person who structures or assists in structuring a currency transaction at a financial institution for the purpose of evading CTR reporting, or causes or attempts to cause a financial institution to fail to file a CTR, or causes the financial institution to file a CTR that contains a material omission or misstatement of fact, is subject to the criminal and civil violations of the BSA regulations. Financial institutions are required by the BSA to have monitoring procedures in place to identify structured transactions.

Knowledge of the three stages of money laundering (discussed below) has multiple benefits for financial institutions. These benefits include, but are not limited to, the following:

- Identification and reporting of illicit activities to FinCEN,
- Prevention against losses stemming from fraud,
- Prevention against citation of apparent violations of BSA and SAR regulations, and
- Prevention against assessment of CMPs by FinCEN and/or the FDIC.

The following discussions and "red flag" lists, while not all-inclusive, identify various types of suspicious activity/transactions. These lists are intended to serve as a reference tool and should not be used to make immediate and definitive conclusions that a particular activity or series of transactions is illegal. They should be viewed as potentially suspicious warranting further review. The activity/transactions may not be suspicious if they are consistent with a customer's legitimate business.

The Three Stages of Money Laundering

There are three stages in typical money laundering schemes:

1. Placement,
2. Layering, and
3. Integration.

Placement

Placement, the first stage of money laundering, involves the placement of bulk cash into the financial system without the appearance of being connected to a criminal activity. There are many ways cash can be placed into the system. The simplest way is to deposit cash into a financial institution; however, this is also one of the riskier ways to get caught laundering money. To avoid notice, banking transactions involving cash are likely to be conducted in amounts under the CTR reporting thresholds; this activity is referred to as "structuring."

Furthermore, the use of false identities to conduct these transactions is common; banking officers should be vigilant in looking for false identification documents. In an attempt to conceal their activities, money launderers will often resort to "smurfing" activities to get illicit funds into a financial institution. "Smurfing" is the process of using several individuals to deposit illicit cash proceeds into many accounts at one or several financial institutions in a single day.

Furthermore, cash can be exchanged for traveler's checks, food stamps, or other monetary instruments, which can then also be deposited into financial institutions. Placement can also be done by purchasing goods or services, such as a travel/vacation package, insurance policies, jewelry, or other "high-ticket" items. These goods and services can then be returned to the place of purchase in exchange for a refund check, which can then be deposited at a financial institution with less likelihood of detection as being suspicious. Smuggling cash out of a country and depositing that cash into a foreign financial institution is also a form of placement. Illegally-obtained funds can also be funneled into a legitimate business as cash receipts and deposited without detection. This type of activity actually combines placement with the other two stages of money laundering, layering and integration, discussed below.

Layering

The second stage of money laundering is typically layering. This stage is the process of moving and manipulating funds to confuse their sources as well as complicating or partially eliminating the paper trail. Layering may involve moving funds in various forms through multiple accounts at numerous financial institutions, both domestic and international, in a complex series of transactions. Examples of layering transactions include:

- Transferring funds by check or monetary instrument;
- Exchanging cashier's checks and other monetary instruments for other cashier's checks, larger or smaller, possibly adding additional cash or other monetary instruments in the process;
- Performing intrabank transfers between accounts owned or controlled by common individuals (for example, telephone transfers);
- Performing wire transfers to accounts under various customer and business names at other financial institutions;
- Transferring funds outside and possibly back into the U.S. by various means such as wire transfers, particularly through "secrecy haven" countries;
- Obtaining certificate of deposit (CD) secured loans and depositing the loan disbursement check into an account (when the loan is defaulted on, there is no loss to the bank); and
- Depositing a refund check from a canceled vacation package or insurance policy.

Layering transactions may become very complex and involve several of these methods to hide the trail of funds.

Integration

The third stage of money laundering is integration, which typically follows the layering stage. However, as mentioned in the discussion of the placement stage, integration can be accomplished simultaneously with the placement of funds. After the funds have been placed into the financial system and insulated through the layering process, the integration phase is used to create the appearance of legality through additional transactions such as loans, or real estate deals. These transactions provide the criminal with a plausible explanation as to where the funds came from to purchase assets and shield the criminal from any type of recorded connection to the funds.

During the integration stage, the funds are returned in a usable format to the criminal source. This process can be achieved through various schemes, such as:

- Inflating business receipts,
- Overvaluing and undervaluing invoices,
- Creating false invoices and shipping documents,
- Establishing foreign trust accounts,
- Establishing a front company or phony charitable organization, and
- Using gold bullion schemes.

These schemes are just a few examples of the integration stage; the possibilities are not limited.

Money Laundering Red Flags

Some activities and transactions that are presented to a financial institution should raise the level of concern regarding the possibility of potential money laundering activity. Evidence of these "red flags" in an institution's accounts and transactions should prompt the institution, and examiners reviewing such activity, to consider the possibility of illicit activities. While these red flags are not evidence of illegal activity, these common indicators should be part of an expanded review of suspicious activities.

General

- **Refusal or reluctance to proceed with a transaction, or abruptly withdrawing a transaction.** A customer may be reluctant to proceed, or may even withdraw all or a portion of a transaction after being informed that a CTR will be filed, or that the purchase of a monetary instrument will be recorded. This action would be taken to avoid BSA reporting and recordkeeping requirements.

- **Customer refusal or reluctance to provide information or identification.** A customer may be reluctant, or even refuse to provide identifying information when opening an account, cashing a check, recording the purchase of a monetary instrument, or providing information necessary to file a CTR.

- **Structured or recurring, non-reportable transactions.** An individual or group may attempt to avoid BSA reporting and recordkeeping requirements by breaking up, or structuring a currency transaction or purchase of monetary instruments in amounts less than the reporting/recordkeeping thresholds. Transactions may also be conducted with multiple banks, branches, customer service representatives, accounts, and/or on different days in an attempt to avoid reporting requirements.

- **Multiple third parties conducting separate, but related, non-reportable transactions.** Two or more individuals may go to different tellers or branches and each conduct transactions just under the reporting/recordkeeping threshold. (This activity is often referred to as "smurfing.")

- **Even dollar amount transactions.** Numerous transactions are conducted in even dollar amounts.

- **Transactions structured to lose the paper trail.** The bank may be asked to process internal debits or credits containing little or no description of the transaction in an attempt to "separate" a transaction from its account.

- **Significant increases in the number or amount of transactions.** A large increase in the number or amount of transactions involving currency, the purchase of monetary instruments, wire transfers, etc., may indicate potential money laundering.

- **Transactions which are not consistent with the customer's business, occupation, or income level.** Transactions should be consistent with the customer's known business or income level.

- **Transactions by non-account holders.** A non-account holder conducts or attempts to conduct transactions such as currency exchanges, the purchase or redemption of monetary instruments, with no apparent legitimate reason.

<u>Cash Management: Branch and Vault Shipments</u>

- **Change in currency shipment patterns.** Significant changes in currency shipment patterns between vaults, branches and/or correspondent banks as noted on cash shipment records may indicate a potential money laundering scheme occurring in a particular location.

- **Large increase in the cash supply.** A large, sustained increase in the cash balance would normally cause some increase in the number of CTRs filed. Another example of a red flag in this area would be a rapid increase in the size and frequency of cash deposits with no corresponding increase in non-cash deposits.

- **Currency shipments to or from remote locations**. Unusually large transactions between a small, remote bank and a large metropolitan bank may also indicate potential money laundering.

- **Significant exchanges of small denomination bills for large denomination bills**. Significant increases resulting from the exchange of small denominations for large denominations may be reflected in the cash shipment records.

- **Significant requirement for large bills.** Branches whose large bill requirements are significantly greater than the average may be conducting large currency exchanges. Branches that suddenly stop shipping large bills may be using them for currency exchanges.

- **International cash shipments funded by multiple monetary instruments.** This involves the receipt of funds in the form of multiple official bank checks, cashier's checks, traveler's checks, or personal checks that are drawn on or issued by U.S. financial institutions. They may be made payable to the same individual or business, or related individuals or businesses, and may be in U.S. dollar amounts that are below the BSA reporting/recordkeeping threshold. Funds are then shipped or wired to a financial institution outside the U.S.

- **Other unusual domestic or international shipments.** A customer requests an outgoing shipment or is the beneficiary of a shipment of currency, and the instructions received appear inconsistent with normal cash shipment practices. For example, the customer directs the bank to ship the funds to a foreign country and advises the bank to expect same day return of funds from sources different than the beneficiary named, thereby changing the source of the funds.

- **Frequent cash shipments with no apparent business reason**. Frequent use of cash shipments that is not justified by the nature of the customer's business may be indicative of money laundering.

Currency Exchanges and Other Currency Transactions

- **Unusual exchange of denominations**. An individual or group seeks the exchange of small denomination bills (five, ten and twenty dollar bills) for large denomination bills (hundred dollar bills), without any apparent legitimate business reason.

- **Check cashing companies**. Large increases in the number and/or amount of cash transactions for check cashing companies.

- **Unusual exchange by a check cashing service.** No exchange or cash back for checks deposited by an individual who owns a check cashing service can indicate another source of cash.

- **Suspicious movement of funds.** Suspicious movement of funds out of one financial institution, into another financial institution, and back into the first financial institution can be indicative of the layering stage of money laundering.

Deposit Accounts

- **Minimal, vague or fictitious information provided**. An individual provides minimal, vague, or fictitious information that the financial institution cannot readily verify.

- **Lack of references or identification.** An individual attempts to open an account without references or identification, gives sketchy information, or refuses to provide the information needed by the financial institution.

- **Non-local address**. The individual does not have a local residential or business address and there is no apparent legitimate reason for opening an account with the bank.

- **Customers with multiple accounts.** A customer maintains multiple accounts at a bank or at different banks for no apparent legitimate reason. The accounts may be in the same names or in different names with different signature authorities. Routine inter-account transfers provide a strong indication of accounts under common control.

- **Frequent deposits or withdrawals with no apparent business source**. The customer frequently deposits or withdraws large amounts of currency with no apparent business source, or the business is of a type not known to generate substantial amounts of currency.

- **Multiple accounts with numerous deposits under $10,000**. An individual or group opens a number of accounts under one or more names, and makes numerous cash deposits just under $10,000, or deposits containing bank checks or traveler's checks, or a combination of all of these.

- **Numerous deposits under $10,000 in a short period of time**. A customer makes numerous deposits under $10,000 in an account in short periods of time, thereby avoiding the requirement to file a CTR. This includes deposits made at an ATM.

- **Accounts with a high volume of activity and low balances**. Accounts with a high volume of activity, which carry low balances, or are frequently overdrawn, may be indicative of money laundering or check kiting.

- **Large deposits and balances.** A customer makes large deposits and maintains large balances with little or no apparent justification.

- **Deposits and immediate requests for wire transfers or cash shipments**. A customer makes numerous deposits in an account and almost immediately requests wire transfers or a cash shipment from that account to another account, possibly in another country. These transactions are not consistent with the customer's legitimate business needs. Normally, only a nominal amount remains in the original account.

- **Numerous deposits of small incoming wires or monetary instruments, followed by a large outgoing wire**. Numerous small incoming wires and/or multiple monetary instruments are deposited into an account. The customer then requests a large outgoing wire to another institution or country.

- **Accounts used as a temporary repository for funds.** The customer appears to use an account as a temporary repository for funds that ultimately will be transferred out of the financial institution, sometimes to foreign-based accounts. There is little account activity.

- **Funds deposited into several accounts, transferred to another account, and then transferred outside of the U.S.** This involves the deposit of funds into several accounts, which are then combined into one account, and ultimately transferred outside the U.S. This activity is usually not consistent with the known legitimate business of the customer.

- **Disbursement of certificates of deposit by multiple bank checks.** A customer may request disbursement of the proceeds of a certificate of deposit or other investments in multiple bank checks, each at or under $10,000. The customer can then negotiate these checks elsewhere for currency. The customer avoids the CTR requirements and severs the paper trail.

- **Early redemption of certificates of deposits**. A customer may request early redemption of certificates of deposit or other investments within a relatively short period of time from the purchase date of the certificate of deposit or investment. The customer may be willing to lose interest and incur penalties as a result of the early redemption.

- **Sudden, unexplained increase in account activity or balance**. There may be a sudden, unexplained increase in account activity, both from cash and from non-cash items. An account may be opened with a nominal balance that subsequently increases rapidly and significantly.

- **Limited use of services.** Frequent large cash deposits are made by a corporate customer, who maintains high balances but does not use the financial institution's other services.

- **Inconsistent deposit and withdrawal activity.** Retail businesses may deposit numerous checks, but there will rarely be withdrawals for daily operations.

- **Strapped currency**. Frequent deposits of large amounts of currency, wrapped in currency straps that have been stamped by other financial institutions.

- **Client, trust and escrow accounts**. Substantial cash deposits by a professional customer into client accounts, or in-house company accounts, such as trust and escrow accounts.

- **Large amount of food stamps.** Unusually large deposits of food stamps, which may not be consistent with the customer's legitimate business.

Lending

- **Certificates of deposits used as collateral.** An individual buys certificates of deposit and uses them as loan collateral. Illegal funds can be involved in either the certificate of deposit purchase or utilization of loan proceeds.

- **Sudden/unexpected payment on loans**. A customer may suddenly pay down or pay off a large loan, with no evidence of refinancing or other explanation.

- **Reluctance to provide the purpose of the loan or the stated purpose is ambiguous**. A customer seeking a loan with no stated purpose may be trying to conceal the true nature of the loan. The BSA requires the bank to document the purpose of all loans over $10,000, with the exception of those secured by real property.

- **Inconsistent or inappropriate use of loan proceeds**. There may be cases of inappropriate disbursement of loan proceeds, or disbursements for purposes other than the stated loan purpose.

- **Overnight loans.** A customer may use "overnight" loans to create high balances in accounts.

- **Loan payments by third parties.** Loans that are paid by a third party could indicate that the assets securing the loan are really those of a third party, who may be attempting to conceal ownership of illegally, gained funds.

- **Loan proceeds used to purchase property in the name of a third party, or collateral pledged by a third party.** A customer may use loan proceeds to purchase, or may pledge as collateral, real property in the name of a trustee, shell corporation, etc.

- **Permanent mortgage financing with an unusually short maturity, particularly in the case of large mortgages.**

- **Structured down payments or escrow money transactions**. An attempt to "structure" a down payment or escrow money transaction may be made in order to conceal the true source of the funds used.

- **Attempt to sever the paper trail**. Attempts may be made by the customer or bank to sever any paper trail connecting a loan to the collateral.

- **Wire transfer of loan proceeds**. A customer may request that loan proceeds be wire transferred for no apparent legitimate reason.

- **Disbursement of loan proceeds by multiple bank checks**. A customer may request disbursement of loan proceeds in multiple bank checks, each under $10,000. The customer can then negotiate these checks elsewhere for currency. The customer avoids the currency transaction reporting requirements and severs the paper trail.

- **Loans to companies outside the U.S.** Unusual loans to offshore customers, and loans to companies incorporated in "secrecy havens" are higher risk activities.

- **Financial statement.** Financial statement composition of a business differs greatly from those of similar businesses.

Monetary Instruments

- **Structured purchases of monetary instruments.** An individual or group purchases monetary instruments with currency in amounts below the $3,000 BSA recordkeeping threshold.

- **Replacement of monetary instruments**. An individual uses one or more monetary instruments to purchase another monetary instrument(s).

- **Frequent purchase of monetary instruments without apparent legitimate reason**. A customer may repeatedly buy a number of official bank checks or traveler's checks with no apparent legitimate reason.

- **Deposit or use of multiple monetary instruments**. The deposit or use of numerous official bank checks or other monetary instruments, all purchased on the same date at different banks or different issuers of the instruments may indicate money laundering. These instruments may or may not be payable to the same individual or business.

- **Incomplete or fictitious information**. The customer may conduct transactions involving monetary instruments that are incomplete or contain fictitious payees, remitters, etc.

- **Large cash amounts.** The customer may purchase cashier's checks, money orders, etc., with large amounts of cash.

Safe Deposit Boxes

- **Frequent visits.** The customer may visit a safe deposit box on an unusually frequent basis.

- **Out-of-area customers.** Safe deposit boxes may be opened by individuals who do not reside or work in the banks service area.

- **Change in safe deposit box traffic pattern.** There may be traffic pattern changes in the safe deposit box area. For example, more people may enter or enter more frequently, or people carry bags or other containers that could conceal large amounts of cash.

- **Large amounts of cash maintained in a safe deposit box**. A customer may access the safe deposit box after completing a transaction involving a large withdrawal of cash, or may access the safe deposit box prior to making cash deposits which are just under $10,000.

- **Multiple safe deposit boxes**. A customer may rent multiple safe deposit boxes if storing large amounts of currency.

Wire Transfers

- **Wire transfers to countries widely considered "secrecy havens."** Transfers of funds to well known "secrecy havens."

- **Incoming/outgoing wire transfers with instructions to the receiving institution to pay upon proper identification**. The instructions to the receiving bank are to "pay upon proper identification." If paid for in cash, the amount may be just under $10,000 so no CTR is required. The purchase may be made with numerous official checks or other monetary instruments. The amount of the transfer may be large, or the funds may be sent to a foreign country.

- **Outgoing wire transfers requested by non-account holders.** If paid in cash, the amount may be just under $10,000 to avoid the CTR filing requirement.

Alternatively, the transfer may be paid with several official checks or other monetary instruments. The funds may be directed to a foreign country.

- **Frequent wire transfers with no apparent business reason**. A customer's frequent wire transfer activity is not justified by the nature of their business.

- **High volume of wire transfers with low account balances.** The customer requests a high volume of incoming and outgoing wire transfers but maintains low or overdrawn account balances.

- **Incoming and outgoing wires in similar dollar amounts**. There is a pattern of wire transfers of similar amounts both into and out of the customer's account, or related customer accounts, on the same day or next day. The customer may receive many small incoming wires, and then order a large outgoing wire transfer to another city or country.

- **Large wires by customers operating a cash business**. Could involve wire transfers by customers operating a mainly cash business. The customers may be depositing large amounts of currency.

- **Cash or bearer instruments used to fund wire transfers**. Use of cash or bearer instruments to fund wire transfers may indicate money laundering.

- **Unusual transaction by correspondent financial institutions.** Suspicious transactions may include: (1) wire transfer volumes that are extremely large in proportion to the asset size of the bank; (2) when the bank's business strategy and financial statements are inconsistent with a large volume of wire transfers, particularly outside the U.S.; or (3) a large volume of wire transfers of similar amounts in and out on the same or next day.

- **International funds transfer(s) which are not consistent with the customer's business**. International transfers, to or from the accounts of domestic customers, in amounts or with a frequency that is inconsistent with the nature of the customer's known legitimate business activities could indicate money laundering.

- **International transfers funded by multiple monetary instruments**. This involves the receipt of funds in the form of multiple official bank checks, traveler's checks, or personal checks that are drawn on or issued by U.S. financial institutions and made payable to the same individual or business, or related individuals or businesses, in U.S. dollar amounts that are below the BSA reporting threshold. The funds are then wired to a financial institution outside the U.S.

- **Other unusual domestic or international funds transfers.** The customer requests an outgoing wire or is the beneficiary of an incoming wire, and the instructions appear inconsistent with normal wire transfer practices. For example, the customer directs the bank to wire the funds to a foreign country and advises the bank to expect same day return of funds from sources different than the beneficiary named, thereby changing the source of the funds.

- **No change in form of currency.** Funds or proceeds of a cash deposit may be wired to another country without changing the form of currency.

<u>Other Activities Involving Customers and Bank Employees</u>

- **Questions or discussions on how to avoid reporting/recordkeeping**. This involves discussions by individuals about ways to bypass the filing of a CTR or recording the purchase of a monetary instrument.

- **Customer attempt to influence a bank employee not to file a report**. This would involve any attempt by an individual or group to threaten, bribe, or otherwise corruptly influence a bank employee to bypass the filing of a CTR, the recording of purchases of monetary instruments, or the filing of a SAR.

- **Lavish lifestyles of customers or bank employees**. Lavish lifestyles of customers or employees, which are not supported by their current salary, may indicate possible involvement in money laundering activities.

- **Short-term or no vacations.** A bank employee may be reluctant to take any vacation time or may only take short vacations (one or two days).

- **Circumvention of internal control procedures**. Overrides of internal controls, recurring exceptions, and out-of-balance conditions may indicate money laundering activities. For example, bank employees may circumvent wire transfer authorizations and approval policies, or could split wire transfers to avoid ceiling limitations.

- **Incorrect or incomplete CTRs**. Employees may frequently submit incorrect or incomplete CTRs.

Terrorist Financing Red Flags

Methods used by terrorists to generate funds can be both legal and illegal. In the U.S., it is irrelevant whether terrorist funding is obtained legally or illegally; any funds provided to support terrorist activity are considered to be laundered money. Funding from both legal and illegal sources must be laundered by the terrorist in order to obscure links between the terrorist group (or cell) and its funding sources and uses. Terrorists and their support organizations typically use the same methods that criminal groups use to launder funds. In particular, terrorists appear to favor:

- Cash smuggling, both by couriers or in bulk cash shipments;
- Structured deposits and/or withdrawals;
- Purchases of monetary instruments;
- Use of credit and/or debit cards; and
- Use of underground banking systems.

While it is not the primary function of an examiner to identify terrorist financing while examining an institution for BSA compliance, examiners and financial institution management should be cognizant of suspicious activities or unusual transactions that are common indicators of terrorist financing. Institutions are encouraged to incorporate procedures into their BSA/AML compliance programs that address notifying the proper Federal agencies when serious concerns of terrorist financing activities are encountered. At a minimum, these procedures should require the institution to contact FinCEN's Financial Institutions Hotline to report such activities.

SUSPICIOUS ACTIVITY REPORTING

Part 353 of the FDIC's Rules and Regulations requires insured state nonmember banks to report known or suspected criminal offenses to the Treasury. The SAR form to be used by financial institutions is Form TD F 90-22.47 and is available on the FinCEN website. FinCEN is the repository for these reports, but content is owned by the Federal Banking Agencies. The SAR form is used to report many types of suspected criminal violations. Details of the criminal violations can be found in the Criminal Violations section of this manual.

Suspicious Activities and Transactions Requiring SAR Filings

Among the suspicious activities required to be reported are any transactions aggregating $5,000 or more that involve potential money laundering, suspected terrorist financing activities, or violations of the BSA. However, if a financial institution insider is involved in the suspicious transaction(s), a SAR must be filed at any transaction amount. Other suspected criminal activity requires filing a SAR if the transactions aggregate $5,000 or more and a suspect can be identified. If the financial institution is unable to identify a suspect, but believes it was an actual or potential victim of a criminal violation, then a SAR must be filed for transactions aggregating $25,000 or more. Although these are the required transaction levels for filing a SAR, a financial institution may voluntarily file a SAR for suspicious transactions below these thresholds. SAR filings are not used for reporting robberies to local law enforcement, or for lost, counterfeit, or stolen securities that are reported pursuant to 17 CFR 240.17f-1.

If the suspicious transaction involves currency and exceeds $10,000, the financial institution will also need to file a CTR in addition to a SAR.

For suspected money laundering and violations of the BSA, a financial institution must file a SAR, if it knows, suspects, or has reason to suspect that:

- The transaction involves funds derived from illegal activities or is intended or conducted in order to conceal funds or assets derived from illegal activities (including without limitation, the ownership, nature, source, location, or control of such funds or assets), as part of a plan to violate or evade any Federal law or regulation or to avoid any transaction reporting requirement under Federal law;
- The transaction is designed to evade any regulation promulgated under the BSA; or
- The transaction has no business or apparent lawful purpose or is not the sort of transaction in which the particular customer would normally be expected to engage, and the financial institution knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

Preparation of the SAR Form

The SAR form requires the financial institution to complete detailed information about the suspect(s) of the transaction, the type of suspicious activity, the dollar amount involved, along with any loss to the financial institution, and information about the reporting financial institution. Part V of the SAR form requests a narrative description of the suspect violation and transactions and is used to document what supporting information and records the financial institution retains. This section is considered very critical in terms of explaining the apparent criminal activity to law enforcement and regulatory agencies. The information provided in this section should be complete, accurate, and well-organized. This section should contain additional information on suspects, describe instruments and methods of facilitating the transaction, and provide any follow-up action taken by the financial institution. Data inserts in the form of tables or graphics are discouraged as they are not compatible with the SAR database at FinCEN. Also, attachments to a SAR form will not be stored in the database because they do not conform to the database format. Consequently, a narrative in Part V that states only "see attached" will result in no meaningful description of the transaction, rendering the record in this field insufficient.

The financial institution is also encouraged to detail a listing of documentation available that supports the SAR filing in Part V of the SAR form. This notice will provide law enforcement the awareness necessary to ensure timely access to vital information, if further investigation results from the SAR filing. All documentation supporting the SAR must be stored by the financial institution for five years and is considered property of the U.S. Government.

FinCEN has provided ongoing guidance on how to prepare SAR forms in its publication, "SAR Activity Reviews," under a section on helpful hints, tips, and suggestions on SAR filing. These publications are available at the FinCEN website. Financial institution management should be encouraged to review current and past issues as an aid in properly completing SARs.

SAR Filing Deadlines

By regulation, SAR forms are required to be filed no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing a SAR. If no suspect was identified on the date of detection of the incident requiring the filing, a financial institution may delay filing a SAR for an additional 30 calendar days in order to identify a suspect. In no case shall reporting be delayed more than 60 days after the date of initial detection of a reportable transaction.

Customers Engaging in Ongoing Suspicious Activity

If a customer's suspicious activity continues to occur, FinCEN recommends the financial institution file an update on the activity and amounts every 90 days using the SAR form. In such instances, the financial institution should aggregate the dollar amount of previously reported activity and the dollar amount of the newer activity and put this amount in the box on the SAR requesting "total dollar amount involved in known or suspicious activity." Similarly, for the date range of suspicious activity, the financial institution should maintain the original "start" date and extend the "to" date to include the 90 day period in which the suspicious and reportable activity continued.

Failure to File SARs

If an examiner determines that a financial institution has failed to file a SAR when there is evidence to indicate a report should have been filed, the examiner should instruct the financial institution to immediately file the SAR. If the financial institution refuses, the examiner should complete the SAR and cite violations of Part 353 of the FDIC's Rules and Regulations, providing limited details of suspicious activity or the SAR in the Report of Examination. In instances involving a senior officer or director of the financial institution, examiners may prepare the SAR, rather than request the financial institution to do so in order to ensure that the SAR explains the suspicious activity accurately and completely. Each Regional Office is responsible for monitoring SARs filed within that region. Examiner-prepared SARs should be forwarded to their Regional Special Activities Case Manager to ensure timely and proper filing. Any examiner-prepared SARs and all supporting documents should be maintained in the field office files for five years.

SAR Filing Methods

SARs can be filed in paper form, by magnetic tape, or through the Patriot Act Communications System. Financial institutions may contact law enforcement and their Federal Banking Agency to notify them of the suspicious activity, and these contacts should be noted on the SAR form.

Notification to Board of Directors of SAR Filings

Section 353.3 of the FDIC's Rules and Regulations requires the financial institution's board of directors, or designated committee, be promptly notified of any SAR filed. However, if the subject of the SAR is a senior officer or member of the board of directors of the financial institution, notification to the board of directors should be handled differently in order to avoid violating Federal laws that prohibit notifying a suspect or person involved in the suspicious transaction that forms the basis of the SAR. In these situations, it is recommended that appropriate senior personnel not involved in the suspicious activity be advised of the SAR filing and this process be documented.

In cases of financial institutions that file a large volume of SARs, it is not necessary that the board of directors, or designated committee thereof, review each and every SAR document. It is acceptable for the BSA officer to prepare an internal tracking report that briefly discusses all of the SARs filed for a particular month. As long as this tracking report is meaningful in content, then the institution will still be meeting the requirements of Part 353 of the FDIC's Rules and Regulations. Such a report would identify the following information for each SAR filed:

- Customer's name and any additional suspects;
- Social Security Number or TIN;
- Account number (if a customer);
- The date range of suspicious activity;
- The dollar amount of suspicious activity;
- Very brief synopsis of reported activity (for example, "cash deposit structuring" or "wire transfer activity inconsistent with business/occupation"); and
- Indication of whether it is a first-time filing or repeat filing on the customer/suspects.

Such a tracking report promotes efficiency in review of multiple SAR filings. Nevertheless, there are still some SARs that the board of directors, or designated committee thereof, should review individually. Such "significant SARs" would include those that involve insiders (notwithstanding the guidance above regarding the handling of SARs involving board members and senior management), suspicious activity above an internally determined dollar threshold, those involving significant check kiting activity, etc. Financial institutions are encouraged to develop their own parameters for defining "significant SARs" necessitating full reviews; such guidance needs to be written and formalized within board approved BSA policies and procedures.

Safe Harbor for Institutions on SAR Filings

A financial institution that files a SAR is accorded safe harbor from civil liability for filing reports of suspected or known criminal violations and suspicious activities with appropriate authorities. Any financial institution that is subpoenaed or otherwise requested to disclose information contained in a SAR or the fact that a SAR was filed to others shall decline to produce the SAR or provide any information or statements that would disclose that a SAR has been prepared or filed. This prohibition does not preclude disclosure of facts that are the basis of the SAR, as long as the disclosure does not state or imply that a SAR has been filed on the underlying information.

Recently, the safe harbor protections were reiterated and expanded. Section 351 of the USA PATRIOT Act, amended Section 5318(g)(3) of 31 USC and included directors, officers, employees, and agents of the financial institutions who participate in preparing and reporting of SARs under safe harbor protections. Section 355 of the USA PATRIOT Act, implemented at Section 18(w) of the FDI Act, established a means by which financial institutions can share factual information of suspected involvement in criminal activity with each other in connection with references for employment. To comply, employment references must be written and the disclosure made without malicious intent. The financial institution still may not disclose that a SAR was filed. The sharing of employment information is voluntary and should be done under adequate procedures, which may include review by the institution's legal counsel to assess potential for claims of malicious intent.

Examination Guidance

Examiners should ensure that the financial institution has procedures in place to identify and report suspicious activity for all of the financial institution's departments and activities. The guidance may be contained in several policies and procedures; however, it may be advisable for the financial institution to centrally manage the reporting of suspicious activities to ensure that transactions are being reported, when appropriate. A single point of contact can also expedite law enforcement contacts and requests to review specific SARs and their supporting documentation.

As part of its BSA and anti-money laundering programs, the financial institution's policies should detail procedures for complying with suspicious activity reporting requirements. These procedures should define reportable suspicious activity. Financial institutions are encouraged to elaborate and clarify definitions using examples and discussion of the criminal violations. Parameters to filter transactions and review for customer suspicious activity should also be established. Typically, the criteria will be used to identify exceptions to expected customer and transaction activity patterns and identify high-risk customers, whose accounts and transactions should be subject to enhanced scrutiny. Procedures to facilitate accurate and timely filing of SARs, as well as to ensure proper maintenance of supporting documentation, should also be prescribed. Procedures to document decisions not to file a SAR should also be established. Reporting requirements, including reporting SAR filings to senior management and institution directors should be defined. Any additional actions, such as closer monitoring or closing of an involved account(s) that the financial institution may wish to take should be defined in the policy. Many institutions are concerned about facilitating money laundering by continuing to process these suspicious transactions. As there is no requirement to close an account, the institution should assess each situation and provide corresponding guidance on this area in its policy. If the financial institution does plan to close an account that is under investigation by law enforcement, then the institution should notify law enforcement of its intent to close the account.

SAR Database

If examiners need specific SAR filing information, they should contact their Regional SACM or other designees. These specially designated individuals have access to the FinCEN computer system and the database containing records of SAR filings. The database contains information from SARs filed by all federally insured financial institutions. The database is maintained according to the numbered reporting fields in the SAR form, so information can be searched, for example, by suspect, type of violation, or location.

Under current guidance, examiners should obtain a listing or copies of the SARs filed in the current and previous two years by a financial institution for pre-examination planning purposes. Additional searches may be requested as needed, such as to identify whether a SAR has been filed for suspicious activity discovered during the examination, or to obtain information about additional SAR filings on a particular suspect or group of transactions.

For additional guidance on obtaining SAR data, refer to the detailed instructions provided within the "Currency and Banking Retrieval System" discussion within the "Financial Crimes Enforcement Network Reporting and Recordkeeping Requirements" section of this chapter.

OFFICE OF FOREIGN ASSETS CONTROL

The Treasury's Office of Foreign Assets Control administers laws that impose economic and trade sanctions based on foreign policy and national security objectives. Sanctions have been established against various entities and individuals such as targeted foreign countries, terrorists, international narcotics traffickers, and those engaging in activities relating to the proliferation of weapons of mass destruction. Collectively, such individuals and companies are called Specially Designated Nationals (SDNs) and Blocked Persons.

OFAC acts under Presidential wartime and national emergency powers, in addition to authority granted by specific legislation. OFAC has powers to impose controls on transactions and to freeze foreign assets under U.S. jurisdiction. Sanctions can be specific to the interests of the U.S.; however, many sanctions are based on United Nations and other international mandates. Sanctions can include one or more of the following:

- Blocking of assets,
- Trade embargoes,
- Prohibition on unlicensed trade and/or financial transactions,
- Travel bans, and
- Other financial and commercial prohibitions.

A complete list of countries and other specially-designated targets that are currently subject to U.S. sanctions and a detailed description of each order can be found on the Treasury website.

OFAC Applicability

OFAC regulations apply to all U.S. persons and entities, including financial institutions. As such, all U.S. financial institutions, their branches and agencies, international banking facilities, and domestic and overseas branches, offices, and subsidiaries must comply with OFAC sanctions.

Blocking of Assets, Accounts, and Transactions

OFAC regulations require financial institutions to block accounts and other assets and prohibit unlicensed trade and financial transactions with specified countries. Assets and accounts must be blocked when that property is located in the U.S., or is held by, possessed by, or under the control of U.S. persons or entities. The definition of assets and property can include anything of direct, indirect, present, future, and contingent value. Since this definition is so broad, it can affect many types of products and services provided by financial institutions.

OFAC regulations also direct that prohibited accounts of and transactions with SDNs and Blocked Persons need to be blocked or rejected. Generally, U.S. financial institutions must block or freeze funds that are remitted by or on behalf of a blocked individual or entity, are remitted to or through a blocked entity, or are remitted in connection with a transaction in which a blocked entity has an interest. For example, a financial institution cannot send a wire transfer to a blocked entity; once a payment order has been received from a customer, those funds must be placed in an account on the blocked entity's behalf. The interest rate must be a commercially reasonable rate (i.e., at a rate currently offered to other depositors with similar deposit size and terms). Customers cannot cancel or amend payment orders on blocked funds after the U.S.

financial institution has received the order or the funds in question. Once these funds are blocked, they may be released only by specific authorization from the Treasury. Full guidelines for releasing blocked funds are available on the OFAC website. Essentially, either the financial institution or customer files an application with OFAC to obtain a license or authorization to release the blocked funds.

Rejected transactions are those that are to be stopped because the underlying action is prohibited and cannot be processed per the sanctions program. Rejected transactions are to be returned to the sending institution. Transactions include, but are not limited to, the following:

- Cash deposits;
- Personal, official, and traveler's checks;
- Drafts;
- Loans;
- Obligations;
- Letters of credit;
- Credit cards;
- Warehouse receipts;
- Bills of sale;
- Evidences of title;
- Negotiable instruments, such as money orders;
- Trade acceptances;
- Wire transfers;
- Contracts;
- Trust assets; and
- Investments.

OFAC Reporting Requirements

OFAC imposes reporting requirements for blocked property and blocked or rejected transactions. OFAC does not take control of blocked or rejected funds, but it does require financial institutions to report all blocked property to OFAC annually by September 30th. Additionally, financial institutions must notify OFAC of blocked or rejected transactions within 10 days of their occurrence.

When an institution identifies an entity that is an exact match, or has many similarities to a subject listed on the SDN and Blocked Persons List, the institution should contact OFAC Compliance at 1-800-540-6322 for verification. Unless a transaction involves an exact match, it is recommended that the institution contact OFAC Compliance before blocking assets.

Issuance of OFAC Lists

OFAC frequently publishes updates to its list of SDNs and Blocked Persons. This list identifies individuals and companies owned or controlled by, or acting for or on behalf of, targeted countries. It also includes those individuals, groups, and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific. OFAC adds and removes names as necessary and appropriate and posts those updates to its website. The Special Activities Section in Washington D.C. notifies FDIC-supervised institutions that updates to the SDN and Blocked Persons List are available through Financial Institution Letters.

Maintaining an updated SDN and Blocked Persons list is essential to an institution's compliance with OFAC regulations. It is important to remember that outstanding sanctions can and do change and names of individuals and entities are added to the list frequently. Financial institutions should establish procedures to ensure that its screening information is up-to-date to prevent accepting, processing, or facilitating illicit financial transactions and the potential civil liability that may result.

Financial Institution Responsibilities – OFAC Programs and Monitoring Systems

Financial institutions are subject to the prohibitions and reporting required by OFAC regulations; however, there are not any regulatory program requirements for compliance. Neither OFAC nor Federal financial institution regulators have established laws or regulations dictating what banking records must be screened for matches to the OFAC list, or how frequently reviews should be performed. A violation of law occurs only when the institution conducts a blocked or rejected transaction, regardless of whether the financial institution is aware of it. Additionally, institutions that fail to block and report a transfer (which is subsequently blocked by another bank) may be subject to adverse publicity, fines, and even criminal penalties.

OFAC has the authority to assess CMPs for any sanction violation, and these penalties can be severe. Over the past several years, OFAC has had to impose millions of dollars in CMPs involving U.S. financial institutions. The majority of these fines resulted from institution's failure to block illicit transfers when there was a reference to a targeted country or SDN. While the maximum penalties are established by law, OFAC will consider the Federal banking regulator's most recent assessment of the financial institution's OFAC compliance program as one of the mitigating factors for determining any penalty. In addition, OFAC can pursue criminal penalties if there is any evidence of criminal intent on the part of the financial institution or its employees. Criminal penalties provide for imprisonment up to 30 years and fines ranging up to $10 million.

Furthermore, financial institutions are not permitted to transfer responsibility for OFAC compliance to correspondent banks or a contracted third party, such as a data processing service provider. Each financial institution is responsible for every transaction occurring by or through its systems. If a sanctioned transaction transverses several U.S. financial institutions, all of these institutions will be subject to the same civil or criminal action, with the exception of the financial institution that blocked or rejected the transaction, as appropriate.

Examination Considerations

Financial institutions should establish and maintain effective OFAC programs and screening capabilities in order to facilitate safe and sound banking practices. It is not the examiner's primary duty to identify unreported accounts or transactions within an institution. Rather, examination procedures should focus on evaluating the adequacy of an institution's overall OFAC compliance program and procedures, including the systems and controls in place to reasonably assure accounts and transactions are blocked and rejected.

In reviewing an institution's OFAC compliance program, examiners should evaluate the operational risks the financial institution is willing to accept and determine if this exposure is reasonable in comparison with the business type, department or product, customer base, and cost of an effective screening program for that particular institution, based on its risk profile.

The FDIC strongly recommends that each financial institution adopt a risk-focused, written OFAC program designed to ensure compliance with OFAC regulations. An effective OFAC program should include the following:

- Written policies and procedures for screening transactions and new customers to identify possible OFAC matches;
- Qualified individual to monitor compliance and oversee blocked funds;
- OFAC risk-assessment for various products and departments within the financial institution;
- Guidelines and internal controls to ensure the periodic screening of all existing customer accounts;
- Procedures for obtaining and maintaining up-to-date OFAC lists of blocked countries, entities, and individuals;
- Methods for conveying timely OFAC updates throughout the financial institution, including offshore locations and subsidiaries;
- Procedures for handling and reporting prohibited OFAC transactions;
- Guidance for SAR filings on OFAC matches, if appropriate, such as when criminal intent or terrorist activity is involved;
- Internal review or audit of the OFAC processes in each affected department; and
- Training for all appropriate employees, including those in offshore locations and subsidiaries.

Departmental and product risk assessments are fundamental to a sound OFAC compliance program. These assessments allow institution management to ensure appropriate focus on high-risk areas, such as correspondent banking activities and electronic funds transfers. An effective program will filter as many transactions as possible through OFAC's SDN and Blocked Persons List, whether they are completed manually or through the use of a third party software program. However, when evaluating an institution's compliance program, examiners should consider matters such as the size and complexity of the institution. Adequate compliance procedures can and should be targeted to transactions that pose the greatest risk to an institution. Some transactions may be difficult to capture within a risk-focused compliance program. For example, a customer could write a personal check to a blocked entity; however, the only way the financial institution that the check is drawn upon could block those funds would be if it reviewed the payee on each personal check, assuming the information is provided and legible. Under current banking practices, this would be costly and time consuming. Most financial institutions do not have procedures for interdicting these transactions, and, yet, if such a transaction were to be processed by a U.S. financial institution, it is a violation of OFAC regulations and could result in CMPs against the bank.

However, if a financial institution only screens its wire transfers through the OFAC SDN and Blocked Persons List and never screens its customer database, that is a much higher and, likely, unacceptable risk for the financial institution to assume in relation to the time and expense to perform such a review. Particular risk areas that should be screened by all financial institutions include:

- Incoming and outgoing electronic transactions, such as ACH;
- Funds transfers, including message or instruction fields;
- Monetary instrument sales; and

- Account beneficiaries, signors, powers of attorney, and beneficial owners.

As mentioned previously, account and transaction screening may be done manually, or by utilizing computer software available from the Treasury website or other third party vendors. In fact, many institutions have outsourced this function. If automated, OFAC offers the SDN list in a delimited file format file that can be imported into some software programs. Commercial vendors also offer several OFAC screening software packages with various capabilities and costs. If an institution utilizes an automated system to screen accounts and transactions, examiners should ensure that the institution's policies and procedures address the following:

- OFAC updates are timely;
- OFAC verification can be and is completed in a reasonable time;
- Screening is completed by all of bank departments and related organizations; and
- Process is reasonable in relation to the institution's risk profile.

Wholly-owned securities and insurance subsidiaries of financial institutions must also adopt an OFAC compliance program tailored to meet industry specific needs. The OFAC website provides additional reference material to these industries concerning compliance program content and procedures.

OFAC maintains current information and FAQs on its website. For any questions, OFAC encourages financial institutions to contact its Compliance Hotline at 800-540-6322 (7:30am-6:00pm, weekdays).

EXAMPLES OF PROPER CITATION OF APPARENT VIOLATIONS OF BSA-RELATED REGULATIONS IN THE REPORT OF EXAMINATION

The situations depicted in the examples below are intended to provide further clarification on when and how to cite apparent violations of the BSA and implementing regulations, within the context of findings that are typical for BSA reviews conducted during regular Safety & Soundness examinations. As is often the case, deficiencies identified within an institution's BSA compliance policies and procedures may lead to the citation of one or more apparent violations. The identification of numerous and/or severe deficiencies may indicate an ineffective and inadequate program. When an institution's BSA compliance program is considered inadequate, an apparent violation of Part 326.8(b)(1) of the FDIC's Rules and Regulations should also be cited.

Example 1

An examiner is conducting a BSA review at Urania Bank, a $100 million dollar financial institution in El Paso, Texas. The examiner identifies a systemic violation because the financial institution has not filed CTRs on cash purchases of monetary instruments. This is an apparent violation of 31 CFR 103.22(b)(1). The examiner also identifies a complete failure to scrub the institution's database against 314(a) Requests. This is an apparent violation of 31 CFR 103.100(b)(2). In addition, the examiner identifies numerous incomplete CTRs in apparent violation of 31 CFR 103.27(d). Because of the internal control inadequacies, the examiner also cites an apparent violation of Section 326.8(c)(1). The examiner further determines that the problems are sufficiently serious, warranting the citation of an apparent violation of Section 326.8(b)(1) for failure to develop and provide for an adequate BSA program. After doing additional research, the examiner determines that an apparent violation of Section 326.8(c)(2) should also be cited for inadequate independent testing that should have identified the ongoing weaknesses found by the examiner. Furthermore, the examiner decides that an apparent violation of Section 326.8(c)(4) should be cited for inadequate training. Employees are given cursory BSA training each year; however, no training exists for appropriate identification of cash activity and adequate CTR filings. The examiner also determines that an apparent violation of Section 326.8(c)(3) is appropriate because the BSA officer at Urania Bank comes in only two days per week. This is clearly inadequate for a financial institution of this size and complexity, as exhibited by the systemic BSA problems. In addition to fully addressing these deficiencies in the Violations and Risk Management sections of the Report of Examination, the Examiner-In-Charge fully details the findings, weaknesses, and management responses on the Examiner Comments and Conclusions pages.

Example 2

Examiners at Delirium Thrift, a $500 million financial institution in Southern California, begin the BSA review by requesting the wire transfer log for incoming and outgoing transactions. Information being obtained by the institution for the outgoing wire transfers is identified as inadequate. Consequently, the examiners cite an apparent violation of 31 CFR 103.33(g)(1). Additional research reveals that deficiencies in the wire log information are attributed to several branch locations that are failing to provide sufficient information to the wire transfer department. Because the deficiencies are isolated to transactions originating in a few locations, examiners determine that the deficiencies are not systemic and the overall program remains effective. However, because it is evident in interviews with several branch employees that their training in this area has been lacking, examiners also cite an apparent violation of Section 326.8(c)(4) and request that the institution implement a comprehensive training program that encompasses all of its service locations.

Example 3

Examiners at the independent BSA examination of Bullwinkle Bank and Trust, Moose-Bow, Iowa, a $30 million financial institution, were provided no written BSA policies after several requests. However, actual internal practices for BSA compliance were found to be fully satisfactory for the size and BSA risk-level of the financial institution. Given the low risk profile of the institution, including a nominal volume of reportable transactions being processed by the institution, the BSA/AML procedures in place are sufficient for the institution. Therefore, examiners cite only an apparent violation of Section 326.8(b)(1) for failure to develop an adequate *written* BSA compliance program that is approved by the financial institution's board of directors.

Example 4

Appropriately following pre-examination scoping requirements, examiners obtain information from their Regional SACM or other designees on previous SAR filings relating to money laundering. Upon arrival at Mission Achievement Bank, Agana, Guam, a $250 million financial institution with overseas branches, examiners determine that several of the accounts upon which money laundering SARs had been previously filed are still open and evidencing ongoing money laundering activity. However, the financial institution has failed to file subsequent SARs on this continued activity in these accounts and/or the parties involved. Consequently, the examiner appropriately cites apparent violations of Section 353.3(a) of the FDIC Rules and Regulations for failure to file SARs on this ongoing activity. Further analysis identifies that the failure to appropriately monitor for suspicious or unusual transactions in its high-risk accounts and subsequently file SARs is a systemic problem at the financial institution. Because of the institution-wide problem, the examiner cites an apparent violation of Section 326.8(c)(1) for inadequate internal controls. Furthermore, after consultation with the Regional SACM, the examiner concludes that the institution's overall BSA program is inadequate because of the failures to identify and report suspicious activities and, therefore, cites an apparent violation of Section 326.8(b)(1).

The examples below provide examiner guidance for preparing written comments for apparent violations of the BSA and implementing regulations. In general, write-ups should fully detail the nature and severity of the infraction(s). These comments intentionally omit the management responses that should accompany all apparent violation write-ups.

Part 326.8(b)(1) of the FDIC Rules and Regulations

Part 326.8(b)(1) requires each bank to "develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with recordkeeping and reporting requirements" of the Bank Secrecy Act, or 31 CFR 103. The regulation further states that "the compliance program shall be written, approved by the bank's board of directors, and noted in the minutes."

The Board and the senior management team have not adequately established and maintained appropriate procedures reasonably designed to assure and monitor the financial institution's compliance with the requirements of the BSA and related regulations. This assessment is evidenced by the weak internal controls, policies, and procedures as identified at this examination. Furthermore, the Board and senior management team have not made a reasonable effort to assure and monitor compliance with recordkeeping and reporting requirements of the BSA. As a result, apparent violations of other sections of Part 326.8 of the FDIC Rules and Regulations and 31 CFR 103 of the U.S. Treasury Recordkeeping Regulations have been cited.

Part 326.8(b)(2) of the FDIC Rules and Regulations

Part 326.8(b)(2) states that each bank must have a customer identification program to be implemented as part of the BSA compliance program.

Management has not provided for an adequate customer identification program. Current policy requirements do not meet the minimum provisions for a customer identification program, as detailed in 31 CFR 103. Current policies and practices require no documentation for new account openings on the Internet with the exception of a "verification e-mail" sent out confirming that the signer wants to open the account. Signature cards are mailed off-site to the Internet customer, who signs them and mails them back without any evidence of third-party verification, such as notary seal. Based on the risk of these types of accounts, this methodology for verification is clearly inadequate to meet regulatory requirements and sound customer due diligence.

Part 326.8(c)(1) of the FDIC Rules and Regulations

Part 326.8(c)(1) states, in part, that the compliance program shall, at a minimum, provide for a system of internal controls to assure ongoing compliance.

Management has not provided for an adequate system of internal controls to assure ongoing compliance. Examiners identified the following internal control deficiencies:

- Incomplete BSA and AML policies for a bank with a high-risk profile.
- Insufficient identification systems for CTR reporting.
- Late CTR filings.
- Insufficient reporting mechanisms for identification of structured transactions and other suspicious activity.
- Weak oversight over high-risk customers.
- Insufficient customer identification program and customer due diligence.

Due to the financial institution's high-risk profile, management should go beyond minimum CIP requirements and do a sufficient level of due diligence that provides for a satisfactory evaluation of the customer. Management must provide for adequate reporting mechanisms to identify large cash transactions as well as suspicious activity. Timely completion and review of appropriate reports, in conjunction with a sufficient level of due diligence, should allow for the accurate and timely reporting of CTRs and SARs.

Part 326.8(c)(2) of the FDIC Rules and Regulations

Part 326.8(c)(2) states that the compliance program shall provide for independent testing for compliance to be conducted by an outside party or bank personnel who have no BSA responsibility or oversight.

The financial institution's BSA policies provide for independent testing. However, the financial institution has not received an independent review for over three years. An annual review of the BSA program should be completed by a qualified independent party. This review should incorporate all of the high-risk areas of the institution, including cash-intensive accounts and transactions, sales and purchases of monetary instruments; customer exemption list; electronic funds transfer activities, and compliance with customer identification procedures.

Part 326.8(c)(3) of the FDIC Rules and Regulations

Part 326.8(c)(3) states that the compliance program shall designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance.

The board of directors has named Head Teller Ben Bison as the BSA officer. While Mr. Bison has a basic understanding of CTR filing, he does not have any training on detecting and reporting suspicious activity. Furthermore, Ben Bison does not have policy-making authority over the BSA function. Management needs to appoint someone with policy-making authority as the institution's BSA Officer.

Part 326.8(c)(4) of the FDIC Rules and Regulations

Part 326.8(c)(4) states that the compliance program shall provide training for appropriate personnel.

Example 1:

While BSA training programs are adequate, management has trained less than half of the appropriate operational personnel during the last calendar year. Management must ensure that all appropriate personnel, including the board of directors and officers, receive adequate BSA training a minimum of once per year and ongoing for those whose duties require constant awareness of the BSA requirements.

Example 2:

BSA training needs improvement. While regular BSA training sessions are developed and conducted for branch operations personnel, the training programs do not address internal BSA policies and, more importantly, BSA and anti-money laundering regulations. Management must ensure that comprehensive BSA training is provided to all directors, officers, and appropriate operational personnel. Training should be provided at least annually, and must be ongoing for those whose duties require constant awareness of BSA requirements. The training must be commensurate with the institution's BSA risk-profile and provide specific employee guidance on detecting unusual or suspicious transactions beyond the detection of cash structuring transactions.

Part 353.3 of the FDIC Rules and Regulations and 31 C.F.R. 103.18

Part 353.3(a) and 31 C.F.R. 103.18 state, in part, that Suspicious Activity Reports (SARs) should be filed when:

- Insider abuse is involved in any amount;

- Transactions aggregating $5,000 or more when the suspect can be identified;
- Transactions aggregating $25,000 or more when the suspect can not be identified; and
- Transactions aggregating $5,000 or more that involve money laundering or violations of the BSA… if the bank knows, suspects, or has reason to suspect that:
  - The transaction involves funds derived from illegal activities,
  - The transaction is designed to evade BSA reporting requirements, or
  - The transaction has no business or apparent lawful purpose or is not the sort of transaction in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

Management failed to file SARs on several different deposit account customers, all of which appeared to be structuring cash deposits to avoid the filing of CTRs. These transactions all appeared on large cash transaction reports reviewed by management; however, no one in the institution researched the transactions or filed SARs on the incidents. Management must file SARs on the following customer transactions and appropriately review suspicious activity and file necessary SARs going forward.

Account Number	Dates	Total Cash Deposited
123333	02/20/xx-02/28/xx	$50,000
134445	03/02/xx-03/15/xx	$32,300
448832	01/05/xx-03/10/xx	$163,500
878877	03/10/xx-03/27/xx	$201,000

Part 353.3(b) of the FDIC Rules and Regulations and 31 C.F.R. 103.18(b)(3)

Part 353.3(b) of the FDIC Rules and Regulations and 31 C.F.R. 103.18(b)(3) state that a bank shall file a suspicious activity report (SAR) no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing a SAR. In no case shall reporting be delayed more than 60 calendar days after the date of initial detection.

Management and the board have failed to file several hundred SARs within 30 calendar days of the initial detection of the suspicious activity. The BSA officer failed to file any SARs for the time period of June through August 20XX. This information was verified through use of the FinCEN database, which showed than no SARs had been filed during that time period. In addition, SARs filed from February through May of 20XX were filed between 65 days and 82 days of the initial detection of the activity. Management must ensure that suspicious activity reports are not only identified, but also filed in a timely manner.

Part 353.3(f) of the FDIC Rules and Regulations

Part 353.3(f) of the FDIC Rules and Regulations states that bank management must promptly notify its board of directors, or a committee thereof, of any report filed pursuant to Part 353 (Suspicious Activity Reports).

Management has not properly informed the board of directors of SARs filed to report suspicious activities. The management team has provided the board with erroneous reports showing that the bank has filed SARs, when, in fact, the management team never did file such SARs. Board and committee minutes clearly indicate a reliance on these reports as accurate.

31 C.F.R. 103.22(c)(2)

This section of the Financial Recordkeeping Regulations requires the bank to treat multiple transactions totaling over $10,000 as a single transaction.

Management's large cash aggregation reports include only those cash transactions above $9,000. Because of this weakness in the reporting system's set-up, the report failed to pick up transactions below $9,000 from multiple accounts with one owner. The following transactions were identified which should have been aggregated and a CTR filed. Management needs to alter or improve their system in order to identify such transactions.

Customer Name Account #	Date	Amount
Mini Meat Market		
122222222	12/12/xx	$8,000
122233333	12/12/xx	$4,000
122222222	12/16/xx	$6,000
122233333	12/16/xx	$5,000
Claire's Club Sandwiches a/k/a Claire's Catering		
15555555	12/22/xx	$4,000
17777777	12/22/xx	$7,000
17777788	12/22/xx	$3,000

31 C.F.R. 103.22(d)(6)(i)

This section of the Financial Recordkeeping regulation states that a bank must document monitoring of exempt person transactions. Management must review exempt accounts at least one time per year and must document appropriate monitoring and review of each exempt account.

Management has exempted three customers, but has failed to document monitoring of their accounts. Management has stated that they did monitor the account transactions and no suspicious activity appears evident; however, management must retain appropriate documentation for all account monitoring of exempt customers. Such monitoring documentation could include, but is not limited to:

- Reviews of exempt customers cash transactions,
- Review of monthly statements and monthly activity,
- Interview notes with account owners or visitation notes from reviewing the place of business,
- Documenting changes of ownership, or
- Documenting changes in amount, timing, or type of transaction activity.

31 C.F.R. 103.27(a)

This section of the Financial Recordkeeping regulation requires the financial institution to retain all Currency Transaction Reports for five years.

Management failed to keep copies of all of the CTRs filed during the past five years. Management can locate CTRs filed for the past two years but has not consistently retained CTR copies for the three years preceding. Management needs to make sure that its record-keeping systems allow for the retention and retrieval of all CTRs filed for the previous five year time period.

31 C.F.R. 103.27(d)

This section of the Financial Recordkeeping regulation requires the financial institution to include all appropriate information required in the CTR.

Management has consistently failed to obtain information on the individual conducting the transaction unless that person is also the account owner. This information is required in the CTR and must be completed. Since this is a systemic failure, management needs to ensure proper training is provided to tellers and other key employees to ensure that this problem is corrected.

31 C.F.R. 103.121(b)(2)(i)(A)(4)(ii)

This section of the Financial Recordkeeping regulation states that the financial institution must obtain a tax identification number or number and country of issuance of any government-issued documentation.

The financial institution's policies and programs require that all employees obtain minimum customer identification information; however, accounts in the Vermont Street Branch have not been following minimum account opening standards. Over half of the accounts opened at the Vermont Street Branch since October 1, 2003, when this regulation came into effect, have been opened without tax identification numbers or similar personal identification number for non-U.S. citizens. Management must ensure that BSA policies and regulations are followed throughout the institution and verify through BSA officer reviews and independent reviews that requirements are being met.

WEB-SITE REFERENCES

Financial Crimes Enforcement Network (FinCEN):
www.fincen.gov

FinCEN Money Services Businesses:
www.msb.gov

Financial Action Task Force:
www.oecd.org/fatf

Office of Foreign Assets Control:
www.ustreas.gov/offices/eotffc/ofac

INTRODUCTION

The early detection of apparent fraud and insider abuse is an essential element in limiting the risk to the FDIC's deposit insurance funds and uninsured depositors. Although it is not possible to detect all instances of apparent fraud and insider abuse, potential problems can often be uncovered when certain warning signs are evident. It is essential for examiners to be alert for irregular or unusual activity and to fully investigate the circumstances surrounding the activity. Examiners should not restrict concern to internal crimes, but should also be alert to any attempts by outsiders to defraud financial institutions.

This section is organized by separate subject areas with each providing a summary of potential problems, a listing of warning signs of possible fraud and insider abuse, and suggested action for investigation. The lists are not all-inclusive but rather cover only those areas in which fraud and insider abuse occur most frequently. This section is designed to help alert examiners to possible fraudulent activity and insider abuse. It is intended to serve as a reference source during examinations and should be used as a supplement to standard examination procedures on an "as-needed" basis.

Any important situations should be commented on in the Report of Examination. Appropriate comments should be included in the Examination Conclusions and Comments schedule and in any other report pages as applicable.

Note the restrictions on disclosing irregular transactions in examination reports. This is more fully explained in the Report of Examination Instructions.

Any apparent criminal activity should be investigated thoroughly and reported on the Interagency Criminal Referral Form. The procedures for reporting apparent criminal violations are included in the Criminal Violations Section, Part IV.

SUBJECT AREAS

Included under each of the following subject areas is a summary of potential problems, a listing of warning signs of potential fraud and insider abuse and suggested action for investigation.

1. Corporate Culture/Ethics
2. Insider Transactions
3. Loan Participations
4. Real Estate Lending
5. Secured Lending
6. Third Party Obligations
7. Lending to Buy Tax Shelter Investments
8. Linked Financing/Brokered Deposits
9. Credit Cards and ATM Transactions
10. Advance Fee Schemes
11. Offshore Transactions
12. Wire Transfers
13. Money Laundering
14. Securities Trading Activities
15. Miscellaneous

CORPORATE CULTURE/ETHICS

Potential Problems

Complete dominance of an institution's policies and administration by one or a few directors may lead to inept management at lower levels. Absence of a written code of conduct may make it difficult to discipline directors, officers or employees who may be involved in questionable activities and may cause problems for directors, officers, employees and agents under the Bank Bribery Statute (18 U.S.C. 215). The code of conduct should identify allowable nonbank activities and acceptable gifts or gratuities received in the normal course of business.

Warning Signs

1. Absence of a code of ethics.
2. Absence of a clear policy restricting or requiring disclosure of conflicts of interest.
3. Absence of a policy restricting gifts and gratuities.
4. Lack of oversight by the institution's board of directors, particularly outside directors.

5. Absence of planning, training, hiring and organizational policies.

6. Absence of clearly defined authorities and lack of definition of the responsibilities that accompany the authorities.

7. Lack of independence of management in acting on recommended corrections.

8. CEO controls internal and outside auditors.

9. Lax control and review of expense accounts.

Suggested Action

Review the institution's code of conduct. Determine if there is a policy covering conflicts of interest and if prohibited practices are clearly stated along with the consequences for failure to refrain from these practices. Determine whether all insider interests are accurately reported to the institution's board of directors. Closely review the minutes of the board of directors' meetings and note the reporting of insider interests and the dominance of any director(s) in discussion of policy matters and administration. Also note the discussion of insider transactions and see if there are any directors who frequently or consistently vote against insider transactions in general or against those of one or more insiders in particular. Attempt to determine the reason for the dissent. If directors, officers and employees are required to report gifts and gratuities from present or potential customers, review the report to see if the gifts or gratuities conform to the institution's guidelines.

INSIDER TRANSACTIONS

Potential Problems

Insider fraud has accounted for over one-half of all bank fraud and embezzlement cases closed by the FBI during the past several years. Insiders are in a position of trust and can abuse that trust for their own personal benefit. Insider abuses include failure to disclose their interests that borrow from the institution or otherwise have business dealings with the institution; diverting assets and income for their own use; misuse of position by approving questionable transactions for relatives, friends and/or business associates; abuse of expense accounts; acceptance of bribes and gratuities; and other questionable dealings related to their positions at the institution. Insider abuse undermines confidence in institutions and often leads to failure.

Warning Signs

1. Insider lending personal funds to customers or borrowing from customers.

2. Insider involvement in silent trusts or partnerships and/or shell corporations.

3. Insider appears to receive special favors from institution customers or shows unusual favoritism toward certain institution customers.

4. Insider purchases assets from the institution, directly or indirectly, and there is no evidence of independent appraisal of the assets.

5. Insider has apparent reciprocal lending arrangements with insiders of other institutions and his/her institution has correspondent relationships with those institutions.

6. Insider is involved in a business that arranges its financing through the institution.

7. Insider "perks" include use of expensive institution-owned automobiles, boats, airplanes, housing, etc., where the institution's earnings do not appear to support such extravagance.

8. Insider heavily indebted and debt service appears to require most, if not all, of the insider's salary.

9. Insider financial statements show large or unusual fluctuations. Net worth cannot be reconciled from disclosed sources of income.

10. Insider is financing large purchases (home, auto, etc.) through private, nonbanking sources that may have a business relationship with the institution.

11. Insider financial statement reflects heavy concentration of high-risk investments and speculative ventures.

12. Insider sells personal assets to third party and the institution provides financing without benefit of an independent appraisal.

13. Insiders or their interests frequently appear on transaction suspense item listings or on computer-generated past due loan lists, but do not appear on the "updated" version presented to the board of directors or to examiners.

14. Insider "unofficially" guarantees loans and/or loan participations.

15. Insider is responsible for clearing up audit exceptions on loan balance confirmations.

16. Insider "forgets" to process credit entry for official bank checks causing the account to be out-of-balance because checks are sometimes paid (debited) before the credit is posted, sometimes several days later.

17. Insider conducts a cash transaction over $10,000 but "forgets" to have the institution file a Currency Transaction Report or asks an employee to "structure" the transaction to avoid filing a Currency Transaction Report with the Internal Revenue Service.

18. Insider's stock in the institution is pledged to secure loans obtained from sources other than financial institutions. If true, what is the purpose of the loan and are payments current?

19. Insider conducts personal business from the institution using equipment, supplies, employees, etc., and/or spends most of their time out of the institution on business unrelated to the institution.

20. Insider has substance abuse problems or is known to associate with people who have these problems.

21. Insider is known to associate with "high rollers".

22. Insider suggests that institution change servicers or vendors even though there appears to be no problem with the current servicers or vendors.

23. Insider abruptly suggests changes in outside auditors or legal counsel.

24. Insider loans increase dramatically at about the same time as the institution is recapitalized.

25. Insider's major assets are parcels of real estate that appear to increase in value at a rate that is not consistent with market conditions.

26. Insider sells his stock to an Employee Stock Option Plan (ESOP), sometimes arranging for the ESOP to obtain a loan to purchase the stock.

27. Insider's interests have a direct business relationship with the institution and compensation for services is not commensurate with the level of services provided.

28. Insider agrees to buy fixed assets from the institution with the understanding that the institution will repurchase the fixed assets at some future date.

29. Insider receives incentive pay or "bonuses" based on volume of loans generated.

30. Insider buys a home from a builder whose development project is financed by the institution.

31. Insider is involved in "churning" of the institution's securities portfolio.

32. Insider arranges sale of EDP equipment at book value in connection with the conversion to a new data processing servicer. Also check "side" deals.

33. Insider authorizes ORE related expenses such as landscaping, remodeling, etc., when such expenses do not appear justified. (May be making improvements or repairs to personal residence.)

34. Insider makes frequent trips at the institution's expense to areas where the institution has no business relationships.

35. Insider will not allow employees to talk to examiners.

36. Insider keeps an unusual number of customer files in his/her office.

37. Insider is making payments on other borrowers' loans.

38. Insider's loan is being paid by someone else.

39. Insider receives commissions on credit life insurance premiums and those commissions are not properly adjusted in cases where the insurance company gives rebates for the borrower's prepayment of the loan or gives refunds to borrowers for premium overcharges.

40. Insider sells some of his/her personal stock of the institution to borrowers (as a condition for approving loan) and buys more stock from the institution at about the same time that the institution is under pressure to increase capital.

41. Insider purchases investment securities for his personal portfolio through the institution but

"forgets" to reimburse the institution until a few days or weeks later, and then only if the investment has increased in value. In spite of the increase in value, the insider only pays the original purchase price to the institution.

42. Insider's accounts at the institution are frequently overdrawn. Deposits to cover overdrafts come from loans or some undisclosed source.

43. Insider maintains total control over the institution and does not allow other officers and employees to make independent decisions.

44. Insider has past due loans at other financial institutions.

45. Insider maintains signed, blank notes in personal or customer loan files.

46. Insider is rumored to have financial problems due to divorce, business failure, gambling losses, etc.

47. Insider maintains several personal accounts outside of his/her own institution.

48. Insider frequently takes loan papers out of the institution for customer signatures; personally handles the disbursement of the loan proceeds; routinely cashes checks for customer loan proceeds; and insists on personally handling certain past due accounts as a "special favor" to certain customers.

49. Insider insists that different audit firms audit different divisions or departments. (Hopes there will be no comparison of findings between firms.)

50. Insider insists that different departments be audited at different times. (Makes it easier to hide fraudulent inter-departmental transactions.)

Suggested Action

Review all insider transactions to see if they comply with policy and applicable state and federal regulations. Follow up on any exceptions. Any nonconforming transactions should be discussed with the institution's board of directors. Apparent fraudulent activities should be referred to the proper authorities.

LOAN PARTICIPATIONS

Potential Problems

Loan participations can lead to substantial losses if not documented properly and if not subjected to the same credit standards and reviews as direct loans. Participations purchased as an accommodation to affiliated institutions often do not receive the same scrutiny as those purchased from non-affiliated institutions. Informal repurchase agreements between participating institutions may be used to circumvent legal lending limitations and could subject institutions to substantial undisclosed contingent liabilities. Participations may also be used to disguise delinquencies and avoid adverse classifications.

Warning Signs

1. Excessive participation of loans between closely related institutions, correspondent institutions and branches or departments of the lending institution.

2. Absence of any formal participation agreement.

3. Poor or incomplete loan documentation.

4. Investing in out-of-territory participations.

5. Reliance on third party guaranties.

6. Large paydown or payoff of previously classified loans.

7. Some indication that there may be informal repurchase agreements on some participations.

8. Lack of independent credit analysis.

9. Volume of loan participations is high in relation to the size of the institution's own loan portfolio.

10. Evidence of lapping of loan participations. For example, the sale of a loan participation equal or greater than, and at or about the same time as, a participation that has matured or is about to mature.

11. Disputes between participating institutions over documentation, payments, or any other aspect of the loan participation transaction.

12. Formal participation agreements are missing; therefore, responsibilities and rights of all participating institutions may be unclear.

13. Participations between affiliated institutions may be "placed" without the purchasing institution having the benefit of reviewing normal credit information,

particularly where there is dominant ownership and a "rubber stamp" board of directors.

14. Payments that are not distributed to each participant according to the participation agreement may indicate preferential treatment; or where the participants are affiliated, it may indicate an attempt to disguise the delinquent status of the loans in the weaker institutions.

15. Informal guaranties by insiders may be one method of disguising insider transactions.

16. There is some indication that the credit information contained in the selling institution's files is not the same as the credit information in the purchasing institution's files.

17. Be aware of reciprocal arrangements in the sale/purchase of participations. For example, Institution A sells a 100% participation in a loan to an insider of the selling institution to Institution B which, in turn sells a 100% participation in a loan to one of their insiders to Institution A.

18. There are a number of outstanding items in correspondent accounts just prior to or during an examination or audit which relate to participations purchased or sold.

19. There is some indication that payments on participations purchased are being made by the selling institution without reimbursement from the borrower.

Suggested Action

Where possible, determine the current status of participations at each participating institution. Make special note of any disputes between participating institutions and follow up. Review any debits or credits related to participations posted to the correspondent institution accounts just prior to or during the examination. Follow up on any exceptions. Attempt to determine if the participation has been adversely classified by examiners at any participating institution. Look for any indication of any informal repurchase agreements.

REAL ESTATE LENDING

Potential Problems

Real estate lending abuses have been given a lot of publicity due to the problems encountered by financial institutions that have suffered substantial losses from problem real estate loans. These problems have not been confined to any particular area of the country. Many of the problems revolve around inflated appraisals, land flips (interparty transactions), fraudulent sales contracts, forged title documents, misapplication of loan proceeds, financing of nonexistent properties, loans in the name of trustees, holding companies and offshore companies to disguise the true identity of the actual borrowers and fraudulent loan applications from purchasers, including false income statements, false employment verifications, false credit reports and false financial statements. In many cases, important documentation is missing or is intentionally deficient in an attempt to conceal material facts.

Warning Signs

1. An unusually large number of loans in the same development are exactly equal to the institution's maximum loan-to-value (LTV) ratio for real estate mortgages.

2. The institution has an unusually high percentage of "No Doc" loans. (A "No Doc" loan is one in which extensive documentation of income, credit history, deposits, etc., is not required because of the size of the downpayment, usually 25% or more. Theoretically, the value of the collateral will protect the lender.)

3. Borrower has never owned a home before and does not appear to have the financial ability to support the size of the downpayment made.

4. Property securing loan has changed ownership frequently in a short period of time. Related entities may be involved.

5. Insured value of improvements is considerably less than appraised value.

6. Appraiser is a heavy borrower at the institution.

7. Appraisal fee is based on a percentage of appraised value.

8. Borrower furnishes his/her own appraisal which is a photocopy of an appraisal signed by a reputable appraiser.

9. Use of "comparables" which are not comparable.

10. Appraisal is based on an estimated future value.

11. All comparables are new houses in the same development that were built by the same builder and appraised by the same appraiser.

12. An unusual number of "purchasers" are from out of the area or out of state.

13. Credit history, employment, etc., are not independently verified by the lender.

14. Large number of applicants have income from sources that cannot be verified, such as self-employment.

15. The value of the home the applicant desires to purchase is not in line with the applicant's income. For example, the applicant makes $90,000 per year and only wants to purchase a $90,000 home.

16. The applicant's credit history is incomplete. For example, the applicant is 45 years old, but credit history only dates back five years.

17. The institution's normal procedure is to accept photocopies of important documents rather than to make their own copies of the originals.

18. If copies of income tax returns are provided, columns are uneven and/or do not balance.

19. Appraiser is from out of the area and not likely to be familiar with local property values.

20. A close relationship exists between builder, broker, appraiser and lender.

21. Construction draws are made without visual inspections.

22. All "comparables" are from properties appraised by the same appraiser.

23. Generally, housing sales are slow, but this development seems unusually active in sales.

24. There seems to be an unusual number of foreclosures on 90% to 95% loans with Private Mortgage Insurance on homes in the same development built by the same builder. (Sometimes it is cheaper for the builder to arrange for a straw buyer to get the 95% loan and default than it is to market the home if the market is sluggish.)

25. Applications received through the same broker have numerous similarities.

26. Sales contracts have numerous crossed out and changed figures for sales price and downpayment.

27. Appraiser for the project owns property in the project.

28. Lending officer buys a home in a project financed by the institution.

29. Assessed value for tax purposes is not in line with appraised value.

30. The project is reportedly fully occupied, but the parking lot always appears to be nearly empty.

31. The parking lot is full, but the project appears empty. Nobody is around in the parking lot, pool, etc.

32. After a long period of inactivity, sales suddenly become brisk.

33. Sales contract is drawn up to fit the lender's LTV requirements. For example, the buyer wants an $80,000 home but has no down payment. The lender only lends 80% of appraised value or selling price. Contract is drawn up to show a selling price of $100,000 instead of the actual selling price of $80,000.

34. Builder claims a large number of presold units not yet under construction while many finished units remain unsold.

35. The borrower's interest in the property is not logical given the distance between the property and his/her place of employment and the supply of comparable housing near his/her employer. For example, employment of the prospective borrower/purchaser is 100 miles from the location of the property, while comparable housing is readily available within 10 miles of employment.

36. Applicant's stated income is not commensurate with his/her stated employment and/or years of experience.

37. Applicant's financial statement shows numerous assets that are self evaluated and cannot be readily verified through independent sources.

38. Applicant claims to own partial interests in many assets but not 100% of any asset, making verification difficult.

39. Appraised value of property is contingent upon the curing of some property defect such as drainage problems.

40. The applicant's financial statement reflects ownership of valuable items, such as jewelry and art work, but no insurance is carried on these items.

41. Applicant's tax return shows substantial interest deductions, but the financial statement shows little debt. For example, the borrower's tax return shows substantial mortgage interest deductions, but the self-prepared financial statement shows no mortgage or a very small mortgage.

42. Appraised value of a condominium complex is arrived at by using the asking price for one of the more desirable units and multiplying that by the total number of units.

43. Loans are unusual considering the size of the institution and the level of expertise of its lending officers.

44. There is a heavy concentration of loans to a single project or to individuals related to the project.

45. There is a heavy concentration of loans to local borrowers with the same or similar real estate collateral which is located outside the institution's trade area.

46. There are many loans in the names of trustees, holding companies, and/or offshore companies but the names of the individuals involved are not disclosed in the institution's files.

47. A loan is approved contingent upon an appraised value of at least a certain amount and the appraised value is exactly that amount.

48. Independent reviews of outside appraisals are never conducted.

49. The institution routinely accepts mortgages or other loans through brokers but makes no attempt to determine the financial condition of the broker or to obtain any references or other background information.

50. Borrower claims substantial income but his/her only credit experience has been with finance companies.

51. Borrower claims to own substantial assets, reportedly has an excellent credit history and above average income, but is being charged many points and a higher than average interest rate which is indicative of high risk loans.

52. The institution allows borrowers to assign mortgages as collateral without routinely performing the same analysis of the mortgage and mortgagor as they would perform if the institution were mortgagee.

53. Asset Swaps - Sale of other real estate or other distressed assets to a broker at an inflated price in return for favorable terms and conditions on a new loan to a borrower introduced to the institution by the broker. The new loan is usually secured by property of questionable value and the borrower is in weak financial condition. Borrower and collateral are often outside the institution's trade area.

Suggested Action

Review all real estate files and request any missing documents. Review appraisals to attempt to determine whether any land flips have been involved. Compare appraised value to other stated values such as assessed value or insured value. Attempt to identify any pattern or practice which appears to be suspicious such as a large number of borrowers having the same employer, a large number of properties appraised by the same appraiser, a large number of loans presented by the same broker, a large number of out-of-territory borrowers, etc. If possible, visit construction sites to see if activity is as represented.

SECURED LENDING

Potential Problems

Financial institutions are often lulled into a false sense of security when they believe that they have adequate collateral for their loans; however, many institutions fail to properly record their liens and/or fail to physically verify the existence of their collateral. In many cases, there are no independent appraisals to support collateral value. Out-of-territory collateral may be difficult to verify and monitor. Where fraud is suspected, it is often difficult to prove in cases where institutions have failed to follow generally accepted procedures for documenting collateral.

Warning Signs

1. Lack of independent appraisals of collateral.
2. Significant out-of-territory lending.
3. Loans with unusual terms or conditions.
4. Poor or incomplete documentation used to intentionally conceal material facts.
5. Loans that are unusual considering the size of the institution and the level of expertise of its lending officers.
6. Heavy concentration of loans secured by the same or similar types of collateral.
7. Financing of 100% of the value of any collateral that is subject to rapid depreciation or wide fluctuation in market value.
8. Appraisals which appear to be made to cover the borrower's loan request rather than to reflect the true value of the collateral.
9. Appraisal fee based on amount of loan or on appraised value of collateral may encourage inflated appraisals.
10. Review of records indicates numerous related party purchases and sales of the collateral which could be used to inflate the collateral price far beyond actual market value.
11. Loans in the names of trustees, holding companies, and offshore companies may disguise the identity of actual borrowers.
12. Assigned notes and mortgages are accepted as collateral without verifying all underlying documentation and conducting normal credit analysis on the obligor.

Suggested Action

Review collateral inspection records to determine if there are any exceptions. Review appraisals for similar types of collateral and reconcile any differences. Determine whether in-house appraisals are based on physical inspection of the collateral. If not, why not? Be sure that adequate collateral margins are required at the inception of loans and monitored throughout the term of the loans.

THIRD PARTY OBLIGATIONS

Potential Problems

A guaranty is only as good as the guarantor and a guaranty without adequate documentation to support its value to the institution may be worthless. A guaranty that is separate from the note may contain restrictions that could render it worthless unless the restrictions are closely followed and a guaranty signed in blank may be legally unenforceable if contested. A false third party obligation may be created for the sole purpose of obtaining a loan from the institution. It may have no actual value. This is particularly true where offshore "shell" institutions are involved.

Warning Signs

1. Documentation on guaranties is incomplete.
2. Loans are secured by obligations of offshore institutions.
3. Lack of credit information on third party guarantor.
4. Financial statements reflect concentrations of closely held companies or businesses that lack audited financial statements to support their value.
5. A guaranty signed in blank may be used indiscriminately by some dishonest individuals to cover weak loans. Guaranties signed in blank may also be legally unenforceable if contested.
6. Guaranties that are separate from the notes may contain restrictions that could render them worthless unless the restrictions are closely followed.
7. Third party obligor is not informed of the assignment of the obligation to an institution; this may allow payments to be diverted to some use other than payment of the loan.

8. Guaranties from insurance companies or letters of credit from insurance companies to guaranty payment are accepted without an evaluation of the financial soundness of the guarantors and their ability to honor the guaranties or letters of credit if necessary.

9. Guaranties or letters of credit from insurance companies are not directly verified with the issuer.

10. The institution's audit procedures do not include a request for acknowledgement of guaranties by guarantors.

11. Corporate guaranties are used, but there is no information in the institution's files to support the authority of the corporations to make the guaranties or to indicate that they are still in force.

12. The institution purchases substandard consumer contracts from a third party relying on recourse to the seller without performing proper analysis of seller's financial condition.

13. The institution purchases substandard consumer contracts for automobiles, home improvements, etc., while relying on some type of insurance to cover delinquencies, skips, etc., without verifying the financial condition of the insurer.

Suggested Action

All guaranties should be reviewed to determine that all documentation is complete and that each guarantor is financially sound and reputable. Corporate guaranties and letters of credit from insurance companies and financial institutions should be verified directly with the issuer. If a loan is collateralized by an obligation of an offshore bank, determine if the lender has attempted to verify the existence, reputation and financial stability of the offshore bank. Guaranties signed in blank should be reviewed to determine their validity.

LENDING TO BUY TAX SHELTER INVESTMENTS

Potential Problems

Be wary of deals where there is no economic purpose except to generate tax write-offs. If the Internal Revenue Service (IRS) successfully challenges the tax benefits claimed from the tax shelter, the investor would have to pay not only additional income tax on the amounts disallowed but also interest and possible penalties. Should this occur, investors might walk away from their loans, and institutions holding the loans would suffer losses.

Warning Signs

1. Block loans to individuals to buy tax shelters arranged by a tax shelter promoter.

2. Shelters which promise tax deductions that would not appear to withstand the scrutiny of the IRS.

3. Specific use of the invested funds cannot be ascertained.

4. Loan payments are to be made by a servicing company.

5. Investments reflect no economic purpose except to generate tax write-offs.

6. Financial "no cash" deals where transactions are structured to avoid any actual cash flow. For example, a long-term CD is matched against a loan payable from the proceeds of the CD at its maturity. Interest accumulates on the CD in an amount equal to or greater than the compounded interest owed on the corresponding loan. The depositor/borrower never provides or receives any cash but still gets the tax write-off.

Suggested Action

Try to determine if the tax shelter is legitimate. Section 465 of the Internal Revenue Code states that an investor can only use losses available from such at risk activity to the extent that the taxpayer is actually economically at risk in connection with the activity.

LINKED FINANCING /BROKERED DEPOSITS

Potential Problems

Linked financing and brokered deposit transactions have contributed to the failure of several banks and savings associations. Offers of large deposits in return for favorable treatment on loans to out-of-area borrowers or to other borrowers previously unknown to the institution should be handled with caution. Where the brokered deposits are not pledged to secure the associated loans, the institution is exposed to substantial risk since it must refund the deposits regardless of the collectability of the loans.

Warning Signs

1. Short-term volatile deposits are used to fund long-term loans of questionable credit quality.

2. A generous point spread exists between the loan interest rate and the interest rate on deposits, which are usually below prevailing market rates.

3. Out-of-territory lending to previously unknown borrowers.

4. Large dollar deposits are offered in consideration for favorable treatment on loan requests, but deposits are not pledged as collateral for the loans.

5. Brokered deposit transactions where the broker's fees are paid from the proceeds of related loans.

6. Institution is presented with a large loan request that cannot be funded without the use of brokered deposits.

7. An unsolicited offer to purchase the institution comes at about the same time as brokered deposits and related loans are processed.

8. Long term discounted certificates of deposit pledged or matched at face value and not actual book value and structured to repay the loan automatically.

Suggested Action

Loans and other transactions associated or connected with brokered deposits should be carefully reviewed. Special attention should be given to transactions where the broker's fee is paid out of loan proceeds or fees for other related transactions instead of being paid directly by the institution as a cost of obtaining the funds.

CREDIT CARDS AND ATM TRANSACTIONS

Potential Problems

Poor control by the issuing institution over unissued cards, PINs, returned mail, credit limit increases and name and address changes can contribute to credit card and ATM card fraud. Credit card merchant accounts can be used to defraud the institution, particularly where the institution does not exercise care in screening prospective accounts. If not handled properly, credit card programs secured by deposit accounts can create substantial liability to the institution for inadequate or improper disclosures of fees and interest charges to customers and can create losses where credit limits are not adequately monitored and/or controlled. Delay in payments to merchants and payments from cardholders could signal the beginning of problems with a third party servicer (generally an outside marketing firm).

Warning Signs

1. Lack of separation of duties between the card issuing function and issuance of personal identification number ("PIN").

2. Poor control of unissued cards and PINs.

3. Poor control of returned mail.

4. Customer complaints.

5. Poor control of credit limit increases.

6. Poor control of name and address changes.

7. Frequent malfunction of payment authorization system.

8. Unusual delays in receipt of cards and PINs by the customers.

9. The institution does not limit amount of cash that a customer can extract from an ATM in a given day.

10. Evidence that customer credit card purchases have been intentionally structured by a merchant to keep individual amounts below the "floor limit" to avoid the need for transaction approval.

11. Credit card merchant accounts are opened without obtaining any background information on the merchant.

12. Credit card merchant account activity reflects an increase in the number and size of chargebacks.

13. The institution's credit card merchant is depositing sales drafts made payable to a business or businesses other than the business named on the account.

14. Credit card merchant frequently requests the wire transfer of funds from the merchant account to other institutions in other parts of the country or to offshore institutions almost immediately after deposits are made.

15. Merchant is engaged in telemarketing activities and is the subject of frequent customer complaints.

16. The institution contracts with third party servicer to process credit card customer and merchant transactions without verifying the financial stability and reputation of the servicer.

17. The institution contracts with a third party to establish and market a secured credit card program without verifying the financial stability and reputation of the third party and without determining the institution's potential liability for participation in the program.

18. Credit card merchant account deposits appear to exceed the level of customer activity observed at the merchant's place of business.

19. Merchant has access to EDC (electronic data capture) equipment but frequently inputs credit card account numbers manually. Be especially alert if manually keyed transactions exceed 10% of total transactions.

20. Merchant has a sudden or unexplained increase in the level of authorization requests from a particular merchant location.

Suggested Action

Review customer complaints, no matter how insignificant they may appear to be, and review the institution's follow-up procedures. Be sure proper controls are in place at all points throughout the card issuing and transaction processing functions. Review possible causes of frequent malfunctions of the payment authorization system and follow-up on remedial actions taken by the institution. Monitor the level of authorization requests to spot potential problems before sales drafts are deposited. Conduct on-site inspections of merchant's operations. Review contracts and correspondence between the institution and Visa, MasterCard, etc. Review contracts with third party servicers, secured credit card programs and marketing agencies to determine possible exposure to liability.

ADVANCE FEE SCHEMES

Potential Problems

Advance fee schemes have been around for many years. They usually involve offers of sizable funds available for loans at below market rates, with the funds supposedly coming from some foreign interests who are seeking a safe haven in the United States. The targets are usually individuals or businesses experiencing financial difficulties. The goal of the perpetrator is to collect a fee in advance since the rest of the transaction is a sham and will never be consummated.

Although Institutions have been victimized by advance fee schemes, they are seldom the primary targets. However, institutions may be unwittingly used to lend false credibility to an advance fee scheme. Evidence of association with a reputable United States financial institution is critical to the success of the scheme. Institutions that act as agent, custodian, or in some other legal capacity face potential liability: (1) They have been sued by the perpetrators of the scheme for nonperformance under agency or escrow agreements, (2) They could be charged criminally for aiding and abetting a fraud, or (3) They may be civilly liable to the victims of the fraud.

Warning Signs

1. A person having no previous relationship with the institution suddenly appears and offers fantastic opportunities for the institution and/or its customers.

2. Broker claims to be part of a major financial organization, but this claim cannot be verified.

3. Broker claims to have access to huge sums of money from a secret, undisclosable or unverifiable source.

4. Broker becomes irritated if the institution suggests that references be checked.

5. Broker makes frequent references to such terms as "ICC Form 254, 290 or 322" and frequently uses the terms "emission rate", "prime bank notes", "tranches", "letters of commitment", "bank acceptances", "arbitrage", "hedge contracts" or "escrow agreements".

6. Broker initially requests an advance fee for his services but often "reluctantly" agrees to defer the fee until settlement of the transaction.

7. As the deadline for settlement nears, the broker urgently requests an advance on his fee to cover expenses such as travel, documentation, communication costs, etc.

8. Broker states that funds will be forthcoming from some offshore bank in the Caribbean or South Pacific.

9. Attempts to verify the broker's references are unsuccessful.

10. Broker's references include telephone numbers which are answered by machines and addresses which are mail drops, hotel rooms, etc.

11. Broker proposes a self-liquidating loan where earnings from a deposit or other investment will be such that they will pay the principal and interest of the loan with no additional funds needed from the borrower.

12. Broker conducts most of the negotiations by telephone or telex and appears to resist any meeting with the institution's counsel.

13. Broker repeatedly delays the settlement of the deal citing numerous "technical" problems.

14. The deal frequently falls through at the last minute while the broker searches for another source of funds.

15. Broker asks institution to serve as a transfer bank, middleman or agent in the transfer of funds between a sending institution and a receiving institution.

16. Broker who originally presents the deal may be known to the institution but other persons involved may be unknown to the institution and may have questionable backgrounds.

17. Broker asks for the institution's telex numbers and frequently, a long, instructional telex from the lender's agent is received by the institution.

18. The receiving institution may be asked to send a number of letters, contracts, or telex messages to the lender's agent or the lender's institution.

19. Broker expresses a great deal of urgency in completing the transaction so that the loan will not be lost.

20. Broker offers funds that the borrower can invest in U. S. Treasury Notes or similar instruments at a 4 or 5 point spread which will help the borrower to cover part of the fees, but offers only flimsy excuses as to why the lender does not directly invest in these instruments.

21. Broker does not allow borrower or institution any direct contact with the proposed lender, often citing confidentiality requirements by the lender or some sensitive political situation in the lender's home country.

22. Broker often requests that the borrower's institution issue a standby letter of credit to the foreign lender to guarantee payment.

23. Broker is often a name dropper, but the people named are either deceased or impossible to contact for reference because of political reasons.

Suggested Actions

The key to avoiding direct losses and/or potential legal liability in an advance fee scheme is to "know the customer" and carry out an extensive due diligence review. Each proposal involving any offer of large sums of money from previously unknown sources should be thoroughly investigated. No commitments should be made until all references are directly verified through some reputable and reliable source. Until references are verified, telex and written communications concerning the transactions should be avoided. Fees should not be paid until funds are verified and physically transferred. Suspicious transactions should be immediately reported to the FDIC and to the FBI. Remember, if the deal sounds too good to be true, it probably is.

OFFSHORE TRANSACTIONS

Potential Problems

Although there are legitimate and reputable institutions operating offshore offices, many are only "shell" institutions with little or no capitalization, no actual main office, no fixed asset investment, no actual staff and few other characteristics of a legitimate institution. Licenses for many offshore financial institutions are issued upon receipt of relatively nominal fees and minimal background verifications. The names of these offshore "shell" institutions are often similar to those of major legitimate financial institutions which are listed in international banking directories. There have been many instances of fraud involving obligations of offshore institutions, including certificates of deposit, letters of credit, drafts, commitments, etc. In some cases, these obligations have been purchased for a fraction of their face value for the sole purpose of defrauding legitimate institutions and other businesses.

Offshore companies, including financial institutions, are frequently established for the purpose of hiding the true identity of the principals, laundering money, inflating financial statements and issuing false documents to secure loans. Loans to offshore companies and loans secured by obligations of offshore institutions must be viewed with extreme caution.

Warning Signs

1. Loans made on the strength of a borrower's financial statement when the statement reflects major investments in and income from businesses incorporated in bank secrecy haven countries such as Panama, Cayman Islands, Netherlands Antilles, Montserrat and others.
2. Loans to companies domiciled in bank secrecy haven countries.
3. Loans secured by obligations of offshore institutions.
4. Transactions involving an offshore "shell" institution whose name may be very similar to the name of a major legitimate institution.
5. Frequent wire transfers of funds to and from bank secrecy haven countries such as Panama, Cayman Islands, Netherlands Antilles, Montserrat and others.
6. Offers of multi-million dollar deposits at below market rates from a confidential source to be sent from an offshore institution or somehow guaranteed by an offshore institution through a letter, telex, or other "official" communication.
7. Offshore companies are used to disguise the true identity of borrowers or guarantors.
8. No independent verification of the financial strength of the offshore institution is available from any source.
9. In order to make an offshore bank transaction appear legitimate, innocent third parties are brought into the scheme, unaware of its fraudulent nature.

Suggested Action

Offshore transactions should be closely examined to determine the legitimacy of the entities involved. Suspicious wire transfers to and from offshore institutions should be reviewed to determine the source and disposition of the funds. Obligations issued by questionable offshore institutions should not be accepted at face value unless the value can be substantiated through independent sources.

WIRE TRANSFERS

Potential Problems

Wire transfer fraud is often possible because of a breakdown in internal controls and/or system security measures at the financial institution. Transactions may be introduced by unauthorized persons who have obtained the proper procedures from an unsuspecting employee. Transactions may be altered in processing and posted to the wrong account, posted in the wrong amount or posted to the correct beneficiary but wrong account. Wire transfers are a popular form of laundering money, providing an easy way of sending funds to and from bank secrecy haven countries.

Warning Signs

1. Lack of separation between authority to initiate a wire transfer and authority to approve a wire transfer.
2. Indications of frequent overrides of established approval authority and other internal controls.
3. Intentional circumvention of approval authority by splitting transactions.
4. Wire transfers to and from bank secrecy haven countries.
5. Frequent or large wire transfers for persons who have no account relationship with the institution.
6. Large or frequent wire transfers against uncollected funds.

7. Frequent requests for immediate wire transfer of funds from a credit card merchant account to institutions in other parts of the U. S., offshore institutions or foreign institutions.

8. Frequent wire transfers from accounts with numerous cash deposits of just under $10,000 each.

9. Frequent errors in payment by authorized system officials.

10. Lack of security of the wire transfer system safeguards such as the password and other details of wire transfer transactions.

11. Unconfirmed wire transfer requests initiated by telephone.

12. Incoming wire transfers in which the account name and account number do not match.

13. Wire transfer or payment request that does not conform to established procedures.

14. Absence of written funds transfer agreements between the institution and its customers.

15. Large international funds transfer to or from the accounts of domestic customers in amounts and of a frequency that are not consistent with the nature of the customer's known business activities.

16. Receipt of funds in the form of multiple cashier's checks, money orders, traveler's checks, bank checks or personal checks that are drawn on or issued by U. S. financial institutions and made payable to the same individual or business, in U. S. dollar amounts that are below the $10,000 Bank Secrecy Act reporting threshold and which are then wire transferred to a financial institution outside the U. S.

17. The deposit of funds into several accounts and then aggregated into one account followed by the wire transfer of those funds from that account outside of the U. S. when such action is not consistent with the known business of the customer.

18. Any other unusual international funds transfer requests wherein the arrangements requested appear to be inconsistent with normal funds transfer practices, e.g., where the customer directs the institution to wire transfer funds to a foreign country and advises the institution to expect same day return of funds from sources different from the beneficiaries initially named, thereby changing the source of the funds.

19. A pattern of wire transfers of similar amounts both in and out of the customer's account on the same day or next day.

20. Wire transfers by customers operating a cash business, i.e., customers depositing large amounts of currency.

21. Wire transfer volume is extremely large in proportion to the asset size of the institution.

22. The institution's business strategy and financial statements are inconsistent with large volumes of wire transfers, particularly outside the United States.

Suggested Action

Review wire transfer procedures for possible circumvention of internal controls and system security measures. Follow-up on any exceptions. Verify source and disposition of suspicious wire transfers. Review accounts with frequent wire transfers to determine if the activity appears legitimate.

MONEY LAUNDERING

Potential Problems

An institution may be liable for civil or criminal penalties for willful participation in a money laundering scheme. The length of time involved in a money laundering investigation and the surrounding publicity can be disrupting and costly to an institution even if no formal charges are filed and no fines are levied. A money launderer usually needs the assistance of someone within the institution to whom he is often willing to pay a substantial fee. With the employee's assistance, money launderers are often able to hide their activities for an extended period of time.

Warning Signs

1. Increase in cash shipments that is not accompanied by a corresponding increase in number of accounts.

2. Cash on hand frequently exceeds limits established in security program and/or blanket bond coverage.

3. Large volume of cashier's checks, money orders, traveler's checks, etc., sold for cash to noncustomers

in amounts ranging from several hundred to just under $10,000 each.

4. Large volume of wire transfers to and from offshore institutions.

5. Large volume of wire transfers for noncustomers.

6. Accounts which have a large number of small deposits and a small number of large checks with the balances of the accounts remaining relatively low and constant. The accounts have many of the same characteristics as accounts used for check kiting.

7. A large volume of deposits to several different accounts with frequent transfer of major portions of the balances to a single account at the same institution or at another institution.

8. Loans to offshore companies and loans secured by obligations of offshore institutions.

9. Large volume of cashier's checks, money orders and/or wire transfers deposited to an account where the nature of the account holder's business would not appear to justify such activity.

10. Large volume of cash deposits from a business that is not normally cash intensive, such as a wholesaler.

11. Cash deposits to a correspondent account by any means other than through an armored carrier.

12. Large turnover in large bills that would appear uncharacteristic for the institution's location.

13. Cash shipments which appear large in comparison to the dollar volume of currency transaction reports filed.

14. Dollar limits on the list of customers exempt from currency transaction reporting requirements which appear unreasonably high considering the type and location of the businesses. No information is in the institution's files to support the limits.

15. Currency Transaction Reports, when filed, are often incorrect or lack important information.

16. List of exempted customers appears unusually long.

17. Customer expresses some urgent need to be included on the institution's list of customers exempt from currency transaction reporting requirements.

18. Customer requests information on how to avoid the filing of currency transaction reports on cash transactions involving amounts over $10,000.

19. Upon being informed of the currency transaction reporting requirements, customer withdraws all or part of the transaction to avoid the filing of the CTR.

20. Customer frequently conducts cash transactions in amounts just under $10,000 each.

21. Customer refuses to provide information required to complete a CTR.

22. Corporate customer makes frequent large cash deposits and maintains high balances but does not avail itself of other services such as loans, letters of credit, payroll services, etc.

23. Customer almost never comes to the institution but has numerous couriers making deposits to the account.

24. A large increase in small denomination bills and a corresponding decrease in large denomination bills with no corresponding CTR filings.

25. Customers who open accounts providing minimal or fictitious information or information which is difficult or expensive for the institution to verify.

26. Customers who decline to provide information that normal customers would provide to make them eligible for credit or other banking services that normal customers would regard as valuable.

27. Customers who appear to have accounts with several institutions within the same locality, especially when there is a regular consolidation of balances in the accounts and transfer of funds out of the accounts by wire transfer, or other means, to offshore institutions or to large domestic institutions.

28. Customers whose deposits frequently contain counterfeit bills or bills which appear musty or extremely dirty.

29. Customers who have deposit accounts at the institution but frequently purchase cashier's checks, money orders, etc., with large amounts of cash.

30. Retail customer which deposits a large volume of checks but seldom, if ever, requests currency for its daily operations.

31. Retail business has dramatically different patterns of cash deposits than other similar businesses in the same general location.

32. Exempted customer frequently requests increases in exemption limits.

33. Substantial increase in cash deposits of any business without any apparent cause.

34. Substantial increase in cash deposits by professional customers using client accounts or in-house company accounts such as trust accounts, escrow accounts, etc.

35. Customers who make or receive large transfers of funds to or from countries associated with production, processing and marketing of narcotics.

36. Size and frequency of cash deposits increases rapidly without any corresponding increase in non-cash deposits.

37. Size and frequency of cash deposits is not consistent with observed activity at the customer's place of business.

38. Customer makes large and frequent cash deposits but checks or other debits against the account are not consistent with the customer's stated line of business. For example, customer claims to be in the retail jewelry business, but checks are mostly to individuals and/or firms not normally associated with the jewelry business.

39. Customer frequently deposits large amounts of currency that is wrapped in currency straps that have been stamped by other financial institutions.

40. Customer frequently deposits strapped currency or currency wrapped in rubber bands that is disorganized and does not balance when counted.

41. Customer is often observed entering the safety deposit box area just prior to making cash deposits just under $10,000.

Suggested Action

Review results of the institution's independent testing for compliance with the Bank Secrecy Act. Perform Bank Secrecy Act examination procedures. Request verification of Currency Transaction Reports filed by the institution. Review all transactions involving offshore institutions to see if they appear to represent legitimate business activities.

SECURITIES TRADING ACTIVITIES

Potential Problems

Speculative securities trading activities may result in unsafe and unsound banking practices. Some bond salesman have made extensive use of the telephone to employ high pressure sales techniques, sometimes accompanied by oral guarantees which purport to limit an institution's exposure. Situations have been reported where an institution's board of directors and/or senior management have not monitored or controlled these practices and, in effect, have relinquished the management of their institution's investment portfolio to a broker.

Warning Signs

1. Management lacks the expertise needed to fully understand the ramifications of proposals made by brokers and/or they perceive an unrealistic opportunity to enhance income.

2. Investments bear no reasonable relationship to the institution's size or its capital accounts.

3. Overreliance is placed on the purported safety of the securities since they involve U. S. Government issues.

4. Little or no attention is given to "interest rate risk" prior to the transaction taking place.

5. Delayed settlements over unreasonable time periods sometimes allow management to make imprudent purchases and avoid booking the transaction on a timely basis.

6. The institution engages in reverse repurchase agreements with brokers which allows institutions to erroneously defer recognition of losses.

7. Securities held for short-term trading are not appropriately identified and segregated from those that are held primarily as a source of investment income.

8. Trading account securities are not revalued periodically and are not reported consistently at market value or the lower of cost or market value.

Suggested Action

Review the institution's investment policy to see if the board of directors has implemented prudent limits and comprehensive controls to suit their particular circumstances. Review the institution's files to determine if the institution has satisfied itself that it is dealing with a reputable and financially stable dealer. Ensure that management has sufficient expertise to analyze each transaction independently of the broker's sales pitch and recommendations.

MISCELLANEOUS

Potential Problems

Lack of proper supervision and lack of effective internal controls makes an institution especially vulnerable to fraud and insider abuse. Customer complaints, even seemingly insignificant ones, may be an indication of much greater problems.

Warning Signs

1. Lack of supervision of lending activities by officers of the institution.
2. Lack of lending policies or failure to enforce existing policies.
3. Lack of code of conduct or failure to enforce existing code.
4. Dominant figure allowed to exert influence without restraint.
5. Lack of separation of duties.
6. Lack of accountability.
7. Lack of written policies and/or internal controls.
8. Circumvention of established policies and/or controls.
9. Lack of independent members of management and/or Board.
10. Entering into transactions where the institution lacks expertise.
11. Excessive growth through low quality loans.
12. Unwarranted concentrations.
13. Volatile sources of funding such as short term deposits from out of area brokers.
14. Too much emphasis on earnings at the expense of safety and soundness.
15. Compromising credit policies.
16. High rate - high risk investments.
17. Underwriting criteria allows high risk loans.
18. Lack of documentation or poor documentation.
19. Lack of adequate credit analysis.
20. Failure to properly obtain and evaluate credit data, collateral, etc.
21. Failure to properly analyze and verify financial statement data.
22. Too much emphasis on character and collateral and not enough emphasis on credit.
23. Lack of balance in loan portfolio.
24. Poor loan administration after credit is granted.
25. Unresolved exceptions or frequently recurring exceptions on exception reports.
26. Out-of-balance conditions.
27. Purpose of loan is not recorded.
28. Proceeds of loan are used for a purpose other than the purpose recorded.
29. Lax policies on payment of checks against uncollected funds.
30. The institution is defendant in a number of lawsuits alleging improper handling of transactions.

Suggested Action

Out-of-balance conditions should be given proper attention and not merely charged off if their amount is small. Be alert to rumors and gossip inside and outside the institution because in many cases, embezzlers and perpetrators of other frauds are betrayed by jealous peers or subordinates. Review any loans that do not appear to conform to the written loan policy. Determine the circumstances under which they were approved and who approved them. Each attempt to circumvent existing policies, controls and/or regulations should be investigated. Be alert to any overrides or attempted overrides of internal controls and determine who is responsible and the reason.

INTRODUCTION

Criminal conduct and fraudulent acts undermine public confidence in the financial system and contribute to financial institution failures. Confidence is especially eroded when offenses involve bank insiders. When failures occur, the FDIC deposit insurance fund can suffer significant losses.

If allegations or evidence of wrongdoing comes to the FDIC's attention, a prompt response is warranted. The scope of a response varies based on the severity and specificity of allegations and the reliability of corroborating evidence. Examiner discretion, sound judgment, and regional office coordination are needed to appropriately respond to indications of improper conduct or fraudulent acts.

The primary responsibility for preventing, detecting, and reporting fraud and insider abuse rests with a bank's board of directors and senior management. Early detection and reporting of suspicious activities is in a bank's best interest as it can reduce liabilities resulting from operational errors and may limit or prevent monetary losses. The board must establish appropriate internal controls and effective audit programs to fulfill their legal and fiduciary duties. Controls and safeguards should address internal and external offenses and include procedures for identifying and reporting suspicious activities. Financial institutions must report questionable actions using a Suspicious Activity Report (SAR).

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SUSPICIOUS ACTIVITY REPORTS

Part 353 of FDIC Rules and Regulations and CFR[1] Title 31, Chapter X, § 1020.320 of the Financial Crimes Enforcement Network (FinCEN) regulations require insured nonmember banks and state chartered savings associations to report suspicious activities to FinCEN, a bureau of the U.S. Department of the Treasury. The primary purpose of the reporting requirement is to ensure investigators and prosecutors are provided relevant information in an orderly and timely fashion. Financial institutions must report suspicious activities on electronically filed SARs, which allow law enforcement and regulatory agencies to more efficiently assess and respond to questionable actions.

[1] The U.S. Code of Federal Regulations (CFR) is the codification by subject matter of the general and permanent laws of the United States. It is divided by broad subjects into 50 titles and published by the Office of the Law Revision Counsel of the U.S. House of Representatives.

Filing Suspicious Activity Reports

A financial institution is required to file an SAR when it detects a known or suspected criminal violation of federal law, a suspicious transaction related to potential money laundering, or a violation of the Bank Secrecy Act (BSA). Banks should file SARs with appropriate federal law enforcement agencies and the Department of the Treasury in accordance with the report's instructions. Generally, completed SARs should be transmitted to FinCEN in the following circumstances:

- Insider abuse[2] involving any amount when the financial institution believes it is either an actual or potential victim of a committed or attempted criminal transaction and the financial institution has identified a director, officer, employee, agent, or other institution-affiliated party as having committed or aided in the commission of the criminal act;
- Transactions aggregating $5,000 or more in funds or other assets when a suspect can be identified and the financial institution believes it is either an actual or potential victim of a committed or attempted criminal transaction;
- Transactions aggregating $25,000 or more in funds or other assets regardless of potential suspects and the financial institution believes it is either an actual or potential victim of a committed or attempted criminal transaction; or
- Transactions aggregating $5,000 or more that involve potential money laundering or violations of the BSA.

Note: Financial institutions are not required to file an SAR for a robbery or burglary committed or attempted that is appropriately reported to law enforcement authorities.

Reporting Timeframes

Financial institutions are required to file SARs no later than 30 calendar days after the date of the initial detection of facts that constitute the basis for filing an SAR. An institution may delay filing an SAR for an additional 30 calendar days to identify a suspect. However, in no case should institutions delay reporting more than 60 calendar days after the date of initial detection of a reportable transaction. Further, in situations involving violations that require immediate attention, such as ongoing money

[2] Insider abuse may involve known or suspected criminal violations of federal law committed by an insider against a bank customer involving a transaction or transactions facilitated by or through the bank.

laundering activities, the financial institution should immediately notify an appropriate law enforcement authority by telephone in addition to promptly filing an SAR. Refer to Part 353 and CFR Title 31, Chapter X, § 1020.320(b) for additional details.

Record Retention

Financial institutions must maintain a copy of any SAR filed and the original, or business record equivalent, of any supporting documentation for a period of five years from the date of filing. Supporting documentation identified and maintained by the financial institution as such, will be deemed to have been filed with the SAR. The financial institution must make all supporting documentation available upon request to FinCEN, appropriate law enforcement agencies, and state or federal regulatory authorities that examine the bank for compliance with the BSA.

Board Reporting

Management is required by Part 353 to promptly notify its board of directors, or a committee thereof, of any SAR filed. In addition, the board should record such notification in its minutes.

Confidentiality

Suspicious activity reports are confidential. Any institution subpoenaed or otherwise asked to disclose an SAR or related information shall decline to produce the SAR or provide any information indicating an SAR was prepared or filed. Institutions should notify their FDIC regional office of any such requests.

Additionally, neither the financial institution, nor its current or former directors, officers, employees, agents, or contractors may notify any person involved in a transaction that an SAR was filed or disclose any information that would reveal the existence of an SAR.

Safe Harbor Provision

In general, financial institutions and their directors, officers, employees, and agents are protected from civil liability for filing SARs and for failing to provide notice of such filings to individuals named in the SARs. Refer to CFR Title 31, § 5318(g) for additional information.

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THE ROLE OF EXAMINERS

Examiners should consider the adequacy of internal controls at each examination and remain alert for suspicious or unusual activities during each functional review. If examiners identify or become aware of questionable conduct or transactions, they should discretely investigate their concerns and discuss the issues with the examiner-in-charge and field or regional office personnel. Examiners should securely retain documentation of transactions, discussions with management (or other bank personnel) and any other pertinent information relating to their investigations. Explanations by bank personnel that appear unreasonable should not be accepted without being fully investigated; however, information that supports management's explanations should be clearly documented.

If material concerns remain after examiners complete their initial investigations, they must immediately notify field and regional office personnel. This is paramount when board members or senior managers are suspected of wrongdoing, or when losses attributable to the activity imperils the institution's continued operation.

Examiners must consult with the supervisory regional office before informing the institution's board of directors or anyone associated with the institution of the suspicious activity. Generally, (after consulting with the regional office) apparent criminal violations that are detected by examiners should be brought to management's attention. However, the examiner should only present facts and must not make any statements or insinuations regarding possible conclusions as to particular individuals.

Generally, examiners should discuss the requirements of Part 353 with bank officials. However, it may be inappropriate to notify the board of directors or management when senior financial institution officials are implicated in the suspicious activity, or if the examiner has reason to believe that an official might flee, warn the target, destroy evidence, or otherwise jeopardize an investigation.

Further, if the financial institution fails to file an SAR, examiners should report the financial institution's decision to the regional office. The regional office should then determine whether a SAR should be filed.

Under certain circumstances, examiners may need to collect information supporting an SAR and submit it directly to the regional office. These situations generally occur when the financial institution is unable to file an SAR without alerting the subject, unwilling to file an SAR on an insider, or unwilling to file an SAR when the activity may imperil the institution's continued operation. If the regional office agrees with the examiner's assessment, an SAR may be filed by regional office staff.

The fact that an SAR has been filed does not prevent the examiner from making a more detailed written report. If necessary, the examiner may need to gather facts to support corrective actions, which may include recommendations for removal and prohibition.

Notification Prohibition

Pursuant to Title 31, U.S.C. 5318(g)(2)(A), no current or former officer or employee of, or contractor for, federal, state, local or territorial government who has knowledge that an SAR was filed, may disclose that fact to any person involved in the transaction, except in fulfilling official duties.

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INTERAGENCY COOPERATION

The FDIC, other federal banking regulators, and various other agencies have agreed to cooperate and exchange information when necessary to address suspicious activity affecting insured financial institutions.

Communication and Points of Contact

Procedures have been formalized for interactions between RMS and the Office of Inspector General - Office of Investigations (OIG) with respect to investigations involving operating institutions. If an examiner or other RMS staff member is contacted directly by law enforcement, they must report the contact through the appropriate channels to the RMS deputy regional director or designee, who will notify the OIG and the Legal Division. Furthermore, the transfer of FDIC documents or records requested by law enforcement must comply with 12 C.F.R. § 309.6 (Disclosure of Exempt Records). The OIG and the Legal Division will coordinate the transfer of such documents and records. The OIG may oversee the investigation and coordinate interviews of appropriate RMS employees or the review of documents. No RMS employee should communicate directly with law enforcement, without prior approval of regional management and the Legal Division. However, permission is not required when disclosure is made solely to the FDIC Office of Inspector General - Office of Investigations. Refer to the Right to Financial Privacy Act for more information.

Referrals to the Department of Justice (DOJ)

The referral of suspicious activity to the DOJ or various U.S. Attorney Offices does not restrict the FDIC from continuing its own research into the same activity. However, the FDIC may cease or suspend such activity if requested to do so by the DOJ due to an ongoing criminal investigation or prosecution. In all cases, the FDIC should keep the DOJ or U.S. Attorney informed of the progress of any parallel civil investigation with a view toward reaching a cooperative solution. Such cooperation might lead to a demand for restitution and stipulation to a prohibition from future banking employment being included in a criminal plea agreement or pre-trial diversion arrangement.

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ASSISTANCE TO LAW ENFORCEMENT

Examiners may be asked to provide expertise to law enforcement agents investigating suspicious activity or prosecuting a criminal case. Requests are usually made in connection with bank fraud or money laundering cases, and the assistance is often needed for the following reasons:

- To interpret subpoenaed documents obtained from the financial institution;
- To explain the flow or processing of documents;
- To determine whether acquired documents are relied upon by FDIC examiners, other regulators, auditors, or managers to formulate business decisions or opinions as to the condition of the financial institution;
- To provide information concerning banking policies or general banking practices; or
- To provide specific assistance, such as testifying at a trial or before a federal grand jury.

Examiners should cooperate to the fullest extent possible in honoring reasonable requests for assistance, and the regional office should supply examiners with specific guidance governing each assignment. A written agreement may be necessary for long-term assignments, and the following guidelines apply to most requests for examiner assistance:

- The request for assistance must be for a legitimate law enforcement purpose within the jurisdiction of the requesting agency;
- The information requested, or that which the examiner has been asked to review, must be relevant to a legitimate law enforcement inquiry;
- The suspicious activity should involve an FDIC-insured institution, its directors, officers, employees, agents or customers;
- Any known, potential respondents (employees, officers, directors, or other IAPs) resulting from an investigation should be identified in addition to naming the institution itself;
- Compliance with all applicable provisions of the Right to Financial Privacy Act covering disclosures of

information derived from financial institution customer records must be assured; and

- The examiner should be instructed that while assisting the law enforcement authorities, he or she will be acting solely as a representative of the law enforcement authority, will not represent the FDIC in any way, and should not assert or exercise any authority as an FDIC examiner.

Parallel Proceedings

Although administrative and criminal investigations may occur concurrently, they must remain separate, independent investigations. Maintaining independence is critical when conducting coordinated investigations. While a coordination of activities between investigations is acceptable, a lack of independence may result in the suppression of evidence and/or the dismissal of an indictment. Therefore, examiners should not accompany law enforcement agents onto a financial institution's premises in order to collect records as it may create the appearance of a lack of independence between separate investigations.

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FEDERAL GRAND JURY SUBPOENAS

A federal, grand jury subpoena is an investigatory tool used to build the prosecution's case without compromising the privacy of investigation targets or prematurely revealing their investigatory directions. Rule 6(e) of the Federal Rules of Criminal Procedure requires that grand jury proceedings be kept secret to the fullest extent practicable. Grand jury secrecy is maintained principally:

- To encourage witnesses to come forward and to testify freely and confidentially;
- To minimize the risks that prospective defendants will flee or use corrupt means to thwart investigations and escape punishment;
- To safeguard the grand jurors and proceedings from extraneous pressures and influences;
- To avoid unnecessary disclosures that may make individuals appear guilty of misconduct without their being afforded opportunity to challenge the allegations; and
- To prevent information given under compulsion and for purposes of public justice from being used for insubstantial purposes, such as gossip, to the detriment of the criminal justice system.

Rule 6(e)(3)(A)(iii) allows grand jury matters to be disclosed to government attorneys and banking regulators for enforcing civil forfeiture and civil banking laws pursuant to 18 U.S.C. 3322. However, 18 U.S.C. 3322 requires that a person to whom a matter has been disclosed shall not use such matter other than for the purposes for which such disclosure was authorized. The term "banking law violation" means a violation of, or a conspiracy to violate, sections 215, 656, 657, 1005, 1006, 1007, 1014, 1344, 1956 or 1957 of Title 18; as well as any violation of section 1341 or 1343 affecting a financial institution; or any provision of subchapter II of Chapter 53 or Title 31.

FDIC management must make a determination as to allowing appropriate and sufficient RMS and legal staff access to grand jury information. Nevertheless, possession of grand jury documents or testimony requires great care in order to comply with the secrecy requirements of Rule 6(e) of the Federal Rules of Criminal Procedure.

The FDIC's General Counsel has the delegated authority to authorize an examiner to appear and testify before the grand jury or at a criminal trial. The examiner may be directed to contact the prosecutor or investigator either before or after a grand jury subpoena is issued to assist in identifying and gathering documents pertinent to the investigation. The examiner will be provided with appropriate counsel before testifying.

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SAFEGUARDING EVIDENCE

Copies of the SAR and all supporting evidentiary documents should be segregated and stored in the regional office to ensure that the documents are readily retrievable and can be provided to law enforcement officials if needed.

Examiners should consult the regional office regarding necessary documentation. Generally, copies of documents must be made during the examination. The copies should be initialed and dated by the examiner in case the originals are misplaced or destroyed.

In addition to electronically copied documents, the examiner should document the flow of funds, approvals, and employees responsible for handling each transaction. Flow charts or similar methods may be appropriate for documenting complex transactions.

The following questions provide examples of the line of inquiry an examiner may follow in deciding how to review and document a particular circumstance:

- What is the financial institution's policy for handling this type of transaction?
- Was there deviation from the policy?
- Who was authorized to make this transaction?

- Who handled this transaction?
- Who had knowledge?
- Who benefited ultimately from the transaction?
- What knowledge did the financial institution's directors have?
- What was the credit quality at the time of making a loan and what it is now?
- Was the documentation adequate at inception?
- Was collateral value adequate at inception?
- Are there presently any credit or legal problems?
- Is the financial institution facing possible risk or damage other than financial loss?

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BONDING COMPANY NOTIFICATION

The FDIC and financial institution management have a mutual interest in ensuring that all of a financial institution's employees are protected by a fidelity bond. When a financial institution files an SAR involving an employee, it normally is required to notify its fidelity insurer of the subject activity. However, a financial institution may not provide a copy of the SAR to the insurer.

The notification requirement is usually included in the terms of the insurance contract and is not dependent upon the filing of a claim against the insurance coverage. The standard financial institutions bond contains a termination clause that automatically cancels coverage of any employee as soon as there is knowledge of any dishonest or fraudulent act on the part of such employee. The insurer need not give notice of such termination; in fact, the decision of the insurer may be made at a subsequent date. In the rare case in which a financial institution official has knowledge of a suspicious act on the part of an employee, yet wishes to continue to employ that person, management should obtain either an assurance in writing from the insurer's main office (agents generally are not so empowered) that such person is still covered under the bond, or obtain a new bond covering that person. Refer to the Manual Section 4.4, Fidelity and Other Indemnity Protection for additional information.

If an examiner becomes aware that an employee has or will be reported to the fidelity bond company for suspicious acts (whether coverage is terminated or not), the examiner should contact the regional office. The regional office and examiner should consider whether to commence an investigation of the employee's acts to determine if removal and prohibition or other administrative action under section 8 is warranted.

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OTHER MATTERS

Examiners that receive information about alleged misconduct by a financial institution, its officers, employees, or directors may be asked to protect the informant's identity. When this happens, the examiner should advise the informant that the FDIC will try to protect the identity of the informant. However, prior to receiving the information, the examiner should advise the informant of the following facts:

- Mere inquiry into the situation may allow the institution's management or employees to deduce the informant's identity;
- The information may be referred to another agency, such as the Department of Justice, which may request the informant's identity to continue or complete an investigation; and
- If the information becomes the basis for a criminal prosecution, the court may order disclosure of the informant's identity to the defendant.

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CRIMINAL STATUTES

United States Code Title 18 is applicable to many criminal or fraudulent acts relating to financial institutions. Several sections of Title 18 and other pertinent Titles that an examiner might encounter are described below.

Title 18 - Crimes and Criminal Procedure
Part I › Chapter 1 › § 2
Aiding and Abetting

Whoever aids, abets, counsels, commands, induces, or procures the commission of a federal offense is punishable as a principal.

18 U.S.C. § 4 - Misprision of Felony

This statute applies to a person who has knowledge of the actual commission of a felony but conceals the knowledge and does not report that knowledge to a judge or other person in civil or military authority. A financial institution that fails to report an offense of which it is aware can be charged with violating this section.

18 U.S.C. § 20 - Financial Institution Defined

The definition of financial institution was expanded under the Fraud Enforcement and Recovery Act (FERA) of 2009 to include a mortgage lending business or any person or entity that makes in whole or part, a federally related mortgage loan as defined in the Real Estate Settlement Procedures Act (RESPA) of 1974. Under § 27, a mortgage lending business is defined to include an organization which finances or refinances any debt secured by an interest in real estate, including private mortgage companies and any subsidiaries, and whose activities affect interstate or foreign commerce. Prior to the amendment, only FDIC or NCUA insured institutions, Federal Home Loan Banks, Farm Credit System, uninsured foreign banks, and Federal Reserve member banks were considered financial institutions.

Chapter 11 - Bribery, Graft, and Conflicts of Interest

18 U.S.C. § 201 - Bribery of Public Officials

This statute bans the offering or soliciting of bribes to or by federal officials, elected representatives, jurors or witnesses in official proceedings with the intent to influence an official act, or to influence the public official to commit, aid in committing, collude in, or allow any fraud; or to induce the public official to omit to do any act in violation of his lawful duty.

18 U.S.C. § 215 - Bank Bribery

Anyone who corruptly gives, offers, or promises anything of value with the intent to influence or reward an officer, director, employee, agent, or attorney of a financial institution in connection with any business or transaction, or any financial institution official who corruptly solicits or demands such things of value, would violate this statute.

Financial institutions are encouraged to prohibit insiders from self-dealing or otherwise trading on their positions at the financial institution; or accepting from one doing or seeking to do business with the financial institution, a business opportunity not generally available to the public. In this regard, the financial institution's code of conduct or policies should require that its officials disclose all potential conflicts of interest, including those in which they have been inadvertently placed due to either business or personal relationships with customers, suppliers, business associates, or competitors of the financial institution.

It should be noted that this section does not apply to bona fide salary, wages, fees, or other compensation paid, or expenses paid or reimbursed, in the usual course of business.

Chapter 19 - Conspiracy

18 U.S.C. § 371 - Conspiracy to Defraud

This statute covers a conspiracy of two or more persons to commit a federal offense or to defraud the United States or any agency thereof. This statute has been cited when two or more persons willfully ignored the notice requirements of the Change in Bank Control Act.

Chapter 25 - Counterfeiting and Forgery

18 U.S.C. § 471 - Counterfeiting and Forgery (Counterfeit Deterrence Act of 1992)

This statute applies to persons who falsely make, forge, counterfeit, or alter any obligation or other security of the United States with intent to defraud.

18 U.S.C. § 472 - Counterfeiting and Forgery

This statute applies to persons who intentionally defraud, pass, utter, publish, or sell the items contained in § 471 above. It also includes those persons who attempt to do so, or those who keep in their possession or conceal any such items.

18 U.S.C § 500 - Counterfeiting and Forgery - Money Orders

This statute applies to persons who intentionally defraud, falsely make, forge, counterfeit, engrave, or print any order in imitation of, or purporting to be, a blank money order. It also applies to those who receive or possess any such money order with the intent to convert it for their own use or gain, knowing that it had been embezzled, stolen, or converted.

Chapter 31 - Embezzlement and Theft

18 U.S.C. § 656 - Theft, Embezzlement, and Misapplication by Bank Officer or Employee

This statute prohibits the willful theft, embezzlement, or misapplication of financial institution funds by an officer, director, agent, or employee of a financial institution with the intent to injure or defraud the financial institution. For example:

- Loans granted by a financial institution officer to fictitious borrowers,
- Loans granted based on inadequate or valueless collateral if the loan officer benefited personally or acted in reckless disregard of the institution's interests, and
- Brokered loans where deposits are provided for a fee to fund a loan that is worthless from its inception.

18 U.S.C. § 657 - Theft, Embezzlement, and Misapplication of Funds

This statute requires that any officer, agent, or employee of, or connected in any capacity with the FDIC, et al., who embezzles, abstracts, purloins or willfully misapplies any moneys, funds, credits, securities, or other things of value belonging to an insured institution will be fined or imprisoned.

18 U.S.C. § 658 - Property Mortgaged or Pledged to Farm Credit Agencies

This statute applies to persons who intentionally defraud, knowingly conceal, remove, dispose of, or convert to their own use, or to that of another, any property mortgaged or pledged to, or held by, the Farm Credit agencies.

18 U.S.C. § 664 - Theft or Embezzlement from Employee Benefit Plans

This statute applies to persons who intentionally embezzle, steal, or unlawfully and willfully abstract or convert to their own use or to the use of another, any of the monies, funds, securities, premiums, credits, property, or other assets of any employee welfare benefit plan or employee pension benefit plan, or of any fund connected therewith.

18 U.S.C. § 667 - Theft of Livestock

This statute applies to those who market $10,000 or more in livestock, in interstate or foreign commerce, with the intent to deprive another of a right to the property or a benefit of the property or to appropriate the property to his or another's use.

Chapter 33 - Emblems, Insignia, and Names

18 U.S.C. § 709 - False Advertising or Misuse of FDIC Name

This statute covers false advertising or representations, misuse or unauthorized use of words such as national, reserve, federal deposit, or deposit insurance, or misuse of names such as FDIC, to convey the impression of federal agency affiliation.

Chapter 47 - Fraud and False Statements

18 U.S.C. § 1001 - False Statements or Entries

This statute generally covers oral or written false statements that are knowingly or willingly made, or concealment of a material fact, for the purpose of influencing a determination of any federal department or agency. It is not necessary to show that the governmental body was actually influenced thereby.

18 U.S.C. § 1005 - Bank Entries, Reports, and Transactions

This statute covers false entries and reports or statements, including material omissions, made by an officer, director, agent, or employee of an insured bank with intent to injure or defraud the bank, or to deceive the FDIC or other individuals or companies. This section also prohibits any such person from issuing or putting forth in circulation any notes of the bank or making, drawing, issuing, or assigning any certificate of deposit, draft, order, bill of exchange, acceptance, note, debenture, bond or other obligation, or mortgage, judgment or decree. The crime may be committed personally or by direction (e.g., an officer directing the making of false entries).

Examples:

- Actions taken by an officer or employee to conceal delinquencies or to disguise potential lending limit violations
- Recording securities transactions at other than market value to hide losses

18 U.S.C. § 1007 - Federal Deposit Insurance Corporation Transactions

This statute covers false statements made for the purpose of influencing an action of the FDIC in any way. This includes willfully over-valuing any security for the purpose of obtaining, extending, or renewing a loan and statements made to induce the payment of an insured deposit, the purchase of assets, or the payment of any claim by the FDIC. To establish a violation of this statute, it is not necessary to prove loss or damage to the FDIC caused by the falsification. Violations of this section occur when false statements are made to the FDIC in connection with an application for deposit insurance, notice to acquire control of an insured state nonmember bank, or other processes in which FDIC is required to take action. False or misleading statements made to an FDIC examiner during an examination are also covered.

18 U.S.C. § 1010 - Department of Housing and Urban Development (HUD) Transactions

This statute prohibits for the purpose of obtaining any loan or advance of credit from any person, partnership, association, or corporation with the intent that such loan or advance of credit will be offered to or accepted by HUD for insurance, or for the purpose of obtaining any extension or renewal of any loan, advance of credit, or mortgage insured by HUD, or the acceptance, release, or substitution of any security on such a loan, or for the purpose of influencing in any way the action of HUD, by making, passing, uttering, or publishing any statement, knowing the same to be false, or altering, forging, or counterfeiting any instrument, paper, or document, or uttering, publishing, or passing as true any instrument, paper, or document, knowing it to have been altered, forged, or counterfeited, or willfully overvaluing any security, asset, or income, will be fined and/or imprisoned.

18 U.S.C. § 1014 - False Statements on a Loan or Credit Application

This statute covers any false statements or reports made knowingly on a loan or credit application to an insured bank or to an entity that makes in whole or part, federally related mortgage loans as defined in RESPA of 1974. Such statements or reports must have been capable of influencing the financial institution's credit decision. Actual damage or reliance on such information is not an essential element of the offense.

The statute applies to the following:

- Applications,
- Advances,
- Discounts,
- Purchases,
- Purchase agreements,
- Repurchase agreements,
- Commitments,
- Credit renewals,
- Extensions or Deferments.

The statute applies to willful omissions as well as affirmative false statements. Obsolete information in the original loan application is not covered unless the applicant reaffirms the information in connection with a renewal request.

18 U.S.C. § 1028 - Fraud and Related Activity in Connection with Identification Documents, Authentication Features, and Information

This statute applies to persons who knowingly and without lawful authority produce or transfer an identification document, authentication feature, or a false identification document. This statute also applies to persons who knowingly possess with intent to use or transfer unlawfully five or more identification documents. Further, the statute applies to those who knowingly and unlawfully transfer, possess, or use a means of identification of another person with the intent to commit, or to aid or abet, or in connection with any unlawful activity that constitutes a violation of federal law, or a felony under any applicable state or local law. Finally, this statute covers trafficking in false or actual authentication features for use in false identification documents.

Identification document is defined as a document made or issued by or under the authority of the U.S. government, state or local government, or by a foreign government.

Means of identification is defined as any name or number that may be used, alone or in conjunction with any other information, to identify a specific individual, including:

- Any name,
- Social security number,
- Date of birth,
- Official state or government issued driver's license or identification number,
- Alien registration number,
- Government passport number,
- Employer or taxpayer identification number,
- Unique biometric data (fingerprints, voice, retina or iris image),
- Unique electronic identification number, address, or routing code, or
- Telecommunication identifying information or access device.

18 U.S.C. § 1028A - Aggravated Identity Theft

Persons who during and in relation to §1341, §1343, or §1344, knowingly transfer, possess, or use, without lawful authority, a means of identification of another person, will in addition to punishment for the conviction of §1341, §1343, or §1344, will be sentenced to a term of two years.

18 U.S.C. § 1029 - Fraud and Related Activity in Connection with Access Devices

This statute applies to persons who knowingly and with the intent to defraud, produces, uses, or traffics in one or more counterfeit access devices, **or** during any one-year period, obtains anything of value using an unauthorized access device with an aggregate value of $1,000 or more.

The statute also specifically prohibits whoever knowingly and with intent to defraud:

- Possesses 15 or more devices which are either counterfeit or unauthorized [§1029(a)(3)];
- Produces, traffics in, or has control, custody, or possession of device-making equipment [§1029 (a)(4)];
- Effects transactions with 1 or more access devices issued to another person(s) to receive payment or other

value of $1,000 or more over a 1-year period [§1029(a)(6)] ; or
- Uses, produces, traffics in, has control, custody, or possession of a modified or altered instrument to obtain unauthorized use of telecommunications services, [§1029(a)(7) and (9)] among other factors.

Further, soliciting a person for the purpose of offering an access device, or selling information or an application to obtain an access device is covered, as is causing or arranging for another person to present a credit card for payment evidences or records of transactions made by an access device[§1029(e)(7)] .

The term access device is defined as:

- Any card,
- Plate,
- Code,
- Account number,
- Electronic serial number,
- Mobile identification number,
- Personal identification number,
- Other telecommunications service, equipment, or instrument identifier, or
- Other means of account access that can be used, alone or in conjunction with another access device, to obtain money, goods, services, or any other thing of value, or that can be used to initiate a transfer of funds (other than solely by paper instrument).

18 U.S.C. § 1030 - Computer Fraud

This statute applies to persons who knowingly access a computer without authorization [§1030(a)(1)], or exceed authorized access levels; or who, having accessed a computer with authorization [§1030(a)(2)], but use it for unauthorized purposes [§1030(a)(2)(A)] (e.g., obtaining information contained in records of a financial institution or card issuer, or a file of a consumer reporting agency). This statute also applies to trafficking in any password or similar information through which a computer may be accessed without authorization [§1030(a)(6)] if such trafficking affects interstate or foreign commerce or if the computer is used by or for the U.S. government. Further, the statute covers those who have the intent to extort money or other thing of value by transmitting any interstate or foreign communication containing a threat to cause damage to a protected computer; threat to obtain information from a protected computer without authorization, or in excess of authorization, or to impair the confidentiality of information obtained from a protected computer; or, demand or request for money or other thing of value in relation to damage to a protected computer, where such damage was caused to facilitate the extortion [§1030(a)(7)]. Finally, whoever conspires to commit or attempts to commit an aforementioned offense is also covered by this statute [§1030(b)].

§ 1030(a)(2) applies to the observation or reading of the data and does not require the copying or transporting of the data. In addition, the provision does not require larcenous intent.

Other applicable provisions include the following:

- §1030(a)(4) - Prohibits computer intrusion
- §1030(a)(5) - Concerns damage or destruction of a financial institution's property

18 U.S.C. § 1032 - Concealment of Assets from FDIC

This statute applies to persons who knowingly conceal or endeavor to conceal an asset or property from the FDIC acting as conservator or receiver. This statute also covers impeding the FDIC as conservator or receiver, or placing assets or property beyond the reach of FDIC as conservator or receiver.

18 U.S.C. § 1037 - Fraud and Related Activity in Connection with Electronic Mail also known as the "Can-Spam Act of 2003"

This statute applies to those who, in or affecting interstate or foreign commerce, knowingly access a financial institution's computer without authorization and intentionally initiate the transmission of multiple commercial electronic mail messages from or through such computer; use a financial institution's computer to relay or retransmit multiple commercial electronic mail messages with the intent to deceive or mislead recipients, or any internet access service as to the origin of such messages; materially falsify header information in multiple commercial electronic mail messages and intentionally initiate the transmission of such messages; register, using information that materially falsify the identity of the actual registrant, for five or more electronic mail accounts or online user accounts or two or more domain names, and intentionally initiate the transmission of multiple commercial electronic mail messages from any combination of such accounts or domain names; or falsely represent oneself to be the registrant or the legitimate successor in interest to the registrant of five or more internet protocol addresses and intentionally initiate the transmission of multiple commercial electronic mail messages from such address, or conspires to do so.

Chapter 63 - Mail Fraud and Other Fraud Offenses

18 U.S.C. § 1341 - Frauds and Swindles, also known as the Mail Fraud Statute

This statute covers the use of the mail by sending or receiving items in furtherance of a fraudulent scheme. Note that the statute applies to items sent or received through the U.S. Postal Service and through "any private or commercial interstate carrier." In recent years, this statute has been used to prosecute the perpetrators of check kiting, advance fee, and mortgage fraud schemes where checks or other documents were sent or received through U.S. mail or interstate carriers. Use of the mail after a scheme to defraud has been completed is not an offense under this statute. See also §1349 Attempt and Conspiracy.

18 U.S.C. § 1342 - Fictitious Name or Address

This statute covers the use of a false, assumed, or fictitious name, address, or title for the furtherance of a fraudulent scheme or devise mentioned in § 1341.

18 U.S.C. § 1343 - Fraud by Wire, Radio, and Television also known as the Wire Fraud Statute

This statute applies to a scheme or an artifice to defraud or to obtain property or money through use of wire, radio, or television transmissions in interstate commerce. Recently, in addition to the prosecution of wire and Automated Clearing House transaction fraud cases, this statute has been used to prosecute cases in which commercial and mortgage loan proceeds were wired between states. This statute is also used to prosecute computer-related crimes. See also §1349 Attempt and Conspiracy.

18 U.S.C. § 1344 - Bank Fraud

The statute covers the use of a scheme or artifice to defraud an insured institution or to obtain, through misrepresentations, any of the monies, funds, credits, assets, securities, or other property owned by, or under the control of, the institution. The intent to defraud must be shown, although the scheme does not have to be successful.

Examples:

- Check kiting.
- Diverting loan proceeds for purposes other than stated, including repayment of other debt.
- Out-of-trust in floor plan lending.

18 U.S.C. § 1349 - Attempt and Conspiracy

Any person who attempts or conspires to commit any offense under this chapter will be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy. The conspiracy part of this statute is used frequently in the indictment of individuals.

Chapter 73 - Obstruction of Justice

18 U.S.C. § 1517 - Obstructing Examination of a Financial Institution

This statute applies to persons who corruptly obstruct or attempt to obstruct any examination of financial institution by an agency of the United States with jurisdiction to conduct an examination. The FDIC has agreed to report any such offense to the FDIC Office of the Inspector General (OIG).

18 U.S.C. § 1519 - Destruction, Alteration, or Falsification of Records in Federal Investigations and Bankruptcy

This statute applies to any person who knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the U.S. or any case filed under title 11, or, in relation to or contemplation of any such matter or case.

Chapter 83 - Postal Service

18 U.S.C. § 1708 - Theft or Receipt of Stolen Mail

This statute applies to persons who steal, take, or abstract, or by fraud or deception obtain, or attempt to obtain, from or out of any mail, post office, or station thereof, letter box, mail receptacle, or any mail route or other authorized depository. This statute also covers those who buy, receive or conceal, or unlawfully has in his possession, any item stolen, taken, embezzled, or abstracted.

Chapter 95 - Racketeering

18 U.S.C. § 1952 - Interstate and Foreign Travel or Transportation in Aid of Racketeering Enterprises

This statute is being used in a manner similar to that of the Foreign Corrupt Practices Act. See 15 U.S.C. § 78dd on the following page. The "Travel Act" applies to those who travel in interstate or foreign commerce or use the mail or any facility in interstate or foreign commerce with the intent to distribute the proceeds of any unlawful activity or commit any crime of violence to further any unlawful activity or otherwise promote, manage, establish, carry on, or facilitate the promotion, management, establishment, or carrying on, of any unlawful activity.

Unlawful activity is defined in the statute as any business enterprise involving gambling, liquor which lacks the federal excise tax, narcotics or controlled substances; or, extortion, bribery, or arson in violation of state laws.

18 U.S.C. § 1956 - Laundering of Monetary Instruments

This statute makes it illegal to conduct or attempt to conduct a financial transaction knowing that the property involved in the transaction represents the proceeds of some form of unlawful activity with the intent to promote the carrying on of specified unlawful activity; with the intent to engage in conduct constituting a violation of § 7201 (attempt to evade or defeat tax) or 7206 (false tax returns) of the Internal Revenue Code or knowing that the transaction is designed in whole or part to conceal or disguise the nature, location, source, ownership, or control of the proceeds of the specified unlawful activity or to avoid a state or federal transaction reporting requirement.

The statute also makes it illegal to transport or attempt to transport internationally a monetary instrument or funds with the intent to promote the carrying on of specified unlawful activity or knowing that the monetary instrument or funds constitute the proceeds of some form of illegal activity and knowing that the transportation is designed in whole or part to conceal the nature, location, source, ownership or control of the proceeds, or to avoid a transaction reporting requirement under state or federal law.

18 U.S.C. § 1957 - Engaging in Monetary Transactions in Property Derived from Specified Unlawful Activity

This statute makes it illegal to engage or attempt to engage in a monetary transaction in property constituting, or derived from, proceeds obtained from a criminal offense knowing that it is criminally derived property and has a value of over $10,000.

Chapter 103 - Robbery and Burglary

18 U.S.C. § 2113 - Bank Robbery and Incidental Crimes

In addition to covering theft of bank property by force, violence, or intimidation, this section also covers the entry or attempted entry of a bank building with intent to commit any felony affecting any bank and in violation of any statute of the United States, or any larceny.

Chapter 113 - Stolen Property

18 U.S.C. § 2314 - Transportation of Stolen Goods, Securities, Moneys, Fraudulent State Tax Stamps, or Articles Used in Counterfeiting

This statute applies to persons who transport, transmit, or transfer in interstate or foreign commerce, any goods, wares, merchandise, securities, or money in the amount of $5,000 or more, knowing that the transferred assets were stolen, converted, or taken by fraud. This statute covers falsely made, forged, altered, or counterfeited securities or tax stamps and the device(s) used to make such securities, tax stamps, or traveler checks bearing a forged countersignature. This section does not apply to falsely made, forged, altered, counterfeited obligation or security issued by the U.S. government, or that of any foreign government. This statute may be used in the prosecution of reverse mortgage fraud schemes.

18 U.S.C. § 2315 - Sale or Receipt of Stolen Goods, Securities, Moneys, of Fraudulent State Tax Stamps

This statute prohibits receipt, possession, concealment, storage, bartering selling, or disposing of goods, wares, securities, moneys in the amount of $5,000 or more, or pledges or accepts as security for a loan any collateral of $500 or more, which have crossed state or U.S. borders after being stolen, unlawfully converted, or taken, knowing the same to have occurred.

18 U.S.C. Title 15 - Commerce and Trade
Chapter 2B - Securities Exchanges

15 U.S.C. §§ 78dd and 78ff - Foreign Corrupt Practices Act (FCPA) of 1977

The FCPA is actually part of the Securities Exchange Act of 1934 and has two main provisions: the anti-bribery provisions; and the books, records, and internal control provisions. The anti-bribery provisions of §78dd-1 are applicable to issuers; §78dd-2 is applicable to domestic concerns, which are defined as a U.S. resident or citizen or any entity such as a partnership or corporation having its principal place of business in the U.S. and being organized under state (or comparable, such as territory) laws; and §78dd-3 is applicable to persons other than issuers or domestic concerns. § 78ff covers the penalties associated with violations of §78dd.

In general, the provisions make it unlawful for any person or entity to corruptly use the mail or other means of interstate commerce to further an offer, payment, or promise to pay any money, offer, or gift, etc., to any foreign official in violation of the lawful duty of such official in order to assist the issuer in obtaining or retaining business. See also, 18 U.S. C. 1952 Interstate and Foreign Travel or Transportation in Aid of Racketeering Enterprises

31 U.S.C. Chapter 53

- Subchapter II - Monetary Transactions
- Subchapter III - Money Laundering

Refer to the FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual for discussion.

42 U.S.C., Chapter 8A, Subchapter III, § 1490s - Enforcement Provisions, (a) Equity Skimming

Whoever, as an owner, agent, employee, or manager, or is otherwise in custody, control, or possession of property that is security for a loan made or guaranteed, willfully uses, or authorizes the use, of any part of the rents, assets, proceeds, income, or other funds derived from such property, for any purpose other than to meet actual, reasonable, and necessary expenses of the property shall be fined or imprisoned.

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SIGNIFICANT CIVIL STATUTES

Title 31 - Money and Finance

31 U.S.C. §3729-3733 False Claims Act (FCA)

This civil statute allows for triple damages for the amount that the government paid for false claims submitted. This statute covers many areas unrelated to financial institutions; however, it is currently being used against those who misrepresented the terms and quality of the loans insured by FHA. The statute was amended by the Fraud Enforcement and Recovery Act of 2009, the Dodd-Frank Act, and other acts. FCA lawsuits may be brought by individuals working for financial institutions who file claims on behalf of the government; the U.S. government may or may not join such lawsuits. As a civil action, either the individual or the U.S. government must prove each false claim to the standard of preponderance of evidence. The FCA has a 10-year statute of limitations.

The following are the four major liability clauses within §3729:

- §3729(a)(1)(A) Any person who knowingly presents or causes to be presented, a false or fraudulent claim for payment or approval by or to the U.S. government.
- §3729(a)(1)(B) Any person who knowingly makes, uses, or causes to be made or used, a false record or statement material to get a false or fraudulent claim paid or approved by the U. S. government. Both this provision and §3729(a) (1)(A) are required to pursue claims under the Act.
- §3729(a)(1)(C) involves conspiracy to commit a violation of §§3729(a)(1)(A) - (G). The conspiracy applies in getting a false claim paid as in §3729(a)(1)(A) or conspiring to underpay the government as in §3729(a)(1)(G).
- §3729(a)(1)(G) Any person who knowingly makes, uses, or causes to be made or used, a false record or statement material to an obligation to pay or transmit money or property to the government, or knowingly conceals or knowingly and improperly avoids or decreases an obligation to pay or transmit money or property to the government is liable under the FCA.

Under the FERA amendment, material is now defined as having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property.

Other sections:
§3730 - Civil Actions for False Claims
§3731 - False Claims Procedures
§3732 - False Claims Jurisdictions
§3730 - Civil Investigative Demands

INTRODUCTION

This section of the Manual of Examination Policies provides a broad perspective of international banking. It begins by addressing the concept of country risk, which is the primary risk associated with international banking activities. The section then discusses common international banking products and services such as foreign loans, investments, placements,[1] currency exchange, and funds management.

Within the discussion on foreign loans, significant attention is given to trade finance, which is an important, yet declining, segment of U.S. banks' international credit exposures. Due to increased globalization of international markets and competition from non-bank intermediaries, U.S. banks have become less involved in trade finance and more involved in direct loans to foreign banks, participations in syndicated credit facilities, and loans to individuals and foreign businesses.

This section also discusses the international banking operations of foreign banks in the U.S., the operational structures established by U.S. banks in order to conduct banking activities in foreign jurisdictions, and parallel-owned banking organizations (PBOs). A PBO exists where there is common control or ownership of domestic and foreign banks outside of a traditional bank holding company structure (similar to chain banks). The PBO structure results in a global financial organization that may not be subject to comprehensive, consolidated supervision standards and could present unique supervisory concerns.

Finally, this section discusses supervisory methods and examination guidance relating to the supervision of foreign banking organizations (FBOs) and provides references to applicable laws and regulations. The section concludes with a glossary of international banking terms.

Overview of International Bank Activities

While the number of U.S. banks involved in international finance is relatively small in comparison to the overall number of U.S. banks, many large institutions have notable cross-border exposure and significant international activities. Moreover, in certain markets, a considerable number of smaller banks continue to allocate significant resources to international banking.

Many international banking activities parallel those conducted in domestic banking operations. For example, in both international and domestic markets, a bank may extend credit, issue and confirm letters of credit, maintain cash and collection items, maintain correspondent bank accounts, accept and place deposits, and borrow funds. Other activities are more closely associated with international banking, such as creating acceptances and trading foreign currencies.

The most important element of international banking not found in domestic banking is country risk, which involves the political, economic, and social conditions of countries where a bank has exposure. Examiners must consider country risk when evaluating a bank's international operations.

Despite similarities between domestic and international activities, banks often conduct international operations in a separate division or department. Large banks typically operate an independent international division, which may include a network of foreign branches, subsidiaries, and affiliates. Smaller banks, or banks with limited international activity, often use a separate section that works with a network of foreign correspondent banks or representative offices. In either case, international activity is usually operated by separate management and staff using distinct accounting systems and internal controls.

Given the risks introduced by doing business in a foreign country, particularly in emerging markets, examiners must review and understand international activities when assessing a bank's overall condition. Furthermore, examiners should coordinate international reviews with Bank Secrecy Act (BSA), Anti-Money Laundering (AML), and Office of Foreign Assets Control (OFAC) reviews.

Examination Objectives

The objectives of examining international activities are largely the same as those of examining domestic activities. However, the specialized nature of international banking may require modification of some examination activities due to different accounting procedures, documentation requirements, or laws and regulations. For example, access to information at foreign branches varies according to foreign laws governing such access and the FDIC's relationships with foreign supervisors.

The examination of international activities is usually conducted concurrently with the risk management examination. The scope of the examination and staffing requirements should be established during pre-examination planning. Prior examination reports will usually indicate the existence of an international department, identify foreign branches or subsidiaries, and discuss the type and volume of international activities. Reviewing regulatory reports that the bank may be required to file, such as

[1] Interest-bearing time deposits held in foreign banks or overseas branches of U.S. banks.

Federal Financial Institutions Examination Council (FFIEC) 009 and 009a Country Exposure Reports or Treasury International Capital (TIC) Form B Reports, can also assist examiners determine a bank's level of country exposure. Other resources include recent Reports of Condition and Income (Call Reports) and Uniform Bank Performance Reports.

Examiners can usually examine international activities at a bank's main domestic office or other centralized location. Part 347 of the FDIC Rules and Regulations governs minimum recordkeeping standards at state nonmember banks that operate foreign branches or meet certain investment or control levels. These standards require banks to maintain certain information concerning offshore activities at their head office. This requirement generally enables a centralized review of asset quality, funding operations, contingent liabilities, and internal controls.

In some cases, on-site examinations of foreign branches (branches in the foreign country) may be necessary because of inadequate information at the main domestic office or the existence of unusual branch activities. Examiners should determine the availability and quality of information maintained at the main office during the pre-examination process to gain a general understanding of any unusual branch activities before considering a foreign branch examination. If the information at the centralized location appears inadequate or unusual branch activities are identified, it may be appropriate to conduct a pre-examination visitation or begin the domestic examination before commencing the foreign branch examination in order to obtain additional information.

Note: Examiners must consult with field and regional management before commencing a foreign branch examination. The consultation should include a discussion of the protocol governing notification of the foreign supervisor prior to commencement of the visitation or examination.

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COUNTRY RISK MANAGEMENT

Most facets of international banking are exposed to country risk. To address country risk, the federal regulatory agencies jointly issued a statement titled *Sound Country Risk Management Practices*, (March 2002 Statement). Examiners should assess a bank's conformance with the risk management standards detailed in the March 2002 Statement and summarize the results of their assessment in the Report of Examination (ROE) on the Analysis of the Country Exposure Management System page.

The remainder of this section describes various country risk concepts and risk management processes and describes how the federal agencies evaluate transfer risk (an aspect of country risk). The foundation for the discussion that follows is the March 2002 Statement and the Guide to the Interagency Country Exposure Review Committee (ICERC Guide). Examiners should refer to these documents for further information.

Concept of Country Risk

In addition to the risks present in their domestic operations, institutions engaged in international activities are exposed to country risk. Country risk involves the possibility that economic, social, or political conditions and events in a foreign country will adversely affect an institution's financial interests, such as defaults by obligors in a foreign country. Country risk also includes the possibility of nationalization of private assets, government repudiation of external indebtedness, exchange controls, or significant currency devaluations.

Country risk has a pervasive effect on international activities and should be explicitly considered when assessing the risk of all exposures (including off-balance sheet items) to public- and private-sector foreign-domiciled counterparties. The risk associated with even the strongest foreign counterparties will increase if, for example, political or macroeconomic conditions cause the exchange rate to depreciate and the cost of servicing external debt to rise.

The March 2002 Statement recognizes that country risk is not limited to an institution's exposure to foreign-domiciled counterparties. In some situations, the performance of domestic counterparties may also be adversely affected by conditions in foreign countries. When appropriate, examiners should consider country risk factors when assessing the creditworthiness of domestic counterparties.

Country risk is not limited solely to credit transactions. Changing policies or conditions in a foreign country may also affect matters such as investments in foreign subsidiaries, servicing agreements, or outsourcing arrangements with foreign entities, including those associated with the bank through its holding company.

Country Risk Management System

Country risk management systems should be commensurate with the type, volume, and complexity of the institution's international activities, and examiners should consider these factors when assessing country risk management systems and practices. As more fully described in the March 2002 Statement, sound country risk management systems should include:

- Effective oversight by the board of directors,
- Adequate risk management policies and procedures,
- Accurate systems for reporting country exposures,
- Effective processes for analyzing country risk,
- Forward-looking country risk rating systems,
- Country exposure limits,
- Regular monitoring of country conditions,
- Periodic stress testing of foreign exposures, and
- Adequate internal controls and audit function.

The March 2002 Statement indicates that to effectively control risk associated with international activities, institutions must have a risk management system that focuses on the concept of country risk. A program that is limited to an assessment of transfer risk, and especially one that solely relies on transfer risk designations assigned by the ICERC, ignores other important facets of country risk and would not be appropriate. Transfer risk and the ICERC program are discussed in subsequent subsections.

Policies and Procedures

Management is responsible for developing and implementing sound, well-defined policies and procedures for managing country risk. Management should also ensure that country risk management policies and practices are clearly communicated to applicable offices and staff. At a minimum, policies and procedures should:

- Articulate a strategy for conducting international activities;
- Specify appropriate products, services, and affiliates (e.g., banks, branches, affiliates, joint ventures, etc.);
- Identify allowed and disallowed activities;
- Describe major risks in applicable countries or regions;
- Establish risk tolerance limits;
- Develop standards and criteria for analyzing and rating country risk;
- Delineate clear lines of responsibility and accountability for country risk management decisions;
- Require periodic reporting of country risk exposures and policy exceptions to senior management and the board; and
- Ensure compliance with regulatory guidance and reporting requirements.

Rating Country Risk

Countries often experience political and economic shocks, and institutions with international activities must appropriately manage country risk. Critical risk mitigation components include effective country risk monitoring, accurate risk ratings, and timely implementation of exit strategies.

When collecting data to examine country risk, useful sources of qualitative information may include market data from the bank's internal country studies or representative office; officer visits to the home country, central bank, or correspondent bank; and external credit-rating-agency information. For instance, foreign/local currency ceiling ratings for the sovereign country, foreign/local currency deposit ratings for banks, and bank financial-strength ratings can be effectively employed as part of a country risk management program. Management should have a clear understanding of the assumptions and analysis that rating agencies use to develop external ratings if they consider the information when assigning internal ratings.

The causes of sovereign defaults can be broadly grouped into the following categories:

- Banking crises,
- Chronic economic stagnation,
- High debt burden, and
- Institutional or political factors.

In general, country risk ratings should encompass qualitative and quantitative analysis and reflect an estimate of the likelihood of adverse events. Qualitative analysis does not require sophisticated modeling and may simply involve a careful, general analysis of key indicators. When quantitative models are used, management should apply sound modeling practices typically employed elsewhere (e.g., credit and interest rate risk modeling).

Quantitative factors to consider include gross domestic product (GDP) growth, GDP per capita, inflation and unemployment rates, bond yields, government and private sector debt levels, current account deficits, short- and long-term external debt, credit default swap prices, and foreign exchange/international reserves. Statistics regarding these items are often available through multilateral agencies or official national sources. While the availability of data has substantially improved, examiners should be aware that in certain less-developed countries, data may be unavailable, infrequently reported, or unreliable, and qualitative in-country analysis may be significantly more reliable.

Although a country risk rating should be assigned to all foreign countries, it may be helpful to vary rating methodologies between emerging and non-emerging market countries (or other similar delineations). Also, in certain high-export countries, such as countries heavily dependent on oil exports, it may be useful to monitor specific market factors to more effectively evaluate risks.

Additionally, depending on the size and complexity of certain exposures, it may be appropriate for management to consider institution-specific factors when assigning internal ratings. For example, management should consider the legal and governance framework of the institution's activities in the foreign country, the type and mix of exposures, reliance on in- or out-of-country funding sources, and the economic outlook for specific industries. Additionally, management should consider potential risk mitigants, including the ability to effectively manage foreign exposures through in-country personnel.

It is common for banks to adjust or qualify country risk ratings based on the level and type of exposure of the counterparty. For example, trade-related and banking-sector exposures may receive better risk ratings than other categories of exposure. The importance of trade and banking transactions to a country's economy often results in preferential treatment by foreign governments for repayment. However, management should closely monitor signals from foreign governments when conditions deteriorate to ensure expectations of support are still warranted.

Finally, while country risk rating and monitoring systems can affect general and specific risk management decisions, the information provided should be an integral part of the strategic decision making process as it relates to foreign operations. Ultimately, the information provided should stimulate discussion, assessment, and potential action at the senior management and board levels.

Country Exposure Concentrations

The federal banking agencies recognize that concentration limits and diversification are useful ways to moderate country risk. Diversification is especially relevant to international lending because the assessment of country risk can involve major uncertainties. Diversification provides some protection against a dramatic change in the economic or political environments of a particular country or region.

As part of their country risk management process, internationally active institutions should adopt a system of country exposure limits. Because the limit setting process often involves divergent interests within the institution (such as senior management, country managers, and the country risk committee), country risk limits will usually require the balancing of several considerations, including:

- The overall strategy guiding the institution's international activities,
- The country's risk rating,
- The institution's risk appetite,
- The perceived business opportunities in the country, and
- The desire to support the international business needs of domestic customers.

The March 2002 Statement notes that concentrations of exposures to individual countries that exceed 25 percent of Tier 1 Capital plus the ALLL are considered significant. In the case of troubled countries, lower exposure levels may be considered significant and should be carefully monitored. Refer to the ROE Instructions for preparing ROE commentary and the concentrations schedule.

Sovereign crises are often not limited to just one country. Surrounding regions and industries are typically affected as well, and the March 2002 Statement advises banks to consider limiting exposures on a broader (e.g., regional) basis. Examiners should identify exposures to broader country groupings in the ROE when bank or market analyses identify links or risks between countries where the bank is exposed (e.g., Central America or the Caribbean).

Risk Mitigation - Exit Strategies

Effective risk mitigation requires the development of board-approved policies regarding exit strategies (a.k.a., action plans). Action plans should define trigger points that indicate portfolio exposure in a given country may have escalated beyond an acceptable threshold and should be reduced or eliminated. The substance of an exit strategy should be commensurate with an institution's level of exposure. Items for consideration include how a bank will reduce risk to:

- Aggregate country exposures;
- Asset classes (e.g., loans, Eurobonds, medium-term notes, commercial paper, etc.);
- Issuers (sovereign, financial, private sectors, etc.);
- Product types and concentrations (trade transactions, pre-export finance, foreign-deposit concentrations, derivatives, off-balance sheet items, etc.); and
- Tenor (generally, tenor should be reduced when country risk is increasing).

Management should use quantitative and qualitative data to define, substantiate, and initiate action plans. Related policies should include procedures for estimating risk levels and reporting material exposures. The policies should also incorporate risk-reduction strategies stemming from contagion risk (the likelihood that economic problems in one country, region, or market will affect another).

Some institutions have increased the use of credit derivatives to reduce country risk. When complex financial products are used, management should consider all relevant issues, such as counterparty, credit, and correlation risks.

Transfer Risk

Transfer risk is an important part of country risk. Transfer risk reflects the possibility that an asset cannot be serviced in the currency of payment because the obligor's country lacks the necessary foreign exchange or has put restraints on its availability.

In general, transfer risk is relevant whenever a bank extends credit across international borders and the extension of credit is denominated in a currency other than the obligor's country of residence. In these situations, an obligor must, in the absence of an ability to obtain and retain foreign currency outside the country of residence, obtain the foreign currency from domestic sources. When a country is beset by economic, political, or social turmoil leading to a domestic shortage of foreign currencies, the obligor could default on its external obligations because it is unable to obtain foreign currency at a reasonable price.

Although a country risk management program must be based on the broadly defined concept of country risk, the federal banking agencies consider transfer risk when assigning classifications, designating cross-border exposures, and determining minimum transfer risk reserve requirements on cross-border exposures.

Interagency Country Exposure Review Committee (ICERC)

The ICERC consists of representatives from all federal banking agencies that are jointly responsible for providing uniform transfer risk designations. Transfer risk designations serve as a starting point for adverse classifications of all cross-border exposures. Aided by tools such as balance-of-payment statistics and internal studies of country conditions, the ICERC makes decisions on the extent of transfer risk in countries where U.S. bank exposure meets the committee's review criteria.

When a country is experiencing political, social, or economic conditions leading towards an interruption in debt servicing by obligors within the country, or when an interruption in payments appears imminent, credits within the country are adversely classified using the designations of *Substandard*, *Value Impaired*, or *Loss*. When an adverse classification is assigned, the committee prepares a standard narrative on the country to be used in the ROE. The criteria for reporting transfer risk classifications and designations established during an examination are discussed in the ROE instructions.

For sovereign exposures, ICERC's designation is the only applicable rating. However, if they are carried on the institution's books as an investment, securities issued by a sovereign entity are also subject to the interagency Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts. If a rating is different under the two systems, the examiner should assign the more severe of the two ratings. For private sector exposures, the applicable rating is the more severe of either the ICERC-assigned transfer risk rating for the country or the examiner-assigned credit risk rating (including ratings assigned as a result of the Shared National Credit Program). Further discussion of the application of transfer risk ratings can be found in the ICERC Guide.

Contingent liabilities subject to transfer risk (including commercial and standby letters of credit as well as unfunded loan commitments) that will result in a concomitant increase in bank assets if the contingencies convert into an actual liability (Category I contingent liabilities) should also be considered for special comment or classification, as applicable. Contingent liabilities extended for classification should be classified according to the type and tenor of the bank asset that would result from conversion of the contingency into an actual liability. For example, commercial import/export letters of credit would be accorded the same classification as trade transactions, while commitments to fund long-term project loans would be accorded the same classification as long-term loans. In cases where type or tenor is not easily discernible and the exposure is accorded a split classification, the more severe classification should prevail.

Transfer Risk Reserve Requirements

The International Lending Supervision Act of 1983 (ILSA) directs federal banking agencies to require banks to establish and maintain a special reserve when the value of international loans has been impaired. The ILSA requires that the special reserves be established through a charge against current income and segregated from both the ALLL and capital. A bank must establish a special reserve when an appropriate federal banking agency determines that a bank's assets have been impaired by a protracted inability of borrowers in a foreign country to make payments on their external indebtedness. Factors indicating such impairment include:

- A failure by such public or private borrowers to make full interest payments on external indebtedness,

- A failure to comply with the terms of any restructured indebtedness,
- A failure by the foreign country to comply with any International Monetary Fund (IMF) or other suitable adjustment program, or
- No definite prospects exist for the orderly restoration of debt service.

The federal banking agencies refer to this special reserve as the Allocated Transfer Risk Reserve (ATRR). The ATRR requirements are established on an interagency basis through the ICERC program. When applicable, ICERC assigns ATRR requirements to country exposures classified as Value Impaired. Banks also have the option of taking a charge-off in lieu of establishing an ATRR. The ATRR is a contra-asset to the international asset and is not included as part of the ALLL nor is it included in regulatory capital. For further details on the ATRR, refer to Part 347, Subpart C, of the FDIC Rules and Regulations.

Country Risk Exposure Report

One of the tools examiners may use to monitor a bank's country risk exposure is the FFIEC's Country Risk Exposure Report (Form 009), which details material international exposure and must be filed quarterly by certain financial institutions. This report provides information regarding the amount, type, and location of foreign assets. The examination process should include assurances that management adheres to the reporting requirements and that such reports are accurate. Differences between a bank's method of calculating country exposure and the methods required by the Form 009 are generally acceptable; however, management should be able to reconcile any differences between the two reports, as well as explain the logic behind their internal method.

Form 009 requires reporters to disclose foreign claims (assets excluding premises, ORE, and intangibles) based on the residency of the counterparty, as well as residence of the ultimate obligor (which may be different). A central concept of Form 009 is the difference between *immediate-counterparty* and *ultimate-risk* exposure. Even though a loan may be extended to a counterparty in one country, a common feature of international lending is that the presence of credible guarantees or financial collateral shifts the ultimate repayment source (and thus the source of country risk) to a different country.

For example, if a bank lends to a Brazilian subsidiary of a German parent company, the bank must report the loan as a foreign claim to Brazil on an immediate-counterparty basis. If the German parent guarantees the loan, the bank must report a *risk-transfer*, which is an outward risk-transfer (decrease) from Brazil and a commensurate inward risk-transfer (increase) to Germany. The loan is then reported as a German claim on an ultimate-risk basis. In addition to parent-subsidiary guarantees, cash and securities collateral, insurance, and credit derivatives can all be used to risk-transfer.

Form 009 is required for every U.S.-chartered insured commercial bank or savings association that has, on a fully consolidated bank basis, total outstanding claims on residents of foreign countries exceeding $30 million in the aggregate, and has at least one of the following:

- A branch in a foreign country,
- A consolidated subsidiary in a foreign country,
- An Edge or Agreement subsidiary,
- A branch in Puerto Rico or in any U.S. territory or possession (except that a bank or savings association with its head office in Puerto Rico or any U.S. territory or possession need not report if it meets only this criterion), or
- An International Banking Facility (IBF).

Additionally, institutions that report total gross notional values of derivative contracts exceeding $10 billion on Schedule RC-L of the FFIEC 031 Call Report or FR Y-9C are also required to submit Form 009, regardless of the preceding criteria. In addition, bank regulatory authorities may specifically require a report (or any specific schedule therein) to be filed by other banking organizations that are deemed to have significant country exposures. Detailed instructions for compiling the report can be found on the FFIEC.gov website under Reports/Reporting Forms.

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INTERNATIONAL ACTIVITIES

International banking embraces a wide spectrum of financial services and products. This sub-section describes products and services that an examiner is likely to encounter in a bank that has international activities.

International Lending

Entities that borrow funds from banks include importers, exporters, multinational corporations, foreign businesses, governments, consumers, foreign banks, and overseas branches of U.S. banks. International lending is concentrated at the largest global institutions and a number of smaller institutions in select markets, such as New York City, Miami, and San Francisco.

Interest earned from lending to foreign borrowers, both internationally and domestically, remains a major source of profit for banks that conduct international activities.

Other international activities, such as fund transfers, are necessary components of international banking and enhance a bank's ability to service correspondent relationships, but do not necessarily produce significant, if any, income after expenses.

The tendency for international loans to be larger than domestic loans promotes economies of scale by allowing banks to originate, monitor, and collect the loans more efficiently than smaller loans. However, larger credits often attract strong price competition from other global lenders, which may result in lower net interest margins.

International Lending Risks

All loans involve some degree of default risk, and credit officers must effectively assess the degree of risk in each credit extension. However, while foreign loans share many of the same risks of domestic credits, several other risks are unique to international lending.

As discussed earlier, all international activities are exposed to country risk. International lending is especially exposed, as problems that may arise in a particular country can lead to default, payment moratoriums, or forced modifications.

Additionally, the amount and mix of international credits can affect liquidity, capital, and sensitivity to market risk requirements and risk management practices. Credit and currency risks are also key risks associated with international lending.

Credit Risk refers to the potential inability of a borrower to comply with contractual credit terms. Evaluation of foreign credit risk is similar to domestic credit analysis and requires the review of appropriate information, including the amount of credit requested, loan purpose, collateral, anticipated terms, and repayment source. In addition, reviews should assess standard credit file information such as financial statements covering several years and the borrower's performance history on previous loans.

A key problem with assessing international credits is that applicable information is often less readily available and less detailed than in domestic credit files. Foreign loans are often extended in foreign currencies, and financial statements are often in a foreign language and formats that vary from country to country. Moreover, there are often barriers to acquiring such information from foreign sources. Therefore, when evaluating international loans, credit decisions are frequently based on information inferior to that available in domestic credit files.

Currency Risk reflects the possibility that variations in value of a currency will adversely affect the value of investments denominated in a foreign currency. Currency conversion exposure exists in every international credit extension, and currency risk can affect financial transactions in several ways. For borrowers, rapid depreciation in the home currency relative to the borrowing currency can significantly increase debt service requirements. For lenders, rapid appreciation or depreciation in currencies can substantially affect profit or loss depending on how the institution finances the assets. If a U.S. bank lends in a foreign currency, it must acquire that currency by either borrowing or exchanging dollars for the new currency. In the latter situation, a bank might find itself effectively financing its cross-border lending with domestic liabilities, exposing itself to currency risk. If the foreign currency assets depreciate, a bank might suffer economic or accounting losses even without a default because the foreign currency assets must be translated back into dollars for financial statement purposes. In this capacity, currency risk is a sub-set of market risk, and institutions should apply appropriate techniques to monitor and manage this risk.

U.S. banks can attempt to reduce the market risk aspect of currency risk by lending and requiring repayment in U.S. dollars, but the effectiveness of this technique is limited and may simply substitute currency risk for transfer risk (the risk that occurs when a borrower incurs a liability in a currency different from the currency in which revenues are generated).

For example, a foreign borrower might borrow dollars to use the proceeds in a foreign country because of the relative ease of obtaining loans denominated in dollars from a global institution. In this situation, the borrower may convert some or all of the proceeds into the foreign currency. Subsequently, when payments become due, the borrower will need to exchange some foreign currency for dollars. If the local currency depreciated against the dollar, the borrower may find itself unable to meet its debt service requirements.

Another situation that could arise in smaller markets is the inability to obtain sufficient currency at official exchange rates. This could occur because the exchange rate does not reflect competitive market dynamics, or because the loan being repaid is too large for the private-sector foreign exchange market of that country. Consequently, the borrower may be unduly controlled by its central bank or feel compelled to obtain currency from illicit market sources.

Forms of International Lending

Trade Finance

The most common function of international banking is the financing of trade. Generally, several types of trade credit facilities are used by banks, with the most common types being letters of credit and bankers acceptance financing. Exporters may be willing to ship goods on open account (self-financed) to credit-worthy customers in developed countries, but are often unwilling to accept the risk of shipping goods without established bank financing when dealing with an importer in a high-risk, or developing country. Other types of trade finance instruments and methods, such as discounting of trade acceptances and direct trade advances, are also covered in this section.

Letters of Credit

Letters of credit are issued in many forms depending on the type and circumstances of the underlying transaction. Historically, the use of letters of credit involved many documents and was labor intensive. However, automation has made it easier to create letters of credit, verify documents evidencing shipped goods, and collect payments. In some cases, the process has been streamlined into simple tracking of a bar code, similar to techniques employed at retail stores or shipping companies. Despite technological advances, the careful review of documents is paramount in order to protect the bank from liabilities and financial loss.

Commercial documentary letters of credit are instruments in which a bank (issuing bank) agrees to pay money on behalf of the customer (account party/buyer/ importer) to the party (beneficiary/seller/exporter) named in the instrument. The beneficiary is paid when specific documents are submitted to the issuing bank, as required by the terms of the letter of credit. Therefore, through a letter of credit, the bank substitutes its creditworthiness for that of the account party.

Issuance and negotiation by banks of documentary letters of credit are governed by the *Uniform Customs and Practice for Documentary Credits* of the International Chamber of Commerce. All letters of credit must:

- Be issued in favor of a definite beneficiary,
- Be for a fixed or determinate amount,
- Be in a form clearly stating how to make payments and under what conditions, and
- Include a definite expiration date.

The usual routing of a documentary letter of credit is from the issuing bank, through its correspondent bank in the country of the exporter, to the exporter. Basic letters that correspondent banks receive include *revocable* and *irrevocable* letters of credit.

The revocable form is generally of little use to the exporter. As the term indicates, the importer's bank can revoke its credit if requested to do so by its principals (the buyers) or a bank can amend credit terms without the specific agreement of the beneficiary. Ordinarily an exporter would request an irrevocable letter of credit. In this case, the buyer could not instruct their bank to rescind or change the letter of credit without first securing the consent of the exporter. When the exporter presents their documents exactly as described in the letter of credit to the correspondent bank, the latter will be able to secure payment from the importer's bank.

An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay upon presentation of the documents. The letter of credit may be sent directly to the exporter by the issuing bank or through a local correspondent bank of the issuer. In the latter case, the correspondent may merely *advise* the letter of credit. This means that it is acting as an agent of the importer's bank without any commitment on its part. This is evidenced by a printed clause appearing in the credits such as, "This advice is not an engagement on our part, but is simply for your guidance in preparing and presenting drafts and documents*."*

Some exporters, especially when they are not familiar with the issuing bank, require an agreement from bankers in their own country. For this purpose, the exporter will ask its local (correspondent) bank to *confirm* the irrevocable letter of credit, which requires the correspondent to obtain authorization and compensation from the issuing bank. Once confirmed, the exporter has a definite agreement from a bank in their country that it will make payment upon presentation of documents in accordance with the terms of the letter of credit, regardless of payments by the issuing bank or customer. This is evidenced by a printed clause in the agreement from the confirming bank such as, *"*We undertake that all drafts drawn and presented as specified above will be honored by us.*"* The result of this transaction is that an exporter no longer has credit risk/cross-border risk from the original customer.

Payment terms of a letter of credit usually vary from when presented (sight letter of credit) to 180 days, although special forms of letters of credit allow for other terms. Usually the letter of credit will call for drafts to be drawn on the advising (and confirming) bank. If drawn at sight, the bank will effect payment immediately, provided the terms of the credit have been met. If drawn on a time basis, the bank will accept the draft, which thereafter can be held by the exporter, or by the bank on the exporter's behalf, until maturity. Alternatively, accepted drafts can usually be discounted or sold at going market rates. (Refer to the section on Bankers Acceptances.)

The ultimate repayment of letters of credit generally depend upon the eventual sale of the goods involved, and subsequent negotiations regarding letters of credit rarely occur unless caused by document discrepancies. If discrepancies occur, banks often charge a fee to resolve identified issues. The proper handling and accuracy of the documents used to process letters of credit is of primary concern, and management should maintain appropriate internal controls to ensure transactions are accurately and timely processed.

All commercial documentary letters of credit are contingent liabilities and should be included as such in the Call Report. If the payment of a letter of credit is refinanced, or the draft is discounted, it should be included as an asset in the loan schedules of the Call Report. Management should regularly monitor the volume of letters of credit outstanding through a general ledger memorandum account or contra accounts.

Standby letters of credit are another type of instrument used to facilitate international transactions. This instrument guarantees payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the bank's customer). A standby letter of credit is payable against an official statement of default or nonperformance (whereas a commercial documentary letter of credit is normally payable against the presentation of documents conveying or securing title to goods, such as a bill of lading). Some of the most common purposes for standby letters of credit include:

- Standby credit for the account party's performance under a contract award. In this case, the beneficiary presents the issuing bank a draft accompanied by a statement to the effect that the contract bidder (account party) did not perform under an awarded contract. The issuing bank is obligated to pay the beneficiary and seek reimbursement from the account party (customer).
- Standby credit for the account party's borrowing or advances from another bank. This arrangement requires the issuing bank to reimburse the lending bank if the account party (customer) does not repay their loan.
- Standby credit to back commercial paper or other obligations of the bank's customers.

A standby letter of credit transaction usually involves more risk for the issuing bank than a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of this instrument generally retains nothing of value to protect it against loss, unlike a commercial documentary letter of credit that provides the bank with title to the goods being shipped. Therefore, to reduce the credit risk of standby letters of credit, the issuing bank's credit analysis should be strong and at least equivalent to that applicable to ordinary, unsecured loans.

Back-to-back letters of credit are another type of trade finance transaction that examiners may encounter in international banks. Though the term *back-to-back* does not appear on the letter of credit, this situation is similar to a confirmed letter of credit, except that two separate letters of credit are issued.

These transactions occur when a seller receives a letter of credit covering goods that must first be obtained from a third party, which in turn requires a letter of credit. In this situation, the second issuing bank looks to the first bank for reimbursement by securing the second letter of credit with the first letter of credit.

Banks are typically reluctant to issue back-to-back letters of credit, partly because more documents are involved and the likelihood of technical problems is elevated. Generally, banks issue back-to-back letters of credit only when they have recourse to an alternative source of repayment (usually the applicant's general financial resources) in addition to the first letter of credit.

Bankers Acceptances

Most letters of credit are part of ongoing transactions that evolve from letters of credit to sight or time drafts, acceptances, notes or advances. Bankers acceptances are a common method of financing international trade that was facilitated by a letter of credit. These instruments are used to finance the successive stages of transactions that move goods from a point of origin to a final destination. Bankers acceptances are fundamental methods that banks use to finance trade transactions.

Bankers acceptances are orders in the form of time drafts (a.k.a., *bill of exchange*) that have been drawn on and accepted by a banking institution (accepting bank), or its agent, to pay the holder a certain sum on or before a specified date. The drawee bank creating the acceptance is primarily liable for the instrument, while the payee, as first endorser, is secondarily liable for paying the holder. If the drawee (buyer) is other than a bank, the instrument is a trade acceptance, not a bankers acceptance.

Bankers acceptances are sometimes eligible for purchase and rediscount by Federal Reserve banks. The rules governing whether an acceptance meets eligibility requirements are important for two major reasons. First, acceptances meeting the conditions of eligibility for discount or purchase are more readily salable in the secondary market. As such, they provide a greater degree of liquidity for the accepting bank. Second, ineligible acceptances are subject to reserves (eligible acceptances are not), which increases a borrower's costs.

The creation of eligible bankers acceptances is governed by Sections 12A, 13 and 14 of the Federal Reserve Act and Federal Reserve Board (FRB) Regulation A. Bankers acceptances must meet certain criteria established in Regulation A and by the Federal Open Market Committee (FOMC) in order for the instrument to be eligible for either discount or purchase by Federal Reserve banks. Since banks' holdings of acceptances form part of their secondary reserves, it is important that the paper they buy be readily marketable by conforming to all the rules that make the acceptance eligible for discount by a Federal Reserve Bank.

Examiners that review bankers acceptances should develop a fundamental understanding of acceptances and the regulatory rules relating to eligibility. Since acceptances are negotiable and traded in the secondary market, there are applicable lending limit considerations. Lending limit rules affecting bankers acceptances in nonmember banks are controlled by state banking laws, and many states that are oriented toward international banking have adopted pertinent sections of the federal statutes. Under Section 13 of the Federal Reserve Act, acceptances eligible for discount at the Federal Reserve (subject to specific criteria) are exempt from both reserve requirements and federal lending limits. Bankers acceptances that are ineligible for discount at the Federal Reserve become an unsecured obligation of the accepting bank (for the full amount of the draft) and are subject to prevailing lending limits.

Acceptances Discounted

In a typical letter of credit transaction, a draft is presented to the bank (along with other documentation), is stamped *accepted* on its face, and is endorsed by an appropriate officer. By accepting the draft, the bank acquires an unconditional obligation to pay a specified amount of money at maturity, either to the seller or, more frequently, to the holder of the instrument.

The seller/exporter, or holder, may choose to hold the draft until maturity, but typically chooses to receive immediate payment by selling the acceptance at a discount, usually to the accepting bank itself. The acceptance then becomes what is known as an *acceptance discounted*. If the accepting bank purchases or discounts the acceptance, it may elect to hold it in its own portfolio. In this event, it is recorded as a loan to the borrower who bought the goods and must be funded like any other loan. Once the acceptance discounted is created, it appears on the bank's balance sheet statement. Its accounts for *customers' liabilities on acceptances outstanding* (asset) and *liability for acceptances executed and outstanding* (liability) are reduced and the discounted acceptance is recorded with other loans. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, the acceptance should be appropriately recorded in asset and liability accounts.

Foreign Receivable Financing

Foreign receivable financing is a method of trade finance completed through direct advances against foreign collections, which the exporter pledges to the bank. The exporter may borrow from the bank up to a stated maximum percentage of the total amount of receivables lodged with the bank at any one time. Besides having a pledge on the exporter's outward collections, the bank usually retains recourse to the exporter, whose credit strength and reputation are of prime consideration. The bank also maintains control of the merchandise by ensuring the export bill of lading is *to-the-order-of* the shipper and endorsed in blank or to-the-order-of the bank. The bill of lading must not be consigned to the buyer (importer) since this would give them control over the goods.

Banks also finance foreign receivables through bankers acceptances. To obtain acceptance financing against receivables, the exporter draws two drafts. The first is a time draft drawn on the foreign buyer (importer), which, along with the necessary documents, is sent for collection in the usual manner. The second, for the same or a lesser amount and for the same tenor as the first, is drawn on the exporter's bank. The bank accepts the second draft and discounts it, crediting the net amount to the exporter's account. The bank may hold the acceptance in its loan portfolio or may sell it in the market. When payment is received from the importer on the first draft, the bank applies the proceeds to pay its own acceptance. Should the importer default, the bank has recourse to the drawer (exporter) for payment.

Government-guaranteed Trade Finance

Government-guaranteed trade finance is used by international banks to reduce the risk associated with international trade financing. Many governments have export credit agencies (ECAs) that provide subsidized credit to exporters. These entities are often independent agencies or government-authorized, private sector entities. For a fee, these agencies protect banks from commercial and political risk. Although the programs differ in cost and scope of coverage, they are all designed to encourage commercial banks to participate in export financing and mitigate concerns about transfer risk.

In the United States, the official ECA is the Export-Import Bank (Ex-Im Bank), a government chartered corporation. The Ex-Im Bank was founded in 1934 to finance and facilitate exports from the U.S. to other countries by guaranteeing repayment of loans made to foreign buyers of U.S. exports. The Ex-Im Bank offers a wide range of credit insurance policies covering the risk of nonpayment by foreign debtors. The policies, some designed specifically for financial institutions, cover certain percentages of commercial and political risks as well as interest repayment.

Other agencies that provide government-guaranteed trade financing include:

- The Overseas Private Investment Corporation, which provides project financing, investment insurance, and a variety of investor services, insuring investment projects against political risks.
- The Small Business Administration, which provides revolving lines of credit to fund the short-term needs of exporting firms.
- The Agency for International Development, which provides direct funds to emerging market countries and supports development projects.
- The Commodity Credit Corporation, which provides assistance in the production and marketing of U.S. agricultural commodities.

As with any government-guaranteed financing, familiarity with the specific conditions and requirements of each agency and program is paramount. Like domestic transactions, failure by the lender to comply with the program's conditions may allow the agency to rescind the guaranty. Documentation should be maintained for each participating transaction to show compliance with the outstanding guaranty. These documents should be scrutinized by the examiner when reviewing these credits to determine that the loan is compliant with the guaranty. Failure to comply with the terms of the guaranty may warrant adverse classification or criticism by the examiner.

Loans to Foreign Banks

Loans to foreign banks represent an important segment of international credit. Credit to foreign commercial banks may be in the form of direct loans or through deposit placements, which are discussed under a separate heading below. Often interbank loans are used to facilitate transactions by foreign counterparts that are denominated in U.S. dollars. In some instances, loans to foreign banks may be used for trade-related purposes.

Trade-related loans to foreign banks are commonly referred to as *pre-export/import financing*, and the loans usually function like a working capital line with advances requested so that the foreign bank can fund loans to its local clients. Because of improvements in global communication and payment systems, this type of lending has gained in popularity as a form of trade finance. Changes in foreign bank regulations, increased availability of financial information, and higher costs associated with letters of credit have contributed to the growth of pre-export/import financing.

The trade lines are typically unsecured and tend to have longer terms than letters of credit. Because the local clients are not directly obligated to pay the line of credit, bank underwriting and examination assessments of these lines should be based on the creditworthiness of the foreign bank.

An accurate appraisal of the foreign bank's management is the key consideration when evaluating loans to a foreign bank. Also, when granting these trade lines, U.S. banks should consider:

- The ability of the foreign bank to repay (not simply its current financial condition);
- If there is an established relationship with the foreign bank;
- Prior payment histories of the foreign bank;
- The foreign bank's standing within the market;
- The performance of comparable banks (peer group analysis);
- The foreign country and central bank's financial position and political conditions; and
- The foreign country's banking structure, supervisory programs, and method of reporting problem assets.

In some cases, the foreign bank may secure individual transactions, or an entire line, with cash collateral at the U.S. bank. Alternatively, the foreign bank may agree to maintain compensating balances at a percentage higher than the amount of its trade-related lines to mitigate the repayment risk.

Alternatively, loans may be extended directly to a foreign bank for working capital purposes or capital expenditures, but these loans are less common. The lending institution may also extend credit directly to a foreign borrower, based primarily on the foreign bank's guarantee of the loan. Such credit extensions may be for trade-related purposes, but are often accommodations to the foreign bank, with little or no contact between the lending bank and the direct borrower. This type of transaction should be considered as part of the aggregate credit extended to the foreign bank for legal lending limit purposes.

Domestic Loans

Although some loans to domestic borrowers are extended to facilitate international transactions, they are essentially underwritten as domestic loans, but handled by the international department. A typical transaction would be a loan or other form of credit to a domestic customer to finance imports of inventory shipped on open account or under a letter of credit or bankers acceptance facility. The credit would be in U.S. dollars with repayment expected from the sale of the inventory in the U.S. Since the ultimate repayment is based on the borrower's domestic, not foreign sales, the transaction is generally considered to be a domestic loan.

Loans to overseas units of domestic corporations that are guaranteed by a U.S. parent may also be encountered in international lending. These loans may be for purposes such as short-term working capital or long-term capital improvements of the foreign subsidiary. In these cases, the domestic company's guarantee generally has a significant effect on credit underwriting and approvals, but institutions should also conduct thorough country risk analysis because the borrower operates in a foreign jurisdiction and is subject to the political and legal risks associated with that particular country. Proper execution of the guaranty is also a critical factor in underwriting the credit. On the other hand, loans to foreign affiliates of U.S. corporations, not supported by a guarantee of the domestic corporation, must be considered as any other international loan to a foreign borrower and underwritten on its own merits, without consideration of the domestic parent's support.

The same principles may hold true for domestic subsidiaries of foreign corporations, or loans to domestic entities with a high level of international operations, such as import/export companies or companies that are part of an international supply chain. While these loans may be considered domestic loans by the bank because of the location of the borrowers, country risk analysis is generally required if the ultimate source of repayment is foreign. Analysis should also consider whether any form of support from the foreign parent is legally binding or subject to country risk.

Loans to Foreign Business or Individuals

Banks also lend to foreign companies, their subsidiaries, and wealthy individuals (e.g., international private banking customers). Direct loans to foreign businesses and individuals are based on the same credit principles as domestic loans. As with domestic credits, a bank must know its customer, identify the purpose of the loan, and assess the source of repayment. In evaluating these loans, the examiner must consider these factors and also consider the unique conditions related to international businesses that may influence repayment. Country risk, foreign exchange risk, and reliability of financial statements are additional factors that should be considered.

Loans to foreign customers can be granted on an unsecured basis, and are generally reserved for well-established and highly reputable customers of the lending institution. Usually compensating factors, such as large deposit balances at the lending institution, serve to mitigate the risks associated with this type of unsecured lending. These credits are sometimes granted as accommodation facilities for important customers of the bank's personal banking department.

Loans to foreign borrowers are typically not secured by foreign-based collateral given the difficulties of perfecting liens in foreign locations and jurisdictions. The loans are often directly supported by a domestic affiliate, foreign guarantor, or a foreign government, and evaluation of that support is integral to analyzing the credit.

In some cases, loans to foreign borrowers may be secured with assets located in the U.S. These loans could be for consumer purposes, such as residential real estate, or for commercial purposes, such as foreign entities borrowing to invest in commercial, U.S. real estate. The residency of the borrower determines whether these loans are international transactions for the purposes of regulatory reporting. Often, these loans have some type of foreign-based repayment source and are exposed to risks similar to cross-border loans. In these situations, they should also be included in country-exposure risk management systems.

In certain markets, consumer lending to non-resident aliens is a prevalent form of international lending. This form of lending is often handled outside of the international department because of the homogeneous nature of the credits and market-driven pricing. Because the repayment source is often foreign, the loans should be treated as international loans and assessed in a similar way as other types of domestic loans to foreign borrowers.

Loan Syndications

A bank may enter the international loan market quickly by purchasing participations through syndications. Syndication is the typical structure used by multinational banks to offer credit to entities with significant global funding requirements. Loan syndications are typically put together by international groups for borrowers requiring substantial funding, often to finance public works projects, large capital expenditures, or trade in commodities.

These participations tend to be specialized loans, which are often managed by another bank and may or may not involve existing customers. Nevertheless, participation in syndicated loan markets can offer benefits such as allowing for additional loan portfolio diversification and greater selection of loans with desirable features.

The participating bank should have sufficient financial information and documentation to adequately understand the transaction, as well as conduct analysis of the borrower, risks involved, and source of repayment. The bank's systems should be able to handle the unique operational issues of this type of lending and adequately monitor repayments. Examiners should verify that appropriate risk controls are in place and compatible with the risks applicable to this type of international lending.

When entering these markets, management should define and conform to acceptable risk limits. Often, smaller banks participating in syndicated loans may have limited input in structuring or managing the loans. For the largest institutions, certain loan terms and types are a small part of the loan portfolio, and the retained portion of any one transaction may be inconsequential. This may not be the case for smaller institutions, and all banks should exercise appropriate controls and strict monitoring and reporting systems, especially if they are new to the syndicated loan market.

Placements

Banks may maintain interest-bearing time deposits with foreign banks and overseas branches of U.S. banks, often referred as placements, interbank placements, or re-deposits. The maturity of these deposits may range from overnight to several years. Deposit placements are usually connected with foreign exchange markets and international money centers such as New York and London, and are carried in a *due from foreign banks* time account. The placements are generally made in conjunction with a pre-approved placement line that is, in essence, a line of credit.

The majority of these deposits are Eurodollar placements, with smaller amounts in other Eurocurrencies. Eurodollars and Eurocurrencies are simply dollars or foreign currencies domiciled outside the respective country of denomination. Due from bank time deposits contain the same credit and country risks as any extension of credit to a bank in a foreign country; consequently, a prudently managed bank should place deposits only with sound, well-managed banks after thoroughly investigating their creditworthiness.

Placement activity should be governed by a formal bank policy similar to that used for federal funds transactions. The policy should define acceptable terms, designate tolerable concentration levels (in relation to credit and country risks), and identify appropriate banks for placements. Lists of acceptable depositories with prescribed limits should be provided to traders and placement officers and reviewed regularly by credit officers, particularly during periods of money market uncertainty or changing economic and political conditions.

International Lending Policies

Every bank engaged in international lending should be guided by a formal, written, board-approved policy. Content will vary depending on the risk profile of the bank and the extent of its international activities, but certain factors should be addressed in almost all situations. These include basic credit standards for international lending, a statement of the bank's international lending objectives, a description of its system for credit approval, and the establishment of committee and officer lending authorities. In addition, the policy should define procedures that ensure the board of directors is regularly apprised of the size, performance, and risk profile of the international loan portfolio.

Defining geographic loan limits is one of the most significant components of an adequate international lending policy. Limits should be set according to estimates of where the bank can profitably lend (in accordance with its strategic objectives, financial capacity, and personnel resources). Maximum aggregate limits should be established for each political entity where credit is advanced, based on a comprehensive country risk analysis. Banks should also consider establishing country and credit sub-limits by transaction type. Limits should be considered for specific countries, as well as groups of countries (regions) that have close economic ties.

When evaluating international credit risk, special consideration must be given to reviewing foreign financial statements, types of borrowers, and the forms of indirect support provided by parent companies, banks, and financial institutions. Many banks analyze foreign currency statements in U.S. dollar terms (with a single conversion from the foreign currency), versus U.S. dollar equivalents at the end of each period, which could have several different conversion rates. The merits of either approach depend on the currency of repayment and a clear understanding of which approach is used. Nevertheless, lenders should review financial statements that reflect amounts in both dollars and foreign currencies and that are translated into English.

Because financial information from foreign countries is not always reliable, the bank's policies should enable it to determine borrower capacity and reputation by other means. One of the most effective methods is a program of regular visits to borrowers' countries by bank account officers and by obtaining credit references, followed by preparation of candid reports that become significant parts of credit files. When managing the accounts of international borrowers, there is generally no substitute for regular account officer visits in obtaining this type of information. It may also be prudent to send multiple officers or obtain independent assessments. Banks can also consider the Financial Sector Assessment Program, jointly established by the World Bank and the International Monetary Fund, which analyzes a country's adherence to sound financial sector principles such as the Core Principles of Banking Supervision prescribed by the Basel Committee on Banking Supervision.

Other International Activities

Investments

In addition to international loans and deposit placements, international banks may periodically allocate capital, through international capital markets, to investments such as foreign debt securities or debentures. Banks use the international capital markets to invest funds at a competitive advantage to lending. Capital market activities have increased for several reasons, including:

- Excessive loan losses incurred on emerging-market loans,
- Small spreads between the interest earned on loans and the interest expense of foreign deposits,
- Increasingly stringent risk-based regulatory capital standards, and
- Global recessions and regional financial crises.

These factors have de-emphasized banks' commitment to direct foreign lending, but countries and corporations continue to have capital needs, and banks assist them by underwriting and investing through capital market instruments. Banks are exposed to numerous risks when investing in international markets and should have appropriate risk management in place before engaging in these activities.

Foreign debentures may be issued by a foreign bank, corporation, or sovereign government. Banks with foreign offices might hold the securities of foreign government entities to meet various local laws or reserve requirements, reduce tax liability, retain sufficient asset liquidity, or as an expression of goodwill. As with domestic bond issues, the instruments will have varying durations and maturity and usually represent an unsecured obligation of the issuer.

Foreign debt securities held by U.S. banks are often denominated in U.S. dollars and are in the form of Eurobonds, Medium Term Notes, or Yankee Bonds. These instruments provide liquidity in secondary markets (during normal market conditions) and, depending on the country and circumstances of the issuer, may offer much higher yields than would otherwise be obtainable in the highly competitive trade finance market. Higher yields (over comparable U.S. Treasury instruments) are driven by a confluence of factors including credit quality, country risk (including transfer risk), inflation, monetary policy, and foreign exchange movements.

International investments may be internally reported within a bank's domestic bond portfolio, even though they are reported separately for Call Report purposes. To monitor overall country exposures properly, the instruments should also be included in the appropriate country of risk in both internal and regulatory reports.

Banks with foreign branches are permitted a broader scope of investment activities, including investment services and underwriting of debt and equity securities. International investments and permissible activities are governed by the FRB's Regulation K, which is incorporated into Part 347 of the FDIC Rules and Regulations (for state nonmember banks).As with the domestic investment portfolio, the purchase of foreign debt securities for speculation is an unsuitable investment practice. While risk management considerations are similar to those contained within the Securities section of this Manual, the foreign aspect of Eurobonds, notes, and debentures requires greater due diligence, consideration, and monitoring than would otherwise be expected of a non-complex domestic bond portfolio. Jurisdictional issues and legal systems must be considered when investing in securities issued by sovereigns, and resolving defaults and restructurings of sovereign debt can be problematic if not properly underwritten.

Private Banking

Many banks market personalized services to high net worth customers through a separate unit of the bank commonly known as the private- or personal-banking department. Private banking is an important business line for many financial institutions as it encourages wealthy individuals to develop banking relationships and can generate substantial fee income.

U.S. banks manage private banking relationships for both domestic and international customers. Private-banking departments may provide customers typical financial services, or complex assistance such as facilitating the establishment of shell companies and offshore entities (e.g., private investment companies (PIC) or international business corporations). Typical private-banking services include:

- Cash management,
- Funds transfers,
- Asset management (e.g., trust, investment advisory),
- Lending services,
- Financial planning (e.g., tax and estate planning),
- Custody services, and
- Other support as requested.

Privacy and confidentiality are important elements in international private banking, but may increase a bank's vulnerability to money laundering. Risks of money laundering or other illicit activities may be increased due to having operations in jurisdictions with weak anti-money-laundering laws, the use of shell companies or accounts with fictitious names, or the establishment of accounts in the name of a PIC or blind/numbered trust.

International *private banking accounts* are covered by the Bank Secrecy Act, USA PATRIOT Act, and other recordkeeping and reporting rules and regulations. The accounts are generally defined as an account (or any combination of accounts) maintained at a financial institution that requires a minimum aggregate deposit of funds (or other assets) of not less than $1,000,000, is established on behalf of or for the benefit of one or more non-U.S. persons who are direct or beneficial owners of the account, and is assigned to, or is administered by, in whole or part, an officer, employee, or agent of the bank acting as a liaison between a covered financial institution and the direct or beneficial owner of the account.

Typically, private banking accounts are based on minimum deposit levels and require management to implement effective due diligence, monitoring, and reporting systems. Even when the accounts do not meet the required minimum deposit criteria described above, it is expected that the relationships be subject to appropriate internal controls and due diligence under the institution's risk-based Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance program.

Effective risk management policies, procedures, and practices help protect banks from becoming conduits for money laundering and terrorist financing, which may arise through private banking relationships. Such illicit activities can impair an institution's reputation and have significant costs due to litigation expenses, regulatory sanctions, and loss of business. Additional information relating to required due diligence and risk management of these activities is contained in the FFIEC's BSA/AML Examination Manual and other guidance.

Correspondent Banking

Financial institutions can use U.S. banking relationships to provide services to foreign banks, yet limit their overall exposure to foreign activities. Correspondents provide a range of services to banks located in other countries that do not have local offices, or whose local offices are prohibited from engaging in certain types of activities. This arrangement allows the foreign bank to offer these services more efficiently and economically. Banking services performed through a foreign correspondent bank arrangement may include:

- Cash Management,
- International Funds Transfers,
- Check Clearing,
- Pouch Activities,
- Foreign Exchange Services,
- Sweep Accounts/Overnight Investments,
- Trade Financing, and
- Payable-through accounts (PTAs).

Note: PTA activities should not be confused with traditional international correspondent banking relationships, which do not provide correspondent bank customers with direct access to their account at the U.S. bank, as would be the case in a PTA account arrangement.

Foreign correspondent banking is highly scrutinized because of concerns that some foreign financial institutions are subject to less effective regulatory guidelines than U.S. banks and therefore pose a higher risk of money laundering or other illicit activities.

Per existing regulations, a *correspondent account* is established by a bank for a foreign bank to receive deposits or make payments or other disbursements on behalf of the foreign bank, or to handle other financial transactions related to the foreign bank.

Investigations have disclosed that correspondent accounts have been used by criminals to launder funds and facilitate criminal or terrorist activities. Shell companies are sometimes used to hide the true ownership of accounts. Because of these risks, restrictions that are more stringent have been enacted within the regulatory framework to prevent the use of these accounts for illicit purposes. For instance, according to the amended regulations, a bank is prohibited from establishing, maintaining, administering, or managing a correspondent account in the U.S. for, or on behalf of, a foreign shell bank.

Additionally, a bank that maintains a correspondent account in the U.S. for a foreign bank must maintain records in the U.S. identifying the owners of each foreign bank. A bank must also identify a person who resides in the U.S. who is authorized to be an agent to accept *service of legal process*. (Service of legal process means the agent is willing to accept legal documents, such as subpoenas, on behalf of the foreign bank.)

These stringent regulatory restrictions make foreign correspondent banking an area that requires a higher degree of scrutiny than other international banking activities. Examiners should be aware of the heightened risk posed by this activity, and carefully review policies and risk management controls using the guidelines provided by the FFIEC BSA/AML Examination Manual and other examination guidance on the subject.

Deposit Accounts

Deposit gathering and retention activities of international banks arise from the exercise of other banking activities, such as:

- Receipt of wire transfers,
- Compensating or collateral balances required against credit facilities,
- Disbursement of loan proceeds,
- Payments for trade transactions, and
- Savings or cash-management balances of private banking customers.

The various types of deposit instruments used by banks are defined in applicable Federal Reserve and FDIC regulations governing demand, savings, and NOW accounts. The origin, as well as the types and amounts of deposits that international banks can accept, is dependent on the licensing agency's guidelines or applicable state restrictions, FDIC insurance status, and limitations imposed based on the type of banking office being examined. For instance, U.S. branches and agencies of foreign banks may have restrictions on accepting deposits from U.S. citizens or residents under certain conditions. Examiners should become familiar with the regulatory deposit-taking restrictions that may apply to the type of banking structure under review.

In addition, the volatility and composition of the foreign deposit structure are important elements to consider in the examination process. Foreign deposits tend to have a higher degree of volatility than domestic deposits because of strong competition for funds among banks, the needs of individual and corporate account holders to minimize idle funds, and the effects of disintermediation (the movement of deposits to other higher-yielding markets). A comprehensive deposit development and retention program, which is often included in the funds management policy, is a useful tool for mitigating this volatility.

Management should establish appropriate deposit development and retention policies that include reasonable limits on foreign deposits. When establishing the limits, management should consider prudent competition and the bank's scope of international services. Deposit policies and programs should not only be concerned with deposit growth but also address the desired characteristics of the deposit structure and provide for reporting mechanisms to monitor foreign deposits. Management of the international operations must be able to determine what percentage of the overall foreign deposit structure is centered in stable/core deposits, fluctuating/seasonal deposits, and higher-risk/volatile deposits. Management information systems should provide sufficient information to enable bank management and examiners to evaluate the effect that all material, foreign deposit accounts have on the bank's risk profile.

In addition, examiners should consider BSA/AML risks, and other regulatory/compliance risks related to certain types of deposit accounts, when analyzing the bank's foreign deposits. Deposit products and programs that exhibit elevated risk characteristics are discussed below.

Payable-through Accounts (PTAs) are used directly by customers of the correspondent bank to transact business on their own behalf. Under this arrangement, the sub-account holders of the PTA are generally non-U.S. residents or owners of businesses located outside of the United States. PTAs may be prone to higher BSA/AML compliance risk because banks holding the PTA account may not implement the same due diligence requirements on the sub-account holders that they require of domestic customers. Also, the typically high volume of transactions conducted through PTAs, coupled with inadequate oversight by the banks, may increase money-laundering risks and related criminal activities. The inability of the holding bank to identify and adequately understand the transactions of the ultimate users significantly increase risks associated with money laundering, terrorist financing, and OFAC violations.

Brokered Deposits generally represent funds the bank obtains, directly or indirectly, by or through a deposit broker or agent. Historically, internationally active banks have not relied heavily on funds obtained through deposit brokers to supplement their traditional funding sources. But, in some cases, large, out-of-area deposits are obtained because the U.S. bank is offering attractive rates.

When acquiring foreign deposits, internationally active banks often rely on the assistance of affiliated or parent institutions. International banks may also use independent agents to augment their deposit base. Agented deposits may be the product of personal relationships at a related institution abroad or initiated by foreign customers of related institutions, who are interested in the stability of U.S. insured deposits.

Fundamentally, the risks associated with foreign brokered deposits share many similarities with the risks associated with domestic brokered deposits. Examiners should consult with Capital Markets and International Banking subject matter experts as needed when evaluating foreign deposit gathering and retention activities.

Deposit Sweep programs are often offered by internationally active banks. These sweep programs exist primarily to facilitate the cash management needs of customers who might otherwise move their account to an entity offering higher yields. In sweep programs, banks use an agreement with the deposit customers (typically corporate accounts) that permits the bank to transfer, or sweep, funds, which are above a designated level, from a deposit account into an overnight investment product. The money is transferred out of a deposit account before the close of business and transferred back into the account the next morning. (Conversely, banks may also engage in deposit sweep arrangements with risk averse customers that wish to sweep funds into the bank overnight, in part to obtain deposit insurance.) Investment product examples include Eurodollar deposits, money market funds, and reverse repurchase agreements. *Note:* If a sweep is not properly executed, the depositor may become an uninsured general creditor of a foreign branch or have their funds invested in other short-term obligations and have no claim on the institution if the branch or institution fails.

Banking organizations with deposit sweep programs should have adequate policies, procedures, and internal controls to ensure sweep activities are conducted consistent with sound banking practices and in accordance with applicable laws and regulations. Policies and procedures should ensure that deposit customers participating in a sweep program are given proper disclosures and information regarding the insured status of their deposits.

Borrowings

Borrowings generated through the international department include all non-deposit liabilities. Common forms of borrowings include:

- Federal funds purchased (overnight and term);
- Bills payable to the Federal Reserve;
- Notes and trade bills rediscounted with central banks;
- Short sales from trading securities;
- Overdrafts on deposit accounts;
- Notes, acceptances, import drafts, or trade bills sold with the bank's endorsement or guarantee; and
- Notes or other obligations sold subject to repurchase agreements.

All international borrowing transactions should be treated similar to domestic transactions and be properly recorded on the general ledger and reported in Call Reports.

Note: Foreign time deposits are not borrowings and should be reflected as deposits for reporting purposes and borrowing limit calculations. However, for many banks, little difference exists between how time deposits and borrowings are used and obtained, and foreign time deposits are often viewed as borrowing vehicles.

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FOREIGN EXCHANGE

Foreign exchange involves substituting one country's currency for another. Because international trade and investment require the exchange of currencies, the trading of one country's money for another is a necessary function in international banking.

This section provides examiners with basic information regarding foreign exchange activities. While banks of any size can engage in foreign exchange transactions on behalf of their customers, generally only the largest institutions specializing in international business or international capital markets enter into material foreign exchange transactions for their own account. When necessary, examiners reviewing complex foreign exchange activities should seek assistance from regional, Capital Markets, or Large Bank Supervision subject matter experts.

The Foreign Currency Exchange Market

Foreign exchange transactions can be conducted between any business entity, government, or individual. Financial institutions are ideal foreign exchange intermediaries due to their knowledge of financial markets and experience providing financial services. Banks are involved in a majority of worldwide, foreign exchange transactions with the volume of an activity largely dictated by customer demand.

Importers and exporters often rely on banks to facilitate their foreign currency transactions. The transactions are usually processed in the foreign currency exchange market, which has no specific location or hours of business. Instead, it is a loose collection of entities (commercial banks, central banks, brokers, and private investors) joined by near instantaneous communications links.

The foreign exchange market meets the definition given by most economists of perfect competition, as there are large numbers of buyers and sellers with equal access to price information who are trading a homogeneous product with few transportation costs. Foreign exchange is generally traded in an interbank/dealer network, or organized exchanges such as the London International Financial Futures and Options Exchange or the Chicago Mercantile Exchange.

The interbank market, which is by far the largest market, is housed in the foreign exchange departments of larger banks around the world. It is an over-the-counter (OTC) market because it has no single location or fixed listing of products. It provides opportunities for customers to buy and sell currencies in virtually any amount, for immediate or forward delivery, through contracts to exchange one currency for another at a specified exchange rate (price).

Delivery of currencies may be *spot* (short-term contracts of two business days or less) or *forward* (more than two business days). In either case, the rate of exchange may be established prior to the finalization of the transaction with all related costs calculated and often passed on to the customers. Exchange rates are based upon the amount of time required to exchange currencies. For example, the British Pound Sterling is quoted at a certain rate for immediate (spot) transactions and another rate is quoted on the same day for future (forward) transactions.

In general, exchange rates vary depending on the agreed payment date (value date) of the transaction, i.e., overnight, one week, one month, etc. Also, dealers may quote a different exchange rate for a given transaction depending on whether they are buyers or sellers of currency. This applies to both spot and forward transactions and the two rates are usually referred to as the *bid* (buy) or *offer* (sell) price. The spread between the bid and offered rates represents the dealer's profit.

The system for establishing currency prices is virtually unregulated with exchange rates determined by supply and demand. Exchange rates for most major currencies are free to float to whatever level the market is willing to support, a level that often fluctuates significantly over short periods.

Foreign Exchange Trading

As a result of modern communication systems and rapid price movements, opportunities have soared for speculative trading in the exchange markets. In addition to serving the financial needs of importers and exporters, foreign exchange markets support speculation, arbitrage, and sophisticated hedging strategies, which can create profitable opportunities for banks that have the resources and managerial capabilities to participate in the interbank markets as market makers. While the volume of foreign exchange activity varies widely among banks, transaction volumes are increasingly being driven by interbank trading for banks' own accounts. Banks trading for their own account or as a business line present complex risks.

Banks specializing in this complex and specialized field, particularly those banks that trade foreign exchange for their own account, typically maintain a foreign exchange department with qualified dealers. Banks that only execute their customers' instructions and do no business for their own account (essentially maintaining a *matched book*) generally use the services of another bank or foreign exchange intermediary to place customer transactions.

While trading in foreign exchange is usually encountered only in large global institutions, examiners should be familiar with the fundamental risks inherent in foreign exchange trading.

Foreign Exchange Risks

Trading in foreign currency or holding assets and liabilities denominated in a foreign currency entail risks that fall into five main categories: exchange rate risk, maturity gap risk, credit risk, operational risk, and country risk.

Exchange rate risk arises when a bank takes an open position in a currency. An open position occurs when a bank holds or agrees to buy more foreign currency than it plans to sell, or agrees to sell more foreign currency than it holds or plans to buy. Open positions are either long or short. When a bank buys more of a currency, either spot or forward, than it sells, it has a long position. Conversely, if more currency is sold than bought, a short position is created. Until an open position is covered by the purchase or sale of an equivalent amount of the same currency, the bank is exposed to adverse movements in exchange rates.

Banks often hedge open positions with a forward contract, thereby matching a requirement to deliver with a future contract to receive. The hedging of open positions can be very complex, sometimes using swaps or options, multiple contracts, different types of contracts, or even different currencies. It is important to remember that the level of exchange rate risk is not necessarily dependent on the volume of contracts to deliver or receive foreign currency, but rather the extent that these contracts are not hedged either individually or in aggregate.

All banks that engage in foreign exchange activity should monitor their open positions at least daily. Banks that actively trade foreign currencies should monitor intra-day open positions, closing out or matching exposures at various times during the day.

Maturity-gap risk is the foreign exchange term for interest rate risk. It arises when there are mismatches, or gaps, in a bank's total outstanding spot and forward contracts. Gaps may be present in intra-day, daily, or longer periods of uneven cash inflows or outflows. For example, a maturity spread of a bank's assets, liabilities, and future contracts may reflect a prolonged period over which large amounts of a particular currency will be received in advance of scheduled offsetting payments. The bank's earnings are therefore exposed to adverse shifts in interest rates on the funds provided by cash inflows or on the rates paid on the funds required to meet cash outflows.

In these situations, generally, the bank must hold the currency, invest it short term, sell it for delivery at the time the gap begins and repurchase it for delivery at the time the gap closes, or use a combination of the techniques. The problems of managing gaps are complex; however, banks can mitigate interest rate risks by closely monitoring positions and establishing limits on the volume of mismatches in total foreign exchange positions. Decisions to close a gap when it is created or to leave it until a later date should be based upon a thorough analysis of money market interest rates and spot and forward exchange rates.

Institutions should have firm policies on the maximum gap exposure permitted in certain currencies. The decision to close a gap when it is created, or to let it remain open for a time, will generally depend on money market interest rates as well as the difference between applicable spot and forward exchange rates (commonly known as the swap rate) or the deviations between two forward exchange rates. Estimated movement in the swap rate (primarily determined by interest rate differentials between the two countries) is the customary measure of profit potential or loss exposure during the period within which the gap exists.

Credit risk involves the ability of a bank's customer, or counterparty in a foreign exchange transaction, to meet their financial obligations. Two types of credit risk exist in foreign exchange trading. The first is that a customer might not be able to deliver the currency as promised in order to settle the contract. In this case, the potential mark-to-market profit on the transaction is at risk. The second is delivery or settlement risk. Delivery or settlement risk refers to the possibility a counterparty will take delivery of currency from the bank, but not deliver the counterpart currency. In this situation, the bank is exposed to loss of the entire transaction, not just from currency fluctuations.

To limit both risks, banks must carefully evaluate customers' creditworthiness. The credit reviews should be used to establish an overall limit for exchange contracts for each customer. In order to limit settlement risk, major dealers and third parties also participate in the CLS (Continuous Linked Settlement) system. The CLS reduces risks by facilitating foreign exchange settlements between dealer institutions on a simultaneous or daily basis.

Operational risk reflects the possibility that ineffective controls and operations for foreign exchange activities may result in unanticipated losses to the bank. Banks that engage in foreign exchange transactions must have systems and personnel capable of identifying, controlling, and reporting risks.

Banks should have systems in place to accurately record transactions, perform daily mark-to-market adjustments, reconcile currency positions daily, and assess compliance with established limits. Personnel should also ensure that all confirmations are received or sent to counterparties daily. Appropriate separations of duty are essential in managing operational risk, with the responsibilities of the traders and back-office personnel being strictly segregated. While the form of trades and trade confirmations have changed with the advent of new technology, the independence and appropriate control of these functions remains of paramount importance regardless of the extent of a bank's trading operations.

Country risk reflects potential political changes or adverse economic trends in a country. These types of events are often accompanied by changes in policies that could affect such factors as interest rates, balance of payments, foreign exchange reserves, and capital flows. The policies, whether based on economic necessity or changed attitudes, might affect the availability or transfer of currency to the bank's customers or to the bank itself, and could even affect the convertibility of that country's currency in foreign exchange markets. Exchange controls imposed by a country's central bank may limit the amount of currency that can be exchanged in any single transaction, by any given customer, or within a particular period, and the sources for covering desired currency positions may vanish. Additionally, the exchange rate for the currency may be subject to additional supply and demand influences.

Due-From Nostro Accounts

Domestic banks must be able to make and receive payments in a foreign currency in order to meet the needs of international customers. Since physical movement of currency is impractical, financial institutions maintain accounts or inventories of foreign currency in correspondent banks located in the countries where the institution and its customers conduct business. These accounts are commonly called due-from or *nostro* accounts. Conversely, *vostro* accounts are due-to accounts (demand deposits) representing foreign currency owned by a foreign bank maintained at a U.S. bank.

Close supervision of nostro accounts is required to ensure adequate balances are available to meet customers' needs while avoiding excessive idle funds or overdrawing the nostro account and incurring service charges. Transactions occur in foreign currency denominations, but deposits and withdrawals are normally recorded on a bank's ledgers in both the foreign currency and its U. S. dollar equivalent. All foreign currency transactions, except over-the-counter cash trades, are settled through nostro accounts. Therefore, the volume of activity may be substantial and must be adequately controlled.

Examination objectives are similar to those of domestic correspondent accounts with the additional problem of exchange risk. Nostro account balances are included with other general ledger accounts to determine the department's *position* in each foreign currency. Some banks do not include foreign currency in their net position reports or monthly valuations. Currencies of other countries are foreign assets held in nostro accounts and should be included in position reports.

Conversely, physical control over foreign currencies kept in cash should also be maintained and complemented with adequate accounting systems and controls. Accounting reports should include the U.S. dollar equivalent of foreign currency balances. Separate controls for cash items should be maintained in the general ledger, supported by subsidiary records that permit an evaluation of each item.

Dealing in foreign notes and coins can involve more risk than engaging in foreign currency activity through a due-from account because institutions may unknowingly accept counterfeit currency, and because the physical movement of notes and coins is expensive and time-consuming. Appropriate internal controls should be instituted to compensate for these additional risk factors.

Examination Guidance for Foreign Exchange

An examination of a bank's foreign exchange activities seeks to assess the impact of the foreign exchange activities on the financial condition of the bank. Large, global banks with extensive foreign exchange trading operations earn substantial fee income from this activity, while banks that conduct trades entirely on behalf of their customers generally do not. The nature of foreign exchange trading, wherein a single trader can commit a bank to substantial forward commitments in a short time, makes examinations of related risks and controls important for banks of any size and level of activity. At a minimum, examiners should:

- Determine the extent of foreign exchange activities,
- Identify the types of exchange contracts used by the bank,
- Consider the risks presented by each exchange activity,
- Assess the adequacy of internal controls and risk management systems, and
- Evaluate the overall impact of foreign exchange activities on earnings and capital.

Another important examination objective is to assess the quality of personnel, systems, and controls in relation to the volume of activities and complexity of transactions. When assessing foreign exchange activities and controls, examiners should consider the bank's compliance with Part 349 (Retail Foreign Exchange Transactions) of the FDIC Rules and Regulations.

Examiners should also review compliance with internal exchange limits and note any unusual concentrations or lines of credit to banks with known market problems. Examiners should obtain a current report of all outstanding foreign exchange contracts and determine if there are any contracts in excess of approved limits, other than those reported on the exceptions report. If contracts that exceed approved limits are identified by examiners or included on exception reports, examiners should assess the adequacy of management's plans to bring contract levels into conformance with approved limits.

Banks that are active in foreign exchange trading should have internal controls commensurate with their risk profile. Banks with limited foreign exchange activity and low-risk profiles (e.g., most state nonmember institutions) may not need the sophisticated monitoring/reporting systems and internal controls maintained by larger institutions or that are required by minimum regulatory standards. However, it is incumbent upon management to maintain adequate systems and controls, and to demonstrate to examiners that their systems provide adequate protection for their risk profile.

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STRUCTURE AND SUPERVISION

Foreign Banking Organizations (FBOs) in the U.S.

Foreign banks that conduct operations in the U.S. are known as foreign banking organizations. The FBOs have a longstanding presence in the U.S. and their operations encompass a wide variety of banking and non-banking activities. The activities of FBOs can generally be divided into four main categories: branches, agencies, foreign-owned U.S. bank subsidiaries, and representative offices.

Parallel-owned banking organizations are similar to U.S. bank subsidiaries of FBOs. The critical difference is that a PBO does not have comprehensive, consolidated supervision of all banking entities by the home country. PBOs pose unique supervisory concerns and are covered in more detail under a separate sub-heading.

Branches and Agencies of Foreign Banks

Branches and agencies of foreign banks in the U.S. are extensions of a foreign bank, much like a domestic branch of a U.S. bank. All U.S. branches of foreign banks are required to be licensed at either the state or federal level and are subject to separate insolvency laws. The International Banking Act (IBA) of 1978 established uniform federal requirements for U.S. branches of foreign banks. The main principle of the IBA is one of non-discrimination or *national treatment*, which eliminates the advantages and disadvantages that foreign branches previously faced compared to domestic branches.

U.S. branches of foreign banks may perform all banking functions permissible in the U.S., including accepting deposits and extending loans (unlike a representative office); however, the deposits may not be insured by the FDIC. The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA)[2] effectively prohibits the FDIC from granting deposit insurance to U.S. branches of foreign banks except for those that were insured prior to FBSEA's enactment.

Agencies, similar to branches, may be licensed under state[3] or federal law, but, unlike a branch, an agency may not accept deposits. Agencies are permitted to have occasional credit balances under certain conditions. Such credit balances must be incidental to, or arise from the exercise of other lawful banking powers. Credit balances must be for a specific purpose and should be withdrawn within a reasonable period of time after the specific purpose has been accomplished. These balances are not to be solicited from the general public or used to pay for routine operating expenses in the U.S.

[2] The FBSEA was enacted in 1991 to improve the degree of supervision of foreign banks operating in the U.S. As a result, the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations (the FBO Supervision Program) was established and applied to all FBOs that have a presence in the U.S.

[3] Twenty-six states and the District of Columbia currently authorize the establishment of agencies by foreign banks.

Edge and Agreement Corporations

Edge and Agreement corporations are subsidiaries of financial institutions organized for the purpose of engaging solely in certain international financial and investment activities. There are two types of Edge corporations - *banking* (which accepts deposits) and *investment* (which are essentially holding companies for foreign investments).

Agreement corporations are similar to Edge corporations, except that they are chartered under state law rather than by the FRB. Both Edge and Agreement corporations may be located anywhere in the U.S., can establish branches in the U.S. or overseas, and are permitted to engage in a broad range of banking activities, provided that the transactions are international in nature or directly related to international transactions. Operations of Edge and Agreement corporations are governed by Section 211.6 of the FRB's Regulation K.

Although the operations of Edge and Agreement corporations are governed by Regulation K, the entities are not members of the Federal Reserve System. The FDIC does not insure their deposits, but the entities are required to maintain reserves against deposits. They are also required to maintain capital adequate to support their operations.

Representative and Commercial Lending Offices

Representative offices are usually an organization's first form of entry into a foreign market because of lower operating costs. Representative offices are established under state law with the prior approval of the FRB. These offices have limited presence, as they are mainly a marketing facility for their foreign parent. Unlike branches, they cannot provide traditional banking services, such as accepting deposits or lending funds. Commercial lending offices are similar to representative offices. They are state licensed and cannot accept deposits, but they may borrow and lend on behalf of their parent companies.

FBO Supervision and Examination Guidance

FBOs are supervised under the Interagency Program for Supervising the U.S. Operations of FBOs (FBO Program). The FBO Program is a risk-focused supervisory framework designed to focus on an organization's principal risks and its internal systems and processes for managing and controlling these risks. The FBO Program consists of four primary and interrelated components:

- Understanding the FBO,
- Assessing FBO risks and how they relate to U.S. operations,

- Planning supervisory activities in the U.S., and
- Determining the overall condition of its U.S. operations.

The FBO program is designed to coordinate the regulatory efforts of both domestic and foreign supervisors and to promote a consolidated, comprehensive supervisory approach to analyzing an organization's overall condition.

While the examination of the U.S. bank subsidiary of an FBO is similar to the examination of a domestic institution, the FBO program enables the examiner to understand the FBO's U.S. operations in the context of the entire banking organization. In order to streamline FBO supervision, enhance cooperation, and reduce regulatory costs, the federal regulatory agencies have entered into examination coordination agreements with state banking agencies that protect the confidentiality of information shared by all participants. The information is shared through a secure software platform. When planning the examination of an FBO, the examiner should contact their region's International subject matter expert (SME) and review available information. These parties may have access to more recent information that should be considered in the overall assessment of the FBO.

As part of its oversight responsibility, the FRB coordinates the examinations of FBOs with other federal agencies and with various state banking authorities. FBO oversight requires that the parent company be evaluated through a strength-of-support assessment (SOSA). The purpose of the SOSA is to determine the parent company's ability to support its U.S. operations and the FBO's overall risk profile, as well as to develop an examination strategy and frequency that is commensurate with the risk profile.

As part of the SOSA process, regulatory agencies gain a better understanding of the FBO by also reviewing its home country financial system, supervisory practices, and accounting standards. An assessment of these components result in a combined assessment of an FBO's banking activities in the U.S., which is shared with the FBO's home country supervisors in order to enhance their consolidated supervisory programs.

The Core Principles[4] of the Basel Committee on Banking Supervision (BCBS) recommends that cross-border banking groups be supervised on a consolidated basis. The consolidated approach helps ensure banks within the group are adequately capitalized, risks are managed on a group-wide basis, and contagion risks within a banking group are adequately mitigated. An important principle within this framework is one of the *home-host relationship*, which considers the relationship between the home supervisor where the FBO is headquartered, and the host supervisor where the foreign operations are conducted, e.g., the U.S. branch of an FBO.

The U.S. Banking Agencies' emphasis on consolidated, comprehensive supervision programs have served as the benchmark for many current and evolving international standards for the consolidated supervision of financial groups. Key concepts that have been part of the Agencies' approach to consolidated supervision for many years are reflected in the BCBS Minimum Standards for Internationally Active Banks, capital accords, and Core Principles for Effective Banking Supervision. The concepts are now used by the International Monetary Fund and the World Bank in connection with their assessments of countries' bank supervisory regimes. Refer to the Glossary for additional information on the BCBS.

Insured Branches

Much like the Uniform Financial Institutions Rating System (a.k.a., CAMELS), ratings assigned to domestic banks, branches, and agencies of foreign banks are assigned a ROCA rating. The ROCA rating is a confidential management information and supervisory tool designed to assess the condition of a branch and to identify significant concerns in a systematic, consistent fashion.

The ROCA rating system rates four areas:

- **R**isk Management,
- **O**perational Controls,
- **C**ompliance, and
- **A**sset Quality.

Similar to CAMELS, each ROCA component rating is based on a scale of 1 through 5 in ascending order of supervisory concern, with the risk management component generally considered to be the most important factor. A single component rating (called a *Combined U.S. Operations Rating*) between 1 and 5 is assigned for Operational Controls on a combined basis with the FBO. Unlike CAMELS, ROCA does not rate capital, earnings, or liquidity, as these areas are difficult to separately evaluate at a branch. And, while liquidity is not a separate rating, examiners should be aware of supervisory concerns regarding the nature and tenor of borrowings that could put depositors at risk.

Examination findings must be addressed in a Summary of Condition Letter to senior management. The letter should highlight overall strengths and supervisory weaknesses in the FBO's combined U.S. operations, and be shared with the foreign bank's home country supervisor.

[4] Basel Committee on Banking Supervision-Core Principles for Effective Banking Supervision, September 2012.

Because there are so few FDIC-supervised branches, the FDIC does not maintain a specific examination program in this area. Therefore, examiners may refer to the International Banking Examination Documentation module or other regulatory examination manuals for additional guidance.

FBO Reporting Requirements

The regulatory agencies rely on the timely and accurate filing of regulatory reports by domestic and foreign financial institutions to monitor FBO financial trends. Data collected from regulatory reports facilitate the early identification of problem situations. Some of the reports required for submission by foreign branches and agencies include:

- The Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC Form 002);
- Report of Assets and Liabilities of Non-U.S. Branches that are Managed or Controlled by a U.S. Branch or Agency of a Foreign (Non-U.S.) (FFIEC Form 002s);
- Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (FFIEC Form 019);
- Foreign Branch Report of Condition/Abbreviated Foreign Branch Report of Condition (FFIEC Forms 030/030s); and
- Report of Transaction Accounts, Other Deposits, and Vault Cash (Federal Reserve 2900).

In addition to the reporting requirements for branches and agencies, additional reporting requirements for FBOs include:

- Annual Report of Foreign Banking Organizations (Federal Reserve Form FY-7),
- Financial Statements of U.S. Nonbank Subsidiaries Held by FBOs (Federal Reserve Form Y-7N/Y-7NS),
- The Capital and Asset Report for FBOs (Federal Reserve Form Y-7Q), and
- Changes in Organizational Structure (Federal Reserve Form Y-10).

Parallel-Owned Banking Organization (PBO)

Parallel-owned banking organizations are another form of foreign bank ownership in the U.S. A PBO exists when a U.S. depository institution[5] and a foreign bank[6] are controlled, either directly or indirectly, by an individual, family, or group of persons[7] with close business dealings, or that are otherwise acting in concert. PBOs do not include structures in a recognized financial group[8] subject to comprehensive consolidated supervision via the FBO Supervision Program.

PBOs are not included in the FBO Supervision Program because the parent organization is not a foreign bank or holding company. PBOs present unique challenges to the supervisory process. One key challenge involves assessing risks at PBOs where control is vested in individuals or companies located in a foreign country where U.S. regulatory agencies are unable to obtain reliable, organization-wide information.

Supervisory Control Definition

Identifying a PBO is difficult because control based on common ownership, management, or decision-making authority, often is not clear. The lack of a globally accepted and easily understood definition of control complicates the identification of PBOs. A supervisory definition of presumed control is derived from applying the criteria in the April 2002 Joint Agency Statement on PBOs. The statement indicates, in part, that the U.S. banking agencies consider whether an individual, family, or group of persons acting in concert *control*[9] a depository institution if the individual, family, or group of persons controls 10 percent or more of any class of the voting shares of the bank. In general, 10 percent ownership of voting shares typically results in a rebuttable presumption of control, whereas 25 percent ownership is not rebuttable.

The presence of certain other characteristics may indicate that a PBO relationship exists. These criteria may include situations where the individual, family, or group of persons acting in concert:

- Constitutes a quorum or a significant presence on the board of directors of both the U.S. depository institution and the foreign bank;

[5] References to *U.S. depository institution* represent all banks and savings associations insured by the FDIC.

[6] References to *foreign bank* include a holding company of the foreign bank and any foreign or U.S. non-bank affiliates of the foreign bank.

[7] The term *persons* includes both business entities and natural persons, which may or may not be U.S. citizens.

[8] The term *recognized financial group* refers a structure in which a bank is a subsidiary of another bank, or an entity that is controlled by a company subject to the Bank Holding Company Act or the Savings and Loan Holding Company Act.

[9] A variety of presumptions and technical rules apply to determinations of control. See 12 CFR 5.50, 225.41, 303.82, 391.43.

- Controls, in any manner, the election of a majority of the directors of both the U.S. depository institution and the foreign bank;
- Constitutes a quorum or a significant portion of the executive management of both the U.S. depository institution and the foreign bank;
- Exercises a controlling influence over the policies and/or management of both the U.S. depository institution and the foreign bank;
- Engages in an unusually high level of reciprocal correspondent banking activities or other transactions or facilities between the U.S. depository institution and the foreign bank;
- Requires the U.S. depository institution to adopt particular/unique policies or strategies similar to those of the foreign bank, such as common or joint marketing campaigns, cross-selling of products, sharing customer information, or linked web sites;
- Obtains financing to purchase the stock of either the U.S. depository institution or the foreign bank from, or arranged through, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan;
- Names the U.S. depository institution in a similar fashion to that of the foreign bank; or
- Presents any other factor(s) or attribute(s) that indicate that a PBO relationship exists.

While the presence of any single condition listed above may not demonstrate that an individual, family, or group controls the U.S. depository institution and foreign bank, the existence of multiple conditions may indicate that a PBO relationship exists.

An individual, family, or group of persons acting in concert can rebut both the objective and subjective criteria considered in reaching this conclusion. Therefore, examiners must weigh each factor in relation to all of the other available information in determining whether a PBO relationship does or does not exist, especially when evaluating control relationships that are rebuttable.

PBO versus Affiliate Relationships

An individual, family, or group acting in concert may exercise sufficient control to meet the supervisory definition of presumed control for establishing that a PBO exists; however, they may not meet the criteria to be considered affiliates, as specified in Section 23A of the Federal Reserve Act. Thus, the entities that comprise a PBO may or may not be affiliates. In instances where a PBO relationship exists, but an affiliate relationship does not exist, the transactions between the U.S. bank and the foreign bank may not be subject to the Federal Reserve Act (FRA). However, non-affiliated PBOs cannot be disregarded because such relationships can pose the same or greater risks than those from affiliated PBOs.

The FRA provides a definition of control that serves as a legal basis for determining if an affiliate relationship exists between a U.S. bank and a foreign institution. Section 23A(b)(1)(C) defines an affiliate of a U.S. bank to include any company that is controlled directly or indirectly by shareholders who also directly or indirectly control the bank. In general, Section 23A(b)(3)(A) defines control as:

1. Owning, controlling, or having the power to vote 25 percent or more of any class of voting securities of the U.S. bank;
2. Controlling in any manner, the election of a majority of the directors of the U.S. bank; or
3. Receiving a determination from the FRB that the shareholder or company exercises a controlling influence over the management or policies of a U.S. bank.

Based on this definition, if an individual, family, or group of persons acting in concert collectively has the power to vote 25 percent or more of any class of stock of a U.S. bank and a foreign bank, then a PBO and an affiliate relationship exist. All transactions between the affiliated entities would be subject to the restrictions in the FRA. In addition, the affiliated entities in a PBO cannot take advantage of the sister bank exemption, as it requires ownership by a holding company.

For example, Mr. Smith owns 51 percent of a U.S. depository institution and 30 percent of a foreign bank. This scenario reflects that these two entities are both PBOs and affiliates, and subject to the restrictions in the FRA. If Mr. Smith owned/controlled 12 percent of each institution's outstanding stock, then the two entities would not be affiliated per the FRA, but a PBO may still exist.

If the beneficial owner's stock ownership or voting rights are less than 25 percent, but the criteria in item (2) is met, or the beneficial owner(s) constitute a majority of the boards at both the U.S. bank and the foreign bank, then a PBO and an affiliate relationship exist and the FRA is applicable.

For example, Mr. Jones, Mr. Smith, and Mr. Williams each own 12 percent of a U.S. depository institution. Each person also owns 10 percent of a foreign bank. The minutes of the shareholders meeting of both the U.S. and the foreign bank reflect that these three individuals constitute a quorum of each institution's board. This scenario reveals that these two entities are both PBOs and affiliates subject to the restrictions in the FRA. If these three individuals did not represent a quorum of each institution's board, then the two entities may not be affiliated per the FRA, but a PBO would still exist.

Lastly, if the FRB determines that the shareholder/company exercises a controlling influence over the management or policies of the bank, as stated in Item (3) above, then a PBO and an affiliate relationship exist and the FRA applies.

It is important to note that transactions between the U.S. bank and any person, where the proceeds of the transaction are used for the benefit of, or are transferred to, an affiliated entity, is considered a covered transaction for purposes of Section 23A(a)(2). In situations where regulations do not apply to transactions between a U.S. bank and a foreign affiliate, examiners should still review material transactions for reasonableness and identify any questionable practices.

PBO versus Related Interests of Insiders

An individual, family, or group acting in concert may exercise sufficient control to meet the preceding supervisory definition of presumed control for establishing that a PBO exists; but, they may not meet the criteria to be considered affiliates as specified by FRB Regulation O.[10] Regulation O restricts extensions of credit to the related interests of executive officers, directors, and principal shareholders, collectively known as bank insiders. Related interests are companies controlled by one or more bank insiders, or a political or campaign committee that is controlled by one or more bank insiders or the funds or services of which will benefit bank insiders.

Congress made virtually all of these restrictions applicable to state nonmember banks in Section 18 of the Federal Deposit Insurance Act (FDI Act).[11] Thus, extensions of credit from a state nonmember bank to a domestic or foreign company commonly controlled, as defined by Regulation O, by a bank insider are generally subject to the limitations in Regulation O.

Regulation O defines control as directly or indirectly:

1. Owning, controlling, or having the power to vote 25 percent or more of any class of voting securities of the company or bank;
2. Controlling in any manner the election of a majority of the directors of the company or bank; or
3. Having the power to exercise a controlling influence over the management or policies of the company or bank.

Note that the first two items are very similar to those on the previous page from the FRA. The third item is different. Also, these criteria are not as expansive as the preceding supervisory definitions of control.

If an individual, family, or group of persons acting in concert collectively has the power to vote 25 percent or more of any class of stock of both the U.S. depository institution and the foreign bank, then the same situation exists as under Item (1) of the FRA control definition and all transactions with related interests would be subject to Regulation O.

If the beneficial owner's stock ownership/voting rights are less than 25 percent, the next criteria must be reviewed. Item (2) considers whether the beneficial owner(s) controlled the election of a majority of the directors. For example, Mr. Jones, his son, and his brother each own 20 percent of a U.S. depository institution. Each individual also owns 10 percent of a foreign bank. Minutes of the shareholder meetings of both the U.S. and the foreign bank reflect that these three individuals nominated the candidates for each institution's Board and voted their shares in a block. This scenario reveals that these two entities are PBOs and subject to the restrictions of Regulation O. If these three individuals had voted their shares independently or in a different manner from each other, then it would indicate that these two entities are not subject to Regulation O, but a PBO does exist.

If neither the beneficial owner(s)'s stock ownership/voting rights percentage nor control of the board's election thresholds are met, then Item (3) must be reviewed. Regulation O also states that a person is presumed to have control, including the power to exercise a controlling influence over the management or policies of a company or bank, if the person:

- Is an executive officer or director of the company or bank; and directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; or
- Directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; and no other person owns, controls, or has the power to vote a greater percentage of that class of voting securities.

Ascertaining whether an individual, family, or group acting in concert exercises a controlling influence over the management or policies of the bank is difficult. If the criteria in either item (a) or item (b) above are met, then a

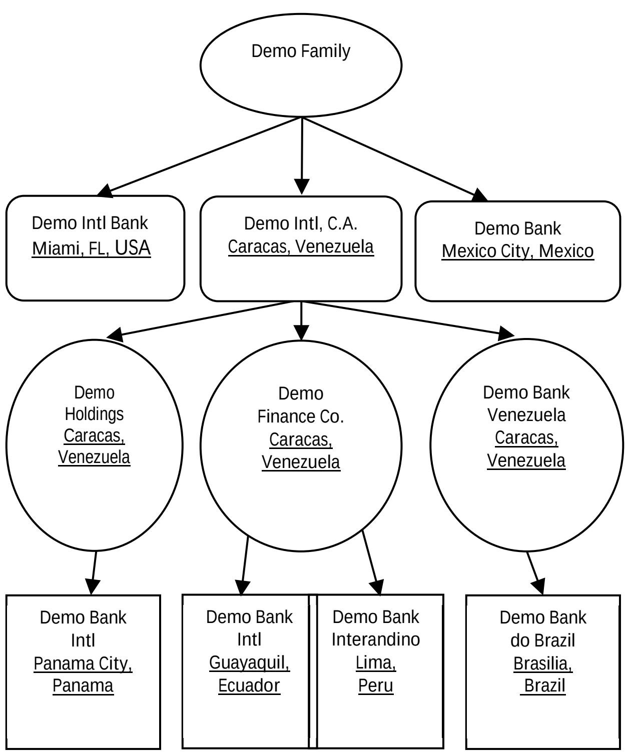
[10] 12 CFR Part 215.
[11] See generally 12 CFR § 337.4, which implements Section 18(j)(2) of the FDI Act (12 U.S.C. § 1828(j)(2).

PBO exists and all transactions with related interests would be subject to the restrictions of Regulation O.

An individual, family, or group acting in concert may exercise sufficient control to meet the supervisory definition of presumed control for establishing that a PBO exists; but not meet the level of control required by Regulation O. In these instances, the transactions between the U.S. bank and the bank insiders' related interests would not be subject to the restrictions of Regulation O. In situations where these types of transactions are not subject to Regulation O, examiners should still review material transactions for reasonableness and identify any questionable practices.

Business Structure of PBOs

A PBO can have a simple or complex organizational structure. A simple PBO business structure consists of an individual who directly controls both a U.S. depository institution and a foreign bank. A complex organizational structure may include multiple domestic and foreign shareholders working in concert, who individually do not have direct control of the U.S. and the foreign bank, but collectively exercise a controlling influence throughout the PBO. The following illustration is an example of a complex PBO structure.



The existence of cross-border organizations compounds the difficulty of supervisory oversight because foreign organizations are often not as transparent as U.S. companies, and U.S. bank supervisors may be unable to effectively evaluate their ownership structure or conduct on-site evaluations of the foreign entities.

Complex PBOs also could be part of privately held multi-national conglomerates that service a particular business sector or geographic region. These privately held PBOs often are the most challenging to understand because public information on their ownership structure, operations, and affiliations is generally difficult to obtain. Conversely, PBOs can be part of large multi-national conglomerates that are publicly traded but do not provide financial services as a main enterprise activity. In these structures, information on ownership, operations, and affiliations is generally easier to obtain.

Supervisory Risks

An examiner's main priority, and frequently greatest challenge, is to gain a comprehensive understanding of a PBO's structure and risk profile. The organizations are complex and often involve cross-border, multi-tiered companies that can be difficult to analyze. Therefore, initial discussions with management are important elements in determining whether the bank is part of a PBO.

The fundamental risk posed by PBOs is that they may act in a de facto organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision.

PBOs present supervisory risks similar to those arising from a chain banking organization (CBO) with the added dimension that part of the chain is in a foreign country or multiple foreign countries. From a regulatory perspective, the risks presented by PBOs may be greater than the risks presented by domestic CBOs because a portion of the PBO structure is subject to the laws and jurisdiction of one or more foreign countries.

The lack of a globally accepted supervisory approach to evaluate risk on an organization-wide basis makes it more difficult to obtain information from foreign regulatory agencies. Additionally, coordinated examinations of the U.S. depository institution and the foreign bank may not be a viable option. Therefore, relationships between the U.S. depository institution and the foreign bank may be difficult to understand and monitor.

PBOs may foster other management and supervisory risks. In 2002, the U.S. bank regulatory agencies issued the Joint Agency Statement on PBOs to assist banks in identifying these entities and managing the risks that PBOs present. Examiners should refer to this guidance when examining PBOs.

In all instances where a PBO relationship exists, examiners should complete the Parallel-Owned Banking Organizations report page; refer to the ROE Instructions for additional guidance.

U.S. Banking Activities Abroad

U.S. banks conduct international banking activities abroad through overseas branches, representative offices, subsidiaries, Edge and Agreement corporations, IBFs, export trading companies (ETCs), consortium banks, offshore branches, and correspondent banking. These structures enable the U.S. banking organizations to serve the needs of their customers in the U.S. and abroad and to compete with foreign banks in the U.S. and foreign markets. The choice of structure is often driven by market opportunity vis-à-vis the laws of the host country, or by tax considerations. U.S. banks' investments in subsidiaries around the world are frequently held in investment Edge corporations that are often managed at the banks' headquarters.

International strategies and vehicles for market entry differ among the numerous types of U.S. banks and are influenced by the banks' structure, strategy and, scale of operations. The largest U.S. banks (money-center and multinational banks) are most likely to utilize the full range of vehicles available to conduct international operations. These banks typically have an extensive network of branches, subsidiaries, and representative offices abroad, and they often maintain correspondent relationships around the world. In the U.S., these banks may have a banking Edge corporation subsidiary located in a major city with branches in other key U.S. locations.

Regional banks in the U.S. that engage in international activities generally have a more limited structure, strategy, and scale of operations. While larger banks can offer international services through their own operations worldwide, banks with limited or no international structure are not precluded from these activities. Smaller banks generally serve their customers' global needs through correspondent banking relationships.

Offshore U.S. Branches

As international trade and foreign exchange trading increased in the 1960s, most major U.S. banks actively expanded their worldwide network to capitalize on this growth. Some banks established full-service branches in important business centers. Many other banks, that could not justify the cost of such branches, established offshore or *shell* branch operations. Many smaller regional banks established offshore branches to obtain a low-cost entry into the Eurodollar market to finance international trade and fund a growing portfolio of purchased international loans.

An offshore, or shell, branch is an overseas branch established for a special purpose, often to take advantage of a favorable tax or regulatory environment in a foreign country. Many of these branches are banking vehicles for booking Eurodollar deposits and loans originated through the home office. These branches generally are no more than a post office box number with few or no personnel. The administration of the branch's assets and liabilities is maintained at either the head office or a designated branch or agency in the U.S. The offshore office is governed by the laws and regulations of its home country and the host country from which it operates.

The passage of the USA PATRIOT Act of 2001 gave the U.S. government expanded authority to combat money laundering, with a particular emphasis on activities conducted through shell banking operations. As such, there have been recent efforts by the international community for offshore banking centers to improve supervision, transparency, disclosure, and cooperation with other bank regulators. For more details, refer to the Bank Secrecy Act, Anti-Money Laundering and Office of Foreign Assets Control sections of this Manual.

International Banking Facilities (IBF)

An IBF is a set of asset and liability accounts, segregated on the books and records of the establishing entity, which reflect international transactions. An IBF is established in accordance with the terms of FRB Regulation D after appropriate notification to the FRB. The establishing entity may be a U.S. depository institution, a U.S. office of an Edge or Agreement Corporation, or a U.S. branch or agency of a foreign bank established pursuant to FRB Regulation D.

An IBF is permitted to hold only certain assets and liabilities. In general, IBF accounts are limited to residents of foreign countries, residents of Puerto Rico and U.S. territories and possessions, other IBFs, and U.S. and non-U.S. offices of the establishing entity. An IBF is an attractive tool for banks because its deposits are not subject to reserve requirements or deposit insurance premiums since they are not FDIC insured. This provides a lower cost of funds and facilitates banking activities. An IBF may also serve to diversify the bank's liability mix and prove less volatile to changes in interest rates.

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LAWS AND REGULATIONS

Several laws and regulations govern international activities of banks. Some are discussed briefly in this section; however, examiners should be familiar with the entire body of laws and regulations that deal with international banking. These can be found in the various examination resource tools available within the FDIC's online library and training materials.

Part 347-International Banking

Part 347 of the FDIC Rules and Regulations specifically covers international banking activities of state nonmember banks; its provisions are similar to FRB Regulation K, which is applicable to state-member banks, as well as Edge and Agreement corporations of state nonmember banks.

Subpart A of Part 347 (and corresponding sections of Part 303) implements Sections 18(d) and 18(l) of the FDI Act and outlines the application process by which state nonmember banks may be given permission to operate foreign branches or invest in foreign banks or other financial entities. The powers or permissible activities of overseas branches are defined by the regulations and, generally, these branches are allowed a wider range of financial activity than is permitted domestically. The regulations also establish minimum standards for accounting and internal controls in foreign branches or subsidiaries. In certain circumstances, state nonmember bank applicants may be granted expedited processing of their applications.

Subpart B of Part 347 implements Sections 6, 7, and 15 of the International Banking Act of 1978 and governs FDIC-insured branch operations of FBOs. This subpart establishes asset pledging and maintenance requirements for insured branches of foreign banks. Subpart B also provides for examinations of these branches and establishes minimum recordkeeping requirements.

Subpart C of Part 347 implements the provisions of the International Lending Supervision Act of 1983 (ILSA). This section deals with the establishment of an Allocated Transfer Risk Reserve (ATRR) and the accounting and reporting of international loans and assets. As with other loan fees, Part 347 requires banks to follow generally accepted accounting principles (GAAP) for the amortization of fees on international loans.

Part 349-Retail Foreign Exchange Transactions

On July 12, 2011, the FDIC adopted rules regarding state nonmember banks' involvement with retail foreign exchange transactions, defined by the regulation as foreign exchange transactions other than traditional spot and forward contracts. Retail foreign exchange transactions include *rolling-spot* transactions, which are spot transactions that are not settled within two days (they are instead perpetually renewed). Retail customers do not include eligible customer participants (such as other financial institutions) as defined by the Commodity Exchange Act. The regulation has requirements in six different areas: disclosure, recordkeeping, capital and margin, reporting, business conduct, and documentation. The regulation does not apply to retail foreign exchange activity conducted between foreign branches of state nonmember banks and non-U.S. customers.

Dodd-Frank Act

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was signed into federal law. Specific to international banking, Sections 165 and 166 of the Dodd-Frank Act affect the oversight of FBOs. Under Section 165(d), *systemically important financial institutions* (SIFIs) and bank holding companies over $50 billion in worldwide assets must create a detailed plan for rapid and orderly resolution (living will) in the event of material financial distress or failure. In the case of FBOs, worldwide assets are used to determine the applicability of planning requirements, but the actual plans must cover only assets in the U.S. Plans must be credible and are to be reviewed jointly by the Federal Reserve and the FDIC. Part 381 of the FDIC Rules and Regulations implements section 165(d) of the Dodd-Frank Act for the purpose of establishing rules and requirements regarding the submission and content of a resolution plan for FBOs, as well as procedures for its review by the FDIC.

The FDIC monitors FBOs to better understand their U.S. operations and to assess their resolution plans in order to facilitate rapid and orderly resolutions in the event of material financial distress or failure.

Regulation YY - Enhanced Prudential Standards

Capital Stress Tests

Foreign banking organizations with total consolidated assets between $10 and $50 billion are required to conduct internal capital stress tests. Annually, the FBO's home-country supervisor must directly conduct a capital stress test or review an internal company-run stress test. If the FBO does not meet the stress-testing requirement, it must conduct a stress test of its U.S. subsidiaries, as well as maintain eligible assets of not less than 105 percent of the total liabilities (asset maintenance) in its U.S. branches and agencies.

A publicly traded FBO of this size is also required to maintain a committee of its global board of directors (either on a standalone basis or as part of its enterprise-wide risk committee) to oversee the risk management policies of its combined U.S. operations. At least one member should have experience identifying, assessing, and managing risk exposures of large, complex firms.

Increased Requirements

Regulation YY has increased requirements for FBOs with assets greater than $50 billion. These FBOs must certify that they meet, on a consolidated basis, the capital adequacy standards established by their home-country supervisor that are consistent with the regulatory capital framework published by the Basel Committee on Banking Supervision. If an FBO's home-country supervisor has not established capital standards consistent with the Basel framework, the FBO must demonstrate that it would meet or exceed the Basel capital standards at the consolidated level if it were subject to them. In addition, these FBOs must maintain a U.S. risk committee that approves and periodically reviews the risk management policies of the combined U.S. operations of the FBO and oversees the risk management framework of the combined U.S. operations of the FBO.

All FBOs of this size must report the results of an internal liquidity stress test for either the consolidated operations of the FBO or the combined U.S. operations of the FBO on an annual basis to the Federal Reserve. The stress tests must be conducted consistent with the Basel Committee principles for liquidity risk management and must incorporate 30-day, 90-day, and one-year stress-test horizons. An FBO that fails to comply with this requirement must limit, on a daily basis, the net aggregate amount owed by its non-U.S. affiliates to the combined U.S. operations to 25 percent or less of the third party liabilities of its combined U.S. operations.

Regulation YY also implements more stringent requirements for FBOs with combined U.S. Assets of $50 billion or more, including more intensive risk committee and liquidity requirements. Companies with U.S. non-branch assets of $50 billion or more are subject to the intermediate holding company requirement in Section 252.153 of Regulation YY. This section requires these FBOs to establish an intermediate holding company organized in the U.S. to hold all ownership interests in any U.S. subsidiary.

Regulation K - International Banking Operations

As explained above, Regulation K is similar to Part 347, but has been revised periodically to implement new laws and amendments and to keep pace with developments in supervisory and regulatory policy. In its last major revision, October 2001, the FRB streamlined application requirements for foreign banks seeking to expand operations in the U.S. and procedures for U.S. banking organizations to branch into foreign countries. Changes were also made to provisions governing: permissible foreign activities of U.S. banking organizations, including securities and investment activities; investments by U.S. banking organizations under the general consent procedures; and the qualification of FBOs for exemption from the nonbanking prohibitions of the Bank Holding Company Act. Lastly, changes were implemented authorizing a bank, with prior Federal Reserve approval, to invest up to 20 percent of capital and surplus in Edge corporations.

Joint Agency Statement on PBOs

The Joint Agency Statement on Parallel-Owned Banking Organizations discusses the characteristics of PBOs, reviews potential risks associated with these banking organizations, and sets forth the supervisory approach of the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System, and the FDIC to monitor those risks. It also provides information on the applications process for proposals involving PBOs.

USA PATRIOT Act

In 2001, Congress enacted the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act, which contains several provisions designed to deter and combat the financing of terrorism and international money laundering. This law substantially increases anti-money laundering responsibilities of financial institutions, including U.S. bank subsidiaries of FBOs and U.S. branches and agencies of FBOs.

Financial Crimes Enforcement Network (FinCEN) and Office of Foreign Assets Control (OFAC)

The FinCEN issues advisories to inform banks and other financial institutions operating in the U.S. of the risks of money laundering and financing of terrorism associated with jurisdictions identified by the Financial Action Task Force, as having deficiencies in their anti-money laundering practices. A listing of FinCEN advisories can be found on FinCEN's website at www.fincen.gov.

Similarly, the OFAC administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries and regimes; terrorists; international narcotics traffickers; those engaged in activities related to the proliferation of weapons of mass destruction; and other threats to the national security, foreign policy, or economy of the U.S. Banks are expected to closely scrutinize transactions with these individuals and countries.

Refer to RMS Manual, Section 8.1, Bank Secrecy Act for additional details regarding the specific laws that would be cited for infractions/non-compliance with FinCEN or OFAC regulations.

Foreign Corrupt Practices Act

Public disclosure of improper payments made by U.S. companies to foreign officials led Congress to enact the Foreign Corrupt Practices Act of 1977 (the Act). The Act is designed to prevent the use of corporate assets for corrupt purposes and applies to all U.S. companies, including banks, bank holding companies, and Edge Corporations.

The Act applies to all state nonmember insured banks, among other U.S. corporations, but does not apply directly to foreign subsidiaries. However, Congress has made it clear that any U.S. corporation that engages in bribery of foreign officials indirectly through any other person or entity, including a foreign subsidiary, would itself be liable under the Act. Since 1998, the Act also applies to foreign firms and persons who take any act in furtherance of corrupt payments while in the U.S.

All violations of the Act are criminal in nature and should be reported following the procedures for reporting apparent criminal violations. Violations of the Act may also result in civil fines and, in the case of private actions under the Racketeer Influenced and Corrupt Organizations (RICO) Act, treble damages. For more information, refer to the Internal Routine and Controls section of this Manual.

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GLOSSARY

Acceptance – A time draft (bill of exchange or usance draft) drawn by one party and acknowledged by a second party. The drawee, known as the *acceptor*, stamps or writes the word *accepted* on the face of the draft and, above their signature, the place and date of payment. Once the draft is accepted, it carries an unconditional obligation on the part of the acceptor to pay the drawer the amount of the draft on the date specified. A *bank acceptance* is a draft drawn on and accepted by a bank. A *trade acceptance* is a draft drawn by the seller of goods on the buyer, and accepted by the buyer.

Account-dealing – Foreign-exchange dealing that involves settlement from bank to bank in the due from accounts. No third party (bank) is involved.

Account Party – The party, usually the buyer, who instructs the bank to open a letter of credit and on whose behalf the bank agrees to make payment.

Ad Valorem – A term meaning *according to value*, used for assessing customs duties that are fixed as a percentage of the value stated on an invoice.

American Depository Receipt (ADR) – ADRs are depository receipts for shares of stock in a foreign company held in safekeeping by a U.S. bank. The ADRs are purchased and sold through listed exchanges.

Advance Against Documents – An advance made on the security of the documents covering a shipment.

After Sight – When a draft bears this name, the time to maturity begins at its presentation or acceptance.

Agent Bank – The bank that leads and documents a syndicated loan.

Allocated Transfer-risk Reserve (ATRR) – A special reserve established and maintained for specified international assets pursuant to the International Lending Supervision Act of 1983 to cover country risk. At least annually, the OCC, FRB, and FDIC determine which international assets are subject to transfer risk, the amount of ATRR for the special assets, and whether an ATRR previously established for specified assets may be reduced.

Anticipation – A deposit of funds to meet the payment of an acceptance prior to the maturity date. Should be applied to reduce customer's liability on acceptances.

Amortizing Swap – A transaction in which the notional value of the agreement declines over time.

Arbitrage – Simultaneous buying and selling of foreign currencies, or securities and commodities, to realize profits from discrepancies between exchange rates prevailing at the same time in different markets, between forward margins for different maturities, or between interest rates prevailing at the same time in different markets or currencies.

Article IV – To facilitate the exchange of goods, services, and capital between countries, members of the IMF (International Monetary Fund) signed the Articles of Agreement. Article IV identifies members' obligations regarding exchange arrangements. To promote stable exchange rates, members agree to foster orderly economic growth with reasonable price stability, to promote economic and financial conditions that do not tend to create erratic disruptions, to avoid exchange rate or international monetary system manipulation, and to follow exchange rates compatible with these goals. Under Article IV, an IMF member country notifies the IMF of its exchange arrangement. The member country has three exchange rate options. First, the country can select an exchange rate in terms of special drawing rights, gold, or some other denominator. Second, the member, by cooperative arrangement, can peg the value of their currency to the currency of another member. Typically, the country will pick its major trading partner's currency. Third, the country can select another exchange arrangement of the member's choice. The member country must notify the IMF of its selected exchange arrangement. Article IV also allows the IMF to conduct surveillance of the member country's exchange rate policies and to offer suggestions for improvement under principles of guidance. Members agree to provide the information necessary to the IMF to conduct this surveillance.

Article IV Consultations – Under the Articles of Agreement, the IMF holds discussions with member countries at least once per year. The IMF typically sends a team of experts to collect various financial and economic information. The IMF staff then discusses its findings with the member country and prepares a consultation report for the IMF's Executive Board. The Article IV Consultation report is returned to the member country and certain aspects of these reports are made publicly available on the IMF's website.

At Sight – A term indicating that a negotiable instrument is payable upon presentation or demand.

Authority to Pay – An advice from a buyer, sent by their bank to the seller's bank, authorizing the seller's bank to pay the seller's (exporter's) drafts up to a fixed amount. The seller has no protection against cancellation or modification of the instrument until the issuing bank pays the drafts drawn on it, in which case the seller is no longer liable to its bank. These instruments are usually not confirmed by the seller's U.S. bank.

Authority to Purchase – Similar to an authority to pay, except that drafts under an authority to purchase are drawn directly on the buyer. The correspondent bank purchases them with or without recourse against the drawer and, as in the case of the authority to pay, they are usually not confirmed by a U.S. bank. This type of transaction is unique to Far Eastern trade.

Baker Plan – Proposed in 1985, this initiative encouraged banks, the International Monetary Fund, and the World Bank to jointly increase lending to less developed countries that were having difficulty servicing their debt, provided the countries undertook prudent measures to increase productive growth.

Balance of Payments – The relationship between money flowing into and out of a country for a given period of time. Directly affected by the country's foreign trade position, capital inflows and outflows, remittances into and out of the country, grants and aid, and tourism. A deficit balance occurs when outflows exceed inflows with the converse situation reflecting a balance of payments surplus.

Balance of Trade – The difference between a country's total imports and total exports for a given period of time. A favorable balance of trade exists when exports exceed imports. An unfavorable trade balance is reflected when imports exceed exports.

Band – The maximum range that a currency may fluctuate from its parity with another currency or group of currencies by official agreement.

Bank for International Settlements (BIS) – Established in 1930 in Basel, Switzerland, the BIS is the oldest functioning international financial organization. It provides a forum for frequent consultation among central bankers on a wide range of issues. The BIS board consists of representatives from the G-10 countries.

Basel Capital Accords – An agreement among the central banks of leading industrialized countries, including those of Western Europe, Canada, the U.S., and Japan, to impose common capital requirements on their internationally active banks.

Basel Committee on Bank Supervision (BCBS) – The Committee was established by the central bank Governors of the G-10 countries in 1975. Its members include senior representatives from banking supervisory authorities and the central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, the U.S., and other countries. The Committee usually meets at the BIS in Basel, where its permanent Secretariat is located.

The BCBS provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.

The Committee has developed international regulatory capital standards through a number of capital accords and related publications that have collectively been in effect since 1988. In June 2010, the Committee published a comprehensive reform package known as Basel III (or the Third Basel Accord), which is a global, voluntary and comprehensive set of reform measures designed to improve regulation, supervision and risk management within the banking sector. BASEL III aims to establish a global regulatory standard on bank capital adequacy, stress testing, and liquidity risk.

Beneficiary – The person or company in whose favor a letter of credit is opened or a draft is drawn. In a documentary letter of credit or acceptance, beneficiary may also be referred to as exporter or seller of goods.

Bid-ask Spread – The difference between a bid and the ask price, for example, the difference between 0.4210 and 0.4215 would be a spread of 0.0005 or 5 points.

Bid Price – A buyer's quote for the purchase of a trading unit from a prospective seller.

Bid Rate – The price at which the quoting party is prepared to purchase a currency or accept a deposit. If the bid rate is accepted by the party to whom it was quoted, then that party will sell currency or place or lend money at that price. The opposite transaction takes place at the offer rate.

Bilateral Trade – Commerce between two countries, usually in accordance with specific agreements on amounts of commodities to be traded during a specific period of time. Balances due are remitted directly between the two nations.

Bill of Exchange – An instrument by which the drawer orders another party (the drawee) to pay a certain sum to a third party (the payee) at a definite future time. The terms *bill of exchange* and *draft* are generally used interchangeably.

Bill of Lading – A receipt issued by a carrier to a shipper for merchandise delivered to the carrier for transportation from one point to another. A bill of lading serves as a receipt for the goods, a document of title, and a contract between the carrier and the shipper, covering the delivery of the merchandise to a certain point or to a designated person. It is issued in two primary forms: an *order bill of lading*, which provides for the delivery of goods to a named person or to their order (designee) but only on proper endorsement and surrender of a bill of lading to the carrier or its agents; and a *straight bill of lading*, which provides for delivery of the goods to the person designated by the bill of lading and no other.

Blocked Currency – A currency that is prohibited by law from being converted into another foreign currency.

Blocked Exchange – Exchange that cannot be freely converted into other currencies.

Brady Plan – Proposed in 1989 and named after then U.S. Treasury Secretary Nicholas Brady, the Brady Plan sought to reduce the debt-service requirements of various developing countries and to provide new loans (Brady bonds) to service existing obligations.

Break-even Exchange Rate – The particular spot exchange rate that must prevail at the maturity of a deposit or debt in a foreign currency, which has not been covered in the forward market, so that there will be no advantage to any party from interest rate differentials.

Buyer's Option Contract – When the buyer has the right to settle a forward contract at their option any time within a specified period.

Buying Rates – Rates at which foreign exchange dealers will buy a foreign currency from other dealers in the market and at which potential sellers are able to sell foreign exchange to those dealers.

Capital Controls – Governmental restrictions on the acquisition of foreign assets or foreign liabilities by domestic citizens or restrictions on the acquisitions of domestic assets or domestic liabilities by foreign citizens.

Capital Flight – A transfer of investors' funds from one country to another because of political or economic concerns about the safety of their capital.

Central Bank Intervention – Direct action by a central bank to increase or decrease the supply of its currency to stabilize prices in the spot or forward market or move them in a desired direction to achieve broader economic objectives (e.g., weaken currency to a given point in order to boost export activity). On occasion, the announcement of an intention to intervene might achieve the desired results.

Certificate of Inspection – A document often required for shipment of perishable goods in which certification is made as to the good condition of the merchandise immediately before shipment.

Certificate of Manufacture – A statement, sometimes notarized, by a producer who is usually also the seller of merchandise that manufacture has been completed and that goods are at the disposal of the buyer.

Certificate of Origin – A document issued by the exporter certifying the place of origin of the merchandise to be exported. The information contained in this document is needed primarily to comply with tariff laws that may extend more favorable treatment for products from certain countries.

Chain – A method of calculating cross rates. For example, if a foreign-exchange trader knows the exchange rate for euros against U.S. dollars and for Mexican pesos against U.S. dollars, the *chain* makes possible the calculation of the cross rates for euros against Mexican pesos.

Charter Party – A contract, expressed in writing on a special form, between the owner of a vessel and the one (the charterer) desiring to employ the vessel setting forth the terms of the arrangement such as freight rate and ports involved in the trip.

Clean Bill of Lading – A bill of lading in which the described merchandise has been received in *apparent good order and condition* and without qualification.

Clean Collection – A collection in which a draft or other demand for payment is presented without additional attached documentation.

Clean Draft – A sight or time draft to which no other documents such as shipping documents, bills of lading, or insurance certificates are attached. This is to be distinguished from a documentary draft.

Clean Risk at Liquidation – A type of credit risk that occurs when exchange contracts mature. There may be a brief interval (usually no more than a few hours) during which one of the parties to the contract has fulfilled its obligations, but the other party has not. During this period, the first party is subject to a 100 percent credit risk, on the chance that, in the interval, an event may prevent the second party from fulfilling its obligations under the contract.

Clearinghouse – A subdivision of an exchange or an independent corporation through which all trades must be confirmed, matched, and settled daily until offset.

Clearinghouse Funds – Funds used in settlement of a transaction that are available for use or that become good funds after one business day.

Closing a Commitment – Allowing a covered foreign-exchange position to expire on maturity or reversing it before maturity by a swap operation.

Combined Transport Document – A through bill of lading that applies to more than one mode of transport.

Commodity Credit Corporation – An agency of the U.S. Department of Agriculture that promotes the export of U.S. surplus agricultural commodities. It provides the necessary financial services to carry forward the public price-support activities, including government lending, purchasing, selling, storing, transporting, and subsidizing certain agricultural commodities.

Consortium Banks – A group of banks forming a joint alliance to enter a new market, in order to reduce the capital requirements and risks involved in new ventures. While they were popular in the 1970s, they have since fallen into disfavor.

Consular Documents – Bills of lading, certificates of origin, or special forms of invoice that carry the official signature of the consul of the country of destination.

Consular Invoice – Detailed statement regarding the character of goods shipped which is duly certified by the consul at the port of shipment. Required by certain countries, including the U.S., its principal function is to record accurately the types of goods and their quantity, grade and value for import duty, balance of payments, and other statistical purposes.

Convertibility – Freedom to exchange a currency, under certain circumstances, without government restrictions or controls.

Core Principles for Effective Bank Supervision (also known as the Core Principles Methodology) – A summary of 25 principles for prudential regulation and supervision prepared by the Basel Committee on Banking Supervision. This document benchmarks the best practices for effective bank supervision. Countries are expected to use the Core Principles Methodology to assess their current bank supervisory environments to identify weaknesses that need to be addressed. The IMF utilizes the Core Principles Methodology when assessing bank regulation and supervision during its Article IV surveillance.

Cost, Insurance, and Freight. (**C.I.F.)** – A price quotation under which the seller defrays all expenses involved in the delivery of goods.

Counterpart Funds – Local currencies deposited in a special account by recipient governments that represent grant aid extended by another government. Those funds, while remaining the property of the recipient government, can generally be used only by agreement of the donor government.

Countertrade – A system of trade, like bartering, when goods or services are accepted in lieu of payment in currency for the purchase of goods or services. Such trade schemes are attractive in developing countries to promote reciprocal trade in a nation's local products as a precondition for consummating an international transaction. Countertrade was popular in East-West dealings during the Cold War and in defense and aerospace contracts. Countertrade may also be useful where foreign exchange is limited or unavailable. The quality and marketability of the goods traded can be a real concern. Other risks involved in countertrade include government intervention, cancellation of contract, and seller insolvency.

Country Exposure – A measurement of the volume of assets and off-balance sheet items considered to be subject to the risk of a given country. This measurement is based, in part, on identifying the country of domicile of the entity ultimately responsible for the credit risk of a particular transaction.

Country Risk – Refers to the spectrum of risks arising from the economic, social, and political environment of a given foreign country, which could have favorable or adverse consequences for foreigners' debt and/or equity investments in that country.

Cover – The execution of an offsetting foreign exchange trade to close or eliminate an open exposure.

Covered Interest Arbitrage – The process of taking advantage of a disparity between the net accessible interest differential between two currencies and the forward exchange premium or discount on the two currencies against each other.

Crawling Peg System – An exchange rate system in which the exchange rate is adjusted every few weeks, usually to reflect prevailing inflation rates.

Credit Risk – The possibility that the buyer or seller of a foreign exchange or some other traded instrument may be unable to meet their obligation at maturity.

Cross-border Exposure – The risk that arises when an office of a bank, regardless of its location or currency, extends credit to a borrower that is located outside the booking unit's national border.

Cross-currency Risk – The risk associated with maintaining exchange positions in two foreign currencies as the result of one transaction. For example, if a U.S. operator borrows Swiss francs at 5 percent and invests the proceeds in British pounds at 12 percent, the cross-currency risk is the chance that the pounds will depreciate in values against the Swiss francs to such an extent that there will be a loss on the transactions in spite of the favorable interest-rate differential.

Cross Rate – The ratio between the exchange rate of two foreign currencies in terms of a third currency.

Current Account – Those items in the balance of payments involving imports and exports of goods and services as well as unilateral transfers. Includes trade, travel, military spending and other short-term financial flows. Short- and long-term capital flows are excluded, as they are included in the capital account balance. A surplus or deficit in the current account is commonly referred to as a trade deficit or surplus.

Customs Union – An agreement between two or more countries in which they arrange to abolish tariffs and other import restrictions on each other's goods and to establish a common tariff for the imports of all other countries.

Date Draft – A draft drawn to mature on a fixed date, irrespective of acceptance.

Demand Draft – Draft payable immediately upon presentation to the drawee. Also called a *sight* or *presentation* draft.

Depth of the Market – The amount of currency that can be traded in the market at a given time without causing a price fluctuation. Thin markets are usually characterized by wide spreads and substantial price fluctuations during a short period of time. Strong markets tend to be characterized by relatively narrow spreads of stable prices.

Devaluation – An official act wherein the official parity of a country's currency is adjusted downward to the dollar, gold, special drawing rights, or a currency. After devaluation, there are more devalued currency units relative to the dollar, gold, special drawing rights, or other currency.

Direct Quote – The method of quoting fixed units of foreign exchange in variable numbers of the local currency unit. Also called a *fixed* or *certain* quotation.

Dirty Float – A floating exchange-rate system in which some government intervention still takes place. A government may announce that it will let its currency float, that is, it will let the currency's value be determined by the forces of supply and demand in the market. But, the government may secretly allow its central bank to intervene in the exchange market to avoid too much appreciation or depreciation of the currency.

Discount – In foreign exchange, the amount by which the forward exchange rate of one currency against another currency is less than the spot exchange rate between the two currencies. If a dealer quotes $2.40 and $2.45 (bid and asked) for sterling and the discounts for six months forward are .0300 and .0275, the forward quotes would be adjusted to $2.3700 and $2.4225. This discount usually represents differences between interest rates in the U.S. and Britain. In periods of crisis, the discount for a currency can represent market anticipation of a lower price.

Documentary Credit – A commercial letter of credit providing for payment by a bank to the named beneficiary, who is usually the seller of the merchandise, against delivery of documents specified in the credit.

Documentary Draft – A draft with documents attached delivered to the drawee when it accepts or pays the draft, and which ordinarily controls title to the merchandise.

Documents – Shipping and other papers attached to foreign drafts, consisting of ocean bills of lading, marine insurance certificates, and commercial invoices. Certificates of origin and consular invoices may also be required.

Documents Against Acceptance (D/A) – Instructions given by an exporter to a bank that the documents attached to a draft for collection are deliverable to the drawee only against their acceptance of the draft.

Documents Against Payment (D/P) – Instructions given by an exporter to their bank that the documents attached to a draft for collection are deliverable to the drawee only against their payment of the draft.

Dollar Exchange Acceptance – Time draft drawn by central banks in specific foreign countries and accepted by banks in the U.S. for the purpose of furnishing foreign exchange. These instruments do not arise from specific commercial transactions, rather they are designed to alleviate shortages of dollar exchange for certain countries specified in a list published by the Federal Reserve System. It is anticipated that the acceptance will be liquidated subsequently from dollar funds acquired by the central bank. Limits are placed on initial maturity of drafts (three months). Member banks may not accept drafts in an amount exceeding 50 percent of paid-in and unimpaired capital and surplus.

Domicile – Place where a draft or acceptance is made payable.

Draft – A draft is an order in writing signed by one party (the drawer) requesting a second party (the drawee) to make payment in lawful money at a determinable future time to a third party (the payee). Drafts occasionally may be written to be non-negotiable, in that they will not meet all the requirements of the Uniform Negotiable Instruments Act. Drafts generally arise from a commercial transaction, whereby the seller makes an agreement with a buyer in advance for the transfer of goods. It may be accompanied by a bill of lading, which the bank will surrender to the buyer upon payment of the draft. The buyer may then claim the goods at the office of the carrier who transported them to the buyer's place of business. Drafts may be classified as to time element, such as sight or presentation drafts. A time draft is presented at sight, accepted, and then paid on the agreed upon date which may be 30, 60, 90 days or longer after presentation and acceptance.

Drawee – The addressee of a draft, that is, the person on whom the draft is drawn.

Drawer – The issuer or signer of a draft.

Eligible Acceptance – A bankers acceptance that meets Federal Reserve requirements related to its financing purpose and term.

Embargo – A partial or total prohibition on trade initiated by the government of one country against another for political or economic reasons.

Eurobank – A bank that regularly accepts foreign currency denominated deposits and makes foreign currency loans.

Eurobond – A medium or long-term debenture underwritten by an international syndicate that is denominated in a currency other than that of the country of origin. Usually, a bond issued by a non-European entity (Sovereign, large multinational company, or bank) for sale in Europe. Instrument may also be called a global bond.

Eurocurrency – Currency deposited in banks outside the home country.

Eurodollars – Dollar deposit claims on U.S. banks that are deposited in banks located outside the U.S., including foreign branches of U.S. banks. These claims, in turn, may be redeposited with banks or lent to companies, individuals, or governments outside the U.S.

Eurodollar Bond – A Eurobond denominated in U.S. dollars.

European Central Bank (ECB) – The ECB is the central bank for the Euro. Collectively, the ECB and member national central banks (NCBs) constitute the Eurosystem. The main function of the Eurosystem is to maintain price stability while supporting the general economic practices of the EU members. Together the ECB and NCBs conduct monetary policy, foreign exchange operations, and maintain the EU payment systems for the Eurozone. The ECB is headed by the Governing Council (composed of the Executive Board and the governors of each of the NCBs).

Exchange Contracts – Documents issued by foreign exchange dealers, by banks dealing in foreign exchange, and by foreign exchange brokers confirming foreign exchange transactions.

Exchange Control or Restrictions – Limits on free dealings in foreign exchange or of free transfers of funds into other currencies and other countries.

Exchange Control Risk – The possibility of defaults on obligations by the imposition of exchange control or restrictions.

Exchange Rates – The price of a currency in terms of another.

Exchange Reserves – The total amount of foreign assets (generally currencies) held by a country's central bank.

Exchange Risk – The risk of market fluctuation of an asset or liability denominated in a foreign currency, such as the ownership of a currency (spot or forward) or trade accounts payable in foreign currency.

Export Credit Insurance – A system to insure the collection of credits extended by exporters against various contingencies. In some countries, only non-commercial risks can be insured.

Export-Import Bank of the U.S. (Ex-Im Bank) – Established in 1934 as an independent federal agency, the Ex-Im Bank provides intermediate and long-term nonrecourse financing for U.S. exports when such facilities are not available from commercial banks. Ex-Im Bank guarantees working capital and other loans for U.S. exporters. Ex-Im Bank also offers other programs such as export credit insurance.

Export Management Company – A domestic firm that provides marketing, distributing, and other international business services for exporters in overseas markets through established networks or contacts in the targeted country.

Export Trading Company (ETC) – A company organized under the Export Trading Company Act of 1982 that facilitates U.S. exports. An ETC may be an affiliate of a bank holding company. ETCs offer a wide range of export-related services such as consulting, international market research, advertising, marketing, insurance, transportation, freight forwarding, and warehousing. This is not an actively used vehicle. Subpart C of Regulation K provides guidance and restrictions for these companies.

External Debt – Total debt owed to creditors outside the country, including both private and public sector debt. In some emerging market countries, this debt may be issued under foreign law (American or English) and payable in foreign currencies.

Financial Stability Board – Established by the G-20 countries to coordinate the development of financial regulatory policies between international standard setters, multilateral organizations, and members' national authorities for financial regulation.

Fixed Exchange Rate System – A system in which the exchange rate of a country's currency is tied to one major currency, such as the U.S. dollar.

Fixed Rate of Exchange – A rate of exchange set by a foreign government relative to the dollar, gold, another currency, or perhaps special drawing rights. It remains in effect as long as that government is willing and/or able to buy or sell exchange at the set rates.

Flexible Rate of Exchange – A rate of exchange subject to relatively frequent changes. It is determined by market forces but subject to various floors or ceilings relative to the dollar, gold, special drawing rights, or another currency when the rate fluctuates beyond certain parameters.

Floating Exchange Rate System – A system in which the values of the currencies of various countries relative to each other are established by supply and demand forces in the market without government intervention.

Floating Rate – A rate of exchange that is determined completely by market forces with no floor or ceiling in relation to the dollar, gold, special drawing rights or any other currency.

Force Majeure – A standard insurance clause in a marine contract that relieves the parties from nonfulfillment of their obligations due to circumstances beyond their control such as earthquakes, floods, or war.

Foreign Bonds – Bonds issued by nonresidents but underwritten primarily by banks registered in the country where the issue is made.

Foreign Deposits – Those deposits that are payable at a financial institution outside the jurisdiction of the U.S. government and in the currency of the country in which the depository is located. See also Nostro Account.

Foreign Draft – An official bank order drawn on a foreign correspondent bank to pay on demand to a designated payee a specific sum of foreign money or U.S. dollars at the drawee's buying rate.

Foreign Exchange – The trading or exchange of a foreign currency in relation to another currency.

Foreign Exchange Rationing – A government requirement that all holders of bills of exchange relinquish them at a stipulated rate.

Foreign Exchange Reserves – The reserves maintained by a central bank that should only include foreign currency deposits and bonds; however, in popular usage may include gold, special drawing rights, and IMF Reserve positions. This larger figure is referred to as International Reserves.

Foreign Exchange Risk – The risk associated with exposure to fluctuation in spot exchange rates.

Foreign Investment Advisory Service (FIAS) – Established in 1986, FIAS counsels developing countries on attracting foreign capital. FIAS operates under the aegis of the World Bank and its affiliates the International Finance Corporation and the Multilateral Investment Guarantee Agency.

Foreign Trade Zone – An area where goods may be received and stored without entering a country's customs jurisdiction and without paying duty. Sometimes called a *free trade zone*.

Forward Book – The aggregate of all forward contracts for a given currency or all currencies.

Forward Exchange – Foreign currency traded for settlement beyond two working or business days from today.

Forward Exchange Position – The long or short position that a dealer may have in the forward market, as compared to spot dealing.

Forward Exchange Risk – The possibility of a loss on a covered position as a result of a change in the swap margin.

Forward-Forward Dealing – The simultaneous purchase and sale of a currency for different forward dates.

Forward Premium – A phrase used to describe a currency with a forward price that is more expensive than its spot price. Also referred to as *at a forward premium*.

Forward Purchase – An outright purchase of a forward contract.

Forward Rates – The rates at which foreign exchange for future delivery are quoted, bought, and sold.

Free Alongside Ship (F.A.S.) – A term for a price quotation under which the seller delivers merchandise free of charge to the steamer's side and pays shipping-related expenses up to that destination, if necessary.

Free On Board (F.O.B.) (destination) – A term for a price quotation under which the seller undertakes at their own risk and expense to load the goods on a carrier at a specified location. Expenses subsequent thereto are for account of the buyer.

Free On Board (F.O.B.) (vessel) – A term for a price quotation under which the seller delivers the goods at their own expense on board the steamer at the location named. Subsequent risks and expenses are for account of the buyer.

Free Port – A foreign trade zone open to all traders on equal terms where merchandise may be stored duty-free pending its re-export or sale within that country.

Free Trade Area – An arrangement between two or more countries for free trade among themselves, although each nation maintains its own independent tariffs toward nonmember nations. It should not be confused with free trade zone, which is synonymous with *foreign trade zone*.

Future (or Forward) Exchange Contract – A contract usually between a bank and its customer for the purchase or sale of foreign exchange at a fixed rate with delivery at a specified future time. A future contract is due later than a spot contract, which is settled in one to ten days depending on the bank or market. Future exchange contracts are generally used by the customer to avoid the risk of fluctuations in rates of foreign exchange.

G-7 (Group of Seven) – A group of industrialized countries comprising Canada, France, Germany, Great Britain, Italy, Japan, and the U.S.

G-10 Countries – The informal term for the Group of ten countries, which consists of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the U.S. Switzerland joined in 1984, but the name remains as is. Luxembourg is an associate member.

Global Bond – A temporary debt certificate issued by a Eurobond borrower, representing the borrower's total indebtedness. The global bond will subsequently be replaced by individual bearer bonds.

Global Line – A bank-established aggregate limit that sets the maximum exposure the bank is willing to have to any one customer on a worldwide basis.

Guidance Line – An authorization, unknown to the customer, or a line of credit. If communicated to the customer, the guidance line becomes an advised line of credit commitment.

Hawalas – Informal exchangers and money transmitters commonly used in Arab and other Islamic countries and in India. The system relies on dealings with a trusted party who has financial connections with another individual in another country. Because of the discreteness and informality of the dealings between the parties, hawalas represent a high risk for money laundering. Furthermore, terrorists have used these networks to transfer funds around the world.

Heavily Indebted Poor Countries (HIPCs) – A designation by the IMF to identify nations targeted that need to reduce external debt to more sustainable levels. To determine sustainability, the net value of a country's debt burden is divided into its export earnings. An HIPC is identified as a nation that has a debt to export ratio one and one-half times the amount considered by the IMF to be sustainable. Under this debt reduction initiative for these poor developing countries, the IMF, the World Bank and other multilateral organizations will get together with all of the creditors of these HIPCs. The creditor group then develops a plan to reduce the HIPC's debt to a more sustainable level. To qualify for HIPC assistance, the country must have adopted a Poverty Reduction Strategy Paper and made progress in initiating this strategy for one year. Then the HIPC must adopt adjustment and reform programs supported by the IMF and the World Bank. The IMF and World Bank will conduct periodic debt sustainability analysis to determine ongoing qualification for assistance. As of March 2015, the IMF identified 39 countries as HIPCs.

Interagency Country Exposure Review Committee (ICERC) – A nine-member joint committee of three federal regulatory agencies established to administer the country risk supervision program. ICERC determines the creditworthiness of individual countries and the proper Allocated Transfer Risk Reserve to be used by U.S. banks in mitigating cross-border exposure within a specific country.

International Banking Act of 1978 (IBA) – The principal legislation pertaining to the activities of foreign banks in the U.S. It established a regulatory framework for foreign banks operating in the U.S.

International Banking Facility – A set of asset and liability accounts segregated on the books and records of a depository institution, U.S. branch or agency or a foreign bank, or an Edge Act or agreement corporation. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. IBFs may receive certain tax advantages from individual states.

International Monetary Fund (IMF) – A specialized agency of the United Nations. It encourages monetary cooperation, establishes international standards for a currency exchange policy, promotes stable foreign exchange rates among member nations, and makes short-term advances and standby credits to members experiencing temporary payments difficulties. In some cases, the IMF advances money subject to conditions that must be met by the borrowing country. Its resources come mainly from subscriptions of members.

International Money Market of the Chicago Mercantile Exchange (IMM) – The IMM is one of the world's largest markets for foreign currency and Eurodollar futures trading.

Intervention – The actions of a central bank designed to influence the foreign exchange rate of its currency. The bank can use its exchange reserves to buy its currency if it is under too much downward pressure or to sell its currency if it is under too much upward pressure.

Intra-country Foreign Currency Position – The risk that exists whenever a subsidiary or a branch lends, invests, places, or extends credit to entities that are located within the same country as the booking unit, but in a currency different from that of the country where the borrower and booking unit are located.

Intra-day Position – The size of spot or forward positions allowed for a dealer during the business day, which may be larger than that allowed for the end of the day. Also called *daylight* limits.

Latin American Integration Association (**LAIA)** – The purpose of the LAIA is to reduce tariff barriers between member countries. The member countries are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela. LAIA is also known under ALADI (its Spanish Acronym).

Letters of Credit-Advised – An export letter of credit issued by a bank that requests another bank to advise the beneficiary that the credit has been opened in its favor. This occurs when the issuing bank does not have an office in the country of the beneficiary and uses the facilities of the advising bank. The advising bank is potentially liable only for its own error in making the notification.

Letters of Credit (Back-to-Back) – A letter of credit issued on the strength (or *backing*) of another letter of credit, involving a related transaction and nearly identical terms. For example, ABC company in the U.S. is designated as the beneficiary of an irrevocable letter of credit confirmed by a U.S. bank to supply XYZ company in Bolivia, whose bank issued the letter of credit, with goods to be purchased from a third company. The third company, however, will not fill ABC's order unless it receives prepayment for the goods either through cash or through some other type of financing. If ABC is unable to prepay in cash, it will request its bank to issue a letter of credit in favor of the third company. If ABC's bank agrees, the domestic credit is then *backed* by the foreign letter of credit and a back-to-back letter of credit transaction exists.

Letter of Credit (Cash) – A letter addressed from one bank to one or more correspondent banks making available to the party named in the letter a fixed sum of money up to a future specific date. The sum indicated in the letter is equal to an amount deposited in the issuing bank by the party before the letter is issued.

Letter of Credit (Commercial) – A letter of credit addressed by a bank, on behalf of a buyer of merchandise, to a seller authorizing the seller to draw drafts up to a stipulated amount under specified terms and undertaking conditionally or unconditionally to provide payment for drafts drawn.

Letter of Credit (Confirmed) – A letter of credit issued by the local bank of the importer and to which a bank, usually in the country of the exporter, has added its commitment to honor drafts and documents presented in accordance with the terms of the credit. Thus, the beneficiary has the unconditional assurance that, if the issuing bank refuses to honor the draft against the credit, the confirming bank will pay (or accept) it. In many instances, the seller (exporter) may ask that the letter of credit be confirmed by another bank when the seller is not familiar with the foreign issuing bank or as a precaution against unfavorable exchange regulations, foreign currency shortages, political upheavals, or other situations.

Letter of Credit (Deferred Payment) – A letter of credit under which the seller's draft specifies that the draft is payable at a later date, for example, 90 days after the bill-of-lading date or 90 days after presentation of the documents.

Letter of Credit (Export) – A letter of credit opened by a bank, arising from the financing of exports from a country. The issuing bank may request another bank to confirm or advise the credit to the beneficiary. If confirmed, the credit becomes a confirmed letter of credit, and, if advised, it becomes an advised (unconfirmed) letter of credit.

Letter of Credit (Green Clause) – Similar to the red clause letter of credit below, except that advance payment is made, generally upon presentation of warehouse receipts evidencing storage of the goods.

Letter of Credit (Guarantee) – A letter of credit guaranteed by the customer (applicant) and often backed by collateral security. In domestic banks, the payment of drafts drawn under this credit is frequently labeled in the general ledger asset account *Customer Liability – Drafts Paid under Guaranteed L/C.*

Letter of Credit (Import) – A letter of credit issued by a bank on behalf of a customer who is importing merchandise into a country. Issuance of an import letter of credit carries a definite commitment by the bank to honor the beneficiary's drawings under the credit.

Letter of Credit (Irrevocable) – A letter of credit that cannot be modified or revoked without the customer's consent or that cannot be modified or revoked without the beneficiary's consent.

Letter of Credit (**Negotiation)** – A letter of credit requiring negotiation (usually in the locality of the beneficiary) on or before the expiration date. The engagement clause to honor drafts is in favor of the drawers, endorsers, or bona fide holders.

Letter of Credit (Nontransferable) – A letter of credit that the beneficiary is not allowed to transfer, in whole or part, to any party.

Letter of Credit (Red Clause) – A clause permitting the beneficiary to obtain payment in advance of shipment so that the seller may procure the goods to be shipped.

Letter of Credit (Reimbursement) – A letter of credit issued by one bank and payable at a second bank that, in turn, draws on a third bank for reimbursement of the second bank's payment to the beneficiary. Those credits are generally expressed in a currency other than that of the buyer (issuing bank) or the seller, and, because of wide acceptability, many are settled in the U.S. through yet another bank as the reimbursing agent. Upon issuance, the correspondent sends the reimbursing bank an authorization to honor drawings presented by the negotiating bank.

Letter of Credit (Revocable) – A letter of credit that can be modified or revoked by the issuing bank up until the time payment is made.

Letter of Credit (**Revolving)** – A letter of credit issued for a specific amount that renews itself for the same amount over a given period. Usually, the unused renewable portion of the credit is cumulative as long as drafts are drawn before the expiration of the credit.

Letter of Credit (Standby) – A letter of credit or similar arrangement that represents an obligation to the beneficiary on the part of the issuer to repay money borrowed by or advanced to or for the account party, make payment on account of any indebtedness undertaken by the account party, or make payment on account of any default by the account party in the performance of an obligation.

Letter of Credit (Straight) – A credit requiring presentation on or before the expiration date at the office of the paying bank. The engagement clause to honor drafts is in favor of the beneficiary only.

Letter of Credit (Telegraphic Transfer Clause) – A clause in which the issuing bank agrees to pay the invoice amount to the order of the negotiating bank upon receipt of an authenticated cablegram from the latter confirming that the required documents have been received and are being forwarded.

Letter of Credit (Transferable) – A credit under which the beneficiary has the right to give instructions to the bank called upon to effect payment or acceptance to make the credit available in whole or in part to one or more third parties (second beneficiaries). The credit may be transferred only upon the express authority of the issuing bank and provided that it is expressly designated as transferable. It may be transferred in whole or in part, but may only be transferred once.

Letter of Credit (Traveler's) – A letter of credit addressed to the issuing bank's correspondents, authorizing them to negotiate drafts drawn by the beneficiary named in the credit upon proper identification. The customer is furnished with a list of the bank's correspondents. Payments are endorsed on the reverse side of the letter of credit by the correspondent banks when they negotiate the drafts. This type of letter of credit is usually prepaid by the customer.

Letter of Credit (Usance) – A letter of credit that calls for the payment against time drafts, or drafts calling for payment at some specified date in the future. Usance letters of credit allow buyers a grace period of a specified number of days, usually not longer than six months.

Local Currency Exposure – The amount of assets and off-balance sheet items that are denominated in the local currency of that country.

Lock-up – The term used to refer to procedures followed in a Eurobond issue to prevent the sale of securities to U.S. investors during the period of initial distribution.

London Interbank Offered Rate (LIBOR) – Key rate in international bank lending. LIBOR is an average of the interest rates that major international banks charge each other to borrow U.S. dollars in the London money market. Like the U.S. Treasury the CD indexes, LIBOR tends to move and adjust quite rapidly to changes in interest rates.

London International Financial Futures Exchange (LIFFE) – A London exchange where foreign currency and Eurodollar futures, as well as foreign currency options, are traded.

Long Position – An excess of assets (and/or forward purchase contracts) over liabilities (and/or forward sales contracts) in the same currency. A dealer's position when net purchases and sales result in a net-purchased position.

Loro Accounts – An account that a bank in one country maintains for a bank in another country. It usually holds foreign currency on behalf of the owner-bank's customers.

Maquiladoras – A program where imports are shipped duty and license free to Mexican firms for assembly and then exported back to the U.S.

Marine Insurance – Insurance for losses arising from specified marine casualties. Marine insurance is more extensive than other types, because it may provide for losses arising from fire, piracy, wreckage, and injuries sustained at sea.

Matched – A forward purchase is matched when it is offset by a forward sale for the same date, or vice versa. As a practical necessity, when setting limits for unmatched positions, a bank may consider a contract matched if the covering contract falls within the same week or semi-monthly period.

Maturity Date – The settlement date or delivery date for a forward contract.

Mercosur – The Mercosur was created by Argentina, Brazil, Paraguay and Uruguay in March 1991 with the signing of the Treaty of Asuncion. It originally was set up with the ambitious goal of creating a common market/customs union between the participating countries based on various forms of economic cooperation that had been taking place between Argentina and Brazil since 1986. The Treaty of Ouro Preto of 1994 added much to the institutional structure of Mercosur and initiated a new phase in the relationship between the countries, when they decided to start to implement/realize a common market. A transition phase was set to begin in 1995 and to last until 2006 with a view to constituting the common market. In 1996, association agreements were signed with Chile and Bolivia establishing free trade areas with these countries based on a *4 plus 1* formula. During this period, Mercosur also created a common mechanism for political consultations, which was formalized in 1998, in which the four countries plus Bolivia and Chile all participate as full members of the so-called *Political Mercosur*.

Multi-currency Line – A line of credit giving the borrower the option of using any readily available major currency.

Multilateral Exchange Contract – An exchange contract involving two foreign currencies against each other, for example, a contract for U.S. dollars against British pounds made in London. Also called an arbitrage exchange contract.

Nationalization – A process where a nation's central government assumes ownership and operation of private enterprises within its territory.

Net Accessible Interest Differential – The difference between the interest rates that can actually be obtained on two currencies. This difference is usually the basis of the swap rate between the two currencies and, in most cases, is derived from external interest rates rather than domestic ones. These external rates or Euro-rates are free from reserve requirements, which would increase the interest rate, and from exchange controls, which would limit access to the money.

Net Exchange Position – An imbalance between all the assets and purchases of a currency, and all the liabilities and sales of that currency.

Net Position – A bank has a position in a foreign currency when its assets, including future contracts to sell, in that currency are not equal. An excess of assets over liabilities is called a net *long* position and liabilities in excess of assets result in a net *short* position. A long net position in a currency that is depreciating results in a loss because, with each day, that position (asset) is convertible into fewer units of local currency. A short position in a currency that is appreciating represents a loss because, with each day, satisfaction of that position (liability) costs more units of local currency.

Netting Arrangement – Arrangement by two counterparties to examine all contracts settling in the same currency on the same day and to agree to exchange only the net currency amounts. Also applies to the net market values of several contracts.

Non-tariff Trade Barriers – Barriers other than tariffs that tend to restrict trade. For example, setting higher inspection standards for imports than for domestically produced items, giving preference to domestic companies in bidding on contracts, import substitution programs, import licensing requirements, additional product labeling requirements, export subsidizing, inadequate protection of intellectual property rights, or limitations on services.

North American Free Trade Agreement (NAFTA) – A free trade area consisting of Canada, Mexico, and the U.S. The goal is to reduce trade barriers between the member countries thereby creating jobs and economic prosperity for the citizens of all three countries.

Nostro Accounts – Demand accounts of banks with their correspondents in foreign countries in the currency of that country. These accounts are used to make and receive payments in foreign currencies for a bank's customers and to settle maturing foreign exchange contracts. Also called *due from foreign bank - demand accounts*, *our balances with them*, or *due from balances*.

Ocean Bill of Lading – A document signed by the captain, agents, or owners of a vessel furnishing written evidence for the conveyance and delivery of merchandise sent by sea. It is both a receipt for merchandise and a contract to deliver it as freight.

Odd Dates – Deals within the market are usually for spot, one month, two months, three months or six months forward. Other dates are odd dates, and prices for them are frequently adjusted with more than a mathematical difference. Hence, most market deals are for regular dates, although commercial deals for odd dates are common.

Offer Rate – The price at which a quoting party is prepared to sell or lend currency. This is the same price at which the party to whom the rate is quoted will buy or borrow if it desires to do business with the quoting party. The opposite transactions take place at the bid rate.

Official Rate – The rate established by a country at which it permits conversion of its currency into that of other countries.

Offshore Branch – Banking organization designed to take advantage of favorable regulatory or tax environments in another country. Many of these operations are shell branches with no physical presence.

Offshore Dollars – Same as Eurodollars, but encompassing the deposits held in banks and branches anywhere outside of the U.S., including Europe.

Open Contracts – The difference between long positions and short positions in a foreign currency or between the total of long and short positions in all foreign currencies. Open spot or open forward positions that have not been covered with offsetting transactions.

Open Market Operations – Purchases or sales of securities or other assets by a central bank on the open market.

Open Position Limit – A limit placed on the size of the open position in each currency to manage off-balance sheet items.

Order Bill of Lading – A bill of lading, usually drawn to the order of the shipper that can be negotiated like any other negotiable instrument.

Order Notify Bill of Lading – A bill of lading usually drawn to the order of the shipper or a bank with the additional clause that the consignee is to be notified upon arrival of the merchandise. The mention of the consignee's name does not confer title to the merchandise.

Organization for Economic Cooperation and Development (OECD) – An organization of 34 countries that fosters democracy and free market development throughout the world. The OECD also researches issues having international implications. The OECD publishes its research findings and international statistics on various countries at its website at http://www.oecd.org. The OECD also benchmarks best practices on economic, social, and governance issues. The OECD supports other international groups such as the FATF that have similar goals.

Outright – Forward exchange bought and sold independently from a simultaneous sale or purchase spot exchange.

Outright Forward Rate – A forward exchange rate that is expressed in terms of the actual price of one currency against another, rather than, as is customary, by the swap rate. The outright forward rate can be calculated by adding the swap premium to the spot rate or by subtracting the swap discount from the spot rate.

Override Limit – The total amount of money measured in terms of a bank's domestic currency that the bank is willing to commit to all foreign exchange net positions.

Parallel Banking Organizations – A PBO exists when a U.S. depository institution and a foreign bank are controlled, either directly or indirectly, by an individual, family, or group of persons with close business dealings, or that are otherwise acting in concert.

Parity – A term derived from par, meaning the equivalent price for a certain currency or security relative to another currency or security, or relative to another market for the currency or security after making adjustments for exchange rates, loss of interest, and other factors.

Parity Grid – The system of fixed bilateral par values in the European Monetary System. The central banks of the countries whose currencies are involved in an exchange rate are supposed to intervene in the foreign exchange market to maintain market rates within a set range defined by an upper and lower band around the par value.

Par Value – The official parity value of a currency relative to the dollar, gold, special drawing rights, or another currency.

Payable Through Accounts – Accounts used directly by customers of a correspondent bank to transact business on their own behalf.

Placement Memorandum – A document in a syndicated Eurocredit that sets out details of the proposed loan and gives information about the borrower.

Political Risk – Political changes or trends often accompanied by shifts in economic policy that may affect the availability of foreign exchange to finance private and public external obligations. The banker must understand the subtleties of current exchange procedures and restrictions as well as the possibilities of war, revolution, or expropriation in each country with which the bank transacts business, regardless of the actual currencies involved.

Position – A situation created through foreign exchange contracts or money market contracts in which changes in exchange rates or interest rates could create profits or losses for the operator.

Position Book – A detailed, ongoing record of an institution's dealings in a particular foreign currency or money market instrument. Also known as position sheet.

Position Limits – The maximum net debit or credit foreign currency balance either during the day (daylight limits) or at close of business (overnight limits) as stipulated by bank management.

Premium – The adjustment to a spot price that is made in arriving at a quote for future delivery. If a dealer were to quote $2.00 and $2.05 (bid and asked) for sterling and the premiums for six months forward are .0275 and .0300, the forward quotes would be adjusted to $2.0275 and $2.0800. The premium usually represents differences in interest rates for comparable instruments in two countries. In periods of crisis for a currency, the premium may represent the market anticipation of a higher price.

Price Quotation System – A method of giving exchange rates in which a certain specified amount of a foreign currency (1 or 100, usually) is stated as the corresponding amount in local currency.

Privatization – The selling of a government owned business (power, gas, communications) to the public. Governments privatize businesses to raise money for fiscal operations or to improve the efficiency of a firm.

Quota – A government-imposed restriction on the quantity of a specific imported good.

Rate Risk – In the exchange market, the chance that the spot rate may rise when the trader has a net oversold position (a short position), or that the spot rate may go down when the operator has a net overbought position (a long position).

Reciprocal Rate – The price of one currency in terms of a second currency, when the price of the second currency is given in terms of the first.

Representative Office – A facility established in the U.S. or foreign markets by a foreign bank to sell its services and assist clients. In the U.S., these offices cannot accept deposits or make loans.

Reserve Account – Those items in the balance of payments that measure changes in the central bank's holdings of foreign assets (such as gold, convertible securities, or special drawing rights).

Reserve Currency – A foreign currency held by a central bank (or exchange authority) for the purposes of exchange intervention or the settlement of intergovernmental claims.

Revaluation – An official act wherein the official parity of a currency is adjusted relative to the dollar, gold, special drawing rights, or another currency, resulting in less revalued units relative to those currencies. Also, the periodic computations of the current values (reevaluations) of ledger accounts and unmatured, future purchase and sales contracts.

Rollover – The process of extending a maturing forward foreign exchange contract.

Sanctions – A coercive governmental action that restricts trade with a specific country (e.g., embargo) for a political purpose rather than for an economic need.

Seller's Option Contract – When the seller has the right to settle a forward contract at their option anytime within a specified period.

Shell Branch – See *Offshore Branch*.

Short Position – An excess of liabilities (and/or forward sale contracts) over assets (and/or forward purchase contracts) in the same currency. A dealer's position when the net of purchases and sales leaves the trader in a net-sold or oversold position.

Sight Draft – A draft payable upon presentation to the drawee or within a brief period thereafter known as *days of grace*.

Society for Worldwide Interbank Financial Telecommunications (SWIFT) – A telecommunications network established by major financial institutions to facilitate messages among SWIFT participants. These messages typically result in a monetary transaction between institutions. The network is based in Brussels.

Soft Currency – A currency that is not freely convertible into other currencies.

Soft Loans – Loans with exceptionally lenient repayment terms, such as low interest, extended amortization, or the right to repay in the currency of the borrower.

Sole of Exchange – A phrase appearing on a draft to indicate that no duplicate is being presented.

Sovereign Risk – The risk that the government of a country may interfere with the repayment of debt.

Space Arbitrage – The buying of a foreign currency in one market and selling it for a profit in another market.

Special Drawing Rights – International paper money created and distributed to governments by the IMF in quantities dictated by special agreements among its member countries. The value of special drawing rights is determined by the weighted value of a *basket* of major currencies.

Spot Contract – A foreign exchange contract traded in the interbank market in which the value date is two business days from the trade date.

Spot Exchange (or Spot Currency) – Foreign exchange purchased or sold for immediate delivery and paid for on the day of delivery. Immediate delivery is usually considered delivery in one or two business days after the conclusion of the transaction. Many U.S. banks consider transactions maturing in as many as ten business days as spot exchange. Their reasons vary but are generally to facilitate reevaluation accounting policies and to initiate final confirmation and settlement verification procedures on future contracts nearing maturity.

Spot Transaction – A transaction for spot exchange or currency.

Spread – The difference between the bid rate and the offer rate in an exchange rate quotation or an interest quotation. This difference is not identical with the profit margin because traders seldom buy and sell at their bid and offer rates at the same time.

Square Exchange Position – To make the inflows of a given currency equal to the outflows of that currency for all maturity dates. This produces a square exchange position in that currency.

Sterilization – Intervention in the foreign exchange market by a central bank in which the change in the monetary base caused by the foreign exchange intervention is offset by open market operations involving domestic assets.

Stale Bill of Lading – A bill of lading that has not been presented under a letter of credit to the issuing bank within a reasonable time after its date, thus precluding its arrival at the port of discharge by the time the ship carrying the related shipment has arrived.

Straight Bill of Lading – A bill of lading drawn directly to the consignee and therefore not negotiable.

Swap – The combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another; merely trading one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures.

Swap Arrangement (Reciprocal) – A bilateral agreement between the central banks enabling each party to initiate swap transactions up to an agreed limit to gain temporary possession of the other party's currency.

Swap Cost or Profit – In a swap transaction, the cost or profit related to the temporary movement of currency into another currency and back again. That exchange cost or profit must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. Furthermore, the true trading profits or losses generated by the foreign exchange trader cannot be determined if swap profits or costs are charged to the exchange function rather than being allocated to the department whose loans or investments the swap actually funded.

Swap and Deposit – A combination of swap transactions that enable the borrower to have use of both currencies for the duration of the transaction.

Swap Position – A situation where the scheduled inflows of a given currency are equal to the scheduled outflows, but the maturities of those flows are purposely mismatched. The expectation in a swap position is that the swap rate will change and that the gap can be closed at a profit.

Swap Rate – The difference between the spot exchange rate of a given currency and its forward exchange rate.

Swap Swap – A swap transaction involving one forward maturity date against another forward maturity date.

Swaption – An option on a swap. It gives the buyer the right, but not the obligation, to enter into an interest-rate swap at a future time period.

Telegraphic Transfer (TT) Rate – The basic rate at which banks buy and sell foreign exchange. Buying rates for mail transfers, foreign currency drafts, traveler's checks, and similar instruments are all based on the TT rate. The TT rate may be slightly less favorable than other rates because of the time required for collection.

Telex – Direct communication between two banks or companies and organizations via satellite or underwater cable.

Terms of Trade – Relative price levels of goods exported and imported by a country.

Test Key – A code used in transferring funds by cable or telephone so that the recipient may authenticate the message. For example, a test key may consist of a series of numbers, including a fixed number for each correspondent bank; a number for the type of currency, a number for the total amount; and, possibly, numbers for the day of the month and day of the week. A single number code indicates whether the total amount is in thousands, hundreds, tens, or digits. To arrive at a test number, the indicated numbers are totaled, and the total amount usually precedes the text of the message.

Third Country Bills – Bankers acceptances issued by banks in one country that finance the transport or storage of goods traded between two other countries.

Through Bill of Lading – A bill of lading used when several carriers are used to transport merchandise, for example, from a train to a vessel or vice versa.

Tied Loan – A loan made by a governmental agency that requires the borrower to spend the proceeds in the lender's country.

Time Draft – A draft drawn to mature at a fixed time after presentation or acceptance.

Tomorrow Next – The simultaneous purchase and sale of a currency for receipt and payment on the next and second business day, respectively, or vice versa.

Tradable Amount – The minimum amount accepted by a foreign exchange broker for the interbank market, for example, 100,000 Canadian dollars or 50,000 pounds sterling.

Trade Acceptance – A draft drawn by the seller (drawer) on the buyer (drawee) and accepted by the buyer. Also called a trade bill, customer acceptance, and two-name trade paper.

Trade Accounts – Those parts of the balance of payments that reflect money spent abroad by the citizens of a country on goods and services and the money spent by foreigners in the given country for goods and services.

Trader's Ticket or Dealer's Slip – The handwritten record of a foreign exchange trade and/or placing and taking of deposits that is written by the dealer who executed the transaction.

Trading Position Worksheet – A record of incomplete transactions in a particular currency.

Tranche – A term sometimes used when referring to the number of drawings of funds by a borrower under a term loan.

Transfer Risk – The risk arising when a borrower incurs a liability in a currency that is not the currency in which revenues are generated. The borrower may not be able to convert its local currency to service an international loan if foreign exchange is not generated.

Trust Receipt – Used extensively in letter of credit financing, this is a document or receipt in which the buyer promises to hold the property received in the name of the releasing bank, although the bank retains title to the goods. The merchant is called the trustee and the bank the entruster. Trust receipts are used primarily to allow an importer to take possession of the goods for resale before paying the issuing bank.

Two-way Quotation – A simultaneous quotation of foreign exchange buying and selling rates implying the willingness of the bank to deal either way.

Two-way Rate – An exchange rate or an interest rate quotation that contains both a bid rate and an offer rate. The size of the spread between the two rates indicates the relative quality of the quotation.

Unclean Bill of Lading – A bill of lading across the face of which exceptions to the receipt of goods ''in apparent good order'' are noted. Examples of exceptions include burst bales, rusted goods, and smashed cases.

Undervalued – Decline in the spot rate below purchasing power parities, so that goods of one country are cheaper than in another country. In relation to foreign exchange, *undervalued* means that forward premiums are narrower or forward discounts are wider than the interest parities between the two financial centers.

Uniform Customs and Practices for Documentary Credits – Sets of rules governing documentary letters of credit formulated by the International Chamber of Commerce. Includes general provisions, definitions, forms, responsibilities, documents, and the transfer of documentary letters of credit.

Unmatched – A forward purchase is unmatched when a forward sale for the same date has not been executed or vice versa.

Usance – The period of time between presentation of a draft and its maturity.

Value Date – The date on which foreign exchange bought and sold must be delivered and on which the price for them in local currency must be paid.

Value-impaired – A category assigned by ICERC that indicates a country has protracted debt problems.

Value Today – An arrangement by which spot exchange must be delivered and paid for on the day of the transaction instead of two business days later.

Value Tomorrow – An arrangement by which spot exchange must be delivered and paid for on the business day following the transaction instead of two business days later.

Volume Quotation System – A method of giving exchange rates in which a certain specified amount of local currency (usually 1 or 100) is stated as the corresponding amount in foreign currency.

Vostro Account – A demand account maintained for a bank by a correspondent bank in a foreign country. The nostro account of one bank is the vostro account of the other bank. See also nostro account.

Warehouse Receipt – An instrument that acknowledges the deposit of goods or commodities in the warehouse that issues the receipt. These receipts may be negotiable or non-negotiable. A negotiable warehouse receipt is made to the *bearer*, and a non-negotiable warehouse receipt specifies precisely to whom the goods shall be delivered. There are several alternatives for releasing goods held under warehouse receipts: (1) the delivery of goods may be allowed only against cash payment or substitution of similar collateral; (2) some or all of the goods may be released against a trust receipt without payment; or (3) a warehouseman may release a stipulated quantity of goods without a specific delivery order. Banks will accept a warehouse receipt as collateral for a loan only if the issuer of a receipt is a bonded warehouseman. The bank must have protected assurances for the authenticity of the receipt and the fact that the commodities pledged are fully available as listed on the warehouse receipt.

Within-line Facility – Subfacilities of the line of credit that establish parameters, terms, and conditions of various other facilities available for specific additional purposes or transactions. The aggregate sum of all outstanding amounts under within-line facilities must not exceed the total of the overall line of credit.

World Bank – An international financial organization whose purpose is to aid the development of productive facilities in member countries, particularly in developing countries. The chief source of funds is capital contributions made by member countries, which vary with the financial strength of the country. Another funding source is the sale of long-term bonds.

Yankee Bond – A U.S. dollar-denominated foreign bond issued in the U.S. market.

Effective October 1, 1998, the FDIC made substantial revisions to Part 303 of the FDIC's Rules and Regulations, which governs the filing and processing of various applications. One of the most significant features of this revised regulation is that of expedited processing that is now available for "eligible depository institutions."

Eligible depository institutions are defined in the regulation as those which meet the following criteria:

- Received a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System (UFIRS) as a result of its most recent federal or state examination.
- Received a satisfactory or better Community Reinvestment Act (CRA) rating from its primary federal regulator at its most recent examination, if subject to CRA
- Received a compliance rating of 1 or 2 from its primary federal regulator at its most recent examination
- Is well-capitalized as defined in the appropriate capital regulation and guidance of the institution's primary federal regulator; and
- Is not subject to a cease and desist order, consent order, prompt corrective action directive, written agreement, memorandum of understanding, or other administrative agreement with its primary federal regulator or chartering authority.

APPLICATIONS FOR DEPOSIT INSURANCE

Introduction

The granting of deposit insurance confers a valuable status on an applicant institution; its denial, on the other hand, may have seriously adverse competitive consequences, and, in the case of a new institution, may effectively preclude entrance into the banking/thrift business. Obviously, the role of the FDIC, in acting upon such applications, involves important responsibilities and the exercise of sound discretion in the public interest.

Sections 5 and 6 of the Federal Deposit Insurance Act specifically deal with deposit insurance. Under Section 5, the FDIC must determine as a threshold matter that an applicant is a "depository institution which is engaged in the business of receiving deposits other than trust funds. If an institution does not satisfy that threshold requirement as codified under Part 303 of the FDIC Rules and Regulations. Additionally, Section 5 states that before approving an application, consideration shall be given to the factors enumerated in Section 6. Those factors are: the financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, the risk presented to the insurance fund, the convenience and needs of the community to be served, and whether or not its corporate powers are consistent with the purposes of the Act.

Subpart B of Part 303 of the FDIC's Rules and Regulations implements the basic statutory provisions and governs the administrative processing of applications for deposit insurance. For those filings subject to a public notice requirement, any person may inspect or request a copy of the non-confidential portions of a filing (the public file) until 180 days following the final disposition of the filing.

Rights of Applicants

An applicant has a statutory right to apply for deposit insurance and to obtain full consideration of its application by the FDIC in light of all relevant facts and without prejudice. If all of the seven statutory factors are resolved favorably, the applicant is entitled to receive deposit insurance coverage. In the event an application is disapproved, an applicant has a right to be informed by the FDIC of the reasons for disapproval.

Obligations of the FDIC

Under applicable law, the FDIC is obligated to consider the seven factors enumerated in Section 6 of the FDI Act in connection with every application for deposit insurance. As a measure of protection against unwarranted and unjustified risks, a full and thorough examination or investigation of each application is conducted. The FDIC has formulated certain guidelines for admission, which are designed to ease administrative problems, aid in preventing arbitrary judgment, and assist in assuring uniform and fair treatment to all applicants. These guidelines must, however, be administered in a manner consistent with the spirit of the Act, and the maintenance of a competitive and free enterprise banking/thrift system. Although applicants are largely required to satisfy criteria under each of the seven statutory factors, in a newly organized institution the FDIC views management and capital adequacy as the most important. The FDIC believes active competition between banks, thrifts and other financial institutions, when conducted within applicable law and in a safe and sound manner, is in the public interest.

Examiner's Responsibility

Whether the applicant is a proposed or newly organized institution or an existing institution, a formal application for deposit insurance coverage must be filed with the FDIC. A copy of the formal application will be made available to an examiner for use in the investigation. Although the application contains data on each of the seven factors enumerated under Section 6 of the Act, reports of investigation are not to be limited to material supplied by the applicant. Reports should be factual as to necessary information and represent the independent and unbiased findings of the examiner. The examiner should in no way indicate to an applicant the probable nature of his recommendations or discuss the applicant's chance of gaining admission to the insurance system unless specifically authorized to do so by the Regional Director. Considerable reliance is placed upon impartial reports by examiners in connection with admission procedures.

The report should detail the relevant facts and data pertinent to each of the seven statutory factors, and under a separate topical heading, an opinion as to whether the FDIC's criteria under each of the statutory factors have been met. A negative opinion on one or more of the statutory factors must be fully explained and supported and, where possible, it should be indicated whether and how the situation may be corrected. The report should also include a general recommendation relative to admission and, if appropriate, a list of conditions which should be imposed. As a rule, the FDIC requires applicants to satisfy all criteria under each of the seven statutory factors. In some cases, however, minor deficiencies in certain factors may be excused when they are more than balanced by conspicuous merits in others.

The seven factors enumerated in Section 6 of the FDI Act which are the criteria used by the FDIC to determine eligibility for deposit insurance are discussed below. The FDIC's admission criteria for proposed or newly organized institutions and existing institutions are generally the same; however, pertinent aspects specifically applicable to admission of existing institutions are covered later in this Section.

Statutory Factors, Proposed or Newly Organized Institutions

Financial History and Condition - Proposed and newly organized institutions have no financial history to serve as a basis for determining qualification for deposit insurance. Some consideration may be given to the history of other institutions presently and formerly operating in the area of the applicant, if pertinent. The ability of the proponents to provide financial support to the new institution should be evaluated under this factor. Past institution failures in a community should not be a prominent consideration in acting upon the application of a new institution. New institution applications are to be judged as far as possible upon their own merits relative to capital, management, and the other factors enumerated in Section 6 of the Act.

The investigation report should include a pro forma statement of the proposed institution for the first three years of operation. The asset and liability projections and composition should be reasonable in relation to the proposed market. Major assets with which the proposed institution intends to begin business, should be fairly valued and supported with appraisals.

Fixed assets are of primary concern in analyzing the asset condition of a proposed or newly organized financial institution. The applicant’s aggregate direct and indirect fixed asset investment, must be reasonable in relation to its projected earnings capacity, capital and other pertinent matters of consideration. Significant assets should be described in detail. For example, the following elements are pertinent to an adequate description and evaluation of applicant's realty interests: the original cost of the premises at time of construction with a breakdown between land and building, original cost to applicant, date of construction, reasonableness of purchase price, from whom purchased, insurance to be carried, assessed value, prospective or immediate repairs or alterations, estimated useful life of the building as of the beginning of business, outstanding liens, tax status, completeness of title papers, desirability of the location, and prospective annual income and expenses if the building is to be other than a one-purpose structure.

The relationship between the applicant's total investment in fixed assets and capital structure should receive comment.

If the leasing of premises is contemplated either through a real estate subsidiary of the proposed institution or otherwise, the terms of the lease are to be outlined in some detail, including a description and estimated cost of any leasehold improvements. In such cases, the lease agreement should contain a termination clause, acceptable to the FDIC. Lease transactions shall be reported in accordance with Financial Accounting Standards Board Statement 13 (Accounting for Leases). Applicants are cautioned against purchasing any fixed assets or entering into any noncancelable construction contracts, leases, or other binding arrangements related to the proposal unless and until the FDIC approves the application.

Any financial arrangement or transaction involving the applicant, its organizers, directors, officers, 10% or more shareholders, or their associates (insiders) should be avoided. If there are any such arrangements or transactions, it must be determined that they are fair and on substantially the same terms as those prevailing at the time for comparable transactions with noninsiders and must not involve more than normal risk or present unfavorable features. Full disclosure of any arrangements with insiders must be made to all proposed directors and prospective shareholders.

An evaluation and comment should be made as to whether the new institution will provide procedures, security devices, and safeguards which will at least be equivalent to the minimum requirements of the Bank Protection Act of 1968 and Part 326 of the Rules and Regulations of the FDIC. In addition, if the new institution plans to utilize electronic data processing services for some or all of its accounting functions, proponents should be apprised of the need to furnish notification in the form prescribed in Part 304.

In applications anticipating the use of temporary quarters pending construction or renovation of permanent facilities, details should be provided regarding the location of the site in relation to the permanent location, the exact address, the rental arrangement, the leasehold improvements, and estimated nonrecoverable costs upon abandonment.

Considerations required by the National Historic Preservation Act and the National Environmental Policy Act of 1969 must also be favorably resolved and the applicant is generally requested to submit data in this regard for evaluation.

Applicants often employ professional assistance, such as attorneys, economic researchers, and other specialists to assist in the preparation and filing of an application for deposit insurance coverage. The revised Statement of Policy on "Applications for Deposit Insurance" was adopted by the Board of Directors of the FDIC effective October 1, 1998, requires that legal fees and all other organizational expenses be reasonable and fully supportable. Expenses for professional or other services rendered by insiders will receive special review for any indication of self-dealing to the detriment of the institution and its other shareholders. The FDIC expects full disclosure to all directors and shareholders of any arrangement with an insider. In no case will a deposit insurance application be approved where the payment of a fee, in whole or in part is contingent upon any act or forbearance by the FDIC or by any other state or federal agency.

Adequacy of the Capital Structure – Normally, the initial capital of a proposed depository institution should be sufficient to provide a Tier 1 capital to assets leverage ratio (as defined in the appropriate capital regulation of the institution's primary federal regulator) of not less than 8.0% throughout the first three years of operation. Initial capital should normally be in excess of $2 million net of any pre-opening expenses that will be charged to the institution's capital after it commences business. In addition, the depository institution must maintain an adequate allowance for loan and lease losses.

If the applicant is being established as a wholly owned subsidiary of an eligible holding company (as defined in Part 303), the FDIC will consider the financial resources of the parent organization as a factor in assessing the adequacy of the proposed initial capital injection. In such cases, the appropriate regional director (DOS) may find favorably with respect to the adequacy of capital factor when the initial capital injection is sufficient to provide for a Tier 1 leverage capital ratio of at least 8% at the end of the first year of operation, based on a realistic business plan, or the initial capital injection meets the $2 million minimum capital standard set forth in the FDIC Statement of Policy on Applications for Deposit Insurance, or any minimum standards established by the chartering authority, whichever is greater. The holding company shall also provide a written commitment to maintain the proposed institution's Tier 1 leverage capital ratio at not less than 8% throughout the first three years of operation.

The adequacy of the capital structure of a newly organized financial institution is closely related to its risk appetite, deposit volume, fixed asset investment, and the anticipated future growth in liabilities. Deposit projections made by the applicant must, therefore, be fully supported and documented. Projections should be based on established growth patterns in the specific market, and initial capitalization should be provided accordingly. Special purpose depository institutions (such as credit card banks) should provide projections based on the type of business to be conducted and the potential for growth of that business.

In most cases, the first three years of operation is a reasonable time frame for measuring deposit growth in newly organized institutions. Accordingly, in assessing the adequacy of initial capital as related to prospective deposit volume, the examiner should develop a reasonable estimate of the deposit volume a new financial institution may generate in each of the first three years of operation, which may differ considerably from the estimates provided in the proponents' application, feasibility study, or economic survey. It is not unusual to find that the proponents' deposit projections and feasibility study are influenced by the proposed capital structure. The proponents' deposit projections may also be out-of-date or not fully supportable due to lack of adequate information and documentation. The best sources of information to assist in formulating reasonable estimates are local economic indicators, population data, deposit and loan growth in other financial institutions in the area, comments and observations of

depository institution managers in the area, the competitive impact of other financial institutions, and the ability of the proponents to generate business in the trade area. In the final analysis, the estimated deposit volume for a new institution's third year of operation is highly significant because it serves the dual purpose of measuring earnings capability as well as capital adequacy after projecting a reasonable operating period.
The number of shares of stock and its par value as of the commencement of business should be scheduled. The per share price of the stock should be stated, and, in cases where an additional amount per share is assessed to cover organizational and preopening expenses, that amount should also be identified. The components of the beginning capital structure can then be allocated to capital stock, surplus, other segregations, and the organizational expense fund. It should be ascertained whether or not the State or Office of Thrift Supervision statutory minimum capital requirements are met and how evidence will be provided to the FDIC that capital funds are fully paid in prior to opening for business. If it appears the proposed capital structure will not meet the FDIC's criteria, the investigation report should reflect fully the extent of and reasons for the inadequacy and recommend to the FDIC an amount which would be acceptable. Should the attitude of the proponents be receptive to a request for supplying additional capital, it should be so indicated.

All stock of a particular class in the initial offering should be sold at the same price, and have the same voting rights. Proposals which allow the insiders to acquire a separate class of stock with greater voting rights are generally unacceptable. Insiders should not be offered stock at a price more favorable than the price for other subscribers. Price disparities provide insiders with a means to gain control disproportionate to their investments.

When securities are sold to the public, the disclosure of all material facts is essential. The FDIC's Statement of Policy regarding use of Offering Circulars in connection with Public Distribution of Bank Securities (dated September 5, 1996) provides additional guidance. A copy of the offering circular prepared by the applicant, the stock solicitation material, and the subscription agreement should be submitted to the FDIC when they become available.

Future Earnings Prospects - Allowing a new institution to commence operations without some indication that it can be operated profitably not only creates a potentially unsatisfactory situation, but could also have a detrimental effect on other competing financial institutions. Usually the operations of a new institution are not profitable for at least the first year. Estimates of operating income and expenses for the first three years of operation should be made using, among other things, the projections of loan and deposit volume made in connection with the "Adequacy of the Capital Structure" factor.

In determining future earnings prospects, the probable income from loans and discounts, bonds and securities, service charges and commissions, and other sources of income must be estimated. Assistance in this task may be obtained from evaluating the applicant's projections, the demand for loans in the area and types thereof, the probable nature of the institution's investment policy, the amount of time and demand deposits likely to be acquired, the probable competitive reaction from existing depository institutions, the economic conditions in the community, the possibility of future development or retrogression in the area, the apparent moneymaking ability of the institution's management, and the FDIC's statistical data for depository institutions operating in the same general area. In addition, estimates must be made for expenses such as salaries and other employee benefits, interest, occupancy and equipment outlays, electronic data processing service costs, and other current operating expenses. Assistance in making these projections may generally be obtained from the same sources used in projecting the various income categories. A review and comparison of original projections and actual data for other recently organized operating financial institutions in the same or comparable areas may be of assistance in projecting earnings and expense data. Applicants need to demonstrate through realistic and supportable estimates that, within a reasonable period (normally three years); the earnings will be sufficient to provide an adequate profit.

The report of investigation should pinpoint any marked divergence between the examiner's findings and those presented in the application and the reasons for such variances. Comment should also be made on the proponents' plans for payment of cash dividends, bonuses, directors' fees, retainer fees, etc, and the accounting system to be used. During the first three years, dividends shall be paid only from net operating income after tax and not until an appropriate allowance for loan and lease losses has been established and overall capital is adequate. In regard to accounting systems, the FDIC requires use of the accrual method from the outset of operations.

As indicated previously, this portion of the investigation report is, by reason of Part 303 of the FDIC's Rules and Regulations, available for public inspection.

General Character of the Management - The quality of an institution's management is vital and perhaps the single most important element in determining the applicant's acceptability for deposit insurance. To satisfy the FDIC's criteria under this factor, the evidence must support a management rating which in an operating institution would be tantamount to a rating of "2" or better. In most instances, the management of a proposed or newly organized institution will not have an operating record as a functioning unit to assist in forming a judgment; therefore, the management rating essentially becomes a question of directly evaluating the individual directors and officers and then making a composite overall rating premised upon the individual analyses.

In general, the individual directors and officers will be evaluated largely on the basis of the following:

- Financial institution and other business experience;
- Duties and responsibilities in the proposed depository institution;
- Personal and professional financial responsibility;
- Reputation for honesty and integrity; and
- Familiarity with the economy, financial needs, and general character of the community in which the depository institution will operate.

The report of investigation should, therefore, contain a schedule giving the name, address, approximate age, total liabilities, and net worth of each director and officer. In addition, for each proposed member of the management team comments should be included that detail present occupation or profession and past banking, thrift, business, farming, or other experience; including observations as to how successful the individuals have been in their present and past activities and whether they have been asked to resign from a position or positions held or have been associated with serious business failures or debt compromises. As a rule of thumb, success of the majority of an applicant's management in their present business endeavors is some evidence of their ability to manage successfully the affairs of the proposed institution.

In addition, all firms, companies, corporations, and organizations in which a given director or officer is substantially interested should be indicated. If the facts denote that the institution is being organized primarily to finance the businesses or personal interests of certain officers and directors, particularly when the assets related thereto are likely to be of dubious quality, the relevant facts should be fully covered.

Duties and responsibilities as well as the title of each proposed officer and director should be outlined. If the proposed duties and responsibilities are regarded as beyond the capabilities of a particular officer or some other distribution of duties and responsibilities among officers would be more effective than that contemplated, the opinions and reasons therefore should be indicated.

Net worth figures on each director and officer will be available from financial reports filed with the application. In listing net worth figures in the report of investigation, an opinion as to the validity of the figures and any pertinent information relating to sizable liabilities may be made.

Stock holdings of each director and officer are to be indicated. Successful operation of a financial institution requires a real interest in its welfare as well as a willingness to devote a substantial amount of time to its affairs. When directors and officers have a significant financial investment, genuine and continuing interest is more likely.

Section 19 of the FDI Act prohibits, without the prior written consent of the FDIC, a person convicted of criminal offense involving dishonesty, breach of trust, money laundering, or who has entered into a pretrial diversion or similar program in connection with a prosecution for such offense, from becoming or continuing as an institution-affiliated party, owning or controlling, directly or indirectly an insured institution, or otherwise participating, directly or indirectly, in the conduct of the affairs of an insured depository institution. If an employee, officer, or director is involved in a criminal conviction, or fidelity insurance has been denied with respect to any employee, officer, or director, a thorough investigation of the circumstances should be conducted. If the facts of the investigation dictate, the institution may be required to file an application pursuant to Section 19 of the FDI Act.

Length of residence in the community or trade area of the proposed institution and degree of familiarity with the major activities of the locale should be indicated with respect to each director and officer.

The above information should be particularly complete with respect to individuals who are likely to dominate the policies and operations of the institution. In addition, comparable information should be included on any shareholder (other than a proposed director or officer) who is subscribing to 10% or more of the aggregate par value of stock to be issued. Examiners should also include in their report any information that may come to their attention concerning possible changes that may be made in the institution's management after commencement of operations. In addition, the FDIC has found that on occasion, subsequent to approval of an application for deposit insurance and prior to the actual opening of a proposed new institution, changes have occurred in the management or ownership. In order to monitor such changes, the FDIC requires that the prospective incorporators advise the Regional Director in writing if changes in the directorate, active management, or in the ownership of stock of 10% or more of the total are made prior to opening. When conducting investigations, this notification should be stressed in any discussions with the proponents.

Certain other information relative to the sale and purchase of the proposed institution's stock and the exercise of voting rights may also reflect on the general quality and character of management. While these matters may also relate to the "Adequacy of Capital Structure" factor, on balance they are more appropriately treated herein. Stock financing arrangements by proposed officers, directors and 10% shareholders of their investments in stock of the proposed depository institution will be carefully reviewed. Such financing will be considered acceptable only if the party financing the stock can demonstrate the ability to service the debt without reliance on dividends or other forms of compensation from the applicant. When stock financing arrangements are anticipated, information should be submitted with the application demonstrating that adequate alternative independent sources of debt serving are available. Direct or indirect financing by proposed officers, directors and 10% shareholders of more than 75% of the purchase price of the stock subscribed by any individual, or more than 50% of the purchase price of the aggregates stock subscribed by the proposed officers, directors and 10% shareholders as a group, will require supporting justification in the application regarding the reason that the financing arrangements should be considered acceptable. If the proposed financing arrangements are not considered appropriate, the FDIC may find unfavorably on the adequacy of the capital structure.

It should be determined whether any commissions are to be paid in connection with the sale of the stock and confirmed that no loans representing applicant stock purchases will be refinanced by the institution. Any evidence that the institution is being organized on a promotional basis should also be covered. Ownership control by several individuals or groups of shareholders as well as any contemplated or existing buy-sell, voting trust, or proxy agreements between various individuals or other entities, such as holding companies, should also receive comment and copies of any such agreements obtained from the applicant or proponents involved.

Stock Benefit Plans – Stock benefit plans, including stock options, stock warrants and other similar stock based compensation plans will be reviewed by the FDIC and must be fully disclosed to all potential subscribers. Participants in stock benefit plans may include incorporators, directors and officers. A description of any such plans proposed must be included in the application submitted to the appropriate regional director. The structure of stock benefit plans should encourage the continued involvement of the participants and serve as an incentive for the successful operation of the institution. Stock benefit plans should contain no feature that would encourage speculative or high-risk activities or serve as an obstacle to or otherwise impede the sale of additional stock to the general public. The following are the factors to use to evaluate stock benefit plans:

- The duration of rights granted should be limited and in no event should the exercise period exceed ten years;
- Rights granted should encourage the recipient to remain involved in the proposed depository institution
- Rights granted should not be transferable by the participant;
- The exercise price of stock rights shall not be less than the fair market value of the stock at the time that the rights are granted;
- Rights under the plan must be exercised or expire within a reasonable time after termination as an active officer, employee or director; and
- Stock benefit plans should contain a provision allowing the institution’s primary federal regulator to direct the institution to require plan participants to exercise or forfeit their stock rights if the institution’s capital falls below the minimum requirements, as determined by its state or primary federal regulator.

Stock benefit plans provided to directors and officers will be reviewed as part of the total compensation package offered to such individuals.
Stock benefit plans provided to incorporators will also be closely scrutinized. In reviewing such plans, the FDIC will consider the individual’s time, expertise, financial commitment and continuing involvement in the management of the proposed institution. The FDIC will also consider the amount and basis of any cash payments which will be made to the incorporator for services rendered or as a return on funds placed at risk. Plans to compensate incorporators that provide for more than one option or warrant for each share subscribed will generally be considered excessive. It is further expected that incorporators granted options or warrants at or near this level will actively participate in the management of the depository institution as an executive officer or director. On a case-by-case basis, the FDIC may not object to additional options being granted to an incorporator who will also be a senior executive officer.

The FDIC recognizes that there will be limited instances where individuals who substantially contribute to organization of a new depository institution do not intend to serve as an active officer or director after the institution opens for business. The FDIC will generally not object to awarding warrants or options to incorporators who agree to accept shares of stock in lieu of cash payment for funds placed at risk or for professional services rendered. In such instances, the FDIC defines funds placed at risk to include seed money actually paid into the organizational fund and the value of professional services rendered as the market value of legal, accounting and other professional services rendered. Generally, warrants or options for organizers who will not participate in the management of the institution will be considered excessive if the amount of options or warrants to be granted exceeds the number of shares of stock at risk and/or for professional services rendered. The granting of options to incorporators who guarantee loans to finance an institution's organization generally would not be objectionable, but options granted should be limited so that the market value of the stock subject to option does not exceed the amount of the loan guarantees (although guarantees exceeding the amount drawn or expected to be drawn will not be considered.) When continuing service is not contemplated, the FDIC will not require vesting or restrictions on transferability, but will review the duration of the rights, exercise price and exercise or forfeiture clauses in the same manner as discussed above.

In evaluating benefit and compensation plans for insiders, the FDIC will look to the substance of the proposal. Those proposals that are determined to be substantially stock based plans will be evaluated on the above stock benefit plan criteria. Stock appreciation rights and similar plans that include a cash payment to the recipient based directly on the market value of the depository institution's stock are unacceptable.

If the proposal involves the formation of a de novo holding company and a stock benefit plan is being proposed at the holding company level, that stock benefit plan will be reviewed by the FDIC in the same manner as a plan involving stock issued by the proposed depository institution.

Proponents should be made aware of the prohibition against interlocking management relations applicable to depository institutions (banks, savings and loan associations, mutual savings banks, and credit unions) and depository holding companies (banks, and savings and loan holding companies) contained in Title 11 of FIRIRCA and Part 348 of the FDIC's Rules and Regulations. The FDIC adheres to a fixed policy requiring that all applicants provide at least a five-member board of directors, even though the State law may, in some cases, permit a lesser number.

On the basis of the facts and considerations detailed in the report of investigation, examiners should state, and factually support to the greatest extent possible, their conclusions as to the management rating. A notation as to the type and amount of the insurance (fidelity, burglary, robbery, etc.) to be carried by the institution should be included in the report under the management heading. With respect to fidelity coverage, the FDIC's position is that applicants should subscribe to and maintain adequate coverage and have in force at all times a $1 million excess bank employee dishonesty bond, if primary blanket bond coverage is less than $1 million.

Applicants are expected to develop appropriate written investment, loan, funds management and liquidity policies. Establishment of an acceptable audit program is required for proposed depository institutions. Applicants are expected to commit the depository institution to obtain an audit by an independent public accountant for at least the first three years of operation.

An applicant bank or an applicant branch of a foreign bank that expects to operate an international loan department or conduct international lending and investment activities is expected to address country risk and related concentrations of credit with respect to these activities in their written policies. These factors should be segregated from other lending and investment risk criteria and addressed separately in the policies. Policy coverage should not be limited to just loans, but should also encompass securities, deposit balances, acceptances, and other activities that are expected to be included in the bank's or branch's operations. If an applicant does not intend to engage in such activity, they should specifically so state.

Risk Presented to the Insurance Fund - This factor is to be broadly interpreted and may be the most relevant in the unusual circumstance where none of the other factors is clearly identifiable as unfavorable. For example, "risk to the fund" might be resolved unfavorably and the application denied based on the applicant's unsound business plan even though all the other factors might be favorably resolved. The FDIC expects that an applicant will submit a business plan commensurate with the capabilities of its management and the financial commitment of the incorporators. Any significant deviation from the business plan within the first three years of operation must be reported by the insured depository institution to the primary federal regulator before consummation of the change. An applicant's business plan should demonstrate the following:

- Adequate policies, procedures, and management expertise to operate the proposed depository institution in a safe and sound manner;
- Ability to achieve a reasonable market share;
- Reasonable earnings prospects;
- Ability to attract and maintain adequate capital; and

- Responsiveness to community needs.

Operating plans that rely on high risk lending, a special purpose market, significant funding from other sources other than core deposits, or that otherwise diverge from conventional bank related financial services will require specific documentation as to the suitability of the proposed activities for an insured institution. Similarly, additional documentation of plans is required where markets to be entered are intensely competitive or economic conditions are marginal. Like a recommendation based on any other factor, an unfavorable finding based on "risk to the fund" must be clearly articulated.

Convenience and Needs of the Community to be Served - Generally, there is a presumptive indication of need if the directors or organizers of the applicant are a responsible group of persons willing and able to supply a substantial and adequate amount of money to back up their judgment, and if the management of the proposed institution is competent, honest, and familiar with the problems of the area to be served. However, consideration should be given to the adequacy of existing depository institution facilities in the community and in nearby rival communities, for a financial institution is unlikely to fulfill a need if it is unable to command sufficient volume to maintain profitable operations. In this connection, the Examiner should endeavor to ascertain whether or not the services rendered by existing depository institutions are satisfactory, and whether or not such institutions are meeting the legitimate credit needs of the community.

It should be noted that the provisions of the Community Reinvestment Act are especially relevant in evaluating this statutory factor.

In considering the question of need, it is important that the examiner not adopt the viewpoint of depository institutions located in the community, to the exclusion of other, equally persuasive viewpoints. As in the other lines of business, existing financial institutions may regard any new institutions as unnecessary and a potentially "harmful competitor". An unbiased conclusion in this connection requires impartial consideration of the opinions of the organizers of the applicant as well as those of the management of existing institutions. In addition, it is sometimes necessary to solicit the views of representative business and professional persons in the community, together with those of citizens of more modest means. The results of canvasses and surveys of local individual or business persons should be set forth in the report in order to assist in evaluating support for the proposed institution, the adequacy of present depository institution facilities, whether the legitimate banking needs of the community are being met, whether and to what extent the new facility would be used, and the knowledge these persons have of the proponents. In the final analysis, the value of any information so obtained will depend largely on the examiner's ability to discriminate between those views which proceed from intelligent and rational consideration of the real needs of the community and those which are mainly inspired by a false sense of community pride or selfish personal interest.

A clear definition of the proposed institution's trade area is essential in determining convenience and needs. A brief description of the general area in which the proposed institution is to be situated and its location in relation to other prominent nearby communities, developments, or other important landmarks should be initially presented. The primary trade area as described in the application should then be discussed along with an opinion as to the validity of the applicant's definition of the trade area. In some instances, the applicant may artificially draw its trade area boundaries so as to exclude factors which would be unfavorable to the proposal (nearby depository institutions, depressed areas, etc.) and include others which would increase the attractiveness of the proposed location (significant residential or commercial developments, highly concentrated population area, etc.). Any differences between the examiner's conception of the trade area and that of the proponents should be discussed fully in the report together with a description of the trade area as the examiner perceives it. Once the trade area has been defined, information regarding the following should be set forth.

The principal industrial, trade, or agricultural activity should be described and, if considered relevant, annual values of principal products indicated. The presence and source of large payrolls in the area may also be an important consideration. The number and value of residential and commercial building permits can often be of considerable value in determining the vitality of the area. Figures regarding retail sales from public sources or trade organizations are useful; however, if they are not available, it may be possible to obtain some estimates of volume in the course of conducting a survey of the locale's business establishments. Information regarding medical facilities and other professional services can be a useful indicator of the self- sufficiency of the community or trade area. Statistical information on governmental units such as; assessed valuations, tax levies, bonded indebtedness, and tax delinquencies, and data on the educational environment of the area are also valuable indicators. Reports of investigation should not, however, be filled with pages of statistics unless the figures are relevant.

Demographic figures within the trade area as well as the general surrounding areas are significant determinants in considering convenience and needs. While population as of the date of investigation is important, data which establishes population trends as well as projections for the future should be presented. In some cases it is difficult to obtain accurate population data for a particular trade area, as statistics combine portions of several census tracts. In some instances, data showing the number of household units in the area may be a more appropriate basis for assessing reasonable population estimates.

The examiner should assess the competitive dynamics of the proposed market and how the institution will compete for market share. Officials of area depository institutions should be contacted during the investigation and given an opportunity to express their attitudes on the proposal. Any formal objections to the proposal should be investigated and comments relative to discussions with the objector(s) set forth in the investigation report. The probable competitive effects of a new institution proposal should be fully weighed by the examiner. While the number of depository institutions operating in the city or area to be served is important in determining whether the addition of a new institution may result in an overbanked condition, consideration should also be given to possible procompetitive consequences flowing from the new institution proposal, such as increased customer services and banking options to residents of the area. Therefore, it is necessary to furnish complete factual data with respect to the probable impact of the proposal on existing financial institutions in the community.

The extent of new or proposed residential, commercial, and industrial development and construction is a significant secondary consideration in resolving the convenience and needs factor. Plans for the development of shopping centers, apartment complexes and other residential subdivisions, factories, or other major facilities near the proposed site should, therefore, receive comment. In certain instances, inclusion of maps may be desirable to clarify comments, showing location of competing depository institutions or branches, important buildings, offices, shopping centers, industrial parks, and the like in relation to the office site. As in the case of the "Future Earnings Prospects' factor, this portion of the investigation report is also available for public inspection under Part 303 of the FDIC's Rules and Regulations.

Consistency of Corporate Powers – Generally, the FDIC will presume that a proposed national bank's or federal savings association's corporate powers are consistent with the purposes of the Act. Pursuant to section 24 of the Act, no insured state bank may engage as principal in any type of activity that is not permissible for a national bank unless the FDIC has determined that the activity would pose no significant risk to the appropriate deposit insurance fund and the state bank is, and continues to be, in compliance with applicable capital standards prescribed by its primary federal regulator. Similarly, section 28 of the Act provides that a state chartered savings association may not engage in any type of activity that is not permissible for a federal savings association, unless the FDIC has determined that the activity would pose no significant risk to the affected deposit insurance fund and the savings association is and continues to be, in compliance with the capital standards for the association. Since the applicant will have agreed in its application not to exercise nonbanking powers whether granted by charter or statute, the examiner need only refer to this previously obtained agreement. Additional comments may be included if the terms of the agreement are not generally understood by the applicant or if they regard the agreement as being incomplete or amendment to the Articles of Association or Charter is necessary or desirable.

Miscellaneous - The existence of any conflicting applications to establish depository facilities in the immediate area should be indicated and receive appropriate comment in the examiner's report of investigation. If operation of a trust department is contemplated, applicant must also file with the FDIC the appropriate form covering "Application for Consent to Exercise Trust Powers". This form will provide much of the information necessary for the completion of the report of investigation with respect to this phase of the applicant's operations. If the proposed trust functions will materially affect the examiner's findings in making a recommendation on anyone of the seven factors contained in Section 6 of the Federal Deposit Insurance Act, it may be advisable to analyze the prospects for the operation of the commercial and trust departments under separate subheadings for any factor so affected.

If any of the documents essential for full consideration of the application have not been submitted to the FDIC, the proponents should be instructed to transmit such documents at the earliest practical date and a notation to that effect included in the report.

Statutory Factors, Existing Institutions

As indicated previously, the FDIC's admission criteria for proposed or newly organized institutions and for existing institutions are generally the same. Consequently, principles previously discussed in this section of the Manual are not repeated herein. Prior to processing applications for existing institutions for deposit insurance coverage, examiners should familiarize themselves not only with the following provisions but also those set forth under "Statutory Factors, Proposed or Newly Organized Institutions". In the case of an existing institution, the FDIC will conduct an examination of the ongoing institution or its predecessor institution and a report prepared on the regular printed FDIC form, with appropriate notation on the cover indicating the special purpose of the examination. Under Examiner's Comments and Conclusions of the Supervisory Section of the Report of Examination, the examiner is required to discuss separately each of the seven statutory factors.

Financial History and Condition - While the financial history of an operating institution is usually reflected in its present condition, the basic cause or causes for an institution's condition, whether satisfactory or unsatisfactory, should be analyzed and the reasons therefor ascertained. Accordingly, where the financial history of an operating institution has not been successful or is questionable, the FDIC generally requires reasonable assurance that the cause or causes of any past difficulties of a serious nature have in large measure either been overcome or ceased to exist.

Date of primary organization should be indicated. Another important feature in the financial history of an existing institution is its past attitude on the prompt recognition and current charge-off of losses and the administration of dividend policies. In addition, mergers, consolidations, recapitalizations, reorganizations, liability assumptions, deposit waivers, deposit deferments, and similar events, which are not recent, should be covered in the Report of Examination, but in less detail.

With respect to an operating institution's financial condition, the FDIC customarily requires that the general quality of its net assets be satisfactory and on a par with that of peer institutions. In appraising the value and quality of an applicant operating institution's assets, the same appraisal and classification procedures and criteria are to be followed as in regular FDIC examinations. The "Items Subject to Adverse Classification" as well as the "Items Listed for Special Mention" pages in the Report of Examination as well as the "Summary Analysis of Examination Report" (SAER) should include data on the quality of an institution's net assets. This information should be summarized in the "Examination Conclusions and Findings" under an appropriate caption. General comments on asset condition and problems should also be included, as well as a summary of "Violations of Laws and Regulations", contingent liabilities, existing litigation against the institution, dividend and remuneration policies, and other matters which could affect the institution's condition.

Adequacy of the Capital Structure - An existing institution applying for deposit insurance should have sufficient capital to support the volume, type, and character of its business, provide for losses, and meet the reasonable credit needs of the community which it serves. The process of determining the adequacy of an institution's existing capital as well as that after three years of operation (considering estimated deposit growth) begins with a qualitative evaluation of critical variables that directly bear on the institution's overall financial condition. These variables as well as all the principles set forth in the FDIC Statement of Policy on Capital (Appendix B to Part 325), are applicable here. The Statement, setting forth various levels for adjusted equity capital, only provides a benchmark for evaluating capital adequacy. Although it establishes uniform standards for capital levels among depository institutions regardless of size, the ratios set forth therein are, however, only starting points since such ratios are not in themselves determinative and must be integrated with all other relevant factors such as character of management, quality of assets, and so on. In the final analysis, each case must be judged on its own merits. It should be recognized that various State banking departments may impose more stringent capital requirements than those set forth in the FDIC Statement of Policy on Capital.

The Report of Examination should include some of the data necessary for determining whether the applicant's capital is adequate. The data should also be summarized and augmented in the Examiner's Conclusions and Recommendations of the Supervisory Section under the caption "Adequacy of Capital Structure". If for any reason a substantial increase in deposits is anticipated, or any plans of the applicant with respect to the institution's capital structure are contemplated, or if the proponents appear receptive to a request for supplying additional capital, it should be so indicated in the Report of Examination. It is desirable to include under this caption, or as a supplemental page to the Report of Examination, a complete or reasonably complete list of all shareholders, their holdings, and related interests.

Future Earnings Prospects - The earnings capability of an existing institution is reflected in its earnings record. Ordinarily, an operating institution's earnings record should indicate ability to pay all operating expenses with a safe margin for the absorption of losses and for the payment of reasonable dividends. For comparative purposes, current earnings ratios may be obtained from various data prepared by the FDIC. If earnings have not been sufficient, areas where income may be improved or expenses reduced should be noted. The principles described in the Earnings Section of this Manual are applicable here. The income and expense figures reflected in the Report of Examination are book figures. If the examiner regards these figures as incorrect or misleading because of improper accounting for unearned discounts, failure to charge off losses, failure to properly depreciate fixed assets, or similar deviations from accepted practices, the matter should be fully discussed in the presentation of earnings data in the Supervisory Section. The examiner should also comment on the effect deposit insurance coverage might have on the institution's income and expenses in the future.

General Character of Management - In the case of an existing institution, management may be evaluated both from the standpoint of the institution's condition and the vantage point of management's past performance as reflected in the books and records of the institution, previous Reports of Examination and correspondence from other regulators, and internal records, such as committee and board of directors' minutes. A management rating of "2" or better is necessary to satisfy the requirements of this statutory factor. The rating of management is discussed in the Management Supervision, Administration and Control Section of this Manual.

Complete information on management will be included in the report. In addition, a summary discussion of important aspects of this information, together with information on director and officer indebtedness to the institution, should be included under this caption in the "Examiner's Conclusions and Recommendations" of the Supervisory Section. If management is not regarded as warranting a rating of "2" or better, it should be indicated what changes are believed essential to warrant such a rating. Fidelity insurance on active officers and employees and other indemnity protection should receive comment to the extent necessary under this captioned statutory factor.

Risk Presented to the Insurance Fund - Analysis of this factor is the same as previously described for proposed new institutions.

Convenience and Needs of the Community - The FDIC's criteria under this statutory factor are closely related to those outlined with respect to the "Future Earnings Prospects" factor. A going institution which is being successfully and profitably operated, and which has a recognized place and established customer relationships in its community, is for self-evident reasons convenient to and fulfilling the needs of the community it serves. An institution may, however, have had inferior earnings in the past and nevertheless qualify under this statutory factor. Any pertinent information with respect to local economic conditions, population trends, or unusual circumstances which have affected or may affect the community and the applicant should be commented on under this caption. It should be noted that the provisions of the Community Reinvestment Act are relevant in evaluating this statutory factor.

Consistency of Corporate Powers - Nonbanking powers and certain saving associations activities, other than trust powers, are regarded by the FDIC as inconsistent with the purposes of the Act. In some states, institutions have been granted the right under their charters or by statute to engage in certain nonbanking activities. Section 24 of the Act limits the powers of insured state banks and section 28 of the Act limits the powers of state chartered savings associations. If the institution is exercising any powers not authorized under the applicable statute, the application should contain an agreement and plan for eliminating the activity as soon as possible, or a separate application should be submitted seeking the FDIC’s consent to continue the activity.

Miscellaneous - If the applicant operates a trust department, an examination will be conducted and a Report of Examination compiled. The examiner should consider the condition and the prospects of the trust department in developing the conclusion for each factor enumerated under Section 6 of the Act. Should trust department operations be of sufficient influence in the final determination of the examiner's findings on any of the factors, it may be advisable to analyze the commercial and the trust operations under appropriate subheadings. The examiner should indicate the number of tellers' windows at which insured deposits will be received. If any of the documents essential for full consideration of the application have not been submitted to the FDIC, the proponents should be instructed to transmit such documents at the earliest practical date and a notation to that effect included in the report.

Examiners should indicate in their reports the sources of information on significant points covered in their comments. During the examination, the examiner should review reports of examination of other supervisory authorities and correspondence from these authorities.

Deposit Insurance Applications from Proposed Publicly Owned Depository Institutions

An application for deposit insurance from a depository institution which would be owned or controlled by a domestic governmental entity (such as, for example, a state, county or a municipality) will be reviewed very closely. The FDIC is of the opinion that due to their public ownership, such depository institutions present unique supervisory concerns that do not exist with privately owned depository institutions. For example, because of the ultimate control by the political process, such institutions could raise special concerns relating to management stability, their business purpose, and their ability and willingness to raise capital. On the other hand, such institutions may be particularly likely to meet the convenience and need of their local community, particularly if the local community is currently un- or under- served by depository institutions.

APPLICATIONS TO ESTABLISH A BRANCH OR TO MOVE MAIN OFFICE OR BRANCH

Provisions of Law

Under the provisions of Section 18(d) of the Federal Deposit Insurance Act (the "Act"), no State nonmember insured bank may establish and operate any new branch, or change the location of any existing branch, or move its main office, unless it obtains the prior written consent of the FDIC. The factors to be considered in granting or withholding such consent are those enumerated in Section 6 of the Act. Also included in Section 18(d) of the Act, no state nonmember insured bank shall establish or operate any foreign branch, except with the prior written consent of the FDIC. There are further restrictions detailed below concerning either establishment or relocation of branches in states other than the applicant's home state. Subpart C of Part 303 of the FDIC's Rules and Regulations governs the administrative handling of applications to establish a branch or to relocate an office.

Filing Procedures for Branch Applications

In applying to establish a branch or to relocate an existing office, State nonmember insured banks must file an application in letter form with the FDIC. A complete letter application shall include:
(1) a statement of intent to establish a branch or to relocate the main office or a branch;
(2) the exact location of the proposed site including the street address; and
(3) details concerning any involvement in the proposal by an insider of the bank;
(4) a statement on the impact of the proposal on the human environment, including information on compliance with the provisions of the NEPA (National Environmental Protection Act);
(5) a statement as to whether or not the site is eligible for inclusion in the National Register of Historic Places for purposes of complying with the applicable portions of NHPA (National Historic Preservation Act);
(6) comments on any changes in services to be offered, the community to be served, or any other effect the proposal may have on the applicant's compliance with the Community Reinvestment Act;
(7) a copy of each newspaper publication required; and
(8) when an application is submitted to relocate the main office of the applicant from one state to another, a statement of the applicant's intent regarding retention of branches in the state where the main office exists prior to relocation.

Expedited processing per Part 303 is available for eligible depository institutions. For those applications which are not processed pursuant to the expedited procedures, preliminary consideration will be given in the Regional Office to applications to determine whether an examination of the applicant bank should be ordered. In all cases, however, a Summary of Investigation Form for Branch Applications will be completed. Please refer to the Case Managers Procedures Manual for additional processing and filing information.

Interstate Banking Branch Applications

For applications to establish a de novo branch that is not in the applicant's home state and in which the applicant does not already maintain a branch, the application must comply with the state's filing requirements. The FDIC needs to determine that the applicant is adequately capitalized as of the date of the filing and will continue to be adequately capitalized and adequately managed upon consummation of the transaction; and confirmation that the host state has a law permitting state "opt-in" elections to enable interstate branching, pursuant to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

For applications where the applicant already has one or more existing branches in a state other than the applicant's home state, a determination needs to be made that the application has not failed the host state's credit needs test and that it is reasonably helping to meet the credit needs of the communities which the branches serve.

Other Considerations for Branch Applications

As in the case of applications for deposit insurance, the provisions of the Community Reinvestment Act, the National Historic Preservation Act, and the National Environmental Policy Act of 1969, must be favorably resolved.

APPLICATIONS FOR CONSENT TO EXERCISE TRUST POWERS

Introduction

1. FDIC Section 333

The FDIC does not grant trust powers, but only gives its consent to exercise such powers as granted by state authorities. Section 333.2 of the FDIC's Rules and Regulations prohibits an insured state nonmember bank from changing the general character of its business without the FDIC's prior written consent. The test to determine when a change in character of business has occurred is left to the discretion of the FDIC. For trust powers, this normally occurs when a fiduciary relationship is created under the laws of the governing state authority. Therefore, it is general policy that unless a bank is exempted through the circumstances described in the Background section below, it must file a formal application with the FDIC to obtain prior written consent before it may exercise trust powers. It should also be noted that the statute applies only to banks. Separately chartered and capitalized uninsured trust company subsidiaries of banks need not apply for FDIC consent to exercise trust powers.

2. Background

In 1958 the FDIC articulated its basis for requiring consent to exercise trust powers (refer to page C-41 of the FDIC Trust Examination Manual), and established conditions for grandfathering consent. Banks granted trust powers by state statute or charter prior to December 1, 1950, regardless of whether or not such powers have ever been exercised, are not required to file an application with the FDIC for consent to exercise trust powers. Such consent is grandfathered with the approval for Federal deposit insurance.

Banks approved for Federal deposit insurance after December 1, 1950, are required to file an application to exercise trust powers, unless such filing was made simultaneously with the application for Federal deposit insurance.

3. Applications for Consent

Part 303 of the FDIC's Rules and Regulations governs the administrative handling of applications for consent to exercise trust powers. Application procedures are set forth in both Part 303 and the Case Managers Procedures Manual. Banks eligible for expedited processing under Part 303 (as defined therein) may file an abbreviated application. Application forms for both expedited and non-expedited processing are available at Regional Offices. Applications are reviewed in the context of the financial institution's ability to satisfactorily perform trust activities. In reviewing any such application, the statutory factors set forth in Section 6 of the Federal Deposit Insurance Act are also considered. Other factors which examiners should be aware of include:

a. Statement of Principles of Trust Department Management

The FDIC's "Statement of Principles of Trust Department Management" outlines minimum requirements for the sound operation of a trust department. Before final approval of any application for consent to exercise trust powers may be given, the applicant's board of directors is required to adopt the minimum requirements set forth in the "Statement".

b. Management Adequacy

To approve any application for consent to exercise trust powers, it must be concluded that management of the contemplated trust operation is capable. By adopting the "Statement of Principles of Trust Department Management", the applicant bank resolves to provide sufficient staff and facilities to meet minimum standards of competency in trust matters. Applications submitted for consent to exercise full trust powers by banks having inexperienced trust management, or management which is considered incapable of administering trust activities other than routine matters, should not be approved. Such applications should not be accepted for processing, but returned to the bank for resubmission at a later time. Where limited powers will suffice, the bank should be encouraged to amend its application for specified limited powers. Otherwise, the board of directors should be requested to seek qualified trust management if it wishes to obtain consent to exercise full trust powers. Nevertheless, Regional Directors may, when warranted, approve an application conditioned on the bank's hiring of qualified trust management which is acceptable to the FDIC.

c. Limited Trust Powers

Banks will sometimes be granted limited trust powers, usually confined to a few specific functions such as agent for employee benefit accounts, guardian of the property of minors, or capacities not requiring extensive expertise. In processing an application for consent to exercise limited trust powers, applicants should be required to specify the exact functions to be performed. At
examinations of banks having limited trust powers, the examiner should determine that only authorized activities are being performed.

d. Unauthorized Trust Activities

Commercial banks may be found performing fiduciary services without having obtained full or limited trust powers, or the FDIC’s consent to exercise such powers. In these cases, the examiner should determine what services are being performed, and review all written customer agreements. If a bank is acting in any capacity requiring trust powers, the examiner should:

(1) cite a violation of state law for performing fiduciary services without trust powers (if applicable);
(2) cite a violation of FDIC Section 333.2 for changing the character of its business without the FDIC's prior written consent;
(3) advise management:
(a) it must discontinue accepting any additional appointments;
(b) it should (upon advice of counsel) discontinue performing fiduciary services, if it can do so without jeopardizing its accounts or incurring additional liability upon itself;
(c) that it must apply to its state authority for trust powers (if applicable); and
(d) that it must also apply to the FDIC for consent to exercise the powers.

If a bank is acting in an agency capacity, the examiner should make a determination of the bank's duties and responsibilities.

Particular attention should be given to the degree of discretionary authority exercised. It should also be determined whether the bank is required to manage the assets, or to simply hold them subject to customer direction. If the bank's duties are those which require trust powers, the examiner should follow the procedures outlined in the preceding paragraph. Applications for consent to exercise trust powers subsequent to the discovery of unauthorized activities do not merit expedited processing. Such applications warrant consideration for approval subject to prior written conditions with management.

e. "Customer Service" versus "Fiduciary Activity"

It is not unusual for a bank to hold securities, notes, mortgages, or similar instruments in a "Customer Collections" department, collecting income and remitting it to customers. This could be considered a normal banking function not requiring trust powers. However, there have been instances where banks have entered into arrangements to make investment recommendations, buy and sell securities on their own authority, vote proxies, and otherwise deal with securities in the manner of a fiduciary. Banks have also entered into discretionary arrangements to execute repurchase agreements, or make other short-term investments using demand deposit accounts to settle transactions. Some escrow departments may hold, manage, rent, or otherwise administer real property in a manner, which reaches beyond conventional escrow relationships. All these activities constitute discretionary agencies typically requiring trust powers. Normally, the most important determining factor is the degree of discretionary authority exercised over funds and assets, with resulting exposure to contingent liabilities. Questionable cases should be submitted by the examiner to the Regional Office for determination.

f. Additional Information

Whether or not additional information is necessary to approve or recommend denial of an application for consent to exercise trust powers, is generally left to the discretion of the Regional Director. Additional information may be obtained by correspondence, telephone, or personal visit. Matters, which may be relevant in considering applications which, are not eligible for expedited processing include:

(1) Competition - If the lack of sufficient trust services in the trade area is of importance in determining a recommendation, competitive information should be secured from the Annual Report of Trust Assets of area banks.

(2) Trust Business Development - The size and scope of the proposed operation may be influenced considerably by the extent to which the applicant plans to use advertising, personal solicitation, and other public relations activities.

(3) Amount and Kind of Property and Potential Volume of Business - The sources of such data will vary. Any information as to trade area demographics, and the types of assets or property by which it is principally represented would, in some instances, prove beneficial.

(4) Deposit Structure - If collateral benefits to the bank, such as a substantial volume of new deposits in the banking department, are anticipated from the establishment of trust services, the bank may be required to provide full details. Caution is suggested in allowing too much weight in consideration for claims of collateral benefits, as these are often short-lived while the obligations of the trust services continue.

(5) Fixed Assets - If establishment of the trust department results in a significant increase in an already heavy fixed asset investment, full details should be requested.

(6) Deposit Insurance - As noted in FDIC Section 330.12, depending on the institution's Prompt Corrective Action capital category, pass-through deposit insurance may not be available on deposits of retirement and

employee benefit plans. This applies to deposits, which may obviously be made in the bank without regard to whether it has trust powers.

However, the likelihood of such deposits being made increases when banks acquire trust powers. The applicability of this section to applicants seeking consent should be ascertained. To the extent that deposits of such plans exist in the bank, or are contemplated, and pass-through deposit insurance is not available, care should be taken to ensure that procedures in both Parts 325 (Capital Maintenance) and 330 (Deposit Insurance Coverage) are being followed, and that corrective plans are in place.

C. CORPORATE STRUCTURE AND ORGANIZATION OF FIDUCIARY ACTIVITIES

1. General

The offering of trust services has long been regarded as an ancillary customer service, primarily the dominion of banks. However, toward the end of the twentieth century a number of forces have combined, with the result that fiduciary services are a dynamic and sought-after product line with significant profit potential. In the U. S., population trends have been a significant factor as the large post-World War II "baby boom" generation matures and accumulates wealth. The large size and consumer influence of this group has created much emphasis on wealth management and transfer. While this has presented trust service providers with more opportunity, it has also attracted competition from banking and non-banking industries. New delivery systems, new products, advances in technology, and consolidation within the financial industry, have all contributed to changes in how banks offer trust services. To properly evaluate these delivery systems the examiner needs an understanding of both the legal and functional organization of the bank's trust services.

The trust department, as a separate and visually distinct department of the bank, remains the most prevalent method for banks to deliver fiduciary services. However, the recent trend toward consolidation within the financial services sector has led to diverse restructuring and merger activity. In some instances, banks previously lacking trust product lines may have acquired them through mergers. In other cases, the "trust" line of business may have been purchased or sold by a bank. In some cases, trust services being provided by several individual banks owned by the same holding company may have been consolidated within one bank, or within a separately chartered trust company. In still other instances, a bank may have contracted with an unrelated outside party, to provide such services on-premises. Or conversely, the bank under examination may provide such services to other banks. In all cases, the examiner should seek to understand the organization, and review the structure of the delivery system for legality, reasonableness, and adequacy of compensation to the bank.

CHANGE IN BANK CONTROL ACT

Introduction

The Change in Bank Control Act of 1978, Title VI of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, amended Section 7(j) of the Federal Deposit Insurance Act. The amendments gave Federal banking agencies authority to disapprove changes in control of insured banks and bank holding companies. The appropriate agencies for changes in control are: the FDIC for insured nonmember banks, The Board of Governors of the Federal Reserve System for member banks and bank holding companies, the Comptroller of the Currency for national banks, and the Director of the Office of Thrift Supervision for savings associations and savings and loan holding companies. Previous reporting requirements relating to loans by banks secured by stock of other banks and management changes occurring after a change in control were retained with some modification and these requirements were extended to bank holding companies and loans secured by bank holding company stock. The FDIC's objectives in its administration of the Change in Bank Control Act are to enhance and maintain public confidence in the banking system by preventing identifiable serious adverse effects resulting from anticompetitive combinations of interest, inadequate financial support, and unsuitable management in these institutions. The FDIC will review each notice to acquire control of an insured State nonmember bank and disapprove transactions likely to have serious harmful effects.

Provisions of Law

Section 7(j) of the FDI Act; Subpart E, Section 303.80 of the FDIC's Rules and Regulations and the FDIC Statement of Policy, "Changes in Control in Nonmember Banks," set forth in detail all necessary requisites and instructions.

Procedures

Any person (broadly defined) seeking to acquire control (power to vote 25% or more of any class of voting securities) of any insured bank or bank holding company, is required to provide sixty days prior written notice to the appropriate agency. A person means an individual or a corporation, partnership, trust, association, joint venture, pool, syndicate, sole proprietorship, unincorporated organization, or any other form of entity. A Notice of Acquisition of Control form is required to be filed with the appropriate Regional Office, accompanied by a completed and signed Financial Report and Biographical Information form for each of the acquiring parties to the extent known. Certain newspaper publication requirements are also required as indicated in Part 303.

The FDIC reviews the information reported in a Notice to assess any anticompetitive or monopolistic effects of the proposed acquisition, to determine if the financial condition of any acquiring person is such as might jeopardize the financial stability of the bank or prejudice the interests of the depositors of the bank, and to determine whether the competence, experience, or integrity of any inquiring person, or any of the proposed management personnel, indicates that it would not be in the interest of the depositors of the bank, or in the interests of the public, to permit such person to control the bank.

While processing and handling of Notices may parallel the procedures related to applications for deposit insurance, new branches, relocations, etc., at least one fundamental difference is present. In the case of statutory applications, the burden of making a case in support of a proposal falls on the applicant; in considering Notices, the FDIC exercises a veto, with a burden of sustaining a disapproval falling on the FDIC. Accordingly, in evaluating Notices, the FDIC need not find favorably on the various factors; the absence of unfavorable findings approximates tacit approval.

Regional Directors are delegated, with certain exceptions, authority to issue a written notice of the FDIC's intent not to disapprove an acquisition of control. Authority to disapprove has been delegated to the Director and Deputy Director (DOS) and where confirmed in writing by the Director to an associate director. If written views of the State authority recommend disapproval, or if an acquiring party discloses a conviction or a plea of no contest to a criminal charge involving dishonesty or breach of trust, the Regional Director makes a recommendation to Washington based on the findings under the factors.

The factors considered in evaluating Notices and the basis for disapproval are, in brief: whether the proposed acquisition of control would result in a monopoly; whether the effect the proposed acquisition of control in any section of the country may be substantially to lessen competition or to tend to create a monopoly, or would in any other manner be in restraint of trade; the financial condition of the acquiring party and its potential impact on the financial stability of the bank or prejudice the interests of depositors; the competence, experience or integrity of any acquiring person or proposed management; if any acquiring party neglects, fails, or refuses to furnish all the information required by the FDIC; or the effect on the Bank Insurance Fund or Savings Association Insurance Fund is adverse.

A transaction triggering the notice requirements may not result in the acquiring party actually gaining effective control of an institution. For example, a person acquiring 25% of voting control would not gain effective control if there were an existing shareholder with 50% of voting control. Nonetheless, the transaction triggers the notice requirement and a Notice should be evaluated as if it were an actual change in effective control. After once complying, further acquisitions by the same person in the same bank do not require filing of notices. An acquiring party who continuously remains within the definition of control needs to file only one notice per bank to be in compliance.

Certain types of transactions are exempt from prior notice requirements, such as those subject to Section 3 of the Bank Holding Company Act, Section 10 of the Home Owner's Loan Act, or Section 18 of the FDI Act, since they are covered by existing regulatory approval procedures. Accordingly, changes in control due to acquisitions by bank holding companies and those resulting from mergers, consolidations, or other similar transactions are not covered. Acquisition of shares of foreign banks are exempt, however, foreign banks with insured domestic branches are subject to the after-the-fact reporting requirements. Transactions resulting in voting control of 10% or more of any class of voting securities of banks whose securities are subject to the regulation requirements of Part 335 of the FDIC's Rules and Regulations are presumed to be acquisitions of control as are similar transactions of unregistered banks resulting in 10% or more control whereby the acquiring party would become the largest shareholder. These latter two are rebuttable presumptions of control. In addition, the following types of transactions are also exempt: a foreclosure of a debt previously contracted in good faith; testate or intestate successions; a bona fide gift; and; a transaction described in Section 2(a)(5) or 3(a)(5)(A) or (B) of the Bank Holding Company Act by a person there described.

Persons acquiring control by exempt transactions while not required to give prior notice, are required to provide after-the-fact information on the transaction and other information regarding changes in management or policies of the bank. Personal financial and biographical information may be requested subsequent to changes in control of these types at the discretion of the Regional Director. Affected banks are required to report changes or replacement of chief executive officers or directors occurring within twelve months after change in control, including a statement of the past and current business and professional affiliations of the new chief executive officer or director.

Section 7(j) of the FDI Act also requires the chief executive officer of an insured bank that makes a loan secured or to be secured by 25% or more of the voting stock of another insured bank to report the facts to the appropriate regulatory agency. No report need be made where the stock is that of a newly organized bank prior to its opening. Through the definition of insured bank, the reporting requirement is extended to include loans secured by bank holding company stock.

Effective enforcement of Section 7(j) of the FDI Act requires examiners to review stockholder ledgers and records and review correspondence files to determine whether any nonexempt stock transactions have occurred which would constitute an acquisition of control, whether prior notice has been provided to the FDIC where required, and, if bank management has complied with the after-the-fact reporting requirements relating to bank stock loan reports and changes or replacement of the chief executive or directors. Review of stockholder records must be conducted with particular attention to the statutory definition of control, including the presumptions of control established in Part 303 of the FDIC's Rules and Regulations. All substantial change in ownership transactions between examinations should be reviewed, however, a relatively small transaction may trigger the notice requirements and the statutory definition of control does not necessarily imply effective control. Examiners should also be alert to the formation of voting trusts, assignments of proxies of duration beyond the customary annual meeting solicitations, and other similar arrangements which effectively transfer voting control and which may require prior notice. The statute and implementing regulations do not elaborate on what constitutes a group acting in concert. A series of transactions which are individually insignificant, but significant when aggregated, may indicate a subterfuge, particularly if the individuals or entities involved have other business or professional relationships. Consultation with the Regional Office would appear prudent should such a situation of this type be encountered.

Apparent violations regarding acquisitions consummated without filing of a prior notice should be communicated to the Regional Office by telephone and reported in the Supervisory Section of the Report of Examination. Apparent violations for failure to comply with the after-the-fact reporting requirements should be detailed in the open section of the report under Violations of Laws and Regulations since civil money penalties may be invoked (refer to the Civil Money Penalties Section of this Manual).

APPLICATIONS FOR RETIREMENT OF CAPITAL

Introduction

Refer to the current FDIC Statement of Policy on Capital in the Capital Section of this Manual. Section 303.241 of the FDIC Rules and Regulations contains the procedures to be followed when an institution seeks the FDIC's prior approval to reduce the amount or retire any part of its common or preferred stock, or to retire any part of its capital notes or debentures.

There is concern that approval of a request to retire subordinated notes by a bank which is in danger of failure may in effect be granting preferred creditor status to the note holder. Consequently, unless a bank is in a condition which indicates it might fail within a reasonable time, the Regional Director should exercise delegated authority and approve the request.

Applicants should submit a letter application containing the following: type and amount of the proposed change to the capital structure and the reason for the change; a schedule detailing the present and proposed capital structure; the time period that the proposal will encompass; if the proposal involves a series of transactions affecting Tier 1 capital components which will be consummated in twelve months or less, the application shall certify that the insured depository institution will maintain itself as a well-capitalized institution as defined in Part 325 of the FDIC Rules and Regulations, both before and after each of the proposed transactions; if the proposal involves the repurchase of capital instruments, the amount of the repurchase price and the basis for establishing the fair market value of the repurchase price; a statement that the proposal will be available to all holders of a particular class of outstanding capital instruments on an equal basis, and if not, the details of any restrictions; and the date that the applicant's board of directors approved the proposal. Expedited processing is available for eligible depository institutions as defined in Part 303.

Adequacy of the remaining capital is the chief factor considered in acting upon applications for capital retirement or reduction. In granting or withholding consent, the FDIC must consider the six statutory factors: the financial history and condition of the bank; the adequacy of its capital structure; its future earnings prospects; the general character of its management; the convenience and needs of the community to be served and whether or not its corporate powers are consistent with the purposes of the FDI Act.

Section 18(i) of the FDI Act deals specifically with the subject of capital retirement. The FDIC's Legal Division has ruled that the provisions of this section also apply to capital retirements or reductions relative to the following: retirements or reductions which are part of another proposal for which a current application has been filed for FDIC approval; conversion of capital notes or debentures to an equivalent amount of common stock or preferred stock; conversion of preferred stock to an equivalent amount of common stock; and repurchase and retention by a bank of its own capital as part of a stock option plan.

Capital Notes and Debentures

Insured State nonmember banks customarily seek the FDIC's consent to retire subordinated notes or debentures at the time of proposed issuance of such obligations. The Legal Division is of the opinion that where a replacement of capital issues is clearly of a formalistic nature only, without an effective reduction in the amount of the bank's capital and with no change to the governing terms and conditions of the instruments themselves, the replacement should not be deemed to come within Section 18(i)(1) of the FDI Act.

All new subordinated note and debenture agreements must contain a statement to the effect that the prior consent of the FDIC is required before any portion of the debt can be retired. The purpose of including the statement is to assure that all parties involved, including future holders of the notes, are aware of the requirements of Section 18(i)(1). Where periodic mandatory payments are required, the agreement and the notes may include the additional statement that these particular mandatory payments have already been consented to by the FDIC, if such advance consent has, in fact, been given.

APPLICATIONS FOR MERGERS

Introduction

It is the policy of the FDIC to preserve the soundness of the banking system and promote market structures conducive to competition. A proposed merger, consolidation, and purchase of assets and assumption of liabilities are all hereafter referred to collectively as "mergers."

Provisions of Law

Section 18(c) of the FDI Act (the "Act"), popularly known as the Bank Merger Act, provides that, except with the prior written approval of the FDIC, no insured depository institution may merge with any other insured depository institution, if the acquiring, assuming or resulting institution is to be a nonmember insured bank. The section also requires approval before an insured depository institution may merge with a noninsured bank or institution. The section contains special provisions for interstate merger transactions. These are subject to section 44 of the FDI Act. In addition, the FDIC will consider in evaluating merger applications the requirements of the Community Reinvestment Act. The factors to be considered in granting or withholding approval are those enumerated in Section 18(c) of the "Act". Subpart D of Part 303 of the FDIC Rules and Regulations governs the administrative handling of "merger" applications.

Paragraph (4) of Section 18(c) of the "Act" provides that, before acting on an application, the FDIC must request reports on the competitive factors involved from the Attorney General, the Comptroller of the Currency and the Board of Governors of the Federal Reserve System. These reports must ordinarily be furnished within 30 days, and the applicant will, if it so requests, be given an opportunity to submit comments to the FDIC respecting the contents of the competitive factor reports.

Paragraph (5) of Section 18(c) prohibits the FDIC from approving anticompetitive mergers. To establish that any anticompetitive effect is clearly outweighed in the public interest, the proponents must show that probable effect of the transaction in meeting convenience and needs is likely to benefit all seekers of banking services in the areas of competitive impact, rather than merely those who seek, for example, large loan and trust services, and that the expected benefit cannot reasonably be achieved through other, less anticompetitive means. The statute also requires the FDIC to consider in every case the financial and managerial resources, future prospects of the existing and proposed institutions, as well as the convenience and needs of the community to be served.

Under Section 8(q) of the "Act," whenever the liabilities of an insured depository institution are assumed by another insured depository institution; the insured status of the institution whose liabilities are assumed terminates on the date of receipt by the FDIC of satisfactory evidence of the assumptions, and separate insurance of all assumed deposits terminates at the end of six months from the date the assumption takes effect or, in the case of any time deposit, the earliest maturity after the sixth-month period.

Branch closings in connection with a merger transaction are subject to the notice requirements of Section 42 of the FDI Act, including requirements of notification to customers.

Statement of Policy - Bank Merger Transactions

The FDIC Statement of Policy on Bank Merger Transactions was revised effective October 1, 1998. The FDIC is prohibited by law from approving any merger that would tend to create or result in a monopoly, or which would further a combination, conspiracy or attempt to monopolize the business of banking in any part of the United States. Similarly, the FDIC may not approve a transaction whose effect in any section of the country may be to lessen competition substantially, or which in any other manner would be in restraint of trade. The FDIC may, however, approve any such transaction if it finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by its probable effect in meeting the convenience and needs of the community to be served, for example, where approval of the merger may prevent the probable failure of one of the banks involved. In every case, the FDIC must also consider the financial and management resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served.

In evaluating the various factors prescribed and making the necessary judgments on proposed merger transactions, it is the intent and purpose of the FDIC to foster and maintain a safe, efficient and competitive banking system that meets the needs of all elements of the communities served. With these broad goals in mind, the FDIC will apply the specific standards listed in the Policy Statement in evaluating and deciding proposed bank merger transactions.

Procedures

Banks seeking the FDIC's consent to engage in a merger transaction must file a formal application with the FDIC on the appropriate form. The FDIC will not take final action on an application until notice of the proposed transaction is published in a newspaper or newspapers of general circulation in the appropriate community or communities, in accordance with the requirements of Section 303.65 of the FDIC's Rules and Regulations.

Section 303.64 of the FDIC Rules and Regulations provides for expedited processing to eligible applications. In evaluating a merger application, the FDIC considers the following factors: the extent of existing competition between and among the merging institutions, other depository institutions, and other providers of similar or equivalent services in the relevant product markets within the relevant geographic markets. In its analysis of the competitive effects of a proposed merger transactions, the FDIC will focus particularly on the type and extent of competition that exists and that will be eliminated, reduced or enhanced by the proposed merger transaction.

In order to determine the effect of the proposed merger on competition, it is necessary to identify the relevant geographic market. The delineation of such market can seldom be precise, but realistic limits should be established so the effect of the merger upon competition can be properly analyzed. The FDIC recognizes that different banking services may have different relevant geographic markets. However, the market should not be drawn so expansively as to cause the competitive effect of the merger to seem insignificant. Conversely, the market should not be drawn so narrowly as to place competitors in entirely different markets. After the relevant geographic market has been identified, the competitive effect of the proposed merger can be analyzed. A merger not having a substantially adverse competitive effect may nevertheless be disapproved if, after considering the banking factors, the FDIC concludes that the resultant bank will have inadequate capital, unsatisfactory management, or poor earnings prospects. Refer to the policy statement for further competitive effects analytical explanation.

In addition to the competitive analysis, the FDIC will consider prudential factors. These include the existing institutions overall condition, including capital, management and earnings. Apart from competitive considerations, the FDIC normally will not approve a proposed merger transaction where the resulting institution would fail to meet existing capital standards, continue with weak or unsatisfactory management, or whose earnings prospects, both in terms of quantity and quality are weak, suspect or doubtful. In assessing capital adequacy and earnings prospects, particular attention will be paid to the adequacy of the allowance for loan and lease losses. In evaluating management, the FDIC will rely to a great extent on the supervisory histories of the institutions involved and of the executive officers and directors that are proposed for the resultant institution.

The Convenience and Needs factor is also evaluated. Under this factor, the FDIC will consider the extent to which the proposed merger transaction is likely to benefit the general public through higher lending limits, new or expanded services, reduced prices, increased convenience in utilizing the services and facilities of the resulting institution, or other means. The FDIC, as required by the Community Reinvestment Act, will also note and consider each institution's CRA performance evaluation record. An unsatisfactory record may form the basis for denial or conditional approval of an application.

The commitment to pay or payment of unreasonable or excessive fees and other expenses incident to an application reflects adversely upon the management of the applicant institution. The FDIC will closely review expenses for professional or other services rendered by present or prospective board members, major shareholders or other insiders for any indication of self-dealing to the detriment of the institution. As a matter of practice, the FDIC expects full disclosure to all directors and shareholders of any arrangement with an insider. In no case will the FDIC approve an application where the payment of a fee, in whole or part, is contingent upon any act or forbearance by the FDIC or by any other federal or state agency or official.

Where banking offices are to be closed in connection with the proposed merger transaction, the FDIC will review the merging institution's conformance to any applicable requirements of section 42 of the FDI Act concerning notice of branch closing as reflected in the interagency Policy Statement Concerning Branch Closing Notices and Policies. Although the appropriate application must be filed with the FDIC and statutory factors are considered in the case of "interim" (mergers or other transactions involving an existing bank and a newly chartered bank or corporation for the purpose of corporate reorganization) and other corporate reorganizations (transactions involving banks controlled by the same holding company or transactions involving banks or their subsidiaries), these types of transactions normally do not have any effect on competition or otherwise have significance under relevant statutory standards set forth in Section 18(c) of the FDI Act. The guidelines set forth above for "mergers" have only general applicability and may have no applicability depending on the specific circumstances involved in individual transactions.

APPLICATIONS BY UNDERCAPITALIZED DEPOSITORY INSTITUTIONS FOR A WAIVER TO ACCEPT, RENEW OR ROLLOVER BROKERED DEPOSITS

Provisions of Law

Section 224 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 added Section 29 to the FDI Act, prohibiting the acceptance, renewal or rollover of brokered deposits by any undercapitalized insured depository institution (bank or savings association) except on specific application to and waiver of the prohibition by the FDIC.

Section 337.6 of the FDIC's Rules and Regulations provides guidance and detail on when an institution is considered undercapitalized, when certain deposits are considered "brokered" for purposes of the prohibition, and the circumstances under which a waiver from the prohibition may be obtained. Section 303.243 contains the procedures to follow to file with the FDIC for a brokered deposit waiver. Expedited processing of these filings is extended to eligible depository institutions with the caveat that for purposes of this filing, eligible depository institutions may be adequately capitalized, according to the definition found in Section 325.103 of the FDIC's Rules and Regulations, rather than well-capitalized as is required for other filings.

The regulation takes a broad view of when an institution is considered undercapitalized and a narrow view of the circumstances under which a waiver may be obtained with the result and expectation that such institutions will not accept new brokered deposits and over some reasonable time frame all undercapitalized depository institutions utilizing brokered deposits will have to either meet applicable capital standards or eliminate brokered deposits from their books.

Procedures

Undercapitalized insured depository institutions may file waiver applications under section 337.6 with the Regional Office where they are headquartered. Institutions may apply for a waiver in letter form or on an optional application form. Applications should contain: the time period for which the waiver is requested, a statement of the policy governing the use of brokered deposits in the institution's overall funding and liquidity management program; the volume, rates and maturities of the brokered deposits held currently and anticipated during the waiver period sought, including any internal limits placed on the terms, solicitation and use of brokered deposits; how brokered deposits are costed and compared to other funding alternatives and how they are used in the institution's lending and investment activities, including a detailed discussion of asset growth plans; procedures and practices used to solicit brokered deposits, including an identification of the principal sources of such deposits; management systems overseeing the solicitation, acceptance and use of brokered deposits; a recent consolidated financial statement with balance sheet and income statements; and the reasons the institution believes its acceptance, renewal or rollover of brokered deposits would pose no undue risk.

Authority is delegated to Regional Directors or Deputy Regional Directors to approve or deny brokered deposit waiver applications. Based upon a preliminary review, any delegate may grant a temporary waiver for a short period in order to facilitate the orderly processing of a filing for a waiver. A waiver should be for a fixed period, generally no longer than two years, and may be revoked by the FDIC at any time by written notice to the institution.

POLICY STATEMENT ON ENCOURAGEMENT AND PRESERVATION OF MINORITY OWNERSHIP OF FINANCIAL INSTITUTIONS

Introduction

In recognition of the unique status of minority-owned depository institutions in the financial system, it is the policy of the DOS to proactively preserve minority ownership of financial institutions and to encourage minority participation in the management of financial institutions. This policy is intended to be consistent with the FDIC's broader mission of preserving the soundness of the banking system and promoting fair market structures conducive to competition and community service.

For the purposes of this policy statement, the term minority-owned institution means an FDIC-insured depository institution where more than 50% of the voting stock is owned or controlled by minority individuals or organizations, or in the case of a mutual depository institution, the majority of the Board of Directors, account holders and the community which it serves are members of a minority group. The term "minority" means any Black American, Native American, Hispanic American, or Asian American.

Statutory Requirements

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) contains several provisions relating to the preservation of minority ownership of financial institutions. These statutes provide a framework for this policy statement.

Section 13(k) of the FDI Act deals with emergency acquisitions of distressed savings associations. Section 13(k)(2)(B) addresses the acquisition of minority-controlled depository institutions by stating: "the FDIC shall seek an offer from other minority-controlled depository institutions before seeking an offer from other persons or entities.

Section 13(f)(12) of the FDI Act eliminates the $500,000,000 asset cut-off for acquisition of a distressed minority-controlled bank by an out-of-state minority-controlled depository institution or depository institution holding company.

Section 308 of FIRREA sets goals to preserve minority ownership of financial institutions. These goals are set out as:

1. Preserving the number of minority depository institutions;
2. Preserving the minority character in cases of merger or acquisition;
3. Providing technical assistance to prevent insolvency of institutions not now insolvent;
4. Promoting and encouraging creation of new depository institutions; and
5. Providing for training, technical assistance, and education programs.

Discussion

The Division of Supervision becomes involved in the creation of new minority ownership through its responsibility for acting on applications for federal deposit insurance and mergers and reviewing notices of acquisition of control. For those minority applicants who are not familiar with the required laws, procedures or forms, technical expertise and assistance should be made available through DOS Regional Offices.

One very effective method of preserving minority ownership is to maintain the health of existing minority-owned depository institutions. In this regard, DOS is committed to a program of regular examination of all banks for which it has primary supervisory responsibility. This examination program is intended to detect deteriorating trends and to work with management to correct them. Correction of any adverse trends in institutions normally is handled through regular supervisory channels. In the event that management is unable to effect correction because of a lack of resources or technical expertise, DOS will provide assistance where practical. Additionally, DOS encourages other depository institutions to be available to provide technical expertise to minority-owned institutions.

Training, education and technical assistance are available through the FDIC in such areas as call report preparation, consumer affairs and civil rights, and accounting. FDIC personnel generally are available for attendance at conferences or seminars dealing with issues of concern to minority groups.

Procedures and Related Matters

Applications - Notices of acquisition of control and applications for deposit insurance and merger from minority-owned institutions will be submitted to the appropriate regional office and processed under established procedures. Those applications which involve creation or preservation of minority ownership also will be considered in the context of the effect of the transaction on the goal of preserving minority ownership. Technical assistance in the completion of the documentation of these applications is available upon request from the regional office.

Operating Institutions in Need of Assistance - Through its normal supervision, the FDIC will be aware of institutions in need of remedial or preventative attention. Field examiners and regional office staff will make suggestions and offer assistance, which an institution is free to accept. Institutions are also urged to make their needs known to the Regional Director who will do all they can to help. To the extent possible, the FDIC will consider invitations to participate in seminars, conferences and workshops directed to minority audiences.

Request for Financial Assistance - Requests from minority groups for assistance in resolving a failing minority-owned depository institution will be considered at the same time as assistance requests or failing bank bids received from non-minority groups; however, preference generally will be given to a minority group proposal. Technical assistance in preparing these applications is available upon request.

Failing Banks - In the event a minority-owned bank deteriorates into a failing condition, a list of eligible bidders is compiled. Generally, preference will be given to qualified minority bidders located 1) in the same local market area, 2) in the same state, and 3) nationwide. Trade associations will be contacted for names of possible interested parties which may be contacted. Groups interested in becoming bidders must have appropriate clearance from other responsible regulatory agencies.

APPLICATIONS PURSUANT TO SECTION 19 OF THE FDI ACT – CRIMES INVOLVING DISHONESTY OR BREACH OF TRUST OR MONEY LAUNDERING, OR PRETRIAL DIVERSION PROGRAMS FOR SUCH OFFENSES

Provisions of Law

Section 19 of the FDI Act prohibits, without the prior written consent of the FDIC, a person convicted of any criminal offense involving dishonesty, breach of trust, money laundering, or who has agreed to enter into a pretrial diversion or similar program for such offense, from becoming or continuing as an institution-affiliated party, owning or controlling, directly or indirectly an insured depository institution, or otherwise participating, directly or indirectly, in the conduct of the affairs of an insured institution.

Section 19 imposes a duty upon the insured institution to make a reasonable inquiry regarding an applicant's history, which consists of taking steps appropriate under the circumstances, consistent with applicable law, to avoid hiring or permitting participation in its affairs by a person who has a conviction or program entry for a covered offense. The FDIC believes that, at a minimum, each insured institution should establish a screening process that provides the insured institution with information concerning any convictions or program entry pertaining to a job applicant. This would include, for example, the completion of a written employment application (although other alternatives may be appropriate) that requires a list of all convictions and program entries. The FDIC will look to the circumstances of each situation to determine whether the inquiry is reasonable.

Upon notice of a conviction or program entry, the institution should obtain forms and instructions from, and file an application with, the appropriate FDIC Regional Director. The application must be filed by an insured depository institution on behalf of a person, unless the FDIC grants a waiver of that requirement. The FDIC will consider such waivers on a case-by-case basis where the institution shows substantial good cause for granting a waiver.

The above information represents a partial summary of the requirements of Section 19. For definitions of terms and additional guidance, examiners should refer to the FDIC Statement of Policy on Section 19 of the FDI Act.

Examiner Responsibilities

Examiners should review conformance with the FDIC Statement of Policy for Section 19 of the FDI Act during examinations of institutions where risk-scoping activities indicate a material degree of risk with respect to this area. The scope or depth of these reviews should comply with the guidelines detailed in the risk-focused supervision examination modules.

APPLICATIONS PURSUANT TO PART 362 OF THE FDIC's RULES AND REGULATIONS – ACTIVITIES AND INVESTMENTS OF INSURED DEPOSITORY INSTITUIONS

Revised Part 362 and related amendments to Part 303 became effective January 1, 1999. The revised rule provides the framework for which certain state-chartered banks or their majority-owned subsidiaries may engage in activities that are not permissible for national banks or their subsidiaries. The institution's chartering authority must permit all contemplated activities.

Under Part 362, well-capitalized, state-chartered banks or their subsidiaries may engage in certain otherwise impermissible activities without seeking specific FDIC consent if the bank complies with any limits or conditions restricting those activities. Other activities require depository institutions to submit either a notice or application to the FDIC.

The notice procedure is designed to expedite the processing of requests from banks meeting various eligibility requirements. Activities to which notice processing has been extended include securities underwriting and real estate investment activities.

OTHER APPLICATIONS

Subpart F of Part 303 – Change of Director or Senior Executive Officer

Insured state nonmember banks are to give the FDIC written notice at least 30 days prior to adding or replacing any member of its board of directors, employing any person as a senior executive officer of the bank, or changing the responsibilities of any senior executive officer so that the person would assume a different senior executive officer position if:

(1) The bank is not in compliance with all minimum capital requirements applicable to the bank

(2) The bank is in troubled condition, or

(3) The FDIC determines, in connection with its review of a capital restoration plan that such notice is appropriate

Waivers to the pre-filing requirement may be applied for and granted if delay would threaten the safety or soundness of the bank or not be in the public interest. In the case of the election of a new director not proposed by management at a meeting of the shareholders, the prior 30-day notice is automatically waived provided that a complete notice is filed with the appropriate regional director within two business days after the individual's election.

Subpart I – Mutual-to-Stock Conversions

An insured state chartered mutually owned savings bank that proposes to convert from mutual to stock form shall file with the FDIC a notice of intent to convert to stock form.

At a minimum, such notice shall contain:

- The plan of conversion with specific information concerning the record date used for determining eligible depositors and the subscription offering priority;
- Certified board resolutions relating to the conversion;
- A business plan including a discussion of how the capital acquired in the conversion will be used, expected earnings for at least a three year period following the conversion and a justification for any proposed stock repurchase;
- The charter and bylaws of the converted institution
- The bylaws and operating plans of any other entities formed in connection with the conversion transaction such as a holding company or charitable foundation;
- A full appraisal report, prepared by an independent appraiser of the value of the converting institution and the pricing of the stock to be sold in the conversion transaction;
- Detailed descriptions of any proposed management or employee stock benefit plans or employment agreements and a discussion of the rationale for the level of benefits proposed;
- Indemnification agreements;
- A preliminary proxy statement and sample proxy;
- Offering circular(s);
- All contracts or agreements relating to solicitation, underwriting, market-making or listing of conversion stock and any agreements among members of a group regarding the purchase of unsubscribed shares;
- A tax opinion concerning the federal income tax consequences of the proposed conversion;
- Consent from experts to use their opinions as part of the notice; and
- An estimate of conversion-related expenses.

The FDIC shall review the notice and other materials for considerations such as: the proposed use of the proceeds, the adequacy of the disclosure materials, the participation of depositors in approving the transaction, the appropriateness of any proposed increased compensation and other remuneration to be granted to officers and directors, the adequacy and independence of the appraisal of the value of the mutual savings bank for purposes of determining the price of the shares of stock to be sold and the extent to which the proposed conversion transaction conforms with the various provisions of the mutual-to-stock conversion regulations of the Office of Thrift Supervision.

The FDIC will issue either a letter of non-objection if the FDIC determines that the proposed conversion transaction would not pose a risk to the institution's safety or soundness, or a letter of objection. In the latter case, if the FDIC determines either that the proposed conversion transaction poses a risk to the institution's safety or soundness, violates a law or regulation, or presents a breach of fiduciary duty, the objection letter would instruct the institution not to consummate the transaction until such point as the objection letter is rescinded.

Other Filings

Golden Parachute and severance plan payments – Pursuant to section 18(k) of the FDI Act and Part 359 of the FDIC Rules and Regulations, an insured depository institution or depository institution holding company may not make golden parachute payments or excess nondiscriminatory severance plan payments unless permission is obtained.

For additional information and guidance on the various applications, please also refer to:

- The Division of Supervision and Consumer Affairs **Formal and Informal Action Procedures Manual**, and
- The Division of Supervision and Consumer Protection **Case Managers Procedures Manual**.

INTRODUCTION

Regulatory agencies may use formal or informal procedures to address weak operating practices, deteriorating financial conditions, or apparent violations of laws or regulations. A memorandum of understanding (MOU) is a common informal agreement used by the FDIC to obtain a commitment from a bank's board of directors to implement corrective measures. Other informal actions include board resolutions, letter agreements, and other forms of bilateral agreements or unilateral actions. Informal actions are not public information or legally enforceable. A financial institution's failure to implement the corrective measures detailed in an informal agreement may lead to formal corrective actions.

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MEMORANDUMS OF UNDERSTANDING

An MOU provides a structured way to correct problems at institutions that have moderate weaknesses, but have not deteriorated to a point requiring formal corrective actions. An MOU may be appropriate if examiners (after discussing examination findings with field- and regional-office personnel and the bank), determine that the board of directors and management are committed to, and capable of, implementing effective corrective measures.

An MOU may be used to address specific problems at institutions rated 1 or 2 and should, at a minimum, be considered for all institutions rated 3. An MOU may not be required at an institution rated 3 if the regional director or designee determines that the institution's financial condition improved significantly or that there are other strong mitigating circumstances. For example, a weak management team may have been replaced by a strong management team, or an acceptable action by a state authority might make an MOU unnecessary. However, the mere belief that management recognized its errors and will improve the bank's condition is generally not a sufficient reason to make an exception.

Examiners should consider recommending formal enforcement action pursuant to Section 8 of the Federal Deposit Insurance (FDI) Act for institutions rated 3 if management appears unwilling to take appropriate corrective measures, and for all composite 4- or 5-rated institutions.

Memorandum Considerations

When determining whether to seek an informal (or formal) action, examiners should consider:

- Management's attitude towards complying with laws and regulations and correcting undesirable or objectionable practices;
- Whether violations or objectionable practices were intentional, repetitive, substantive, or numerous;
- The institution's history of violations and unsatisfactory practices;
- Management's history of instituting timely remedial or corrective actions;
- Whether management already initiated corrective actions;
- Whether management established procedures to prevent future deficiencies or violations;
- The extent of harm caused, or likely to be caused, by the violations or unsatisfactory practices; and
- Any other circumstances that warrant use of an informal action.

Issuing Memorandums

Examiners considering the use of an MOU should contact their supervisory examiner, field supervisor, or regional reviewer (in accordance with regional policy) to discuss the possibility of issuing an MOU. When an institution is affiliated with a bank or holding company supervised by another federal regulatory agency, the regional reviewer should notify the agency of the proposed action. In all instances, state authorities should be notified of, and invited to join, proposed actions.

If an MOU is deemed appropriate, the examiner should draft a memorandum to the regional director recommending the MOU and detailing areas that the MOU should address. The examiner's memorandum to the regional director should include:

- A brief description of the examination findings, and
- Detailed recommendations for addressing each significant concern.

With the concurrence of the regional office, the examiner (and when appropriate, regional- or field-office representatives) should discuss the possible use of an MOU with management and the board at the exit and board meetings. Also, with regional- or field-office concurrence, the examiner should explain that the FDIC might consider implementing other actions if the MOU does not result in effective corrective actions.

Monitoring Compliance with Memorandums

Monitoring an institution's progress in achieving the goals of an outstanding MOU may involve offsite monitoring, visitations, and examinations. Examiners should reflect the adequacy of an institution's response to an MOU in the Management rating.

Examiners should include a summary of outstanding MOUs in the Examination Conclusions and Comments section of the Report of Examinations (ROE). Examiners should detail action provisions and the status of compliance with the provisions on the Compliance with Enforcement Actions page. Examiners should describe each provision and the status of compliance at the first examination after the issuance of an administrative action. At subsequent examinations, examiners may summarize provisions and only address requirements of a continuing nature and items that the institution had not complied with at the previous examination.

Examiner comments should sufficiently detail the institution's actions or inactions so readers can draw meaningful conclusions concerning the extent of compliance. Examiners should not use broad statements of opinion such as "compliance is noted," or "not in compliance." Comments should factually describe corrective efforts and indicate whether or not agreed upon time limits have expired. As part of this analysis, examiners should also determine the underlying reasons for an institution's failure to meet provisions of the MOU or improve the bank's condition over a reasonable time frame, and discuss with the Regional Office whether new or revised provisions, or a formal action, would be appropriate.

Terminating Memorandums

Outstanding MOUs should be terminated promptly when:

- The institution has substantially complied with the terms of the MOU,
- The institution's condition has improved sufficiently and the action is no longer necessary,
- A new formal or informal action is issued that addresses all areas of concern, or
- The institution is merged or closed.

Regional office personnel should coordinate the termination of an MOU with any involved state or other federal authority.

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SECTION 39

Section 39 of the FDI Act requires federal banking agencies to prescribe various standards for insured depository institutions. Section 39 allows the FDIC to request corrective plans from financial institutions that do not meet the standards, which are set forth in Part 364 and the interagency guidelines in Appendix A and Appendix B to Part 364. The standards provide financial institutions guidelines for overseeing activities relating to risk management and daily operations. Section 39 also provides banking agencies a tool to address weak risk management practices or operating weaknesses in otherwise financially sound institutions before deficiencies lead to capital deterioration. The standards relate to issues such as:

- Internal controls, information systems, and internal audit systems;
- Loan documentation and credit underwriting;
- Interest rate exposure;
- Asset growth;
- Compensation, fees, and benefits; and
- Other operational and managerial matters.

Section 39 also provides a tool for the banking agencies to address weak risk management practices or operating weaknesses in otherwise financially sound institutions before deficiencies lead to capital deterioration.

If an institution fails to meet these standards, the FDIC may pursue informal action under Section 39 by requesting management to submit a Safety and Soundness Compliance Plan. The plan must describe the steps the institution will take to correct identified deficiencies and the time frames for completing the steps.

If an institution fails to submit a requested plan or fails to adhere to a submitted plan, the FDIC will pursue formal enforcement action. Procedures for requesting submission of a compliance plan and issuing an enforceable order pursuant to Section 39 are detailed in Subpart R to Part 308 of the FDIC Rules and Regulations.

Examiners considering whether to request a Section 39 plan should contact their case manager to discuss the appropriateness of the request. If regional management determines supervisory action pursuant to Section 39 is warranted, examiners should submit a recommendation memorandum to their regional director.

Note: Examiners and regional directors must exercise care to avoid requesting compliance plans if identified problems are correctable through standard examination practices.

References:
- Manual Section 15.1, Formal Administrative Actions
- Manual Section 16.1, ROE Instructions
- Statement of Policy - Interagency Notification and Coordination of Enforcement Actions by the Federal Banking Regulatory Agencies

INTRODUCTION

The Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRIRCA) gave the FDIC authority to prospectively assess civil money penalties (CMPs) against both banks and individuals. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) significantly increased the penalties for both banks and individuals and broadened the applicability of civil money penalties. Civil money penalties may be assessed for the violation of any law or regulation, any final order or temporary order issued, any condition imposed in writing by the appropriate Federal banking agency in connection with the approval of any application, and any written agreement between a depository institution and Federal banking agency. For example, civil money penalties may be assessed in the following instances:

1. Violations involving changes in control of banks. Refer to Section 7(j) of the FDI Act, Parts 303 and 308 of the FDIC Rules and Regulations, and the Applications Section of this Manual.
2. Violations involving participation by a convicted individual in the affairs of an insured depository institution. Refer to Section 19 of the FDI Act and the Applications Section of this Manual.
3. Violations of cease-and-desist orders that have become final. Refer to Section 8(i)(2) of the FDI Act, Part 308 of the FDIC Rules and Regulations, and the Formal Administrative Actions Section of this Manual.
4. Violations of Section 23A of the Federal Reserve Act (loans to affiliates). Refer to Section 18(j)(1) and 18(j)(3) of the FDI Act, Part 308 of the FDIC Rules and Regulations, and the Related Organizations Section of this Manual.
5. Violations of Section 22(h) of the Federal Reserve Act (loans to directors, officers, and principal stockholders). Refer to Section 18(j)(2) and 18(j)(3) of the FDI Act, Part 308 of the FDIC Rules and Regulations, and the Management Section of this Manual.
6. Violations of Section 106(b) of the Bank Holding Company Act (tying arrangements - official family loans and linked correspondent accounts). Refer to Section 106(b)(2)(F) of the Bank Holding Company Act Amendments of 1970, Part 308 of the FDIC Rules and Regulations, and the Related Organizations Section of this Manual.
7. Violations of Section 3907 of the International Lending Supervision Act of 1983 involving an issued Capital Directive. Refer to Sections 3907 and 3909 of ILSA, Part 325 of the FDIC Rules and Regulations, the Capital Section and the Formal Administrative Actions Section of this Manual.

VIOLATIONS

The previously mentioned statutes and regulations, with the exception of those relating to changes in bank control, define "violations" as including, but not limited to, "any action (alone or with another) for or towards causing, bringing about, participating in, counseling, or aiding or abetting a violation." The definition is exceptionally broad and will likely encompass any violation of the applicable statutes.

ASSESSMENT OF CIVIL MONEY PENALTIES

Civil money penalties are assessed not only to punish the violator according to the degree of culpability and severity of the violation, but also to deter future violations. Although relevant to the FDIC's interests, the primary purpose for utilizing civil money penalties is not to effect remedial action. Such action, in the form of restitution or other corrective measures, should be separately pursued.

In 1998, the FDIC adopted a revised interagency statement of policy regarding the assessment of civil money penalties. To facilitate evaluation of the gravity of such violation(s), the policy statement sets forth the following factors which must be considered in determining whether civil money penalties should be imposed:

1. Evidence that the violation or practice or breach of fiduciary duty was intentional or was committed with a disregard of the law or with a disregard of the consequences to the institution;
2. The duration and frequency of the violations, practices, or breaches of fiduciary duty;
3. The continuation of the violations, practices, or breach of fiduciary duty after the respondent was notified or, alternatively, its immediate cessation and correction;
4. The failure to cooperate with the agency in effecting early resolution of the problem;
5. Evidence of concealment of the violation, practice, or breach of fiduciary duty or, alternatively, voluntary disclosure of the violation, practice or breach of fiduciary duty;
6. Any threat of loss, actual loss, or other harm to the institution, including harm to the public confidence in the institution, and the degree of such harm;
7. Evidence that a participant or his or her associates received financial gain or other benefit as a result of the violation, practice, or breach of fiduciary duty;

8. Evidence of any restitution paid by a participant of losses resulting from the violation, practice, or breach of fiduciary duty;
9. History of prior violation, practice, or breach of fiduciary duty, particularly where they are similar to the actions under consideration;
10. Previous criticism of the institution or individual for similar actions;
11. Presence or absence of a compliance program and its effectiveness;
12. Tendency to engage in violations of law, unsafe or unsound banking practices, or breaches of fiduciary duty; and
13. The existence of agreements, commitments orders, or conditions imposed in writing intended to prevent the violation, practice, or breach of fiduciary duty.

FDIC policy provides that civil money penalty recommendations should only be initiated when the fineable violation is believed to meet the test of gravity as required by FIRIRCA including consideration of the 13 relevant factors found in the interagency statement of policy and the existence of any one of the following criteria:

1. The violation causes the bank to suffer a substantial financial loss;
2. The violation is willful, flagrant, or otherwise evidences bad faith on the part of the bank or individual(s) involved in the violation (including repeated and/or multiple violations, if applicable);
3. The violation directly or indirectly involves an insider, or an associate of an insider, who benefits from the transaction in a material or substantial way; or
4. Previous supervisory means (i.e., specific supervisory comment or correspondence, Memorandum of Understanding, previous civil money penalty assessment, or Cease-and-Desist Order) have not been effective in eliminating or deterring violations.

The aforementioned policy delineates the circumstances under which civil money penalty action may possibly be initiated, but is not intended to preclude consideration of any other matters relevant to a possible civil money penalty assessment. In addition, other fineable violations will be evaluated for recommendation of civil money penalties based on the 13 factors listed above. Where assessment of a civil money penalty is not considered appropriate in these cases, corrective action may be sought by means of a Supervisory Letter sent by the Regional Office to the bank's board of directors. The letter should request adoption of a resolution indicating the directorate's intent to correct the violation(s) and request that procedures be implemented to prevent future infractions. The bank should also be advised to notify the Regional Director when and how the violation(s) have been remedied. An insufficient response from the bank/individual to the Regional Office on the issues covered in the Supervisory Letter may constitute grounds for recommending initiation of civil money penalties.

With regard to a violation of a Cease-and-Desist Order which has become final or an issued Capital Directive, at the discretion of the Regional Director, a recommendation may be made (1) for court enforcement under Section 8(i)(1) of the FDI Act or (2) for initiation of assessment of a civil money penalty, as authorized. The determination should be based on which appears to be most appropriate for the given situation, will most likely result in correction of deficiencies giving rise to the penalty and will achieve the FDIC's objectives.

Penalties

It is the FDIC's policy that, whenever a violation committed by an individual results in personal financial or economic gain and/or financial loss to the bank, the amount involved shall be repaid as a portion of the penalty assessment or, preferably, through restitution to the bank if the bank suffered a loss. More specifically, an attempt should be made to have the individual make restitution to the injured bank for all losses suffered, or absent restitution, repay the personal gain or bank loss through the recommended assessment, plus pay a penalty over and above these amounts for violating the law. If the bank has suffered a loss, willingness and promptness in making restitution should have a bearing on the amount of penalty recommended. If the size of the bank's loss is such that restitution to the bank is desirable and there is no response to informal action, Section 8(b) action should be considered. If the size of the bank's loss is of little consequence in relation to the bank's financial resources, then the amount of loss should be incorporated into the recommended assessment.

Tiered penalty levels have been established. Tier 1 penalties of up to $5,500 per day may be assessed for most violations. If a party commits a violation, recklessly engages in an unsafe or unsound practice or breaches a fiduciary duty which is part of a pattern of misconduct, causes more than minimal loss to the institution or results in a pecuniary gain to such party, then the potential maximum penalty (Tier 2 penalty) increases to $27,500 per day. A Tier 3 penalty of the lessor of $1,100,000 or 1% of total assets may be assessed if a violation, unsafe or unsound practice, or breach of fiduciary duty is knowingly committed and causes a substantial loss to the institution or a substantial pecuniary gain to the violator.

Examiners should recommend a specific money penalty and, as stated in the policy statement, the financial or economic benefit received by the violator should be given significant consideration. In this regard, details of any such benefits must be adequately documented. Depending on the circumstances, the proposed penalty may be:

1. A multiple of the benefit when a strong deterrent on future actions is believed warranted;
2. A fraction when credible assurance of future compliance is received and, where applicable, restitution has been made; or
3. Simply the benefit itself.

To determine an appropriate penalty amount, each case must be considered on its own merits in light of the factors in the law and the policy statement. Consideration should be given to the maximum amount (which must not be exceeded) that can be assessed under the statutes; however, in many cases the amount is so large as to be considered unreasonable and the penalty should be tempered through judgment as to the seriousness of the violation. Prime factors to be considered are the amount of loss to the bank and/or gain to the individual charged, if any. Restitution to the bank of the amount lost should be determined and might be used in reducing the amount of the penalty that otherwise might be assessed. If restitution does not occur, the amount may be included as a portion of the penalty. The financial resources of the individual charged must also be weighed, which may cause a recommended penalty below that which would appear appropriate. Finally, the gravity of the violation and the involvement in the violation of the individual charged should be considered. A determination that the violation was particularly egregious and/or that the individual was directly involved in causing the violation or benefited from it would result in a larger recommended penalty than would a mere technical violation or one in which the individual was not directly involved.

Specific recommendations for assessment of penalties should be forwarded to the Regional Office and not communicated to the bank, its officers, or directors.

EXAMINATION PROCEDURES

The following procedures should be followed whenever fineable violations of laws or regulations are encountered:

1. When fineable violations, unsafe or unsound banking practices, or breaches of fiduciary duty of the type detailed in Section 8(i), 7(j) or 18(j) of the FDI Act are discovered and it is contemplated that CMPs may be an appropriate administrative action, examiners should complete the Civil Money Penalty Matrix. The CMP Matrix will aid the examiner in supporting the appropriateness and/or level of CMPs. The thirteen factors contained in the FFIEC policy statement regarding CMPs are built into the matrix and provide the bases for recommended actions or assessments. Although the CMP Matrix is generally most useful in Tier 1 penalty cases, it should be prepared whenever a penalty is being considered. The CMP Matrix is included at the end of this section.
2. When other fineable violations of statute (such as those detailed in Sections 7(a) and 7(c) of the FDI Act regarding late or inaccurate Reports of Condition and inaccurate certification statements or late payment of deposit insurance assessments) are encountered, the examiner should seek guidance from the Regional Office if the violation is severe and flagrant in nature.
3. Examination comments on the Violations of Laws and Regulations schedule generally should not contain references to the FDIC's power to impose civil money penalties or the maximum dollar amount of CMPs that may be imposed; comments of this nature should be included in only the most serious situations.
4. Reference on the Examination Conclusions and Comments schedule to apparent violations of laws and regulations depends on the seriousness of the situation and the examiner's intentions regarding recommendation of penalties and/or enforcement actions.
5. Examiners should fully discuss violations of law with management; however, discussion of the civil money penalty process should be limited. Unless the examiner intends to recommend the imposition of CMPs, there is minimal need to raise the issue with bank officers or directors. If the issue is raised, examiners may discuss the criteria used by the FDIC to determine whether to assess a penalty and the process involved.
6. The home mailing address for all directors and any other individuals involved in a fineable violation should be included in the Confidential Section of the examination report when it is contemplated that CMPs may be assessed.
7. When a violation involves financial gain to an insider and/or financial loss to the bank (in most instances, the insider's gain will be the bank's loss), the examiner should attempt to determine a monetary value. If management is cooperative, the amount should be determined with the assistance of bank personnel and indicated on the violations page. Otherwise, the examiner should estimate the amount and include it in the violation write-up along with the method of calculation. If the examiner cannot estimate the

monetary value with any degree of confidence, he/she should so state and include the reason why.

8. The Regional Office should be consulted to determine the supporting evidence needed in connection with scheduling a violation where a fine is contemplated. Regional Counsel should be consulted regarding determination of the violation and sufficiency of evidence.
9. Examiners should not discuss penalty matters relating to Section 8 matters; examiners may only confirm to bank management that CMPs may be assessed for noncompliance with terms of the order. This precaution is necessary because determination of noncompliance with a Section 8 Order is made by the Regional Director.
10. Evidence in support of a likely action should be copied and retained in field office files. This evidence should be segregated in a labeled envelope and kept apart from regular workpapers.

OTHER CONSIDERATIONS

If a fineable violation, for which prompt action appears warranted, is cited in a state report of examination, the Regional Office should schedule a visitation. The assigned examiner should be instructed to investigate the violation and, if appropriate, gather sufficient documentation to support a civil money penalty recommendation and/or request for restitution. If a flagrant violation does not appear to be involved, the Regional Director may postpone an investigation until the next scheduled FDIC examination or visitation. A state report of examination should generally not be utilized to support a civil money penalty recommendation or request for restitution, however, the Regional Director does have discretion to utilize it if it is deemed adequate.

Examiners involved in recommending civil money penalties should be mindful that such actions are covered under the Equal Access to Justice Act. The Act provides that certain parties who prevail in contested administrative or judicial proceedings against an agency of the Federal government may be able to recover their litigation expenses from the agency, if the position of the agency in the proceeding was not substantially justified. Examiners should use special care not to charge any practice or violation on inadequate grounds. Examiners should also be mindful that Confidential Section comments will be a matter of record at any required hearing. Comments and observations in the Confidential Section must be well supported and able to withstand cross-examination in a hearing.

GUIDELINES FOR USING THE CMP MATRIX

1. The CMP Matrix contains factors identified by the FFIEC as those which are relevant in determining the appropriateness of initiating a civil money penalty assessment. These factors, along with those statutorily provided, are also used in determining the assessed amount of a civil money penalty. However, these factors and this Matrix are provided solely as guides and do not replace sound supervisory judgment. As a general rule, it is recommended to use the following guidelines in determining how many matrices should be filled out:

   a. One Matrix per person for all violations, reckless unsafe and unsound practices or breaches of fiduciary duty; where there are several violations, practices, or breaches of duty included in one matrix, the highest severity level applicable to any of the violations, practices or breaches of duty should be recorded for each factor on the Matrix. Thus, if a single director approved a loan in violation of Regulation O, another loan in violation of State lending limitations, and engaged in reckless unsafe practices, only 1 Matrix should be completed for that director, with the highest severity level applicable to either of the violations and any of the unsafe practices recorded for each Matrix factor.

   b. One Matrix for a group of persons with similar culpability. Thus, if 6 directors approved a loan in violation of Regulation O, another loan in violation of State lending limitations, and engaged in reckless unsafe practices, and all were equally culpable, only 1 Matrix should be completed for the 6 directors. However, if 2 directors were more culpable than the other 4 directors, a separate Matrix should be completed for those 2 directors.

2. The Matrix generally applies to tier 1 penalties of up to $5,500 per day against institutions and institution-affiliated parties (IAP's) who engage in violations of law, regulations, final or temporary orders, formal agreements, and conditions imposed in writing in connection with the grant of any application or other request by the institution. The FDIC may also assess tier 2 penalties of up to $27,500 per day for the above violations, unsafe and unsound banking practices recklessly engaged in, and breaches of fiduciary duty, which are part of a pattern of misconduct, or cause or are likely to cause more than a minimal loss to the institution, or result in a pecuniary gain to the institution or individual. In addition, the FDIC may assess tier 3 penalties of up to $1.1 million per day for knowing violations, unsafe and unsound practices, and breaches of duty, which knowingly or recklessly cause a substantial loss to the institution, or a substantial pecuniary gain to the institution or individual. If the recommendation is to assess a penalty in excess of $5,500 per day, or if penalties for unsafe practices or breaches of duty are recommended, the examiner should consult with Regional Counsel to determine whether the criteria are met for a tier 2 or tier 3 penalty.

3. One may use the following definitions as a guide in using the Matrix:

   b. An ***Institution-affiliated party (IAP)*** is (1) any director, officer, employee or controlling shareholder (other than a bank holding company) of an insured depository institution, (2) any person who has filed or is required to file a change-in-control, (3) any shareholder, consultant, joint venture partner, or other person who participates in the institution's affairs, or (4) any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in violations of law or regulation, breaches of fiduciary duty, or unsafe or unsound practices, which caused or are likely to cause more than a minimal financial loss to, or a significant adverse effect on, the institution.

   c. An ***unsafe and unsound practice*** is one in which there has been some conduct, whether act or omission, which is contrary to accepted standards of prudent banking operation, and which might result in exposure of the bank or its shareholders to abnormal risk or loss. An unsafe or unsound practice may be considered reckless if it evidences disregard of, or indifference to, the consequences of the practice, even though no harm may be intended.

   d. A ***fiduciary duty*** is a duty of great confidence and trust, which includes a high degree of good faith. For example, bank officers and directors have a fiduciary duty to protect the bank's assets, further the best interests of the bank, and not place their interests above those of the bank.

4. ***Pecuniary Gain or Other Benefit to IAP***: In assessing this factor, the monetary gain or other benefit may be to the IAP who committed the violation, recklessly engaged in an unsafe or unsound practice, or who

breached any fiduciary duty, or to any other IAP or their related interests.

5. ***Previous Administrative Action or Criticism***: Under severity level #1, the reference to "similar violation" could refer to prior criticisms for violations under the same statute or regulation, e.g., a previous violation of a Section 23A provision and currently a violation of a different 23A provision. This could also refer to violations similar in nature, e.g., a previous violation of state law regarding lending limit and currently a violation of the aggregate lending limit provision of Regulation O.

6. ***History***: Under severity level #2, the reference to "similar violation" has the same meaning as the reference to "similar violation" used in the ***Previous Administrative Action or Criticism*** factor explained above.

7. ***Loss***: In assessing this factor, "potential loss" refers to any time at which the bank was in danger of sustaining a loss. Accordingly, if the violation caused a possible loss in its first month, but posed no risk of loss in the second month, the bank experienced a potential loss which falls with this category.

8. ***Continuation***: The reference to "notification" in this factor includes notice of the violation, practice or breach by the FDIC, other regulatory agencies, external auditors, internal auditors or other parties whose responsibilities include providing the bank and/or its subsidiaries with information about its operations.

9. ***Concealment***: This factor pertains to the concealment of a violation, practice or breach from the FDIC, the bank's board of directors or internal and external auditors.

10. ***Impact***: In assessing this factor, it is appropriate to consider any possible negative impact or harm to the bank, other than loss.

11. ***Loss or Harm to Securities Holders or Consumers***: This factor only applies in cases involving violations of securities laws, rules, or regulations applicable to state nonmember banks (where securities holders incur loss or are otherwise harmed) or consumer banking laws, orders, agreements or conditions, unsafe or unsound practices, or breaches of duty.

12. ***Good Faith***: In assessing a person's good faith, the examiner should generally focus on facts and circumstances which occurred prior to notification of the violation, practice or breach by the FDIC, other regulatory agencies, external auditors, internal auditors or other parties whose responsibilities include providing the bank and/or its subsidiaries with information about its operations.

13. ***Full Cooperation***: In assessing this factor, the examiner should generally focus on facts and circumstances which occurred after notification of the violation, practice or breach by the FDIC, other regulatory agencies, external auditors, internal auditors or other parties whose responsibilities include providing the bank and/or its subsidiaries with information about its operations.

For additional information and guidance, please also refer to:

- The **Formal and Informal Action Procedures Manual**, and
- The Division of Supervision and Consumer Protection **Case Managers Procedures Manual**.

CMP Matrix

Boxes on the Matrix (including the empty boxes) should be used to reflect progressive levels of severity. As used in the Matrix, the term "violations" also refers to reckless unsafe and unsound practices and breaches of fiduciary duty.

	0	1	2	3	4	WGT.	POINTS
Intent	No		Should Have Known		Clear Intent	5	
Pecuniary Gain or Other Benefit to Institution Affiliated Party (IAP) or Related Interest	No			Indirect Benefit to IAP or Related Interest	Direct Benefit to IAP or Related Interest	4	
Previous Administrative Action or Criticism	None	Previous Criticism for Similar Violation	Violation or Criticism on Point Cited in Exam or Visit Report	MOU or Supervisory Letter on Point	8(a), C&D, Agreement, Condition in Writing or Prior Assessment on Point	3	
History	None	Unrelated Prior Violations	At least One Similar Violation	Several Similar Violations	Frequent Similar Violations	2	
Loss or Risk of Loss to Bank	No Loss and No Risk of Loss	No Loss or Minimal Risk	Minimal Loss or Moderate Risk		Substantial Actual or Potential Loss	6	
Number of Violations at Issue					Numerous Violations	2	
Duration of Violations Prior to Notification					Violations Outstanding for Long Time	2	
Continuation after Notification	Violation(s) Ceased Prior to Notification	Violation(s) Ceased Immediately Upon Notification		Violation(s) Continued for Period of Time After Notification	Violation(s) Still Continuing	3	
Concealment	None			Purposely Complicated Transaction to Make it Difficult to Uncover	Active Concealment	5	
Impact Other Than Loss	No Impact on Bank or Banking Industry		Substantial Impact on Bank. No Impact on Banking Industry	Moderate Impact on Banking Industry or on Public Perception of Banking Industry	Substantial Impact on Banking Industry or on Public Perception of Banking Industry	6	
Loss or Harm to Securities Holders or Consumers (Securities or Consumer Laws Only)	No Loss and No Harm	No Loss or Minimal Harm	Minimal Loss or Moderate Harm		Substantial Loss or Harm	5	
Subtotal 1							
Restitution	No Restitution	Complete Restitution Under Compulsion	Partial Restitution	Complete Restitution Immediately After Loss or Violation Brought to Attention	Complete Restitution Voluntarily, Before Bank or Examiner Uncovered Loss	2	
Good Faith (prior to Notification)	None				Unintentional Violation	3	
Full Cooperation (after Notification)	None				Forthcoming in Interviews	2	
Subtotal 2							
Total (subtract 2 from 1)							

CMP MATRIX (Continued)

Points	Suggested Action	Responsibility
0-30	Consider not making referral.	Examiner reviews fineable offense(s) and applies Matrix. Workpapers should support decision to not refer.
31-40	Consider sending supervisory letter.	Examiner reviews fineable offense(s) and applies Matrix. Prepares referral to Regional Office. Regional Director considers sending 15-day letter. After consideration of response and referral, Regional Office applies Matrix. Regional Director considers sending a supervisory letter which would inform that, while a penalty assessment will not be pursued, policies which will prevent recurrence of the fineable offense(s) must be adopted and implemented. If decision is made to send a supervisory letter, such letter is sent by the Regional Director.
41-50	Consider assessment of $1M up to $5M.	Examiner reviews fineable offense(s), applies Matrix, and prepares referral to Regional Office. Regional Director sends 15-day letter. After consideration of response and referral, Regional Office applies Matrix. If recommendation is to assess a penalty, case should be submitted to the Washington Office. Prior to submission to Washington Office, Regional Office should determine that recommended penalty does not exceed maximum penalty permitted. Washington Office reviews recommendation and takes appropriate action.
51-60	Consider assessment of greater than $5M up to $10M.	Same as immediately above.
61-80	Consider assessment of greater than $10M up to $25M.	Same as above.
81-100	Consider assessment of greater than $25M up to $75M.	Same as above.
101-120	Consider assessment of greater than $75M up to $125M.	Same as above.
120+	Consider assessment of greater than $125M.	Same as above.

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INTRODUCTION

Examiners must initiate corrective measures promptly if they identify excessive risks at financial institutions. Generally, examiners can use examination comments and supervisory recommendations or informal agreements to correct problems. However, various statutes and regulations authorize the FDIC to use formal enforcement actions, when necessary, to reduce risks and address deficiencies. This chapter discusses some of the main statutes and regulations that authorize formal actions, such as:

- Sections 8, 38, and 39 of the Federal Deposit Insurance (FDI) Act; and
- Part 325 of the FDIC Rules and Regulations.

Section 8 of the FDI Act provides the FDIC's Board of Directors (FDIC's Board) with broad enforcement powers. The FDIC's Board has the power to:

- Terminate deposit insurance - Section 8(a),
- Issue cease and desist orders - Section 8(b),
- Invoke temporary (effective upon service) cease and desist orders - Section 8(c),
- Remove institution-affiliated parties or prohibit their participation in bank affairs - Sections 8(e) and (g),
- Issue orders to cease and desist from violating certain anti-money laundering regulations - Section 8(s), and
- Terminate deposit insurance for certain money laundering offenses - Section 8(w).

Section 38 of the FDI Act and various sections of Part 325 of the FDIC Rules and Regulations authorize the FDIC to take prompt corrective actions against institutions that fail to maintain certain capital levels.

Section 39 of the FDI Act authorizes the FDIC to take formal actions if an institution fails to submit and implement, upon FDIC request, an acceptable plan to achieve compliance with safety and soundness standards.

Authorizations

The FDIC's Board has authority to implement various formal actions and has delegated to various levels within the Division of Risk Management Supervision (RMS), the authority to implement other actions. Parts 303 and 308 of the FDIC Rules and Regulations detail various rules and procedures relating to various types of formal actions.

Ratings

Financial institutions with composite ratings of 4 or 5 have problems of sufficient severity to warrant formal action. Therefore, it is RMS policy to take formal action pursuant to Section 8 of the FDI Act against all insured state nonmember banks rated 4 or 5 where evidence of unsafe or unsound practices is present. Such formal action normally consists of an order to cease and desist under Section 8(b). Under rare circumstances, formal actions may consist of a temporary cease and desist order under Section 8(c) or initiation of insurance termination proceedings under Section 8(a). Exceptions to the policy may be considered when the condition of the bank clearly reflects significant improvement resulting from an effective corrective program or where individual circumstances strongly mitigate against formal action.

Section 8(b) of the FDI Act authorizes the FDIC to declare that a state nonmember bank is engaging in unsafe or unsound practice if the institution receives less than satisfactory component ratings for asset quality, management, earnings, or liquidity. Examiners should assess all facts and circumstances to determine if recommendation of Section 8(b) action is warranted under such circumstances.

Note: Only the FDIC's Board is authorized to make a finding of *unsafe* or *unsound*. Therefore, examiners must not use the statutory words unsafe or unsound in a report of examination (ROE). Other descriptive terms such as undesirable, unacceptable, objectionable, or imprudent are permissible.

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EXAMINATION CONSIDERATIONS

The ROE generally serves as the FDIC's primary supporting evidence for formal actions. Comments must be factually correct, free of inconsistencies, and not contain gratuitous, editorial, or inflammatory statements. All comments, conclusions, and recommendations must be well supported. Primary examiner responsibilities include:

- Identifying unacceptable practices or conditions that may result in excessive risk or loss to the bank or the Deposit Insurance Fund;
- Documenting unacceptable practices or conditions in accordance with instructions for the type of enforcement action recommended;
- Determining, in consultation with field- and regional-office management, if an enforcement action is necessary to address an unacceptable practice or condition;
- Ensuring that all credit classifications, component ratings, and composite ratings are accurate; and

- Submitting a memorandum to the regional director recommending an enforcement action.

Evidence Required

The FDIC must be able to prove that grounds for an action are based on facts and evidence and not merely based on suspicion. Consequently, FDIC examiners and staff must appropriately retain evidence such as:

- Copies of bank records needed to support charges;
- Documentation of all relevant meetings with management and the board;
- Documentation of all applicable recommendations made to management and the board; and
- Documentation of pertinent comments, requests, and commitments by management and the board.

Note: Copies of bank records used as evidence should generally be complete copies of the records. And, as a best practice, at least two examiners should attend relevant meetings and sign or initial examiner notes taken during meetings.

Examiners should use special care not to make any charges on inadequate grounds. Section 8 proceedings are within the purview of the Equal Access to Justice Act. The act provides that certain parties, who prevail in contested administrative or judicial proceedings against a federal government agency, may be able to recover litigation expenses if the position of the agency was not substantially justified. Examiners should also be mindful that any memorandums to the regional director recommending formal actions might be a matter of record at any required hearing. Therefore, comments must be supported by substantive evidence and be able to withstand scrutiny in a hearing.

Recommendations for Action

A recommendation to pursue a formal order is not dependent upon completion of an ROE. If sufficient evidence is otherwise available, examiners should not wait for the completion of an examination or submission of the ROE before recommending a formal order.

Examiners should consult with the regional office prior to discussing possible formal enforcement actions with the bank's board or management. Documentation of notification to the bank's board should be included in the memorandum to the regional director.

When examiners anticipate that Section 8(e) removal action may be taken, they should promptly consult with the regional office, including regional counsel, as directed. It is especially important that the ROE or other documentary evidence support all alleged practices or violations, particularly as they pertain to actions of the respondents.

Examiners that identify sufficient grounds for an action should submit, upon concurrence of regional office staff, a memorandum to the regional director recommending pursuit of an action. The memorandum, and ROE if available, should include as many details and documented facts pertaining to objectionable practices, unacceptable conditions, or apparent violations as reasonably possible.

The information required for inclusion in memorandums to regional directors varies based upon the type of proposed action. For proposed Section 8(b) actions, examiners should draft their memorandum to the regional director in accordance with the following guidelines:

- Detail each undesirable or objectionable practice or condition regarded as unsafe or unsound;
- Identify any undesirable or objectionable practice or condition that deviates from the institution's formal policies;
- Detail any apparent violations of law or regulations;
- Describe all relevant facts regarding each conclusion and recommendation;
- Include any bank director or officer statements that indicate disagreements, support charges, or show corrective actions;
- Describe issues or quote comments from previous examination reports or correspondence letters that support or refute promised corrective actions;
- Reference specific ROE schedules for additional details as necessary; and
- List items in order of importance and under appropriately descriptive subheadings.

For recommendations to pursue personal 8(b) actions and possible limitations on activities imposed against institution-affiliated parties (IAPs), examiners should identify any:

- Applicable misconduct;
- Necessary corrective measures;
- Deficiencies in an IAP's practices, skills, or competence; and
- Additional training or education requirements.

Examiners should include suggested measures and timeframes for correcting each undesirable or objectionable practice or condition detailed in the memorandum to the regional director. The measures should be tailored to each specific issue and allow sufficient time for completion. General examination recommendations that are unrelated to issues being recommended for inclusion in the proposed order should not be included.

The memorandum to the regional director should contain specific comments and recommendations relative to the adequacy of the institution's management. In some cases, existing management may be considered capable of solving the problems facing the institution, although a redirection or a clarification of authority may be necessary. If material management deficiencies are identified, the memorandum should address, as necessary, such matters as:

- The addition of independent outside directors;
- The addition of a chief executive officer, senior lending officer, or other senior officer;
- The establishment or modification of board committees, considering outside director representation;
- The addition or modification of board-approved policies;
- The implementation of board procedures to assure compliance with established directives and policies;
- The assessment of active management or the board by an independent committee or outside consultant;
- The establishment or modification of lines of authority;
- Restrictions on the authority of specific officers; and
- Any other managerial situations particular to the institution's circumstances.

The memorandum to the regional director should include the names and home addresses of any individuals to be named in a formal action to facilitate the service of a Notice of Charges. The memorandum and ROE should include facts that support why each named individual was included.

If the information needed to fully support the examiner's recommendations cannot be obtained through customary examination techniques, the regional office should be notified of the situation as soon as possible. If the matter remains unresolved, the examiner should so indicate in the memorandum and the regional director should consider using more formal investigative procedures authorized under Section 10(c) of the FDI Act.

Reviewing Compliance with an Order

Examiners are required to review a bank's compliance with any outstanding order during examinations. Orders typically require a bank to submit certain documents, including progress reports, to the regional office. Therefore, examiners should review all documentation submitted (since the prior examination) to the regional office to avoid requesting previously submitted information. Examiners should also review any regional office responses to bank submissions and follow-up on any deficiencies or recommendations included in the responses.

Examiners should include a summary of outstanding formal enforcement actions in the Examination Conclusions and Comments section of the ROE. In the Compliance with Enforcement Actions section of the ROE, examiners must document, in a factual manner, the steps taken by the bank to comply with the provisions of the order. As part of this analysis, examiners should also determine the underlying reasons for an institution's failure to meet any provisions of an Order or improve the bank's condition over a reasonable time frame, and discuss with the regional office whether a new or revised Order would be appropriate. At the first examination after the issuance of an order, examiners should detail each provision and management's response. At subsequent examinations, examiners may summarize provisions and only detail items of a continuing nature and those that the institution had not complied with at the previous examination. Examiners should not use conclusory statements of opinion such as, "The institution is in compliance/noncompliance with this provision."

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SECTION 8 – FDI ACT

Section 8 of the FDI Act authorizes the FDIC to take certain formal enforcement actions when unsafe or unsound practices or conditions exist. However, the FDI Act does not define unsafe or unsound practices or conditions. The concept of unsafe or unsound practices or conditions touches upon a bank's entire operations, and a single definition would not capture the broad spectrum of activities or conditions included in the term.

The FDIC's Board has established examples of unsafe or unsound practices or conditions in previous Section 8 proceedings. However, examiners should understand that these examples of activities or conditions are not necessarily unsafe or unsound in every instance or when considered in light of all relevant facts pertaining to that situation.

Practices Deemed Unsafe or Unsound

Generally, an unsafe or unsound practice encompasses any action, or lack of action, by an institution or an IAP which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would result in abnormal risk of loss or damage to an institution, its shareholders, or the Deposit Insurance Fund.

Actions Deemed Unsafe or Unsound

The FDIC's Board has found the following actions to be unsafe or unsound practices:

- Operating with inadequate capital for the type and quality of assets held;
- Engaging in hazardous lending and lax collection practices (such as extending credit that is inadequately secured, extending credit without first obtaining complete and current financial information, extending credit in the form of overdrafts without adequate controls, and extending credit with inadequate diversification of risk);
- Operating without adequate liquidity relative to the bank's asset and liability mix;
- Operating with excessive reliance on volatile deposits;
- Operating without adequate internal controls (including failing to maintain controls on official checks and unissued certificates of deposit, failing to segregate duties of bank personnel, and failing to reconcile differences in correspondent bank accounts);
- Engaging in speculative or hazardous investment policies;
- Paying excessive dividends in relation to the bank's capital position, earnings capacity, and asset quality; and
- Committing violations of law.

Lack of Action Deemed Unsafe or Unsound

The FDIC's Board has found the following lack of actions to be unsafe or unsound practices:

- Failure to provide adequate supervision and direction over the officers of the bank,
- Failure to provide for an adequate allowance for loan and lease losses,
- Failure to post the general ledger promptly,
- Failure to keep accurate books and records,
- Failure to account properly for transactions,
- Failure to enforce programs for repayment of loans,
- Failure to obtain or maintain on-premise evidence of priority of liens on loans secured by real estate, and
- Failure to provide supervision and oversight of the institution's compliance with federal and state laws and regulations.

Conditions Considered Unsafe or Unsound

An unsafe or unsound condition is a condition that, if continued, would result in abnormal risk of loss or damage to the bank or the Deposit Insurance Fund. An assessment of unsafe and unsound condition should be based on an assessment of virtually every aspect of the bank's operation and position. At a minimum, the bank's capital position, asset condition, management, earnings posture, and liquidity position must be carefully evaluated.

The FDIC's Board has found the following conditions to be unsafe or unsound:

- Maintenance of unduly low net interest margins,
- Excessive overhead expenses,
- Excessive volumes of loans subject to adverse classification,
- Excessive net loan losses,
- Excessive volumes of overdue loans, and
- Excessive volumes of nonearning assets.

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TERMINATION OF INSURANCE

Section 8(a)

Section 8(a) provides the FDIC's Board with voluntary and involuntary termination of insurance powers. Voluntary termination of insurance actions are uncommon and are generally requested by institutions in the process of self-liquidation. Involuntary termination of insurance actions are also uncommon and generally used by the FDIC's Board only when other administrative actions have been ineffective and an institution is in imminent danger of failure.

The FDIC's Board may involuntarily terminate an institution's insured status under Section 8(a)(2) on the following grounds:

- An insured institution or its directors or trustees have engaged or are engaging in unsafe or unsound practices;
- An insured institution is in an unsafe or unsound condition; or
- An insured institution or its directors or trustees have violated any applicable law, rule, regulation, order, condition imposed in writing by the FDIC in connection with an application or other request by the institution, or any written agreement entered into with the FDIC.

Note: For the purposes of Section 8(a)(2), the term *written agreement* refers to a legally enforceable document, not an informal agreement such as a Memorandum of Understanding.

Before initiating formal proceedings to terminate an institution's deposit insurance, the FDIC must provide written notice to the institution's primary federal regulator or state authority. If the primary regulator or state authority fails to secure correction of the problems, the FDIC issues a *Notice of Intention to Terminate Insured Status, Findings, and Order Setting Hearing* to the institution. Unless the institution chooses not to litigate the matter, the FDIC has the burden of proving the allegations made in the Findings through the introduction of evidence at the hearing.

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CEASE AND DESIST ORDERS

Section 8(b)

Section 8(b) of the FDI Act authorizes the FDIC to issue a cease and desist order against a state nonmember insured bank or an IAP when facts reasonably support that:

- The bank or IAP is engaging, or has engaged, in unsafe or unsound practices;
- The bank or IAP is violating, or has violated, a law, rule, or regulation; any condition imposed in writing by the FDIC with regard to the approval of a request or application; or a written agreement entered into with the FDIC; or
- There is reasonable cause to believe the bank or IAP is about to do either of the above.

The purpose of a cease and desist order is to remedy unsafe or unsound practices or violations and to correct conditions resulting from such practices or violations. Formal actions may be pursued before a violation or unsafe or unsound practice occurs in order to prevent a developing situation from reaching more serious proportions. Cease and desist orders generally contain provisions that require a bank or IAP to take, or prohibit a bank or IAP from taking, specific actions relating to inappropriate practices, violations, or conditions. Under certain circumstances, the enforcement action may require the institution or IAP to make restitution or provide indemnification against losses.

The failure of a bank to comply with any cease and desist order or consent order that has become final can be the basis for subsequent Section 8(a) termination of insurance action or 8(e) removal action against an IAP, as defined by Section 3(u) of the FDI Act. Such failure also can be the basis for the FDIC petitioning the U.S. District Court to enforce the order. Civil money penalties may also be imposed against the bank or any officer, director, employee or other person participating in the affairs of such bank.

Types of Section 8(b) Orders

The type of Section 8(b) order issued by the FDIC varies based on the institution or IAP's response to an enforcement action. If an institution or IAP agrees to comply with an enforcement action (stipulates), the FDIC will issue a consent order. However, if an institution or IAP does not stipulate, the FDIC may pursue a cease and desist order. Both actions generally contain the same corrective provisions and are public documents.

Cease and Desist Order When an institution or IAP does not agree to stipulate to a proposed enforcement action, the FDIC may pursue a cease and desist order by issuing and serving the institution or IAP with a Notice of Charges. The Notice of Charges contains a statement of facts detailing alleged practices or violations and fixes a time and place for an administrative hearing. A hearing is held to determine whether an order to cease and desist should be issued against the depository institution or IAP. If the party or parties served with the Notice of Charges does not appear at the hearing, they may be deemed to have consented to the issuance of the cease and desist order.

The FDIC's Board may issue a cease and desist order after the hearing. The action orders the institution and/or its IAPs to cease and desist from the unsafe and unsound practices outlined in the order and to take affirmative actions to correct deficiencies. A cease and desist order becomes effective 30 days after it is served upon the institution.

Consent Order Alternatively, if the institution or IAP agrees to a proposed enforcement action, the FDIC will issue a consent order. By stipulating, the institution or IAP waives its right to an administrative hearing. Eliminating the administrative hearing allows the institution or IAP to avoid lengthy and costly legal proceedings and allows the FDIC to address unsafe or unsound practices and violations more quickly. By stipulating to the action, the institution consents to the enforcement action without admitting or denying engagement in unsafe or unsound practices or violations. Unlike a cease and desist order, a consent order generally eliminates the term *cease and desist* from the action and its title and usually eliminates the list of unsafe or unsound practices from the beginning of the document. A consent order becomes effective at the time specified in the order, which is typically the date of issuance.

Personal 8(b) Orders The FDIC can seek 8(b) orders against IAPs under the same statutory authority and on the same statutory conditions as against an institution. The FDIC may pursue a personal enforcement action when remedial action is warranted, regardless of whether a violation of law or an unsafe or unsound practice warrants permanent prohibition of an IAP from the banking industry.

The FDIC may consider prioritizing possible 8(b) action against an IAP when facts reasonably support that an IAP:

- Engaged in dishonest conduct;
- Was a director or officer;
- Had a substantial role in directing the misconduct;
- Engaged in repeated or large-scale misconduct;
- Received an FDIC supervisory letter, but continued the misconduct;
- Was identified in an ROE or other formal or informal enforcement action that detailed their misconduct, but continued the misconduct; or
- Was a director or officer who abdicated their fiduciary duties in an unsafe or unsound manner.

Examiners should assess IAPs' compliance with outstanding enforcement actions during examinations. Information on IAPs subject to personal enforcement actions may be available through regional offices. However, during the examination, examiners should also ask management to identify any IAPs subject to personal enforcement actions to ensure any recently hired IAPs appropriately notified the bank and to ensure management and the board are fulfilling their responsibilities to remain informed on the professional background and qualifications of directors, officers, and employees.

If an IAP appears to be in substantial compliance with all provisions of a personal cease and desist order (PC&D), examiners should detail their findings in the Confidential - Supervisory Section. However, if an IAP appears to be in substantive noncompliance with one or more provisions of an outstanding PC&D, examiners should describe their findings on the Compliance with Enforcement Actions page in a manner similar to evaluations of a bank's compliance with other enforcement actions. Examiners should carry forward a summary of their findings to the Examiners Conclusions and Comments page.

In general, a PC&D should have a time-limit of five years and automatically expire at the end of that time. If the actions of the IAP were particularly egregious, compliance with a specific provision deemed critical, or another important supervisory reason can be articulated, the time-limit can be greater than five years or eliminated completely. This decision will be made at the initiation of the PC&D. Justification for a time-limit longer than five years should be included in the recommendation memo.

Termination prior to the end of five years, or termination of PC&Ds without a time limit should be based on satisfactory or full compliance with the provisions of the Order. When considering the issuance and provisions of a PC&D, the remedies set forth in a PC&D should lend themselves to measureable and verifiable compliance to permit a reasoned basis for termination.

In order to terminate a PC&D, regional directors should submit a memorandum to the appropriate Associate Director - Risk Management Supervision based upon an IAP's satisfactory or full compliance with the provisions of the Order.

Section 8(c) - Temporary Cease and Desist Orders

If the FDIC cannot obtain an institution's stipulation and consent for a cease and desist order, the time required to complete the administrative proceedings and obtain a cease and desist order may result in additional damages to the bank. Section 8(c), therefore, authorizes the FDIC to issue a temporary cease and desist order to stop particularly dangerous practices, or take affirmative actions to remedy conditions, pending completion of the administrative proceedings. Temporary cease and desist orders are not meant to replace permanent orders and must be issued in conjunction with or subsequent to a Notice of Charges supporting an order.

The FDIC may issue a temporary order if a violation, threatened violation, or unsafe or unsound practice specified in the Notice of Charges is likely to cause insolvency or substantial dissipation of assets or earnings, weaken the condition of the bank, or prejudice the interests of depositors prior to the completion of the Section 8(b) action. The FDIC may also issue a temporary order if an institution's accounts and records are so inadequate that the FDIC cannot determine the institution's financial condition or cannot determine the details of a transaction that may have a material effect on the institution.

A temporary order, accompanied by a *Notice of Charges*, can be issued against the bank or IAP. The order becomes effective upon service and, unless set aside or limited by court proceedings, remains effective and enforceable pending completion of the administrative proceedings pursuant to a Section 8(b) action.

Within 10 days after service of a temporary cease and desist order, the bank or IAP may apply for an injunction setting aside, limiting, or suspending the enforcement, operation, or effectiveness of such order.

Due to the nature of temporary actions, recommendations for such actions are frequently developed without the benefit of a completed ROE. In those cases, a visitation report, memorandum, or letter will discuss the practices and violations and the effect, or anticipated effect, on the institution. Examiners should immediately contact the regional office to discuss the possible need for Section 8(c) action when a situation is discovered in which an apparent violation of law or unsafe or unsound banking practice is likely to cause insolvency or substantial dissipation of assets prior to the completion of proceedings under Section 8(b).

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REMOVAL AND PROHIBITION PROCEDURES

Section 8(e) - Removal and Prohibition

Section 8(e) of the FDI Act authorizes the FDIC to order the removal of an IAP (director, officer, employee, controlling stockholder, etc.) from a state nonmember depository institution. It also allows the FDIC to prohibit the IAP from future participation in the conduct of the affairs of any insured depository institution. Removal and/or prohibition orders may be based upon conduct at the institution from which the individual is removed or upon conduct at another institution or affiliate.

The FDIC must establish three distinct and separate grounds to institute a removal and/or prohibition action:

1. **Misconduct** The IAP has directly or indirectly violated any law or regulation, any final cease and desist order, any condition imposed in writing in connection with the granting of an application or other request, or any written agreement; participated in any unsafe or unsound practice in connection with the depository or business institution; or engaged in an act, omission, or practice which constitutes a breach of fiduciary duty; and
2. **Effect of the Misconduct** Due to the misconduct, the insured depository institution or business institution has suffered or will probably suffer financial loss or other damage; the interests of the depositors have been or could be prejudiced; or the IAP has received financial gain or other benefit; and
3. **Culpability** The IAP's acts or omissions involved personal dishonesty or demonstrated willful or continuing disregard for the safety and soundness of the insured depository or business institution.

If an IAP does not consent to the action, the FDIC may serve the IAP with a Notice of Intention to Remove from Office and/or to Prohibit from Further Participation. The Notice of Intention contains a statement of the facts and conclusions constituting grounds for an action.

Pending the hearing, the FDIC may order the temporary and immediate suspension and/or prohibition of an IAP if the IAP's continued participation poses an immediate threat to the institution or to the interests of the institution's depositors. Within 10 days after an IAP has been suspended from office and/or prohibited from participation in the conduct of the affairs of an insured bank, the IAP may apply to the U.S. District Court for stay of such suspension and/or prohibition pending completion of the administrative proceedings. Unless the court issues a stay, a temporary suspension or prohibition order remains effective until the FDIC dismisses the charges or until the effective date of the permanent removal and/or prohibition order.

Examiners should be alert for situations where Section 8(e) may be applicable and should promptly communicate concerns to the regional office. The examiner, regional director or designee, and regional counsel should consult as needed to determine whether to proceed with an investigation authorized under Section 10(c) of the FDI Act. The examiner, regional director or designee, and regional counsel should also determine what evidence should be collected during the course of the investigation. Upon completion of an investigation, examiners are required to submit a recommendation memorandum to the regional director outlining the alleged misconduct and evidence supporting the allegations. If the memorandum is submitted in conjunction with an ROE, the ROE should also support the allegations.

When an IAP's acts support a removal/prohibition action, the examiner should encourage the institution to file a Suspicious Activity Report (SAR). If the institution refuses to file the SAR, the FDIC should file the SAR.

Section 8(g) - Suspension, Removal, and Prohibition

Section 8(g) of the FDI Act authorizes the FDIC to suspend an IAP charged with a felony and to remove an IAP convicted of a felony.

IAP Charged with a Felony Under Section 8(g)(1)(A), the FDIC may suspend an IAP from office or prohibit that IAP from participating in the conduct of any institution's affairs if:

- An IAP is charged with a crime involving dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under state or federal law (a felony); and

- Continued service or participation by the IAP may pose a threat to the interests of the bank's depositors or may threaten to impair public confidence in the bank.

When determining the threat posed by the IAP's continued service or participation, the FDIC must consider all relevant factors, including the nature of the charges and the publicity generated by the indictment. If the indictment relates to alleged crimes against a bank or other financial institution, it is expected that, except in rare instances, the IAP's continued service would pose a threat to the bank. The FDIC should also consider any potential impact to the bank from publicity that associates the bank with the criminal activity due to the IAP's continued service or participation.

If the FDIC determines that the Section 8(g) criteria for suspension have been met, the regional office may notify the IAP of the contemplated recommendation for Section 8(g) action and offer the IAP the option of a voluntary suspension. Voluntary suspension is an IAP's resignation from office and/or pledge not to participate in any manner in the affairs of the bank. A voluntary suspension is not a consent or stipulation to a formal action and it is not enforceable. When factors warrant a formal enforceable action, the FDIC will not offer a voluntary suspension.

If an IAP does not agree to voluntary suspension, the FDIC will serve a written notice of suspension upon the IAP and a copy of the notice upon the bank. The notice will suspend the IAP from office and/or prohibit his or her from further participation in the affairs of any bank. Such suspension or prohibition will remain in effect until the indictment or charge is finally disposed or until the notice is terminated. A finding of not guilty to a specific charge does not preclude the FDIC from instituting removal proceedings under Section 8(e).

IAP Convicted of a Felony Under Section 8(g)(1)(C), the FDIC may remove an IAP from office and/or prohibit an IAP from further participation in the conduct of the affairs of any depository institution without the prior written consent of the FDIC if:

- The IAP is convicted of a felony,
- The judgment is not subject to further appellate review, and
- The FDIC determines that the IAP's continued service or participation may pose a threat to the interest of the bank's depositors or may threaten to impair public confidence in the bank.

Although the FDIC typically has the discretion to determine if it is appropriate to issue a removal and/or prohibition order, Section 8(g) removes such discretion and requires the FDIC to issue a removal and/or prohibition order when an IAP is convicted of violating:

- 18 U.S.C. § 1956 (Laundering of Monetary Instruments),
- 18 U.S.C. § 1957 (Engaging in Monetary Transactions in Property Derived from Specified Unlawful Activities),
- 18 U.S.C. § 1960 (Prohibition of Unlicensed Money Transmitting Businesses), or
- 31 U.S.C. § 5324 (Structuring Transactions to Evade Reporting Requirement Prohibited).

Within 30 days of service of any notice of suspension or order of removal pursuant to Section 8(g), the IAP may request an opportunity to appear before the FDIC to show that continued service to the bank, or participation in its affairs, is not likely to pose a threat to the interests of a bank's depositors or impair public confidence in the bank. Upon receipt, the FDIC shall schedule a hearing before agency personnel (not more than 30 days after receipt of the request). Within 60 days after such hearing, the party will be notified of the FDIC's decision as to whether the prohibition or suspension will be continued, terminated, or modified, or whether an order of removal will be rescinded or modified.

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ENFORCEMENT ACTIONS

Section 8(t) - Authority to Take Enforcement Action

Section 8(t) of the FDI Act authorizes the FDIC to take enforcement action under Section 8 of the FDI Act (among other Sections) against any insured depository institution, holding company, or IAP in certain circumstances.

When the FDIC is not the primary federal regulator, the FDIC may recommend to the appropriate federal banking agency that the agency take any enforcement action authorized under Section 8. If, within 60 days, the federal banking agency does not take the enforcement action recommended or provide a plan acceptable to the FDIC, the FDIC may take the recommended enforcement action if the FDIC's Board determines:

- The insured depository institution is in an unsafe or unsound condition,
- The institution or IAP is engaging in unsafe or unsound practices and the recommended enforcement action will prevent the institution or IAP from continuing such practices,
- The conduct or threatened conduct (including any acts or omissions) poses a risk to the Deposit Insurance

Fund or may prejudice the interest of the institution's depositors, or

- The conduct or threatened conduct (including any acts or omissions) of the depository institution holding company poses a risk to the Deposit Insurance Fund. (Such authority may not be used with respect to a depository institution holding company in a generally sound condition and whose conduct does not pose a foreseeable and material risk of loss to the Deposit Insurance Fund.)

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ANTI-MONEY LAUNDERING

Section 8(s) - Recordkeeping and Reporting

Section 8(s) of the FDI Act states the FDIC shall issue a cease and desist order if an institution:

- Has not established programs and procedures to ensure compliance with the Bank Secrecy Act, or
- Failed to correct any related problems that were reported to the institution by the FDIC.

The FDIC shall issue the order in the same manner prescribed under Section 8(b) or 8(c) and shall require the institution to cease and desist from its violation of Section 8(s) and or its prescribed regulations.

Section 8(w) - Terminating Insurance

Section 8(w) of the FDI Act states the FDIC shall issue a notice of intent to terminate deposit insurance when the Attorney General notifies the FDIC that an institution has been convicted of violating:

- 18 U.S.C. § 1956 (Laundering of Monetary Instruments), or
- 18 U.S.C. § 1957 (Engaging in Monetary Transactions in Property Derived from Specified Unlawful Activities).

Section 8(w) also authorizes the FDIC to issue a notice of intent to terminate deposit insurance if an institution has been convicted of a criminal offense under 31 U.S.C. § 5324 (Structuring Transactions to Evade Reporting Requirement Prohibited).

In determining whether to terminate insurance under Section 8(w), the FDIC's Board shall take into account several factors, such as the extent of:

- Director or executive officer knowledge or involvement in the offense,
- Director or executive officer cooperation in the investigation,
- Existing institutional policies and procedures designed to prevent the offenses,
- Implementation of additional controls subsequent to the offense to prevent future money laundering offenses, and
- Adequate deposit and credit services in the local community if deposit insurance is terminated.

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INADEQUATELY CAPITALIZED INSTITUTIONS

To promote capital adequacy, the FDIC is authorized, and in some instances obligated, to take action against institutions that are less than adequately capitalized. For example:

- Section 38 of the FDI Act grants the FDIC's Board powers to take prompt corrective action (PCA) against institutions that are less than adequately capitalized;
- Part 325 of the FDIC Rules and Regulations authorizes the FDIC, under certain conditions, to utilize Section 8(a), 8(b), or 8(c) powers against institutions that fail to meet certain capital levels; and
- Part 325 of the FDIC Rules and Regulation authorizes the FDIC to issue a capital directive to a bank that fails to maintain capital at or above the minimum leverage capital requirements.

Section 38 - Prompt Corrective Actions

Section 38 of the FDI Act establishes a framework of supervisory actions to address issues at less than adequately capitalized financial institutions. The implementation of a PCA is intended to ensure early intervention at banks experiencing problems and the timely closure of failing institutions.

Prompt corrective actions are based on an institution's capital levels and become increasingly severe if an institution falls into a lower capital category. Some supervisory actions associated with PCAs are mandatory; that is, the actions immediately apply to the institution as it is classified in a particular category. Other actions are discretionary.

Reclassifying a Capital Category

Pursuant to Section 38(g) of the FDI Act (as implemented by Section 325.103(d) of the FDIC Rules and Regulations), the FDIC may reclassify a well capitalized, adequately capitalized, or under capitalized institution to the next lower capital category if:

- The FDIC determines, after notice and opportunity for hearing, that the institution is in an unsafe or unsound condition; or
- The FDIC determines, after notice and opportunity for hearing, that the institution has less than satisfactory asset quality, management, earnings, or liquidity.

Issuing Supervisory PCA Directive

Section 38 outlines supervisory actions applicable to an institution based on its capital category. Section 38 requires the FDIC to impose (by issuing a supervisory PCA directive) one or more of the following provisions on a significantly undercapitalized institution or an undercapitalized institution that failed to submit and implement a capital restoration plan:

- Require recapitalization,
- Restrict transactions with affiliates,
- Restrict interest rates paid,
- Restrict asset growth,
- Restrict activities involving excessive risk,
- Improve management,
- Prohibit deposits from correspondent banks,
- Require prior approval for capital distributions by a bank holding company,
- Require the bank or holding company to divest of subsidiaries,
- Require a holding company to divest of the bank, or
- Require any other action the FDIC determines will resolve the problems of the institution.

Section 38 also authorizes the FDIC to take the following actions if the FDIC determines the action will resolve the problems of the institution at the least possible cost to the Deposit Insurance Fund:

- Impose upon an undercapitalized institution any of the discretionary provisions applicable to a significantly undercapitalized institution or an undercapitalized institution that failed to submit and implement a capital restoration plan; or
- Impose upon a significantly undercapitalized institution or undercapitalized institution that failed to submit and implement a capital restoration plan one or more of the restrictions placed upon significantly undercapitalized institutions by Section 325.105(a)(4) of the FDIC Rules and Regulations.

The FDIC must provide the bank with written notice prior to issuing a supervisory PCA directive that imposes any of the discretionary actions listed above. The notice provides the bank with an opportunity to respond to the proposed directive. Although a supervisory PCA directive does not entitle an institution to a hearing, the FDIC will consider the bank's response prior to determining whether to issue a directive. The FDIC may issue a directive without prior notice if the FDIC deems it necessary to carry out the purposes of Section 38.

Dismissing a Director or Senior Executive Officer

Section 38 authorizes the FDIC to issue a supervisory PCA directive to require institutions to improve management. The supervisory PCA directive may require the institution to dismiss from office any director or senior executive officer who held office for more than 180 days immediately before an institution became undercapitalized. Dismissal by a supervisory PCA directive is not construed as a removal under Section 8 of the FDI Act.

When the FDIC issues a directive to a bank requiring the dismissal of a director or senior executive officer, the FDIC also serves a copy of the relevant sections of the directive upon the person to be dismissed. If removed, the director or senior executive officer may file a request for reinstatement with the FDIC not later than 10 days after receiving notice of the dismissal. A post-dismissal hearing may be requested by the director or senior executive officer at which time the director or officer must demonstrate that continued employment would materially strengthen the institution's ability to become adequately capitalized and to correct the unsafe or unsound conditions or practices.

Part 325 - Section 8 Powers

Section 325.4 of the FDIC Rules and Regulations defines certain capital levels as unsafe or unsound practices or conditions pursuant to Section 8 of the FDI Act.

Unsafe or Unsound Practice Any state nonmember bank that has less than its minimum leverage capital requirement is deemed to be engaged in an unsafe or unsound practice pursuant to Section 8(b) and/or 8(c) of the FDI Act.

Exception: A bank is not deemed to be engaged in an unsafe or unsound practice if the bank has entered into and is in compliance with a written agreement with the FDIC, or the bank has submitted and is in compliance with a plan approved by the FDIC to:

- Increase its Tier 1 leverage capital ratio to such level as the FDIC deems appropriate, and
- Take such other action as may be necessary to be operated so as not to be engaged in such an unsafe or unsound practice.

Unsafe or Unsound Condition Any insured depository institution with a ratio of Tier 1 capital to total assets that is less than 2 percent is deemed to be operating in an unsafe and unsound condition pursuant to Section 8(a) of the FDI Act.

Exception: An insured depository institution is not deemed to be operating in an unsafe or unsound condition if, in the case of a state nonmember bank, it has entered into and is in compliance with a written agreement with the FDIC (or in the case of any other insured depository institution, has entered into and is in compliance with a written agreement with its primary federal regulator and to which agreement the FDIC is a party), to:

- Increase its Tier 1 capital ratio to such levels as the FDIC deems appropriate, and
- Take such other action as may be necessary to be operated in a safe and sound manner.

In most cases, capital levels may be a reflection of other supervisory concerns that have already resulted in Section 8(a), Section 8(b), or Section 8(c) enforcement actions. Institutions subject to enforcement actions that include a capital provision may meet the criteria for the exception from being deemed to be in or engaged in an unsafe or unsound condition or practice due to capital levels. However, when enforcement action has not been taken or is not warranted due to a lack of other supervisory concerns, the FDIC may choose to enter into a written agreement with the institution thereby providing the institution with an exception from the definition of unsafe or unsound practice or condition and precluding Section 8(a), Section 8(b), or Section 8(c) action solely based on capital levels.

It is important to note that the FDIC is not precluded from taking Section 8(a), Section 8(b), or any other enforcement action against an institution with capital levels that exceed those defined as unsafe or unsound in Section 325.4.

Part 325 - Capital Directives

Section 325.6 of the FDIC Rules and Regulations authorizes the FDIC's Board to issue a directive against any insured state nonmember bank that fails to maintain capital at or above the minimum leverage capital requirement. A capital directive requires the bank to restore its capital to the minimum leverage capital requirement within a specified period. The directive may require the institution to submit a plan describing the means and timing by which it shall achieve the minimum leverage capital requirement.

Prior to issuing a capital directive, the FDIC must provide the bank with written notice. The bank may submit a written response to the proposed directive. The FDIC will issue a written determination supporting any decision to issue or not to issue a directive after considering the response.

The key difference between a capital directive and PCA directive is the requirement that the FDIC may impose under each directive. Under a PCA directive, the FDIC can impose requirements ranging from recapitalization to restricting activities. However, under a capital directive, the FDIC is largely limited to requiring the institution to recapitalize and submit a capital restoration plan.

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SAFETY AND SOUNDNESS ORDERS

Section 39 of the FDI Act requires the federal banking authorities to establish various safety and soundness standards. The Act allows the FDIC to request corrective plans from financial institutions that do not meet the standards, which are set forth in Part 364 and the interagency guidelines in Appendix A and Appendix B to Part 364.

If the FDIC requests an informal compliance plan to correct identified deficiencies and the institution fails to submit an acceptable plan, or fails to adhere to a submitted plan, the FDIC will pursue an enforceable order under Section 8 of the FDI Act. In addition, the FDIC may require by order, other corrective measures, such as restricted asset growth, higher capital levels, limits on deposit interest rates, or any other measure deemed necessary to effect corrective action.

Corrective programs for safety and soundness standards can also be incorporated into other types of formal and informal actions pursued against problem institutions. Section 39 actions may be considered for non-problem institutions having clearly inadequate safety and soundness practices and policies; however, this response will normally be limited to situations that could result in material loss to the bank, or where management has not responded effectively to similar criticisms in prior examinations.

Examiners should consult with the regional office prior to discussing possible actions with the bank's board or management. If regional management determines Section 39 action is warranted, examiners should submit a recommendation memorandum to their regional director. The memorandum should detail any discussions with the bank's board or management regarding possible actions.

Note: Examiners and regional directors must exercise care to avoid requesting compliance plans if identified problems are correctable through standard examination practices.

References:

- Manual Section 13.1, Informal Actions
- Manual Section 14.1, Civil Money Penalties
- Manual Section 16.1, ROE Instructions

GENERAL INSTRUCTIONS

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These instructions apply to all safety and soundness Reports of Examination (ROE).

References

Examiners should also consider the following:

- Federal Deposit Insurance Act, FDIC Rules and Regulations, and related statutes and regulations,
- FDIC and other applicable Statements of Policy,
- Instructions for the Preparation of Reports of Condition and Income (Call Reports),
- The User's Guide for the Uniform Bank Performance Report (UBPR),
- RMS Manual of Examination Policies (Manual),
- State Statutes and Regulations,
- FFIEC Information Technology Examination Handbooks,
- Outstanding Memoranda,
- Financial Institution Letters,
- Uniform Financial Institutions Rating System,
- Uniform Rating System for Information Technology,
- Uniform Interagency Trust Rating System, and
- Statements of FDIC Board of Directors

Unless otherwise specified, complete Report financial schedules according to Call Report Instructions.

Reminder: Reports may be affected by changes to definitions, laws, regulations, Call Report Instructions, and regulatory policies within the aforementioned references. When significant Report changes occurred since the previous examination, use footnotes on the applicable report pages to explain the difference(s). Do not footnote minor changes.

Report Comments, Supervisory Recommendations, and Matters Requiring Board Attention

As used in these instructions, the term “report comments” refers generally to text set forth in the ROE. The term “supervisory recommendation” refers to FDIC communications with a bank that are intended to inform the bank of the FDIC’s views about changes needed in its practices, operations or financial condition. As described in the Statement of FDIC Board of Directors on the Development and Communication of Supervisory Recommendations (Statement), a principal purpose of supervisory recommendations is to communicate supervisory concerns to a bank so that it can make appropriate changes in its practices, operations or financial condition and thereby avoid more formal remedies in the future, such as enforcement actions.[1] All supervisory recommendations must address meaningful concerns, communicate concerns clearly and in writing, and discuss corrective action. Supervisory recommendations are not formal or informal enforcement actions, but they are communications of FDIC expectations of banks. The Statement acknowledges that bankers take seriously supervisory recommendations made by FDIC personnel; accordingly, care should be taken in their development and communication.

In the context of the ROE, supervisory recommendations include recommendations communicated on the Examiner’s Comments and Conclusions (ECC) page, and recommendations communicated on other report pages, such as the Risk Management Assessment page. Most supervisory recommendations are generally correctable in the normal course of business. However, when there are material issues and recommendations that require the attention of the institution’s board of directors and senior management, examiners must communicate concerns using Matters Requiring Board Attention (MRBA). MRBA are a subset of supervisory recommendations. It is FDIC policy to make supervisory recommendations in writing in the ROE, in a transmittal letter, or in other correspondence under

[1] See https://www.fdic.gov/about/governance/recommendations.html

official FDIC letterhead. Supervisory recommendations may not be solely verbal, but should be discussed with, and explained to bank management.

Writing Report Comments and Supervisory Recommendations

ROE comments should be fact-based, professional, and objective. Proper presentation of factual information can be very persuasive and will ordinarily be more effective than criticism alone in achieving the desired response from bank management. Use clear, concise, well-organized, language appropriate to the subject or field and the intended audience. Simple language and short sentences are generally the most effective.

Use an Effective Writing Style. While each examiner will develop an individual style of writing comments and supervisory recommendations, the following suggestions may be helpful in increasing effective communication:

- Accurate and descriptive topical headings, in order of importance, promote reader interest.
- Comments should be as brief as is consistent with clarity.
- Comments should be factually objective and not phrased as criticisms of particular individuals.
- Comments on matters not subject to criticism or recommendation, on minor matters, or on unsatisfactory practices corrected during the examination should be limited.
- Ratios, or percentages, are meaningful to examiners, but their significance is not always apparent to bankers and particularly bank directors. Therefore, examiners should not rely upon ratios alone to convey the ideas they wish to express. When ratios are cited, they should be in support of a conclusion or supervisory recommendation, and their import should be made understandable to the reader.

Explain the Basis for any Supervisory Recommendations or Concerns. The ROE should describe the potential consequences of inaction or the benefit of corrective action to the institution related to implementing a supervisory recommendation or correcting a deficiency before the issue leads to deterioration in operations or financial performance. The ROE should factually document bank management and Board commitments for correcting the noted weaknesses.

Reminder on Major Matters. Supervisory recommendations that could establish or change existing FDIC policy, attract unusual attention or publicity, or would involve an issue of first impression must be discussed with regional office management. Regional office management should raise any such matters with senior RMS management for consideration as a Major Matter under the FDIC Board's Major Matter Resolution.

Peer Group Information - Examiners may use UBPR or user-derived ratios and peer group comparisons to support comments. However, examiners are reminded that comparisons to peer are not a part of the UFIRS ratings definitions, and should avoid over reliance on peer group comparisons.

Apparent Criminal Violations - Examiners must not discuss criminal referrals or apparent criminal violations in the open section of the ROE. All comments regarding these matters in confidential report pages or workpapers should be limited to clear-cut statements of fact. Examiners must not include opinions about the probability of indictment, conviction, or related matters. Comments should be as specific as possible and identify who reported an issue and how it occurred. Do not use language such as, "It is reported...," or, "Management indicated...." Instead, use language such as, "President Scott reported...."

Consolidated and Institution-Only Schedules

Examiners should complete ROE schedules on a consolidated basis in accordance with Call Report instructions and generally accepted accounting practices. Institution-only schedules, or a list of an institution's investments in subsidiaries, may be included in ROEs when they add meaningful information. Institution-only schedules may be meaningful when:

- A material volume of a subsidiary's assets is adversely classified and inclusion of institution-only schedules highlight a concentration of risk in a subsidiary,
- A material amount of an institution's assets or capital is invested in a subsidiary, and inclusion of institution-only schedules helps explain an examination concern (such as weak core earnings), or
- An institution is at risk of failing, and inclusion of institution-only schedules might help the bank's board or regulatory authorities develop recovery or resolution strategies.

- Examiners should create institution-only pages on continuation pages. Often, simple lists of investments in each subsidiary are adequate.

Report Dates

The Report uses four different dates:

- ***Examination as of Date -*** This is the date of the financial information analyzed throughout the Report, generally the most recent quarter-end Call Report data available. For example, if an examination commences on August 31, and June 30 financial data is available, the Examination as of Date would likely be June 30.
- ***Examination Start Date -*** This is the date the examination commenced, typically, the date when the examination team begins formal on-site examination of the institution. It is used to monitor ROE completion times and the length of time between examinations.
- ***Date Examination Completed -*** This is the date the examiner formally completes the examination and submits the ROE for review. The date is used to monitor ROE completion and processing times.
- ***Asset Review Date -*** This is the date of the asset data analyzed in the loan review, and often the investment portfolio and other real estate reviews. Although the date could be the same as the Examination as of Date, often examiners are able to obtain more current information. For example, if an examination commences on August 31, and July 31 loan data is available, the Asset Review Date might be July 31. Note the Asset Review Date on the Confidential-Supervisory Section page and within the Asset Quality comment on the Examination Conclusions and Comments (ECC) page.

Selection of the Examination as of Date and the Asset Review Date - When selecting these dates, examiners should consider the availability of the information (quarter-end Call Report data is generally not available until 45 days after the quarter end), the amount of time institutions need to compile requested information, and any material changes that occurred between the dates.

When significant changes in the composition of the balance sheet occur between the Examination as of Date and the Asset Review Date, make appropriate comments in the ROE. There may be circumstances when a more recent month-end date would better serve as the Examination as of Date (rather than the most recent quarter-end).

Page Order and Numbering

Page order is addressed in the Inventory of Report Pages section.

All pages in the open section are sequentially numbered. Sequential numbering continues through the Confidential-Supervisory Section page, but those pages are not listed in the Table of Contents. The Table of Contents lists the titles and page numbers of all open section pages. The sequence of pages should generally follow the pages listed in the Inventory of Report Pages. When user-defined pages are included, they should be included where most appropriate, but not before the Risk Management Assessment (RMA) page.

Generally, do not number the Officer's Questionnaire. However, if the Officer's Questionnaire is included in the Report, numbering may be appropriate when the Officer's Questionnaire is lengthy. In such instances, the letters OQ should precede the number (for example, OQ.1, OQ.2, and OQ.3).

Supplemental Pages

Supplemental (non-mandatory) pages should be used to support the conclusions, supervisory recommendations, and ratings on the ECC page. The Bank of Anytown ROE includes many supplemental pages that provide examples of how to format the pages. Therefore, the supplemental pages shown in The Bank of Anytown do not necessarily provide examples of comments that support ECC page conclusions and should be used as illustrations only.

Rounding

Numbers/Dollar Amounts - Examiners may round dollar amounts to the nearest thousand and omit "000." In narrative comments, "M" is the acceptable abbreviation for thousands. Examiners should round amounts consistently throughout the Report and not use abbreviations like $2.5MM, $2,500M, and $2,500,000 interchangeably.

In the Items Subject to Adverse Classification and the Items Listed for Special Mention pages, round to the nearest thousand and omit "000" in both the heading and the extended criticized amount (refer to the Bank of Anytown). In narrative comments, the numbers and dollar amounts may be rounded and abbreviated; however, it is acceptable to use precise dollar or numerical amounts to avoid confusion. *Example:* The $25,000 loan is secured by a mortgage on an 1,800 square-foot condominium valued at $31,500, or $17.50 per square foot.

When rounding, minor adjustments may be necessary to balance related totals in the Report.

Ratios

Generally, round percentages to the nearest hundredth of a percent, especially critical ratios such as Prompt Corrective Action capital ratios in problem institutions. Round noncritical or imprecise ratios to the nearest whole number.

Abbreviations

MRBA, ECC, and Compliance with Enforcement Actions (CEA) pages - An abbreviated term must be spelled out the first time it is used, with the abbreviation enclosed in parentheses following the term.

Other Report Pages - A list of standardized abbreviations for use on the other Report pages is provided on the back cover of the Report (shown in Appendix A).

Note: The effectiveness of Report comments is significantly diminished if the overuse of abbreviations makes a document harder for readers to understand by forcing them to refer to the list of approved abbreviations too often.

Writing Style and Grammar

Examiners should follow Federal Plain Language Guidelines when completing ROE comments, including loan write-ups. Following the guidelines helps improve the effectiveness of Reports by making comments and recommendations easier for directors and managers to understand. Therefore, examiners should consider the needs of their readers and avoid the use of jargon, and overuse of technical terms, acronyms, adjectives, and adverbs. When considering whether to use an abbreviation, or how many to use in a comment, examiners should keep in mind that abbreviations should make comments easier for readers to understand. The effectiveness of comments and loan write-ups is significantly diminished if the overuse of abbreviations make a document harder for readers to understand by forcing them to refer to the list of approved abbreviations too often.

Listed below are a few style and grammar conventions that should be used in the Report. Refer to the Federal Plain Writing Guidelines; Appendix B (Grammar and Punctuation Guide), of this document; and references such as dictionaries and writer's handbooks for additional guidance.

Footnotes - For ROE pages that have a section titled Footnotes, use the section for footnotes and not for comments.

Dollar signs - Use dollar signs in narrative comments, but not tables.

Commas - Use commas in amounts of 1,000 or more.

Spaces - Use two spaces between sentences.

Negative figures - Consistently enclose negative figures in parentheses or refer to them as negative values. Reminder: Do not write double negative numbers.

Examples:

Correct: The borrower reports a negative NW of $25M.
Or
The borrower reports a NW of ($25M).

Incorrect: The borrower reports a negative NW of ($25M).

Names - On the first reference to a person in the Report, generally use the complete title, first name, middle initial, and last name (for example, Senior Vice President (SVP) John A. Doe). After the initial reference, an abbreviated name may be used (SVP Doe), if confusion with other officers is unlikely. Use references consistently throughout the Report.

Financial Ratios - Typically, UBPR financial ratios are uploaded into the ROE through automated examination tools. The most current information should be in the left column on all pages. Manually calculated ratios should conform with UBPR Users Guide definitions and be footnoted as having been manually calculated.

INVENTORY OF REPORT PAGES

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Report of Examination Page Order

Items in bold font indicates a mandatory schedule or a schedule that is mandatory when applicable.

Page	Section	Mandatory
Cover	**Open**	**Yes**
Table of Contents	**Open**	**Yes**
Matters Requiring Board Attention (MRBA)	**Open**	**Yes, when applicable**
Examination Conclusions and Comments (ECC)	**Open**	**Yes**
Compliance with Enforcement Actions	**Open**	**Yes, when applicable**
Risk Management Assessment (RMA)	Open	No
Violations of Laws and Regulations	**Open**	**Yes, when applicable**
Information Technology and Operations Risk Assessment (ITA)	**Open**	**Yes**
Fiduciary Activities Assessment (FAA)	Open	No
Examination Data and Ratios (EDR)	**Open**	**Yes**
Comparative Statements of Financial Condition	Open	No
Loans and Lease Financing Receivables	Open	No
Recapitulation of Securities	Open	No
Items Subject to Adverse Classification	Open	No
Items Listed for Special Mention	Open	No
Analysis of Loans Subject to Adverse Classification	Open	No
Analysis of ORE Owned Subject to Adverse Classification	Open	No
Assets with Credit Data or Collateral Documentation Exceptions	Open	No
Concentrations	**Open**	**Yes, when applicable**
Capital Calculations	Open	No
Analysis of Earnings	Open	No
Comparative Statements of Income and Changes in Equity Capital Accounts	Open	No
Relationships with Affiliates and Holding Companies	Open	No
Extensions of Credit to Directors/Trustees, Officers, Principal Shareholders, and Their Related Interests	Open	No
Internal Routines and Controls	Open	No
Composite Rating Definitions	**Open**	**Yes**
Signatures of Directors/Trustees	**Open**	**Yes**
Officer's Questionnaire	**Open**	**Yes***
Confidential – Supervisory Section	**Confidential**	**Yes**
Directors/Trustees and Officers	**Confidential**	**Yes***

**Page must be completed at each examination (to collect data), but inclusion in ROEs is optional.*

International Report Page Order

Page	Section	Mandatory
Examination Data and Ratios (International)	Open	Yes, when applicable
Transfer Risks Subject to Classification or Comment	Open	Yes, when applicable
Analysis of the Country Exposure Management System	Open	Yes, when applicable
Selected Concentrations of Country Exposure	Open	Yes, when applicable

For International ROE: Use the EDR (International) page, in lieu of the standard EDR page, in the core section of the Report. Place International Report Pages immediately after the Items Subject to Adverse Classification and Items Listed for Special Mention pages.

MATTERS REQUIRING BOARD ATTENTION (MRBA)

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Purpose

MRBA are a subset of Supervisory Recommendations,[2] which are an FDIC communication intended to inform the institution of the FDIC's views about changes needed in its practices, operations, or financial condition to help directors prioritize their efforts to address examiner concerns, identify emerging problems, and correct deficiencies before the bank's condition deteriorates (or to keep the bank viable if conditions already deteriorated). A principal purpose of supervisory recommendations is to communicate supervisory concerns to a bank so that it can make appropriate changes in its practices, operations or financial condition and thereby avoid more formal remedies in the future, such as enforcement actions.

A MRBA is defined as an issue or risk of significant importance that requires board attention. Examples of matters requiring board attention that could warrant highlighting include:

- Emerging issues in which the board needs to be more proactive in establishing policy and risk management parameters;
- Policy weaknesses that, if left unaddressed, could increase the institution's risk profile or, adversely affect the condition of the institution;
- Ineffective management;
- Repeat examination recommendations or regulatory, audit, or risk management criticisms that have escalated in importance;
- Enforcement action provisions requiring continued attention (these should be included in one summary bullet point); or
- Significant noncompliance with laws, regulations, or the bank's own policies.

When To Include This Schedule

Examiners must use this schedule whenever MRBA are included in the ROE to briefly highlight material issues and recommendations that require prompt attention by the directorate and senior management and follow-up by regulators between examinations. When the MRBA page is included in a Report, place it before the ECC page.

Deficiencies and supervisory recommendations that management can address in the normal course of business should be included in the ECC, RMA, or other supporting pages.

Comment Structure

MRBA should be brief, addressed to the board of directors, and include:

- An introductory statement to explain the purpose of the MRBA comments.
- For each MRBA, a description of the practice or condition that is of concern, a description of the corrective action needed, and a description of the potential consequence of the inaction or non-timely action to the bank's financial condition or operations. Comments should be informative and persuasive by describing the risk(s) associated with an issue and the benefits of corrective action, or consequences of inaction, to the institution and board of directors. The comment should not highlight the threat of potential, escalated supervisory action. In cases where conditions have already deteriorated, comments should prompt the board and senior management to take immediate action to correct deficiencies.
- A statement reminding the directorate and senior management of the importance of addressing the noted issues and its responsibility to respond appropriately to the matters highlighted in the schedule and informing them that there will be follow-up by regulators between examinations.

The MRBA should be listed in order of importance. As with all supervisory recommendations, MRBA are expected to be meaningful, actionable, fully supported and clearly communicated. For example, "develop a plan to reduce

[2] Statement of FDIC Board of Directors on the Development and Communication of Supervisory Recommendations, see footnote 1.

overhead expenses by…" rather than "improve earnings." Clear expectations will enable the institution's board, senior management, and examiners to determine when the MRBA has been adequately addressed.

EXAMINATION CONCLUSIONS AND COMMENTS (ECC)

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Purpose

The ECC page is the primary schedule examiners use to summarize examination findings, inform directors and senior management of undue risks, and guide corrective actions through presentation of supervisory recommendations, when appropriate.

Content

Examiners should convey all significant examination findings on this page, including those relating to risk management, specialty areas, and, when material and relevant, Compliance/ Community Reinvestment Act (CRA) examinations.

The ECC page should include significant issues to be addressed by senior management─with board awareness─that do not meet the significant and immediate criteria of MRBA. However, when applicable, ECC comments should support issues raised on the MRBA schedule. Generally, the remediation of supervisory recommendations set forth on the ECC page can occur during the normal course of business. Supervisory recommendations on the ECC page should be associated with material practices that deviate from sound governance, internal controls, or risk management or consumer protection principles and noncompliance with laws and regulations, enforcement actions, or conditions imposed in writing. Supervisory recommendations should be relevant to the institution and not based on examiner preference or industry “best practices.”

Examiners must document management's response to each supervisory recommendation and include an assessment of each CAMELS component on this page.

In general, comments on the ECC page should not be duplicated on other ROE pages. However, some duplication is acceptable as certain types of examination issues can affect multiple UFIRS components.

Comment Structure

Comments should focus the reader’s attention on the condition or practices that caused or otherwise led to the examiner’s criticisms and supervisory recommendations. Comments should be sufficiently detailed to support all examination findings, ratings, and recommendations. Examiners are encouraged to use tables, charts, or graphs to illustrate a complex concept or to help readers understand examination findings. Generally, commentary for a stable 1-rated component should be concise, while commentary for 2- through 5-rated components should be progressively more detailed.

Page Structure

Numerical Ratings

Uniform Financial Institutions Rating System – The top of the ECC page includes a grid to display the component and composite ratings for the current and two prior examinations. Previous examination dates should correspond to those noted elsewhere in the Report. Identify state examinations with "S" following the date, and designate other agency examinations with appropriate abbreviations. Composite ratings for the current and two prior specialty examinations, and the most recent Compliance and CRA examinations should be included at the bottom of the rating grid. Footnote any examination dates that do not correspond with the current or previous risk management examination dates.

Composite rating definitions for risk management and specialty examinations should be included on the Composite Rating Definitions page. Definitions of component ratings are publicly available in the FDIC Statement of Policy on the Uniform Financial Institutions Rating System.[3]

Overall Condition, and Risk Profile Summary

The first narrative comments on this page should be a concise, high level, executive summary of the overall condition, business model, risk profile, and complexity of the bank. This comment should be concise; however, more extensive comments may be necessary for institutions with elevated risks or a complex business model. The focus should be on providing the reader with a concise description of the bank's nature and scope of major activities and business lines (business model); the overall risk associated with the business model (risk profile) and the complexity of the bank's operations (complexity). The comments should include a description of applicable external factors such as the operating environment in the beginning of the report. Often, bulleted comments can provide brief, yet effective, summaries. Examiners should include brief assessments of specialty areas in this section, but avoid significant duplication of comments included in other sections of the ECC page. In all cases, the narrative should:

- State the approximate asset size of the institution ($80 million, not $80,604M)
- Provide an overview of the institution's business model (e.g. the primary products and/or services offered by the institution).
- Provide a concise analysis of the institution's key risks as it relates to the condition of the institution and an assessment of how management is managing the risks to the institution.
- Summarize the complexity of the institution's operations (e.g. volume, sophistication, and interconnectedness among various activities and business lines)
- Describe external factors, operating environment, major planned changes in management or mergers.
- Avoid using adjectives to describe component areas and instead, focus on how a component area is affected by the institution's risk management practices. For example, avoid statements such as "Liquidity is marginal" in favor of "Management's recent decision to use wholesale funding to support strong loan growth without adopting a contingency funding plan exposes the bank to elevated risk of not being able to secure cost-effective funding going forward."

Compliance with Enforcement Actions

Examiners should include a summary of outstanding formal or informal enforcement actions on the ECC page. Detailed analysis of outstanding actions should be presented on the Compliance with Enforcement Actions page. Generally, the summary should be included after the Overall Condition and Risk Profile summary; however, placement of the comment depends on its significance in relation to other examination issues. Regardless of the type of action (formal or informal), the summary should discuss any unsafe or unsound practices or apparent violation of law that precipitated the enforcement action. Examiners should conclude comments by indicating if each practice, condition, or apparent violation was discontinued or still exists.

Only the FDIC's Board of Directors is authorized to make a finding of unsafe or unsound banking practices. Therefore, do not use the statutorily significant phrase "unsafe or unsound" in ROE comments. However, examiners should describe the facts that relate to unsafe and unsound conditions, and can use terms such as undesirable, unacceptable, or objectionable when commenting on unsafe and unsound practices and describe consequences to the institution of not addressing such practices.

***Prompt Corrective Action* -** When applicable, present a summary of the Prompt Corrective Action (PCA) provisions included on the Compliance with Enforcement Actions page**.**

[3] See https://www.fdic.gov/regulations/laws/rules/5000-900.html

CAMELS Components

Each CAMELS component must be addressed on the ECC page. Components should be addressed in order of risk, although some latitude is allowed to facilitate effective communication. Include the assigned rating after each component heading (for example, Capital - 1). The narrative for each component must include an assessment of pertinent factors and support the assigned rating. If applicable, recommendations and management responses should also be detailed. When recommendations are included, the rationale for the recommendation should be provided. Refer to the Addendum to Section 1.1 (Basic Examination Concepts and Guidelines), of the RMS Risk Management Manual of Examination Policies for rating definitions and specific items to consider when evaluating each component. Note that "peer" is not included among the specific items to consider when evaluating each component. When relevant, peer data may be considered in conjunction with other pertinent evaluation factors. However, peer data should not be used in isolation in assigning ratings.

The length of comments and level of detail should be consistent with assigned ratings. Generally, comments should be brief for 1- and 2-rated components and progressively more detailed for 3-, 4-, and 5-rated components. When comments are critical, ensure the narrative describes the underlying conditions or practices that led to the criticism. As commentary expands, it is important to use effective organization and presentation techniques. Subheadings and bullet points are encouraged to improve readability, as are charts and graphs when appropriate. Generally, lengthy comments should begin with a concise summary of the major issues being covered.

Violations of Law

If apparent violations of law, regulations, or nonconformance with interagency guidelines included as appendices to FDIC Rules and Regulations, are cited in the ROE, the ECC page must include, at a minimum, a brief summary comment and reference to the Violations of Laws and Regulations page. References to other report pages may also be necessary if related issues, such as internal control or policy weaknesses, are detailed elsewhere in the ROE. Based on the significance of the violations, examiners may place the comments under a subheading in the appropriate CAMELS or specialty examination sections, or in a separate section on the ECC page. The amount of detail provided on the ECC page should be based on the materiality of a violation, management's response, and supervisory intentions regarding civil money penalties and enforcement actions.

Disposition of Assets Classified Loss

When applicable, management's response to examination Loss classifications should be discussed within the Asset Quality segment of the ECC page. For example, "President Smith indicated he will charge off all assets classified Loss prior to filing the June 30, xxxx Call Report."

Examiners should not suggest management charge off a portion of loans classified Doubtful except when required by state law or in formal enforcement actions. When securities are adversely classified Doubtful or Loss, examiners should follow guidance contained in Section 3.3 (Securities and Derivatives), of the Manual. Other asset categories against which valuation allowances are not normally maintained require a judgment regarding a recommendation for charge-off.

Specialty Examinations

Concurrent specialty examinations <u>embedded in the Risk Management ROE</u> - Specialty examination findings must be summarized in the ECC pages of the ROE. The placement and length of the comments should be commensurate with identified risks. When structuring comments, examiners should consider a department's risk profile, control environment, and risk management practices. Generally, comments should:

- Summarize the examination scope and key findings,
- Detail material recommendations and violations,
- Include management's response (including the timing of promised corrective actions) to material recommendations and violations, and
- Identify bank officials with whom examination findings were discussed.

With the exception of the ITA page, there are no other mandatory specialty examination pages. However, examiners may include specialty examination pages in the ROE to communicate findings, or to facilitate forwarding of information to other regulators or serviced institutions.

Comments on the ECC page relating to RTA/MSD/GSD examinations should specifically state whether any apparent violations of laws or regulations were discovered. If apparent violations were discovered, but management disagrees, the apparent violation(s) should be cited and discussed in the ROE. If apparent violations were discovered and management agrees the violation occurred, examiners can list the violations associated with the applicable specialty examination in the ROE or include a statement indicating a list of violations was left with management. In either case, an ECC comment must be included detailing management's commitment, or lack of commitment, to correct the violations cited at the examination.

Comments on the ECC page relating to IT examinations must summarize key ITA findings and assessments of the institution's cybersecurity preparedness and conformance with Appendix B to Part 364, Interagency Guidelines Establishing Information Security Standards (Security Guidelines). The length of the comment should vary based on the size and complexity of the institution and the significance of any weaknesses noted and should support the composite Uniform Rating System for Information Technology (USIRT) rating assigned. The comment should reference the ITA page when IT risk examinations are embedded in the Safety and Soundness examination. Significant findings from separate cover IT reports completed during the risk management examination cycle must also be summarized on the ECC page.

Bank Secrecy Act (BSA)

Examiners must describe the adequacy of BSA and Office of Foreign Assets Control (OFAC) programs on the ECC page and factor their assessment into the Management component. The placement and length of comments should relate to the adequacy of the program and any outstanding regional guidance.

- Programs deemed satisfactory should be briefly discussed within a subsection of the Management component.
- Programs with moderate deficiencies should be discussed within a subsection under Management, with details of noted deficiencies and related recommendations included, as deemed appropriate, on the RMA or ECC page.
- Programs with significant deficiencies or violations of BSA related regulations should be presented, as deemed appropriate, in subsections under Management or as a separate section on the ECC page or MRBA page. Details of noted deficiencies and related recommendations should be included on the RMA or ECC pages.

Concurrent specialty examinations <u>submitted under separate cover</u> (Information Technology (IT), Trust, Municipal/Government Securities Dealers (MSD/GSD), or Registered Transfer Agent (RTA)) - In some situations, it may be necessary for specialty examination reports to be completed separately from Risk Management examinations. In these rare cases, separate cover specialty examinations should be prepared consistent with specialty examination instructions. Separate cover specialty ROEs require the approval of the regional director or designee.

Specialty examination findings for separate cover reports should be summarized in the ECC section of the risk management ROE. The placement and length of specialty examination comments should be commensurate with the risk profile of the specialty area.

Meetings with Management and the Board of Directors

If a meeting with the board of directors is held, the ECC page should include a concise description of the topics discussed and any related board responses and commitments. Specific management actions, commitments, or responses that are included in preceding comments need not be repeated. However, examiners should include enough detail to make the comment informative and to document commitments for corrective actions. The date of the meeting and a listing of attendees should be included. If a board meeting was not held, examiners should summarize the exit meeting held with senior management. This comment should precede the Board of Directors Reminder described below.

Board of Directors Reminder

This comment should be under a separate heading and the last narrative item on the ECC page. The comment should remind the directorate of their responsibility to review the entire ROE and sign the Signatures of Directors/Trustees page.

Examiner’s Signature and Reviewing Official’s Signature and Title

The examiner's signature (signatures if joint), and the reviewing official’s signature and title should be the last items on the ECC page.

COMPLIANCE WITH ENFORCEMENT ACTIONS

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Purpose

This schedule presents facts relating to an institution's adherence to formal and informal administrative actions and to Prompt Corrective Actions. As noted below, examiners should address continuing conditions related to applications, notices, or other written requests on a separate schedule.

Formal enforcement actions are notices or orders issued by the FDIC against insured financial institutions and/or individuals. The purpose of formal actions is to correct noted safety and soundness deficiencies, ensure compliance with Federal and State banking laws, assess civil money penalties, and/or pursue removal or prohibition proceedings. Formal actions are legally enforceable and final orders are available to the public after issuance.

Informal enforcement actions are voluntary commitments made by an institution’s board of directors. They are designed to correct noted safety and soundness deficiencies or ensure compliance with Federal and State laws. Informal actions are not legally enforceable and are not available to the public.

When To Include This Schedule

Include this schedule when an institution has one of the following outstanding actions:

Formal Action

- Final Order pursuant to Section 8
- Capital Directive
- Section 39 Safety and Soundness Order
- Other formal administrative action of a state authority or other regulatory agency
- Continuing Condition

Informal Action

- Board Resolution
- Memorandum of Understanding
- Section 39 Safety and Soundness Compliance Plan
- Other informal administrative action of a state authority or other regulatory agency

Prompt Corrective Actions

When an institution is subject to Prompt Corrective Action (PCA), summarize the applicable provisions of the PCA and follow each provision with an examiner assessment.

Continuing Conditions

Create a separate schedule titled "Compliance with Ongoing Conditions" to discuss an institution’s adherence to conditions imposed by the FDIC or other relevant banking agency in connection with an application, notice, or other request made in writing. Address continuing conditions, including any conditions or requirements imposed through orders approving deposit insurance, mergers, or other applications, as well as continuing conditions or requirements imposed through a non-objection to a change in bank control notice or other filing. Continuing conditions or requirements to be addressed may also be included in various agreements relating to an application, notice, or filing such as operating agreements, parent company agreements, capital and liquidity maintenance agreements, and passivity agreements. The schedule should follow the Compliance with Enforcement Actions page (if formal or informal actions are in place) or the ECC page.

Page Structure

Examiners should begin comments with a brief overview of the facts leading to the issuance of an action. (For example, "Based on deficiencies noted at the xx/xx/xx examination, ...") Comments should detail the type of action, effective date, and affected parties. At the first examination after the issuance of a formal or informal administrative action, the action should generally appear verbatim on this page. If the action is lengthy and management is agreeable, it may be paraphrased.

Use bold print, indentation, quotations or similar techniques to differentiate between action provisions and examiner assessments.

Each provision should be followed with an assessment of the adequacy of the steps taken by the institution to comply with each provision of the action. For example, an assessment of a new policy might say, "The updated Liquidity Policy appears to address the requirements of provision X." Examiners should not use conclusory statements of opinion such as, "The institution is in compliance/partial compliance/substantial compliance/noncompliance with this provision." Comments should also indicate whether time limits set forth in actions have been met.

At subsequent examinations, provisions may be paraphrased or summarized. Address only those points of the action that the institution has not complied with since the previous examination and requirements of a continuing nature. When all provisions have been satisfied, and the only remaining provisions are those of a continuing nature having no expiration date, remarks may be limited to a short paragraph concerning the continuing requirements of the action.

In all cases, carry forward a summary of the institution's adherence to any outstanding formal or informal actions to the ECC page.

RISK MANAGEMENT ASSESSMENT

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Purpose

The purpose of this schedule is to highlight deficiencies in risk management policies, procedures, and practices and to provide recommendations for corrective action, ideally before risk management practices impact the institution's condition.

When To Include This Schedule

Examiners should use the Risk Management Assessment (RMA) page to concisely detail supervisory recommendations about risk management deficiencies and corresponding management responses that are material enough to be included in the ROE, but not on the ECC page. When determining where to place comments (ECC vs. RMA), consider the materiality of an issue, the impact an issue has on CAMELS ratings, and how placement of a comment most effectively supports recommendations and ratings.

General

Examiners should answer each RMA question by responding: "Yes," "No," or "Generally, yes." Responses at most 1 and 2 rated institutions will likely be answered: "Yes", or "Generally, yes."

"Yes" answers do not require ROE comments.

"Generally, yes" answers, which may be appropriate for moderate weaknesses, require comment on the RMA page, but may not require ECC page comments. Related comments should be concise and address management's response.

Answers of "No" normally require ECC page comments and may even require MRBA, depending on the significance of the deficiency and urgency and seriousness of required corrective action. To the extent possible, examiners should not duplicate comments on the ECC and RMA pages; however, RMA page comments may be used to address less significant issues or to provide additional details about weaknesses that are addressed on the ECC page.

In some cases, coverage of related issues may be split between the ECC and RMA pages. For example, assume a bank's loan policy is inadequate for several significant reasons. In addition, a number of less significant policy related weaknesses are identified that alone would not justify considering the policy inadequate. In this scenario, an appropriate RMA Question No. 2 response may be:

No. As indicated on the Examination Conclusions and Comments page, underwriting and credit administration practices relating to acquisition and development lending are deficient. Additionally, management should strengthen the Loan Administration Policy by:

- Addressing minimum documentation requirements relating to home lending,
- Developing minimum liquidity and net worth requirements for unsecured borrowers, and
- Modifying accounts receivable lending guidance to be consistent with actual practices.

President Smith agreed to modify the Loan Policy by the end of the year.

Risk Management Questions

The list of items under each question is for illustrative purposes and is not all-inclusive. In responding to these questions, examiners should consider the institution's existing and projected business model, risk profile, and complexity.

1) ***Are risk management processes adequate in relation to economic conditions and asset concentrations?***

Consider issues such as:

- Local economic conditions and trends (including real estate markets),
- Trade area demographics,
- Loan demand and diversification strategies,
- Industry or economic-sector concentrations, and
- Diversity and availability of funding sources.

The level of formality in risk management processes should be consistent with the existing and projected size and complexity of an institution's activities. For example, written policies relating to monitoring economic conditions may not be needed in a stable 1 or 2 rated community bank.

2) ***Are risk management policies and practices for the credit function adequate?***

Consider the adequacy of policies and practices relating to issues such as:

- Credit administration,
- Underwriting standards,
- Credit grading system,
- ALLL or ACL methodology,
- Real estate appraisals and evaluations,
- Concentration limits and oversight,
- Internal and external loan review programs,
- Documentation standards,
- Lending authorities,
- Loan approval processes,
- Loan committee structures,
- Nonaccruals and chargeoffs,
- Environmental risk controls,
- Out-of-area lending,
- Loan purchases and participations,
- Subprime lending programs,
- Credit card lending programs, and
- Renewals and extensions.

Additional guidance regarding this area is included in Section 3.2 (Loans), of the Manual.

3) ***Are risk management policies and practices for asset/liability management and the investment function adequate?***

Consider the adequacy of policies and practices relating to issues such as:

- Asset/Liability management,
- Liquidity strategies,
- Investment strategies,
- Hedging strategies,
- How growth is funded,
- Investment authorities,
- Committee structures, and
- Outside advisory services.

Additional guidance regarding this area is included in Sections 3.3 (Securities and Derivatives), 6.1 (Liquidity and Funds Management), and 7.1 (Sensitivity to Market Risk), of the Manual.

4) ***Are risk management processes adequate in relation to, and consistent with, the institution's business plan, competitive conditions, and proposed new activities or products?***

Consider the adequacy of policies and processes relating to issues such as:

- Strategic and capital planning,
- Management depth and succession,
- New or expanded activities or products,
- Competitive environment,
- Feasibility and budgeting analysis,
- Fidelity insurance coverage, and
- Consistency of present business plan and proposed new activities with that provided with the Application for Federal Deposit Insurance (de novo institutions).

5) ***Are internal controls, audit procedures, and compliance with laws and regulations adequate (includes compliance with the Bank Secrecy Act [BSA] and related regulations)?***

Consider the adequacy of practices, as well as policy coverage and implementation, relating to issues such as:

- Independence, scope, and frequency of internal/external audit programs;
- Internal control standards;
- Management information systems;
- Audit committee composition;
- Management's responses to previous regulatory and audit recommendations;
- Accounting issues/Call Report errors;
- Fidelity insurance coverage;
- Compliance with the Bank Secrecy Act and Financial Recordkeeping regulations; and
- Compliance with laws and regulations, including continuing conditions other than orders granting approval for deposit insurance (which should be covered on the Compliance with Enforcement Actions Page).

RMA page comments should only briefly address cited violations. Primary commentary regarding apparent violations should be included on the ECC and Violations of Laws and Regulations pages.

BSA and OFAC comments are not required on the RMA page if there are no concerns. However, moderate deficiencies or recommendations for program enhancements that do not require MRBA or ECC comments may be detailed on this page. (In all cases, scope comments for BSA and OFAC should be included on the Confidential - Supervisory Section page.)

6) ***Is board supervision adequate; and are controls over insider transactions, conflicts of interest, and parent/affiliate relationships acceptable?***

Consider issues such as:

- Ownership/Control of the institution;
- Quality and completeness of Board reporting;
- Committee structure adequacy to the extent not addressed in prior questions;
- Directorate attendance;
- Transactions with insiders, affiliates, holding companies, and parallel-owned banking organizations;
- Unusual or nontraditional activities conducted through affiliates;
- Policies and procedures regarding conflicts of interest and ethical conduct;
- Affiliate/subsidiary relationships;
- Compensation policies, procedures and practices including excessive compensation and appropriateness of director's fees; and
- Key man life insurance/deferred compensation arrangements.

VIOLATIONS OF LAWS AND REGULATIONS

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Purpose

Examiners use this page to communicate details regarding apparent violations of laws and regulations, or nonconformance with guidelines or standards that are incorporated into regulations as appendices to FDIC rules, such as the appendices to Parts 364 and 365 of the FDIC Rules and Regulations.

General

The ECC page must include a reference to this page whenever violations of laws or regulations, or nonconformance with guidelines incorporated into an appendix to a regulation, are cited. The MRBA page may also require a reference to this page depending upon the significance and prevalence of the infractions and whether they are repeat infractions. References to this page on other report pages may also be necessary if related issues, such as internal control or policy weaknesses, are detailed elsewhere in the ROE.

Because of possible administrative or judicial reviews, all violations must be described as "apparent violations."

Examiners should list violations in order of importance, with consideration given to the materiality of violations, adequacy of management's response, and supervisory intentions regarding civil money penalties and enforcement actions.

Formatting Write-ups

Headings - A descriptive heading should precede each scheduled violation or group of violations.

Citation of Violation - When scheduling apparent violations of laws or regulations:

- Refer to general regulations by part number (for example, Part 329);
- Refer to specific parts of regulations by section number (for example, Section 328.2 or Section 329.1(e));
- Quote or paraphrase the requirements of violated statutes; and
- Ensure all summarized statutes or regulations accurately reflect the key aspects of the statutes or regulations. For example, "Section 337.3(b) of the FDIC Rules and Regulations prohibits banks from making loans exceeding defined amounts to directors without prior board approval."

Description of Violation - Describe the specific actions or circumstances that caused an apparent violation. For example, "The $3 million loan to Director Smith funded on 12/2/16 is in apparent violation of Section 337.3 (b) of the FDIC Rules and Regulations because it was extended without prior board approval." Lengthy descriptions of violations may be unnecessary, especially if details are included in other schedules. In such cases, include references to the other schedules.

Management Response - Comments should include:

- Management's explanation for violations and their commitments for corrective action, or lack thereof,
- The name and title of any officers or directors who provided explanations and commitments, and
- Details of any promises of restitution (when applicable).

Director Approval - To reflect director responsibility, include the names of directors who approved assets held in nonconformance with applicable State or Federal laws, regulations, or similar guidelines. While this is not necessary in all violation write-ups, it is essential when violations may result in civil money penalties. In such cases, show the date approval was granted and include the names of any dissenting directors. Follow this procedure even when an approval consisted merely of ratifying a group of loans identified only by numbers. Generally, also include director approval information when the apparent violation(s) involves insider transactions, whether or not civil money penalties are being recommended.

Summary of Technical Violations – Generally, when citing technical violations involving numerous accounts or credits, examiners may include lists of sample violations in the ROE. If sample lists are included, examiners should give complete lists to management and retain a copy in the workpapers. Refer to specialty examination instructions when citing apparent violations relating to specialty examinations.

Legal Lending Limit Violations

Generally, courts have held that only the loan(s) that cause a borrower's debt to exceed the legal limit is illegal. Therefore, consider only the advance(s) that cause the excess over the legal limit a violation. However, the state law or practices regarding this matter should prevail.

Uncorrectable Vs. Repeat Violations

After violations are first cited at an examination, refrain from citing the violations at subsequent examinations if they cannot be corrected. For example, violations of Regulation O prior approval requirements are not correctable and should not be cited at subsequent examinations. However, examiners should cite repeat violations (new infractions of previously cited violations), and violations that could have been corrected but were not.

Civil Money Penalties

Examiners must not refer to the FDIC's ability to impose Civil Money Penalties (CMPs) except in the most serious circumstances. If institutions repeat or fail to correct serious violations, comments can indicate that violations may be subject to CMPs.

Examiners must determine if an insured depository institution should be considered for a CMP referral when significant violations of the BSA/AML Compliance Program have been cited.

When CMPs are being recommended, the home mailing addresses of all directors and any other individuals involved in the violation should be included in the Confidential-Supervisory Section.

Nonconformance with Guidelines Incorporated into Regulations

After cited apparent violations, list nonconformance with guidelines or standards that are incorporated into an appendix of a regulation under the heading *Nonconformance with Guidelines Incorporated into Regulations*. An example of nonconformance with guidelines incorporated into a regulation would be when the institution did not meet one or more of the standards established in Appendix A or B of Part 364, or Appendix A of Part 365. Write-ups for nonconformance should follow the general format as violation write-ups.

INFORMATION TECHNOLOGY AND OPERATIONS RISK ASSESSMENT (ITA)

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Purpose

The purpose of the ITA page is to convey the URSIT ratings for embedded information and operations risk (IT) examinations and provide detailed comments that support each component rating.

Examiners must include comments on the Examination Conclusions and Comments (ECC) page that summarize key ITA findings, and assessments of the institution's cybersecurity preparedness and conformance with Appendix B to Part 364, Interagency Guidelines Establishing Information Security Standards (Security Guidelines). Significant findings from separate cover IT examination reports completed during the risk management examination cycle must also be summarized on the ECC page.

Page Structure and Order

The ITA is a mandatory page when IT examinations are embedded in the Safety and Soundness examination. The page should immediately follow the Violations of Laws and Regulations page, if it is included. Detailed comments supporting assigned URSIT ratings and assessments of the institution's cybersecurity preparedness and conformance with Security Guidelines are required on the ITA page.

Numerical Ratings

The ITA page includes a grid at the top of the page to display the composite and component ratings for the current and two prior IT examinations.

Supporting Comments

Comments should be presented in order of importance and provide support for the conclusions and supervisory recommendations summarized on the ECC page. Use descriptive subheadings, bulleted lists, and other such devices to promote readability.

Comments should include:

- Assessment or condition statements for each component;
- Findings and, as needed, recommendations;
- Descriptions of the consequences of inaction, or benefit of corrective action, relating to each recommendation; and
- Management's response, name and title of respondent, and timeframe specified for corrective action.

If the institution incorporates a cybersecurity tool or framework (e.g., FFIEC Cybersecurity Assessment Tool or NIST Cybersecurity Framework) into its risk management process, examiners should detail the results of management's assessment. The details should be presented in conjunction with the examiner's review of the institution's overall information security risk assessment and can be included under the supporting comments for cybersecurity preparedness.

FIDUCIARY ACTIVITIES ASSESSMENT (FAA)

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Purpose

The purpose of the FAA page is to convey supporting comments for embedded trust examination findings that are summarized on the ECC page.

When to Include

Examiners have the option to include an FAA page when additional information regarding embedded trust examination findings, recommendations, or management responses is necessary to support ECC page comments.

Supporting comments on an FAA page may relate to apparent violations, contingent liabilities, potential losses, estimated losses, or other issues subject to comment or criticism.

Page Structure and Order

Numerical Ratings

The FAA page includes a grid at the top of the page to display the component and composite ratings for the current and two prior trust examinations. At a minimum, examiners must include composite trust ratings and a summary comment on the ECC page. However, if deemed appropriate, examiners may also include composite and component trust ratings on the FAA page. The definition of the assigned composite rating must be included on the Composite Rating Definitions page.

Supporting Comments

Examiners should prepare comments on an exception-only basis as much as possible. Comments should be presented in order of importance and provide support for the conclusions and supervisory recommendations summarized on the ECC page. Descriptive subheadings, bulleted lists, and other such devices should be used to promote readability.

EXAMINATION DATA AND RATIOS (EDR)

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Purpose

The EDR page includes various data that details trends in key financial components and supplements examination assessments of capital, asset quality, earnings, and liquidity. Examiners must include the EDR page in all examination reports.

Summary of Items Subject To Adverse Classification

Generally, classification information automatically pulls from other report schedules.

Contingent Liabilities

Only Category I contingent liabilities (liabilities that will result in an equivalent increase in bank assets if the contingencies convert to actual liabilities) are subject to adverse classification.

Financial Performance and Condition Ratios

The standard ratios included on this page are derived from examination results, Call Reports, and the UBPR. When Call Report data is used, ratio calculations are consistent with UBPR User's Guide definitions. Call Report instructions require banks to report capital ratios, which are used for determining the PCA capital category, as a percentage, rounded to four decimal places. Capital ratios reflected in the EDR page are truncated at two decimals.

Note: Institutions can elect the Current Expected Credit Loss (CECL) transition provision in order to transition the day-one impact of adopting CECL in regulatory capital through transition adjustments to retained earnings, average total consolidated assets, temporary difference deferred tax assets (DTAs) , and the adjusted allowance for credit losses (AACL). Additionally, those institutions that were required to adopt CECL during the 2020 calendar year can elect the CECL revised transition to delay for two years an estimate of CECL's effect on regulatory capital followed by the three-year transition provision.

Selection of Ratios

Data in the Asset Quality section and the top portion of the Capital section[4] is based on results from current and prior examinations (if applicable). The left column of the bottom three Capital ratios[5] and the Earnings and Liquidity ratios should tie to the Examination as of Date of the current examination. The information in the adjacent columns is user-defined. When selecting the period and type of information displayed in the adjacent columns (whether institution or peer), examiners should select the data that best supports examination conclusions.

For institutions reporting capital under the community bank leverage ratio (CBLR) framework, the risk based capital ratios will not be calculated; the related ratios can be shown as "0.00" and footnoted as "Not calculated under CBLR".

Examiners can add one user-defined ratio to each section to further support examination findings. User-defined ratios for prior periods that are not readily available can be shown as NA and footnoted as Not Available, or manually calculated based on UBPR definitions.

Note: The Capital Category will need to be changed from "W-Well-Capitalized" if the bank is operating under a formal corrective action that contains a capital provision even if the capital ratios meet the requirements of the Well-

[4] Tier 1 Capital/Average Total Assets, Common Equity Tier 1 Capital/Risk Weighted Assets, Tier 1 Capital/Risk-Weighted Assets, and Total Capital/Risk-Weighted Assets.

[5] Retained Earnings/Average Total Equity, Asset Growth Rate, and Cash Dividends/Net Income.

Capitalized PCA category. (Change the category designation by overwriting the Capital Category cell in the automated examination tool.)

COMPARATIVE STATEMENTS OF FINANCIAL CONDITION

←

Purpose

This schedule presents a general snapshot of the balance sheet. It is not intended for detailed financial analysis. Examiners should use the institution's Report of Condition, UBPR, and other sources for balance sheet analysis.

General

This schedule should conform to Call Report Instructions. If Call Report Instructions change, examiners may need to add new line items.

Show all asset categories net of specific and general valuation allowances, except Total Loans and Leases, which has a separate line item for general valuation allowances (the Allowance for Loan and Lease Losses or the Allowance for Credit Losses, as applicable). Additionally, examiners should consider the following:

- *Securities Purchased Under Agreements to Resell*, and *Held-to-Maturity* (HTM) securities - These items are reported net of applicable Allowances for Credit Losses.
- *Securities: Available-for-Sale (AFS) (at Fair Value)* - For institutions that adopted ASU 2016-01, this line item only includes AFS debt securities. For institutions that have not adopted ASU 2016-01, this item would include AFS equity securities.
- *Equity securities with readily determinable fair values not held for trading* - For institutions that adopted ASU 2016-01, this line item includes investments in equity securities, unless the institution has designated the investments as trading.

Dates

Left Column - In the left column, place the financial information for the current Examination as of Date. Generally, this will be the most recent quarter-end available; however, month-end or another date may be more appropriate when circumstances dictate.

Right Column - The right column should usually detail information for the year-end prior to the Examination as of Date shown in the left column. However, when desired, substitute a different date, such as the Examination as of Date from the prior examination. If using a date other than the previous Examination as of Date, ensure the information follows Call Report Instructions.

At the first examination of a new institution, examiners may use the right column to display a projected balance sheet. If this information is not useful, leave the right column blank. In the case of a new institution, footnote the date the institution opened.

Assets, Liabilities, and Equity Capital

Ensure line items tie to Call Reports line items and footnote any unusual items. If an examination as-of date does not correspond to a quarter-end, line items must still conform to Call Report definitions.

Derivatives and Off-Balance Sheet Items

Derivatives and off-balance sheet Items should correspond to amounts listed on Call Report Schedule RC-L, (for banks that file Form 031 or 041), or Schedule RC-L and Schedule-SU, item 1 (for banks that file Form 051). If additional categories are needed, space is available below Other Off-Balance Sheet Items.

Include only Category I contingent liabilities (contingencies that give rise to accompanying increases in assets if the contingencies convert into actual liabilities). Do not include Category II contingent liabilities (those that are not expected to result in an increase in assets if converted to actual liabilities, such as pending litigation). Significant

Category II contingent liabilities should be discussed on the ECC page under the financial aspect most significantly affected (for example, capital, management, earnings, or liquidity). If more than one financial aspect is impacted, comments relating to the other areas should briefly reference the contingencies and be cross-referenced as needed.

Footnotes

Use this section strictly for footnotes, not comments.

LOAN AND LEASE FINANCING RECEIVABLES

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Purpose

The purpose of this schedule is to provide an overview of the types of loans in an institution's loan portfolio and the volume of past-due and nonaccrual loans. This schedule is not intended for in-depth loan analysis. Examiners should review an institution's internal records, Call Reports, and UBPR to gain a thorough understanding of the composition and quality of a loan portfolio.

General

Complete this schedule according to Call Report Instructions.

Percentages - Round percentages to the nearest whole percent in the loan portfolio section and to the nearest hundredth percent in the past-due and nonaccrual section.

Dates - Examiners have the flexibility to use the same or different dates for the loan category and past-due/nonaccrual sections. The loan category date will usually be the Examination as of Date. The past-due/nonaccrual date should normally correspond with the Asset Review Date.

Past due and nonaccrual ratios may not tie to Call Report ratios if the Asset Review Date and the Examination as of Date are not the same. When the dates differ, ensure the dates used are clearly footnoted. Examiners may prepare the loan portfolio section as of the Asset Review Date if significant loan portfolio changes occurred after the Examination as of Date.

Loan Portfolio Breakdown

All Other Loans and Leases - This item includes overdrafts.

Gross loans and leases per the Call Report may actually be total loans and leases (gross loans and leases less unearned income). Call Report Instructions encourage but do not require institutions to report loan categories net of unearned income. Using total loans is acceptable when total and gross figures are not substantially different or unearned income is difficult to separate from loan categories.

Past-due And Nonaccrual Loans And Leases

Past-due and nonaccrual information should correspond to information in Call Report Schedule RC-N. Refer to the instructions for Schedule RC-N and the Call Report Glossary under "Nonaccrual Status."

The past-due columns are only for past due loans that are still accruing interest. The nonaccrual column may contain current and past-due loans.

Total Past Due and Accruing - This column is the sum of the previous two columns within each category.

Percent of Category Columns - The Percent of Category column calculates the ratio of past-due and accruing loans to the respective loan category. The Nonaccrual Percent of Category column calculates the ratio of nonaccrual loans to the respective loan category. (The totals in these two columns are not the sum of the ratios above the totals. The column totals are the Total Past Due and Accruing and the Nonaccrual dollar amounts expressed as a percent of gross loans and leases. The total Percent of Category ratio plus the total Nonaccrual Percent of Category ratio equals the Past Due and Nonaccrual Loans and Leases/Gross Loans and Leases ratio shown on the Examination Data and Ratios Page.) The percent of categories columns should not add to 100 percent unless the entire loan portfolio is past-due or on nonaccrual.

Restructured Loans and Leases

Memorandum: Restructured Loans and Leases - Include restructured loans here only if they are past due and accruing or on nonaccrual. These restructured loans are included in the above past-due and nonaccrual totals. Footnote restructured loans that are not past due and accruing or on nonaccrual.

Restructured loans, also known as troubled debt restructurings, are described in ASC Subtopic 310-40, Receivables - Troubled Debt Restructurings by Creditors (formerly FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," as amended by FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan"). Such loan restructurings may include, but are not limited to, reductions in principal or accrued interest, reductions in interest rates, and extensions of the maturity date because of deterioration in the borrower's financial position.

The following loans are not considered troubled debt restructurings:

- A loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk,
- A loan that was a troubled debt restructuring, which had, subsequent to its restructuring, been assumed by a financially sound, unrelated third party, and
- A loan to purchasers of ORE which, to facilitate disposal, is granted at contract rates lower than market rates for loans of similar risk.

References:

- ASC Subtopic 310-40, Receivables - Troubled Debt Restructurings by Creditors
- Call Report Instruction Glossary under Troubled Debt Restructurings
- Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings (FIL-50-2013)

Footnote

Use this area to clarify items in the above sections. Do not use it to detail loan categories. A continuation page may be used if it is necessary to break down loan categories (such as, construction, commercial real estate, 1- to 4-family residential).

RECAPITULATION OF SECURITIES

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Purpose

The purpose of this schedule is to analyze the general composition of a bank's investment portfolio, as well as any appreciation or depreciation in securities. Review the institution's internal records, Call Reports, and UBPR to gain a thorough understanding of the composition and quality of the investment portfolio.

General

Examiners should complete this schedule in accordance with Call Report Instructions-Schedule RC-B and the Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities.

Rounding - Round percentages to the nearest hundredth of a percent.

Trading Account Assets - Do not include trading account assets, other than as a footnote.

Sub-investment Quality/Investment Quality

This schedule allows examiners to detail investment and sub-investment quality securities for States and Political Subdivisions, Mortgage-backed Securities, Other Debt Securities, and Equity Securities. When applicable, schedule sub-investment quality securities immediately below the appropriate line item. For instance, if an institution has a sub-investment quality other debt security (other domestic debt), add a line item titled Sub-Investment Quality Other Domestic Debt Securities directly below Other Domestic Debt Securities. The manually created Sub-investment line items will not appear unless a sub-investment quality security exists.

Fair Value And Estimated Fair Value

Fair Value is defined as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants in the principal, or most advantageous, market of the asset or liability at the measurement date. The value is often referred to as an "exit" price.

An orderly transaction is a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities. It is not a forced liquidation or distressed sale.

If using other than quarter-end statements and it is impractical to obtain the fair value for some securities, include the amortized cost of those securities in the Fair Value column. For each line item, footnote the dollar amount of amortized costs included in the Fair Value column.

Asset-backed Securities

For the purpose of this schedule, asset-backed securities are backed by assets other than 1- to 4-family residential properties. For example, securities backed by credit card receivables, home equity lines, automobile loans, other consumer loans or commercial and industrial loans. Footnote, if appropriate, the type of assets securitized if other than those previously listed.

References:

- Call Report Instructions for Schedule RC-B
- Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities
- Manual Section 3.3, Securities and Derivatives
- Capital Markets Handbook
- Call Report Glossary (particularly, Coupon Stripping, Treasury Receipts, and STRIPS; Marketable Equity Securities; Participation in Pools of Securities; and Trading Accounts)

ITEMS SUBJECT TO ADVERSE CLASSIFICATION

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Purpose

The purpose of this schedule is to detail adversely classified items, and when necessary, communicate the rationale for adverse classifications via write-ups.

General

The page heading includes the interagency definitions of Substandard, Doubtful, and Loss.

All types of assets are subject to adverse classification.

Asset Classification Write-Ups

Asset classification write-ups are prepared to support the examiner's conclusions and recommendations to the Board of Directors, senior management, and regulatory authorities (including support for enforcement actions). Write-ups may not be necessary when the Asset Quality (AQ) component is rated 1 or 2. However, when AQ is rated 3 or worse, examiners are to prepare a sufficient number of write-ups to explain individual asset classifications, highlight underwriting deficiencies, and support examination supervisory recommendations and ratings.

Examiners should structure their write-ups to present information most effectively. For example, fulsome write-ups, addressing the elements discussed under the Loan Write-Ups heading below, may be completed for loans over a certain size or to support specific conclusions or supervisory recommendations detailed on the ECC or RMA pages. Less comprehensive write-ups, or write-ups that only include a bulleted list of facts, may be completed for less complex credits. Examiners may also include lists of individual loans, or group homogeneous loans together, if appropriate. The examiner-in-charge has discretion as to the level of detail necessary to support conclusions and satisfactorily convey examination findings.

Regardless of the Asset Quality rating, examiners should consider including loan write-ups when any of the following circumstances are present:

- Significant weaknesses or adverse trends in credit underwriting or administration policies or practices,
- Material Loss classifications,
- Management disagrees with one or more classifications,
- Directors or management are not adequately aware of the impact of significant weaknesses in credit policies, practices, or conditions,
- Adversely classified assets involve institution insiders, or
- Internal credit grading systems are deficient.

Report Presentation

General

- In all cases, the dollar amount of adverse classifications must be included in the table at the top of the Examination Data and Ratios (EDR) page.
- If adverse classification write-ups are not prepared, examiners may list individual assets and groups of homogeneous assets on the Items Subject to Adverse Classification page.
- Regardless of ROE presentation, a detailed list of classifications should be left with management before the end of the examination. In this case, a copy of the list, signed by an executive officer (signifying acknowledgement of receipt of the list), should be retained in the workpapers for follow-up at the next examination.
- If classified assets are grouped together, include a comment as to the number of assets and basis for classification. For example, "32 Consumer Installment Loans adversely classified based on the Uniform Retail Credit Classification and Account Management Policy."

- The order of adversely classified asset categories should follow the table at the top of the EDR page. Use appropriate subheadings, alphabetize assets within categories, and subtotal each category containing adversely classified items.

Loan Write-ups

When full-scope loan write-ups are prepared, comments should address pertinent factors affecting a classified asset. To the extent necessary, write-ups should address the following elements:

Identification - Indicate the name and occupation or type of business of the borrower. In the case of business loans, identify the business structure (corporation, partnership, sole proprietorship, etc.). Identify signers, cosigners, endorsers, and guarantors.

Description - Concisely describe the make-up of the debt as to the loan type, original and current amounts, and terms. Briefly describe the loan's general history, purpose, and source of repayment.

Collateral - Describe and evaluate any collateral, including its condition and/or marketability. When relevant, identify the appraiser. Also, state if the appraisal or estimate of value is independent or in-house.

Financial Data - Present key balance sheet and income information of the borrower and guarantors. The amount of financial information included in the write up should coincide with its relevance to the classification.

Summarization of the Problem - Explicitly point out the reasons for the adverse classification. Where portions of the line are accorded different classifications or are not subject to adverse classification, state the reasons for the split classifications.

Management's Intentions - Describe management's intention with the debt/borrower. Include any corrective actions contemplated by management, and identify the bank manager who committed to the actions.

Responsibility - Immediately following each loan write-up, identify the originating officer, servicing officer, and the examiner who reviewed the loan.

Consider the following when preparing write-ups:

- The format of write-ups within each asset category should be consistent in presentation, style, and appearance.
- Be concise, but do not omit pertinent information. Assess only relevant factors.
- Write informatively and factually. Do not include extraneous information that may overshadow important weaknesses.
- Round to the nearest thousand (with 000 omitted) in both the heading and adverse classification. In narrative comments, round dollar amounts to the nearest dollar (for example, $24,985) or to the nearest thousand (for example, $25M). Note: Round all dollar amounts in narrative ROE comments the same.
- When participation loans are adversely classified, list each participant and the participant's corresponding ownership percentage (whether or not originated by the institution). This requirement does not apply to Shared National Credits.
- When applicable, discuss contingent liabilities with the related credit relationship. However, do not extend adversely classified contingent liabilities with classified credits. Adversely classified contingent liabilities should be listed under the subheading Contingent Liabilities.
- When applicable, include overdraft amounts in outstanding debt recaps and discuss details on material or chronic overdrafts of borrowers with adversely classified loans in the same general comment.
- If an adversely classified asset has been partially charged off prior to the asset review date, note the date and amount of the charge-off.
- If an asset was adversely classified at prior examinations, indicate the number of times the asset was previously classified.
- If a previously classified and written up asset is again listed for classification, an abbreviated narrative, or a simple listing of name and amount, may be sufficient, <u>if all of the following conditions are met:</u>
    - The fundamental deficiencies have not materially changed,

- Management agrees with the adverse classification,
  - Management and the board are sufficiently familiar with the deficiencies, and
  - Management and the board are taking feasible steps to improve or collect the asset.
- Indicate whether the loan is identified on the institution's internal watch list. If internally identified, indicate the internal rating.
- Indicate the past-due (30 days or more) or nonaccrual status of an asset. Occasionally, it may be pertinent to disclose delinquencies of less than 30 days.
- Indicate whether a loan had numerous extensions or rewrites.

It may not be necessary to address credit factors that do not have a significant bearing on a classification. For example, it may be unnecessary to identify the interest rate on a loan that is delinquent because a borrower went out of business and is no longer making payments. However, examiners may need to identify the interest rate on a variable rate loan that is chronically delinquent if the rate is about to increase and further strain the borrower's repayment ability. Additionally, it may be unnecessary to include numerous details on several small loans if a majority of a borrower's debt is centered in one or more large loans. For example, if a borrower has six loans totaling $1 million and the current balance of one of the loans is $950,000, the remaining five loans might be grouped together and described as, "Five related loans totaling $50,000 originated in 2005-2010. Debts classified Substandard due to the troubled financial condition of the borrower and weak overall collateral protection." (Do not group small loans together if detailed descriptions of the credits would provide better support for other examination comments or recommendations.)

Miscellaneous

- When adversely classified loans or other assets involve alleged fraud, embezzlement, or other dishonest conduct, state the facts that support the adverse classification. Do not discuss any possible criminal intent or conduct.
- Clearly distinguish the adversely classified assets of consolidated subsidiaries from institution-only classified assets.

ITEMS LISTED FOR SPECIAL MENTION

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Purpose

The purpose of this schedule is to detail assets listed for Special Mention and to communicate the rationale for the criticism.

General

The page heading includes the definition for Special Mention items.

Do not include smaller items unless they are part of a large grouping listed for related reasons.

Write-Ups

Each item listed for Special Mention should be supported by a write-up. However, items that exhibit similar deficient characteristics may be grouped together under a single write-up. The narrative, which generally need not be lengthy, should focus on weaknesses in management's administration, documentation, servicing, and/or collection activities, and on how these deficiencies can reasonably be expected to lead to increased credit risk if not remedied.

ANALYSIS OF LOANS SUBJECT TO ADVERSE CLASSIFICATION

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Purpose

The purpose of this schedule is to provide insight regarding the migration of classified loans from one examination to the next. From the analysis, the examiner will be better able to cite specific areas of change and the causes of these changes. In particular, the schedule may illustrate deterioration in the loan portfolio through the migration of loans previously classified Substandard to more severe classification categories.

When To Complete

- When institutions have marginal or unsatisfactory loan quality.
- When the volume or composition of adversely classified loans changed significantly from the previous examination.

General

Classification totals from the previous FDIC examination should normally be the starting point for the schedule. The FDIC may not always have access to state or other regulatory examination classification workpapers, which makes it difficult to use non-FDIC examinations as the starting point. However, when possible, analyze changes from a previous non-FDIC examination.

Generally, do not include adversely classified consumer loans and overdrafts. If overdrafts or consumer loans are included, they should be footnoted. Examiners also have discretion to exclude other small dollar loan balances from the schedule. Examiners should footnote amounts that are excluded.

Reductions pertain only to loans adversely classified at the previous examination.

Additional Line Items

Examiners may add line items when necessary. For example, other line items under Additions may include Previously Classified ORE where disposition did not originally meet the criteria for consummation of a sale (under ASC Subtopic 360-20, Property, Plant, and Equipment – Real Estate Sales (formerly FASB Statement No. 66, Accounting for Sales of Real Estate)), but now, subsequent to the transfer of the ORE, meets those requirements.

Payments vs. Recoveries

Nominal recoveries on loans charged off since the previous examination may be handled by: (a) including recoveries in Payments and deducting them from the line item Charged-Off, or (b) making no adjustment. However, when recoveries are significant, examiners should add a line item called Recoveries rather than include recoveries in the line item Payments. The amount included in the line item Recoveries would also be deducted from the line item Charged-Off.

Further Advances - Loans Not Adversely Classified Previously

Circumstances when this line item may be used include:

- Advances (since the previous examination) on a loan existing at the previous examination, and
- A new loan is granted to borrowers who were indebted to the institution at the previous examination and whose loans were not adversely classified at that time.

For practical purposes, do not research the payment and advance history on a loan that was on the bank's books at the last examination and not adversely classified previously. The amount listed in Further Advances - Loans Not Adversely Classified Previously should be the difference between the current balance and the previous examination balance (assuming the current balance is greater than the previous examination balance).

Further Advances - Loans Adversely Classified Previously

Circumstances when this line item may be used include:

- Advances (since the previous examination) on an adversely classified loan existing at the previous examination, and
- A new loan granted to borrowers who were adversely classified at the previous examination.

Credits Newly Extended

Include loans to borrowers who were not indebted to the institution at the previous examination.

Note: The aforementioned examples are not all-inclusive.

ANALYSIS OF OTHER REAL ESTATE SUBJECT TO ADVERSE CLASSIFICATION

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Purpose

The purpose of this schedule is to provide analysis of adverse ORE classifications from one examination to the next. From the analysis, examiners will be better able to cite specific areas of change and the causes of the changes. In particular, the schedule may illustrate deterioration in the ORE portfolio through the migration of ORE classified Substandard to more severe classification categories.

When To Complete

Examiners should consider completing this schedule if the volume of ORE is material or the composition of adversely classified ORE changed significantly since the previous examination.

General

Generally, the previous FDIC examination should be the starting point for preparing the schedule. The FDIC does not always have access to state or other regulatory examination workpapers, which makes it difficult to use non-FDIC examinations as the starting point. However, if it is possible to analyze changes from the previous non-FDIC examination, examiners may do so.

This schedule is designed to illustrate changes in adverse ORE classifications since the previous FDIC examination. Therefore, only include activity for ORE that was on the books at the last examination and ORE assets on the books at the current examination. (Do not schedule assets that both transferred into and transferred out of ORE between examinations.) If significant activity in the ORE account occurred between examinations, examiners should evaluate the reasons why assets transferred in and how they transferred out (with or without internal financing). Narrative comments may suffice to address this activity. For example, assume the following:

> Book value at previous examination: $ 5MM
> Book value at current examination: $ 3MM
> Book value of ORE acquired and sold between examinations: $12MM

In situations such as this, a separate schedule may be completed for the acquisition and sale of the $12MM. (This schedule may aid in analyzing management practices, asset quality, and loss histories.)

Examiners have the flexibility to exclude some ORE parcels. (That is, when numerous smaller parcels represent only a small portion of the total volume of ORE.) Footnote the schedule to indicate what is excluded.

Additional Line Items

Add line items when necessary.

Examples of other possible line items under Reductions:

- To Premises
- Sales for Cash
- Sales to Insiders
- Now Adversely Classified Loan (This line item may be used when internally financed sales of ORE, which did not originally meet ASC Subtopic 360-20 requirements, now meets those requirements.)
- Examples of other possible line items under Additions:
- Capitalized Improvements (This line item may be used when capitalized improvements are substantial as a whole or to a particular parcel. Otherwise, one of the Further Advances line items may be used.)
- Formerly Premises

- Loans to Facilitate the Sale of ORE (sales of ORE that do not meet the criteria for the consummation of a sale under ASC Subtopic 360-20). Use this line item when a significant volume of sales has occurred. Otherwise, sales can go under ORE from Credits Newly Extended.

Note: Reductions pertain only to ORE adversely classified at the previous examination.

Charged-off

This line item may include losses on the sale of ORE, or write-downs on existing ORE, that resulted from re-evaluations or new appraisals.

Not Adversely Classified Previously

This line item may include amounts representing both loans and ORE at the previous examination

ORE From Credits Newly Extended

This line item may include loans to facilitate ORE sales that do not meet down-payment requirements (that is, loans reported as ORE for Call Report purposes). Additionally, this item may include loans extended since the previous examination that are now adversely classified ORE.

Note: The aforementioned examples are not all-inclusive.

ASSETS WITH CREDIT DATA OR COLLATERAL DOCUMENTATION EXCEPTIONS

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Purpose

The purpose of this schedule is to support criticisms of excessive documentation exceptions and highlight specific risk management weaknesses, such as numerous exceptions involving outdated financial information.

When To Include

This schedule may be included for support when documentation exceptions are excessive, and comments regarding poor risk management practices on the MRBA page, ECC page or RMA page are appropriate. Do not include this schedule in the Report when the number of exceptions is not deemed excessive. Instead, leave a detailed list with management.

In certain circumstances, MRBA, ECC or RMA page comments about risk management practices may be appropriate if excessive deficiencies were outstanding when the examination commenced, but were substantially corrected during the examination and this schedule is not included in the Report.

General

During the examination, examiners should provide management with a list of documentation deficiencies on specific assets. This procedure is intended to expedite early correction of the deficiencies. Generally, deficiencies corrected during the examination are not included in this ROE schedule. However, examiners may include corrected deficiencies (clearly noted as having been corrected during the examination), to demonstrate reactive, rather than proactive, risk management practices.

Examiners have the flexibility to add line items in the heading to more accurately describe documentation exceptions encountered at the institution. Descriptive headings may include but are not limited to:

- 1 - Appraisal,
- 2 - Title Search or Legal Opinion,
- 3 - Borrowing Authorization,
- 4 - Recordation,
- 5 - Insurance,
- 6 - Collateral Assignment,
- 7 - Financial Statement,
- 8 - Inadequate Income/Cash Flow Statement,
- 9 - Livestock Inspection, and
- 10-Crop Inspection.

Include the date of a borrower's financial statement in the Date of Most Recent Financial Statement column only when financial statements are stale or otherwise deficient. Enter "None" when credit files contain no financial statements.

When documentation deficiencies are listed on adversely classified assets, cross-reference the appropriate ROE page.

Use this schedule to detail loan documentation deficiencies, as well as deficiencies in other assets/items (for example, ORE, securities, and letters of credit). Use subheadings to segregate categories and list exceptions in alphabetical order by the borrower's name within each subheading.

CONCENTRATIONS

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Purpose

The Concentrations page is an analytical page intended to identify *specific* concentrations of assets and liabilities that have similar risk characteristics and to communicate the examiner's evaluation of the institution's risk management practices for concentrations meeting the thresholds for write-ups described below. As an analytical page, the Concentrations page should not contain supervisory recommendations or management comments or commitments.

Overall concentration management practices and supervisory recommendations relating to concentrations should be detailed elsewhere in the ROE, such as on the ECC page, or, if included, the Risk Management Assessment (RMA) page. Material supervisory recommendations and management responses regarding concentrations should always be summarized on the ECC page. Also, depending on the extent of issues identified, commentary may be warranted on the Matters Requiring Board Attention (MRBA) page.

When to Include

Examiners must include this page to highlight asset or funding source concentrations that exceed the *listing* thresholds below, and examiners must include their analysis of the potential risks and risk management practices for concentrations that exceed the *concentration written analysis* thresholds below.

Asset concentrations are pools of assets that share common risk characteristics or have heightened sensitivity to similar economic, financial, or other risk factors. An institution's asset quality, earnings, or capital can be disproportionally affected by a single or localized economic event or market conditions if the institution holds significant asset concentrations. Therefore, having risk management systems that ensure early identification of problems in these portfolios is a prudent risk management practice.

Funding concentrations are funding types that share common risk characteristics or have heightened sensitivity to similar economic, financial, or other risk factors. The primary risk of a funding concentration is that an institution may have to replace the related funds quickly or at unfavorable terms or both. This risk may become more pronounced if the bank's condition, or the condition of the party or parties providing the funds, deteriorates, which can significantly reduce the availability of funding.

The thresholds are only aimed at directing the examiner in the context of when to list a concentration for informational purposes and when to include a written analysis of a particular concentration in the Report of Examination (ROE). The thresholds are **not** limits for institutions.

Sound examiner judgment must be used to determine the most appropriate ROE treatment of concentrations in relation to the overall risk to the institution. Concentrations not meeting thresholds set forth in these instructions may also be included and analyzed on this page at the discretion of the Examiner-in-Charge (EIC) if elevated risk is evident or inclusion supports material examination findings.

Concentration Categories Requiring Listing

Asset and funding concentrations that meet or exceed the thresholds below should be listed on the Concentrations page. As a general rule, asset concentrations for credit-related assets should be measured as a percentage of Tier 1

Capital (T1C)[6] plus the applicable reserve for loans and lease losses. The applicable reserve for loans and lease losses is equal to either the Allowance for Loan and Lease Losses (ALLL) or the Allowance for Credit Losses (ACL) related to loans and leases,[7] for institutions that have adopted the Current Expected Credit Losses (CECL) methodology. Examiners should identify only the funded exposures in the "Detail" and "Amount Extended" columns; unfunded amounts should be commented on in the narrative analysis but not be included in the calculation determining listing applicability.

For institutions that have adopted the CECL methodology and elected to use the three-year CECL transition or the revised CECL transition to delay the impacts of CECL to regulatory capital, transitioned amounts could result in a portion of the ACL to also be included as a component of T1C for the years the institution reports its regulatory capital ratios using the allowable capital relief provided by those rules. To prevent potential double-counting of the transitioned amounts of the ACL in the denominator for purposes of measuring lending-related concentrations, examiners should eliminate from T1C the transitioned amounts during the period the institution reports its regulatory capital ratios using the three-year CECL transition or the revised CECL transition provisions.

The amount to be eliminated from T1C can be calculated as the difference between the item reported on Schedule RC, Balance Sheet, item 26.a., Retained Earnings and the item reported on Schedule RC-R, Part I, Regulatory Capital Components and Ratios, item 2, Retained Earnings in the Consolidated Reports of Condition and Income. As a result of this adjustment, the amount of retained earnings used to calculate T1C for purposes of measuring lending-related concentrations will equal retained earnings as reported on the balance sheet of the institution. Examiners should ensure that, for the purposes of measuring and assessing lending-related concentrations, the denominator within the calculation represents T1C, excluding CECL transitioned amounts, if elected, plus the ACL related to loans and leases.

Asset concentrations for all other assets should be measured as a percentage of T1C, which excludes the allowance for credit losses. When capital is so low that it is no longer useful in identifying an asset concentration, examiners should use an appropriate percentage of assets as a guideline for the calculation (generally two percent of total assets (TA)).

List concentrations in order of importance (concentrations with higher perceived risks should be listed first). In determining whether, and how, to list a concentration, consider whether elevated risk is evident or whether groups of assets or funding types share common characteristics or have heightened sensitivity to similar economic, financial, or other risk factors.

1) Asset concentrations representing 25 percent or more of T1C plus the ALLL or the ACL related to loans and leases (for loans) or T1C (for securities and all other) by:
- Individual borrower,
- Small, interrelated group of individuals,
- Single repayment source, or
- Individual project.

2) Asset concentrations representing 100 percent or more of T1C plus the ALLL or the ACL related to loans and leases (for loans) or T1C (for securities and all other) by:
- Industry,
- Product line,[8]
- Type of collateral, or

[6] "Tier 1 Capital" as reported in the Consolidated Reports of Condition and Income, Schedule RC-R-Regulatory Capital.

[7] "Allowance for Credit Losses (ACL) on loans and leases" as reported in the Consolidated Reports of Condition and Income, Schedule RC-Balance Sheet.

[8] Product lines are common programs used by an institution that target specialty lending within a broad loan category, such as leveraged financing, accounts receivable, home equity, row crops, farm equipment, and subprime.

- Short-term obligations of one financial institution or affiliated group.[9]

3) Funding concentrations representing 10 percent or more of TA by a single funding source.[10]

Concentration Categories Requiring Written Analysis of Risk Management

Examiners are to provide a written analysis on the Concentrations page summarizing the examiner's evaluation of the institution's related risk management practices for each of the following asset or funding concentrations:

- Individual borrower concentrations (including small interrelated groups of individuals, a single repayment source, or an individual project) of 25 percent or more of T1C plus the ALLL or the ACL related to loans and leases (for loans) or T1C (for securities).
- Industry, product line, or collateral type loan concentrations of 300 percent or more of TC. For example, written analysis would be required for a concentration of non-owner occupied commercial real estate (CRE) loans; owner-occupied CRE loans only if they have similar risk characteristics; agricultural real estate loans; agricultural production loans (crop loans and other loans to farmers); livestock loans; or asset-based loans, among others.
- Acquisition, Development, and Construction (ADC) loan concentrations of 100 percent or more of T1C plus the ALLL or the ACL related to loans and leases.
- Correspondent credit concentrations of 100 percent or more of T1C plus the ALLL or the ACL related to loans and leases.
- Obligations of one, or a closely related group of, municipalities of 100 percent or more of T1C.[11]
- Non-agency securities (including private label mortgage backed securities, asset backed securities, and structured products) concentrations of 100 percent or more of T1C.
- Bank-owned Life Insurance (BOLI) concentrations of 25 percent or more of T1C.
- Single funding types representing 10 percent or more of TA.

Written Analysis Instructions

Written analysis for concentrations should be risk-focused and provide a forward-looking assessment of risk that is centered on consideration of the institution's risk management practices. As a risk-focused analysis:

- When concentration risk is appropriately evaluated and controlled by institution management, the examiner's written analysis will usually be more concise than when concentration risk management is weak or deficient.
- Examiners have the option to combine concentrations with similar risk characteristics into one written analysis. For example, if the institution has ADC loans exceeding 100 percent of T1C plus the ALLL or the ACL related to loans and leases, that include an exposure to a single developer of more than 25 percent of the same denominator, then both concentrations may be combined into one analysis. Similarly, agricultural real estate loans and agricultural production loans are generally viewed as separate product lines. However, examiners have the discretion to aggregate the types, if the related risk is supported in the analysis.

The written analysis must address material factors within each of the following areas, although the examiner has discretion on formatting and does not need to expressly list or bullet each of the areas. In situations in which

[9] For the purposes of concentration identification, short-term obligations represent Federal funds sold with a maturity of one day or less or Federal funds sold under a continuing contract, and resale agreements that have an original maturity of one business day (or is under a continuing contract) and are in immediately available funds in domestic offices.

[10] Funding "types" could include funding categories or programs that may be sensitive to interest rates or have other common risk factors. See FDIC RMS Manual of Examination Policies, Section 6.1 "Liquidity and Funds Management" for descriptions of types of funding.

[11] Examiner judgment is needed to assess when municipalities are related. For example, if a bank invests over 100 percent of T1C in municipals located in one county, an examiner could find that there is an economic co-dependence on local employers and other microeconomic factors that could collectively impact the local municipalities' repayment capacity in some counties but not in others. Secondly, an examiner could find that a class of municipal securities, like non-rated bonds, "dirt" bonds, or revenue obligations, might be appropriate for inclusion as a concentration above 100 percent of T1C.

examiners address the areas on other ROE pages, such as the RMA page or ECC page, discussion on the Concentration page should be limited to minimize repetition.

Identification – Describe the concentration and the percentage of capital or assets it represents. Examiners should consider, and address in written analysis if warranted, the impact of unfunded loan commitments in the assessment of concentration management. Also, describe the methodology used by the institution to identify and monitor exposure to this specific concentration.

Economic, Market, and Competitive Factors - Discuss management's consideration of relevant economic, market, and competitive conditions that affect the concentration's risk profile.

Risk Stratification and Vulnerability Assessment - Discuss the current risk profile and trends, including (when appropriate) product type, collateral type, geographic location, internal risk ratings, source of funding, and other factors deemed relevant.

Also, include management's assessment of the concentration's vulnerability to an economic downturn, sharp interest rate movements, or other scenarios as applicable. For asset concentrations, detail management's estimate of potential deterioration in credit quality. For funding concentrations, include management's assessment of the funding type's stability.

Comments must also specifically address any interrelationship between concentrated asset and funding exposures, including whether concentrations in funding types are being used to support significant growth in concentrated assets or whether an economic downturn or other scenario is negatively affecting, or could negatively affect, both asset and funding concentrations concurrently.

Risk Management and Control Processes - Discuss the risk management practices and control processes regarding the concentration including current levels, proposed levels, and adverse scenario sensitivity analyses (if applicable). Risk-focused analysis and comments should also address the following considerations, although examiners have flexibility in presentation and do not need to list all risk management and control processes:

- The reasonableness of the board's and management's risk tolerance in relation to the inherent risk of the concentration, capital protection, and risk management practices.
- Management's consideration of current and projected economic and competitive factors when establishing concentration policies, practices and monitoring processes covering items such as concentration limits, underwriting standards, and pricing terms. When applicable, this should also include scenario analyses and contingency funding plans.
- The presence of risk-mitigating enhancements, such as government guarantees or crop insurance backed by government agencies for loans or asset pledging, private insurance arrangements, or callable features for liabilities.
- Strategic actions to address changing risk profiles of the concentration, including capital adequacy determinations, staffing and managerial needs, and pricing actions.
- Adequacy of the incorporation of analytical information (such as scenario analysis results, if conducted) into policy limits, staffing and managerial resources, capital support, funding requirements, etc.
- Sufficiency of reports used by management and the board regarding concentration exposure levels and risk estimates.

Assessment Summary – Summarize the overall risk posed by the concentration; assess the overall governance, risk management, and controls over the concentration; and address any risk management issues. Also address the volume of adversely classified assets within a concentration, if the volume is material. If management plans to change the administration or size of the concentration, briefly address the change. If a concentration is well-managed and monitored, examiners should comment to that effect.

Treatment of Select Concentration Types

Specialty Business Models - If an institution has a specialty business model concentrated in one general class of credit (such as credit cards or equipment leases), it may be appropriate to simply identify the entire loan class as a concentration and focus assessments on the adequacy of related underwriting, credit administration, monitoring, and other risk management practices.

U.S. Government Securities - Securities issued by the U.S. Treasury, U.S. Government agencies and corporations, and other obligations either backed by the full faith and credit of or fully guaranteed by the U.S. Government (hereafter referred to as "U.S. Government securities") are considered risk-free from a credit risk standpoint. Therefore, these securities and other assets collateralized by them should generally not be scheduled as concentrations, provided the existence of the collateral has been verified.

However, examiners may exercise judgment in scheduling concentrations of U.S. Government securities if the instruments could potentially impact an institution's financial condition, particularly through market risk exposure. For example, an examiner may list a concentration in U.S. Government securities (such as zero coupon bonds) that present outsized market risk and potential depreciation in a changing interest rate environment. Finally, concentrations for other U.S. Government-related securities that are not in the zero percent risk-weighted category for regulatory capital purposes may be scheduled at examiner discretion.

Real Estate Lending Concentrations - Analysis of concentrations in CRE lending is warranted, as evidenced by the significant credit losses experienced in the past when such concentrations were coupled with weak loan underwriting and depressed CRE markets.[12] Accordingly, examiners should schedule non-owner occupied CRE concentrations on the page. The risk profile of owner occupied CRE loans may be somewhat less influenced by the condition of the general CRE market because repayment is dependent on the operations of the business housed by the property. Examiners retain the discretion to schedule owner-occupied portfolios where the portfolio contains common risk elements. The analysis expected is similar to that for other concentration types, and the extent of the written analysis, when necessary, will depend on risk identified in the concentration and in how the institution manages the risk.

Prudently underwritten residential loan portfolios generally would not be required to be scheduled as they do not usually have a common risk characteristic. However, when the residential loan portfolio, or one or more segments thereof, share common risk characteristics and meet or exceed the thresholds, then listing and preparing a written analysis (as appropriate) of the portfolio, or the applicable segment(s) thereof, would be appropriate. Examples could include, but are not limited to, subprime loans, high loan-to-value loans, or nontraditional mortgage loans.

At the discretion of the EIC, Other Real Estate (ORE) may be listed as a concentration if such assets are concentrated in a certain industry, product line or collateral type (e.g., ORE concentrated in ADC properties).

Out-of-Territory Lending Concentrations - When properly managed and monitored, out-of-territory lending can diversify an institution's loan portfolio, but in other instances, if out-of-territory credits are concentrated in a particular loan type or geographic area, these exposures could pose increased risk. When examiners identify out-of-territory concentrations, they should determine concentration levels (for example, by loan type or geographic location) and evaluate common risk factors, such as exposure to depressed local economies or elevated credit administration requirements.

Purchased Loans and Participation Loans - Similar to, and often associated with, out-of-territory loans, a significant volume of purchased or participated loans may result in concentration risks. If the loans are centered in a particular loan type or geographic location, purchased through the same loan broker, or originated from the same financial institution, examiners should list and evaluate the loans as concentrations.

Correspondent Bank Concentrations - A financial institution's relationship with a correspondent may result in credit or funding concentrations. A credit concentration exists when an institution advances or commits a significant volume of funds to a correspondent. A funding concentration exists when an institution depends on one or a few correspondents for a disproportionate share of its total funding. List credit concentrations that exceed 25 percent of

[12] See FDIC, History of the 80's, Lessons for the Future, https://www.fdic.gov/bank/historical/history/ and FDIC, Crisis and Response, an FDIC History, 2008-2013.

T1C plus the ALLL or the ACL related to loans and leases. Also provide a written analysis if the credit concentration exceeds 100 percent of T1C plus the ALLL or the ACL related to loans and leases. Funding concentrations that exceed 10 percent of TA should be listed with a written analysis included. While correspondent concentrations often meet legitimate business needs, the concentrations represent diversification risks that management should consider when formulating strategic plans and internal risk limits. Refer to Federal Reserve Board Regulation F, Part 206-Limitations on Interbank Liabilities and the Correspondent Concentration Risks Interagency Guidance for additional details.

Mutual Funds - Despite their inherent diversification, list an investment in a single mutual fund, the book value of which represents 25 percent or more of T1C (including those investing exclusively in U.S. Government securities).

Non-Agency Securitization Exposures in Structured Credit Products - Non-agency structured credit products, such as private label mortgage backed securities, asset backed securities, collateralized debt obligations, and collateralized loan obligations, can contain complex structures and characteristics that make their performance more volatile and susceptible to losses in adverse market or economic environments. Examiners should include these investments as concentrations when the aggregate book or fair value (whichever is greater) of an investment type represents 25 percent or more of T1C or when the aggregate book or fair value (whichever is greater) of all such investment types exceeds 100 percent of T1C.

Extensions of Credit to a Foreign Government – Examiners are expected to aggregate extensions of credit to a foreign government, its agencies, and majority-owned or controlled entities as a class of borrower. If the extensions of credit equal or exceed the 25 percent of T1C guideline, schedule them as a concentration. Loans to private sector enterprises may also be included with public sector borrowings if an interrelationship exists in the form of government guarantees, moral commitments, significant subsidies, or other pertinent factors pointing toward reliance on public sector support. Include amounts where sizable extensions of credit to related private entities equal or exceed the 25 percent of T1C guidelines.

The aforementioned procedures are intended to facilitate reporting of concentrations involving borrowers evidencing commonality of commercial credit risk. Follow outstanding instructions when handling transfer risk or country risk, where all public and private sector credits within a country are aggregated and related to the institution's capital structure. The International Banking section of the Manual and the instructions for the International section of the Bank of Anytown contain additional instructions regarding concentrations in the area of credit to foreign governments and their entities.

Funding Concentrations – Examiners are to include individual funding type concentrations that equal or exceed 10 percent of total assets when they have common risk characteristics. Examiners should consider management's internal analyses, if comprehensive and reasonable in relation to materiality, when identifying funding concentrations. An institution's liquidity MIS and reporting typically provide information regarding deposit categories, wholesale funding, non-relationship or higher-cost funding strategies and programs, and the stability of deposit customers, among other items. Examiners are also to take into account the purpose for raising the funds and how they are deployed.

Wholesale funding concentrations are relatively straightforward to identify from Call Reports or institution-provided reports. These may include, but are not limited to, Federal Home Loan Bank borrowings, other borrowings, public funds, deposits raised through listing services, or brokered deposits.

Funding concentrations arising from a targeted deposit gathering strategy or program may be more difficult to identify and are dependent on whether the deposits share common risk characteristics. For example, deposits drawn to the institution solely because it pays significantly higher than market rates may be less stable than deposits with other relationships with the bank. Similarly, for institutions with a sizeable volume of uninsured deposits, examiners need to consider whether such deposits, or a portion thereof share similar run-risk attributes. Management information and analysis may show these deposits have characteristics that contribute to stability, such as those from local customers with a long-term relationship, those with compensating accounts, or those that they are not gathered through a targeted program.

Examiners should, however, always include large depositors (depositors who own or control 2 percent or more of total deposits) to the extent that these deposits total 10 percent or more of total assets. Inclusion of these large depositors is premised on run risk as a common characteristic, given the size of the deposits. However, to the extent that management has demonstrated stability or other mitigating factors regarding a concentration of large depositors, this should be noted in the write-up. It is also important to note that, more generally, during times of stress, stability characteristics could be tested when depositors stand to lose their uninsured funds. Therefore, if a bank's financial condition is deteriorating or stress is probable, examiners should assess stability closely and reflect the uninsured levels on the page as warranted.

CAPITAL CALCULATIONS

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Purpose

The purpose of this schedule is to detail regulatory capital calculations, including adjustments resulting from examination findings.

General

Examiners should prepare this schedule according to Part 324 of the FDIC Rules and Regulations. The date of the financial information should be the same as the Examination as of Date.

CBLR – Beginning with the March 31, 2020 Call Report, certain qualifying institutions may elect to use the CBLR framework. Such institutions will not calculate Tier 2 Capital, Total Capital, or risk weighted assets, and therefore those sections of this schedule will not be completed. For further information, refer to FIL-66-2019 *Community Bank Leverage Ratio Framework* and Part 324.

Current Expected Credit Losses (CECL) Methodology – Institutions may begin adopting CECL with the March 31, 2020 Call Report. In general, for those institutions that have adopted CECL, references to the allowance for loan and lease losses (ALLL) below should be considered references to the allowance for credit losses (ACL).

Computation of Common Equity Tier 1 Capital

The definition of Tier 1 Capital is the same for both Leverage and Risk-Based Capital standards.

Individual line items are provided for Common Equity Tier 1 Capital elements, followed by Adjustments and Deductions to Common Equity Tier 1 Capital. Refer to Schedule RC-R of the Call Report Instructions for line item explanations.

In addition to those items, make adjustments for any of the following items identified during the examination process:

Assets Other Than Held-for-Investment Loans & Leases Classified Loss - This item includes assets classified Loss other than held-for-investment loans and leases, such as loans held for sale (or trading), securities, other real estate, and other assets classified Loss.

Automated examination tools may not distinguish between loans held for investment and loans held for sale and may automatically deduct all loans classified Loss from the Allowance for Loan and Lease Losses calculation in Tier 2 Capital. In such instances, examiners should make adjustments to remove the amount of loans held for sale (or trading) classified Loss from the *Less: Held-for-Investment Loans and Leases Classified Loss* line item and make adjustments to include such amount in the *Less: Assets Other than Held-for-Investment Loans and Leases Classified Loss* line item.

Additional Provision to be Transferred to Tier 2 Capital- Refer below for explanation.

Other Adjustments to and Deductions from Common Equity Tier 1 Capital - This item may include:

- Contingent Liabilities Losses - Category I contingent liabilities classified Loss and Category II contingent liabilities Estimated Loss. Refer to the RMS Manual of Examination Policies (Manual) Sections 2.1 - Capital and 3.8 - Off-Balance Sheet Activities for an explanation of Category I and II contingency liabilities, Loss classification, and Estimated Loss. Do not include in this line item Potential Loss, which should be included in the Memorandum section as discussed below. *Note:* To the extent allowances for credit losses on off-balance sheet credit exposures are included in the Allowance for Loan and Lease Losses line item for Tier 2 calculation purposes and are available to cover the Category I contingent liabilities classified Loss, do not include the

Category I Loss classifications in the Contingent Liabilities Losses to be deducted from Common Equity Tier 1 Capital; instead include the Loss in the item for Less: Held-for-Investment Loans and Leases Classified Loss.

- Differences in Accounts Which Represent Shortages - Shortages in assets (to the extent not already included in *Assets Other Than Held-for-Investment Loans and Leases Classified Loss* above), overages in liability accounts, or liabilities not shown on the institution's books. Refer to Section 2.1 - Capital for an explanation of Liabilities Not Shown on Books.
- Losses From Apparent Criminal Violations - Material losses attributed to a criminal violation that cannot be addressed by a specific asset classification should be deducted from Common Equity Tier 1 Capital. When the exact amount of the loss has not been determined, the examiner may recommend that the institution engage an outside accountant or legal counsel to conduct an appropriate audit or investigation.

Include the above items only when significant, and add appropriate footnotes. Refer to Deductions for Loss Classifications and Insufficient ALLL (or ACL, as applicable) section below for discussion on what is significant.

Computation of Additional Tier 1 Capital

Individual line items are provided for the Additional Tier 1 Capital elements. Refer to Schedule RC-R of the Call Report Instructions for line item explanations.

Computation of Tier 2 Capital

Individual line items are provided for Tier 2 Capital elements. Refer to Schedule RC-R of the Call Report Instructions for line item explanations.

Allowance for Loan and Lease Losses (ALLL)

The line item, *Allowance for Loan & Lease Losses,* is the ALLL (excluding any Allocated Transfer Risk Allowances) reflected on the Comparative Statements of Financial Condition page. If applicable, add any allowances for off-balance sheet credit exposures reflected in Schedule RC-G, Other Liabilities. As necessary, deduct the amount of held-for-investment loans and leases classified Loss on the line item *Less: Held-for-Investment Loans and Leases Classified Loss* and include any adjustments necessary to replenish the ALLL to an appropriate level in the line item *Add: Additional Provision Transferred from Common Equity Tier 1 Capital.* The resulting figure is the *Adjusted Allowance for Loan and Lease Losses.*

Loans held for sale (or trading) classified Loss should not be included in the amount *Less: Held-for-Investment Loans and Leases Classified Loss*, such losses should instead be included in *Less: Assets Other than Held-for-Investment Loans and Leases Classified Loss* in the Common Equity Tier 1 Capital calculation. Manual adjustments to automated examination tools may be necessary, as discussed above. Also refer to the discussion on Contingent Liabilities Losses in the Common Equity Tier 1 Capital section above.

Eligible ALLL - The eligible amount of the ALLL to be included in Tier 2 Capital is limited to 1.25 percent of Risk-Weighted Assets base for purposes of calculating the ALLL (RWA base), as defined in Call Report Instructions. The RWA base should be adjusted to reflect examination findings as outlined in the RWA section below. When the eligible amount is less than the amount shown on the line item *Adjusted Allowance for Loan and Lease Losses,* the ineligible ALLL is shown on the line item *Less: Excess Allowance for Loan and Lease Losses (If Applicable).*

Capital Calculations for Institutions that have adopted CECL

For institutions that have adopted CECL, the ALLL is replaced with the adjusted allowance for credit losses (AACL) for purposes of regulatory capital calculations. AACL equals allowance for credit losses (ACL) under U.S. GAAP adjusted to exclude credit allowances for purchased credit deteriorated assets and AFS debt securities.

Institutions can elect the CECL transition provision to transition the day-one impact of adopting CECL in regulatory capital, which permits transition adjustments to retained earnings, average total consolidated assets, temporary differences in deferred tax assets, and the ACL. Additionally, institutions that were required to adopt CECL during the 2020 calendar year can elect the CECL revised transition to delay for two years an estimate of CECL's effect on regulatory capital followed by the three-year transition provision.

The eligible amount of the AACL to be included in Tier 2 Capital is limited to 1.25 percent of the Risk-Weighted Assets base. The RWA base should be adjusted to reflect examination findings as outlined in the RWA section below. When the eligible amount is less than the amount shown on the line item *Examination Adjusted AACL,* the ineligible AACL is shown on the line item *Less: Excess Adjusted Allowance for Credit Losses (If Applicable).*

Deductions for Loss Classifications and Insufficient ALLL (or ACL, as applicable)

Part 324 states that on a case-by-case basis and in conjunction with supervisory examinations of an FDIC-supervised institution, other deductions from capital may also be required. These should include any adjustments deemed appropriate for identified losses, including assets other than held-for-investment loans and leases classified Loss and provisions for an insufficient ALLL.

Use the following method to adjust capital for items classified Loss and to adjust for an insufficient ALLL. This method avoids adjustments that may result in a double deduction when Common Equity Tier 1 Capital already has been effectively reduced through the provision expense in establishing an appropriate ALLL level. Additionally, this method addresses those situations where certain institutions have overstated the amount of their Common Equity Tier 1 Capital by failing to take provision expenses necessary to establish and maintain an appropriate ALLL level.

Method

- The amount of Loss for items other than held-for-investment loans and leases is deducted from the calculation of Common Equity Tier 1 Capital.
- Loss for held-for-investment loans and leases are deducted from the ALLL in the calculation of Tier 2 Capital and, if significant, examiners should deduct from Common Equity Tier 1 Capital the provision expenses necessary to replenish the ALLL to an appropriate level (as discussed in the ALLL paragraph above).

Evaluation of the appropriateness of the ALLL includes consideration of the amount of adversely classified loans and leases. If the ALLL is considered insufficient, make an estimate of the amount of provision expense needed for an appropriate ALLL. Make the estimate after the identified losses in the ROE have been deducted from the ALLL. Do not deduct loans and leases classified Doubtful from capital. These items will be included in the evaluation of the ALLL and, if appropriate, will be accounted for by the adjustment for an insufficient ALLL.

Make an adjustment from Common Equity Tier 1 Capital to Tier 2 Capital for an insufficient ALLL only when the amount is considered significant. The decision as to what is significant is a matter of judgment. As such, consider how much the adjustment would change the capital ratios, how much the reader's perception of the institution's capital level will be influenced, and whether the institution's capital category for Prompt Corrective Action will be changed. Where adjustments for an insufficient ALLL may reduce an institution's capital level to a point where Prompt Corrective Action or other restrictions may apply, particular care and attention, including consultation with the appropriate field supervisor and regional office, should be considered prior to incorporating such adjustments in the ROE.

Other-than-Temporary Impairment (OTTI): If an institution made the Accumulated Other Comprehensive Income (AOCI) opt-out election for regulatory capital purposes and it has debt securities (not held for trading) classified Loss because of OTTI, the portion of the amount classified Loss related to all factors other than credit losses that will be included in AOCI (if any) should be reversed using line item *Other Adjustments to and Deductions from Common Equity Tier 1 Capital.* For examination as of dates prior to January 1, 2018, if an institution did not make the AOCI opt-out election and has debt securities (not held for trading) classified Loss because of OTTI, a percentage of the portion of the amount classified Loss related to all factors other than credit losses that will be included in AOCI (if any) should be reversed using the same line item so that the deduction from Common Equity Tier 1 Capital reflects the AOCI adjustment transition schedule outlined in Part 324.

AFS Securities Classified Loss for institutions that have adopted CECL: For institutions that have adopted CECL and made the AOCI opt-out election for regulatory capital purposes and have AFS securities (not held for trading) classified Loss because of impairment, the portion of impairment that has not been charged to earnings, if any, should be reversed using line item Other Adjustments to and Deductions from Common Equity Tier 1 Capital. Examiners should contact the Regional Office accounting and capital markets specialists for more information.

Capital Treatment of Other Real Estate (ORE) Allowances

ORE valuation allowances are not recognized as a component of capital for either Risk-Based Capital or Leverage Capital standards. A valuation allowance is established for each parcel of ORE during the holding period when the real estate's fair value minus the estimated costs to sell the real estate is less than the real estate's *cost*. Call Report Instructions clarify that valuation allowances must be determined on an asset-by-asset basis. As a result, the individual valuation allowance should be subtracted from the related asset's *cost* to determine the property's carrying value.

Risk-Weighted Assets

Risk-Weighted Assets are as of the latest Call Report date. Refer to Schedule RC-R of the Call Report Instructions for information regarding the Risk-Weighted Assets calculation. Adjustments for any Risk-Weighted Assets classified Loss should be reflected in line item *Less: Risk-Weighted Asset Amounts Deducted from Capital*. This line item should also include adjustments for items identified during the examination process in the *Other Adjustments to and Deductions from Common Equity Tier 1 Capital* line item, but only to the extent the items were risk weighted. For example, a Category I contingent liability classified Loss should be deducted if the contingent liability is included in the calculation of risk-weighted assets; however, other losses that are not associated with an asset or off-balance sheet item that is included in the calculation of risk-weighted assets should not be deducted from Risk-Weighted Assets.

The amount deducted from Risk-Weighted Assets should represent the risk-weighted portion of the asset. Automated examination tools may deduct the classified Loss amount instead of the risk-weighted portion; examiners should adjust the automated examination tool deduction from risk-weighted assets if the difference is significant (refer to the inadequate ALLL section above for discussion on significance).

Average Total Assets

Average Total Assets are as of the latest Call Report date. Refer to Schedules RC-K and RC-R of the Call Report Instructions for detailed information on this figure. Use the amounts deducted from Common Equity Tier 1 Capital above to adjust *Average Total Assets* to calculate *Average Total Assets for the Leverage Ratio. Note:* Do not deduct *Other Adjustments to and Deductions from Common Equity Tier 1 Capital* that are not associated with an asset. For example, do not deduct contingent liabilities losses from *Average Total Assets*.

Use Average Total Assets from the latest Call Report date, even if using a month-end financial date throughout the ROE.

Memoranda Items

Capital Conservation Buffer (beginning first quarter of 2016) - The capital buffer necessary to avoid limitations on distributions and discretionary bonus payments.

Securities appreciation (depreciation) - The dollar amount of securities appreciation (depreciation), net of Loss classifications, reflected in the HTM and AFS portfolios.

Contingent Liabilities - The first item, Contingent Liabilities, refers to Category I contingent liabilities. The second item, Potential Loss, refers only to Category II contingent liabilities. Refer to the *Contingent Liabilities* entry in Manual Section 2.1 – Capital for a discussion of potential and estimated losses.

Advanced Approaches Institutions

For an advanced approaches institution that exited parallel run, consult with the Regional Capital Markets Specialist to make any necessary adjustments to Tier 2 Capital, Total Capital, and Risk-Weighted Assets. It may be necessary to overwrite existing Allowance for Loan and Lease Losses line items in Tier 2 on the Capital Calculations page to reflect eligible credit reserves.

Reminder: Examiners adjusting the Call Report schedule within automated examination tools (such as the Examination Tool Suite) to reflect correction of Call Report filing errors identified during the examination, should also determine whether other capital components are impacted and require adjustments. Adjustments to Tier 2 Capital may impact Additional Tier 1 Capital deductions. Likewise, adjustments to certain Common Equity Tier 1 Capital, Additional Tier 1 Capital, or Tier 2 Capital elements may impact Common Equity Tier 1 Capital deductions. Examiners should ensure that any adjustments are in accordance with Call Report Instructions for schedule RC-R.

References:

- Part 324 of the FDIC Rules and Regulations
- Manual Section 2.1 - Capital
- Call Report Instructions

ANALYSIS OF EARNINGS

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Purpose

This page details changes in income, expense, and equity accounts; activity in the ALLL;[13] and trends in key ratios.

For institutions that have adopted CECL, examiners should ensure that this page reflects the ACL instead of the ALLL.

Selection of Financial Periods

Examiners should use dates consistently in the Comparative Statement of Income, Reconcilement of Allowance for Loan and Lease Losses, and Other Component Ratios and Trends sections. Three data columns are available, allowing for two calendar years and one interim period (or three calendar years for examinations commencing shortly after the end of a calendar year). The interim period should correspond with the Examination as of Date.

Comparative Statement of Income

This schedule reflects data that conforms to Call Report Instructions and generally ties to the supplemental ROE page titled *Comparative Statements of Income and Changes in Equity Capital Accounts*, the Call Report schedule *RI - Income Statement*, and the UBPR *Income Statement* (except that UBPR data is completed on a tax-equivalent basis). Data fields populate automatically; however, examiners should modify the information if necessary (for example, if Call Report changes are required or if information other than quarter end is used). Footnote all changes.

- ***Provision for Loan and Lease Losses*** - Only applicable to institutions that have not adopted CECL.
- ***Provision for Credit Losses*** - Only applicable to institutions that have adopted CECL. This item reflects provisions for credit losses on all financial assets that fall within the scope of CECL.
- ***Securities Gains (Losses)*** - For banks that have not adopted ASU 2016-01, this item includes gains (losses) from the sale of HTM and AFS securities; and, for banks that have adopted ASU 2016-01, this item includes unrealized holding gains (losses) on equities securities not held for trading.
- ***Applicable Income Taxes*** - Worksheets for calculating Applicable Income Taxes are included in quarterly Call Report updates. The worksheets can be beneficial in verifying the accuracy of income tax accruals.
- ***Discontinued Operations, Net of Applicable Income Taxes*** – Corresponds to line item 11, Schedule RI. If the amount reported in this item is a net loss, report it with a minus (-) sign.
- ***Net Income (Loss) Attributable to Noncontrolling (Minority) Interests*** **–** Corresponds to line item 13, Schedule RI. A noncontrolling interest, also called a minority interest, is the portion of equity in a bank's subsidiary not attributable, directly or indirectly, to the parent bank. If the amount reported in this item is a net loss, report it with a minus (-) sign.
- ***Other Increases/Decreases*** - This title does not match a specific Call Report line item but includes all categories in the Changes in Equity Capital section (Schedule RI-A) that are not included in other line items.

Reconcilement of Allowance for Loan and Lease Losses (ALLL), or the Allowance for Credit Losses (ACL), as applicable.

Negative Provisions to the ALLL (or ACL on loans and leases, as applicable) - Negative provisions may be appropriate if clearly supported and applicable accounting guidelines are followed.

- ***Other Increases (Decreases)*** - Refer to Call Report Instructions for details.
- For banks that have adopted CECL, reconcilement reflects Call Report Schedule RI-B, Part II, Column A.

[13] Allowance for Credit Losses on loans and leases held for investment for institutions that have adopted CECL.

Other Component Ratios and Trends

- ***Noncurrent Loans and Leases to ALLL Ratio*** - Noncurrent loans and leases and past-due loans and leases are defined differently. Refer to the UBPR User's Guide and Call Report Instructions for these definitions.
- Examiners should include additional ratios when they are informative and support ECC page comments.
- For institutions that have adopted CECL, references to ALLL should be changed to ACL, reflecting the ACL on loans and leases held for investment.

COMPARATIVE STATEMENTS OF INCOME AND CHANGES IN EQUITY CAPITAL ACCOUNTS

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Purpose

This page provides details of income and expense items and a summary of changes in equity capital accounts. Include this schedule when needed to support ECC page comments.

General

- Complete this schedule according to Call Report Instructions.
- Dates used should be consistent with the Analysis of Earnings page.
- For institutions that have adopted ASU 2016-01, Securities gains (losses) includes Gains (losses) from the sale of HTM and AFS debt securities, and Unrealized holding gains (losses) on equity securities not held for trading.

Footnotes

Only footnotes, not comments, should appear here.

RELATIONSHIPS WITH AFFILIATES AND HOLDING COMPANIES

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Purpose

Examiners use this page for detailing information on bank affiliates, their relationships to the bank, and credits extended to affiliated entities. It can also be used to provide a financial overview of the bank's holding company.

General

Include this schedule, when needed, to support MRBA, ECC, or RMA page comments.

Financial Statements - While examiners may obtain financial statements of the holding company (consolidated and parent-only), affiliates, and consolidated and unconsolidated subsidiaries for financial analysis purposes, include the statements in the Report only when necessary to support comments.

Service Corporations and Premises Subsidiaries - Affiliated service corporations and affiliates holding title to premises or ORE for the institution's benefit should be included here.

Holding Company Ratios and Trends

Ratios are included to facilitate holding company financial analysis. All ratios, except This Institution's Assets to Consolidated Holding Company Assets, are available in the Federal Reserve Bank Holding Company Performance Reports (BHCPR). Calculate the referenced ratio from information in Call Reports and the BHCPR. The inclusion of additional BHCPR ratios is encouraged when the ratios contribute to financial analysis or comments.

The type and availability of BHCPRs depend upon the size of a holding company's consolidated assets. A BHCPR is produced quarterly for three groups of top-tier bank holding companies (collectively, "holding companies"): holding companies with consolidated assets of $1 billion or more, holding companies that are required to file the FR Y-9C and FR Y-9LP to meet supervisory needs, and holding companies that are not subject to the FRB's risk-based capital guideline but elect to voluntarily comply with the guidelines and file the FR Y-9C and FR Y-9LP report forms.

Extensions of Credit to Affiliated Organizations Schedule

Extensions of credit to, and securities issued by, affiliated organizations (when the organizations are related interests of insiders), should be included both here and on the Extensions of Credit to Directors/Trustees, Officers, Principal Shareholders, and Their Related Interests page.

Include extensions of credit to insiders that are collateralized by securities issued by affiliated organizations (as well as on the Extensions of Credit to Directors, Officers, Principal Shareholders and Their Related Interests page). Include these items because they are subject to the provisions of Section 18(j) of the Federal Deposit Insurance Act and Section 23A of the Federal Reserve Act with regard to determining possible violations of extensions of credit to affiliated organizations.

Indirect extensions of credit include borrowings guaranteed by an affiliate.

Comments

Holding Company - Describe holding company relationships here. Generally, include the following information:

- Name,
- Location,
- Period of existence,
- Number of shares of the institution's stock owned or controlled by the company, by each subsidiary of the company, and by trustees for the benefit of stockholders or members of the company, and
- A description of holding company trends and their potential impact on the institution. Consider the amount and terms of outstanding debt, lender- or Federal Reserve System-imposed restrictions or covenants, and the dividend payout record. Discuss any adverse trends, conditions, and recommendations on the MRBA, ECC or RMA page, depending upon their significance.

Include comments on the MRBA or ECC page when payments from an institution to its holding company are large and do not appear justified based on the services received by the institution. Also, consider compliance with Section 23B of the Federal Reserve Act.

Affiliates/Subsidiaries - Fully describe affiliate relationships in the comments section. The following information should be included:

- Name,
- Location,
- Asset size,
- Net income,
- Nature of affiliation,
- Period of existence,
- Circumstances under which the affiliation arose, and
- Primary business activities of the affiliate.

Include officers or directors when relevant. Additionally, include details regarding the amount and terms of any transactions, including extensions of credit, to and from affiliates. This information is important because the provisions of Section 18(j) of the Federal Deposit Insurance Act and Section 23A of the Federal Reserve Act apply insofar as determining possible violations of extensions of credit to affiliated organizations. Generally, comments should be brief pertaining to each extension of credit.

Nonbank Banks - Note when the institution under examination is a grandfathered nonbank bank. List violations of the Competitive Equality Banking Act of 1987 on the Violations of Laws and Regulations page and summarize the violations in a memorandum to the Regional Office. In such cases, include appropriate information on the parent company.

References:

- Related Organizations section of the Manual
- User's Guide for the Bank Holding Company Performance Report
- Section 18(j) of the FDI Act
- Section 23A of the Federal Reserve Act
- Section 23B of the Federal Reserve Act
- Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure
- Federal Reserve Board Regulation W
- Part 362 of the FDIC's Rules and Regulations

EXTENSIONS OF CREDIT TO DIRECTORS, OFFICERS, PRINCIPAL SHAREHOLDERS, AND THEIR RELATED INTERESTS

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Purpose

The purpose of this page is to provide details regarding loans extended to bank insiders and their related interests.

When to Include

Use this schedule to highlight loans to directors, executive officers, principal shareholders, and their related interests that are subject to criticism due to overall volume, credit quality, or preferential treatment.

General

Cross-reference here and on the appropriate Report pages extensions of credit subject to adverse classification, violation, or comment. List the current balances of indebtedness in the total column. Footnote charged-off items.

If a director or principal shareholder is also an executive officer, include that person as an executive officer. (Executive officers are subject to the more stringent restrictions of Regulation O.)

Definition of Terms

Prepare the schedule in conformance with Regulation O definitions of extension of credit, unimpaired capital and surplus, director, executive officer, principal shareholder, and related interest.

List of Insider Credits

List insiders alphabetically by description: Group A (Executive Officers and their related interests), and Group B (Directors/Trustees and Principal Shareholders and their related interests). Generally, comments regarding extensions of credit to insiders should be brief and not include detailed descriptions of the credits or related collateral. However, include details on material overdrafts or other unusual items.

Per Regulation O, directors, executive officers, and principal shareholders of the holding company are considered to be directors, executive officers, and principal shareholders, respectively, of the institution. As such, the prior approval, terms, creditworthiness, and lending limit provisions of Regulation O are applicable. List these individuals when appropriate.

In unusual circumstances, examiners may wish to obtain information regarding extensions of credit to non-executive officers and other employees. If such information is listed, do not include the indebtedness in the table at the top of the schedule.

Duplications With Extensions of Credit to Affiliates

Extensions of credit to, and securities issued by, affiliated organizations that are related interests of insiders should be reported here and on the Extensions of Credit to Affiliated Organizations schedule of the Relationships with Affiliates and Holding Companies page.

References:

- Federal Reserve Board Regulation O
- Section 337.3 of the FDIC Rules and Regulations
- Manual Section 4.3, Related Organizations

COMPOSITE RATING DEFINITIONS

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Purpose

This page provides definitions of the composite CAMELS (UFIRS) and specialty examination ratings detailed in the ROE. Disclosure of composite and component ratings encourages a more complete discussion of examination findings and assists bank directors and managers in making effective risk management decisions.

General

Examiners should ensure that each composite rating listed on the ECC page is defined on this page. List definitions in the same order as the ratings listed on the ECC page.

References:

- Uniform Interagency Consumer Compliance Rating System - Statement of Policy 11/28/80
- Appendix A to Part 345 of the FDIC's Rules and Regulations
- Uniform Rating System for Information Technology (FIL 12-99 02/05/99)
- Uniform Financial Institutions Rating System (FIL 105-96 12/26/96)
- Uniform Interagency Trust Examination Rating System (FIL 115-98 10/21/98)

All rating definitions are available at www.fdic.gov/regulations/examinations/ratings/.

If the automated examination tool is used to generate the ROE, the rating definitions should appear upon entering the composite ratings on the ECC page.

SIGNATURES OF DIRECTORS/TRUSTEES

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Purpose

This page, when signed and dated by all of the institution's directors, serves as the directors' certification that they each reviewed the Report in its entirety.

This form is the last page in all ROEs forwarded to institutions.

General

Enter the full name of each director in alphabetical order. This will facilitate the proper signatures of directors after they reviewed the ROE.

The page will be included in the institution's copy of the ROE. The signed form is to remain attached to the Report and retained in the institution's files for examiner review at subsequent examinations.

OFFICER'S QUESTIONNAIRE

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Purpose

The purpose of the Officer's Questionnaire (Questionnaire) is to obtain information that might not otherwise come to the examiner's attention during the examination.

General

- The Questionnaire is an official document prepared by the institution. Examiners must not alter the specific questions or answers in any way.
- Generally, the chief executive officer (CEO) should sign the Questionnaire. However, an executive officer, as defined by Regulation O, may sign if designated to do so by the CEO and material concerns are not anticipated.
- The EIC has flexibility in determining the as-of date of the Questionnaire. The Questionnaire may be completed as of the Examination as of Date or the Examination Start Date. However, the Questionnaire should never be completed as of a date subsequent to the date the institution received the questionnaire.
- The Questionnaire should be completed on a consolidated-bank basis.
- In general, bank management should be instructed to base their responses on transactions or events that have occurred since the date of the previous FDIC examination. Where a specific timeframe is not specified in the question, examiners have the discretion to request only information since the previous state examination if the state ROE is acceptable. Exception: responses to questions 10, 11, and 12 are not to be limited to any time period.
- Examiners may review these instructions with management to help them understand and complete the Questionnaire.
- Answers can be listed on continuation pages if adequate space is not provided following a question. Copies of the institution's records are acceptable if the documents furnish all the requested information and contain original signatures. If responses are voluminous, they may be provided separately from the Officer's Questionnaire. The Questionnaire should state when separate information was given to the EIC, and the information should identify the questions to which it pertains.
- Financial institutions can submit Questionnaire responses in a printed form (such as hardcopy attachments), in a secure electronic format (such as through FDICconnect), or in a combination or of paper and electronic documents. Upon receipt of Questionnaire responses, examiners should scan any printed forms into an electronic portable document format (pdf) file and convert any electronically received documents into a pdf file, to the extent not already in pdf format. Examiners should then import the pdf files of the documents into the Officer's Questionnaire folder in the Regional Automated Document Distribution and Imaging System (RADD).
- If an EIC believes an officer gave an answer in error due to oversight or misunderstanding, the signing officer may be permitted to correct the answer. The signing officer should initial all corrections.
- The Questionnaire may be submitted with the Report of Examination when appropriate. For example, the
- Questionnaire should be included if the examiner suspects that an officer knowingly provided incorrect information in the document.
- The Questionnaire should be retained for a minimum of ten years from the examination start date.
- The Questionnaire should be retained indefinitely when irregularities are discovered or suspected during the ten-year retention period.
- If management is given an electronic copy of the Questionnaire, examiners must carefully compare the returned questionnaire to ensure the wording in each question is identical to the wording in original documents.

Question 1

List all extensions of credit and their corresponding balances, which, since the last FDIC examination, have been renewed or extended under any of the following circumstances:

a) without full collection of interest due
b) with acceptance of separate notes for the payment of interest
c) with capitalization of interest to the balance of the note

For all listed loans, state which situation applies. Consumer credit/installment loans may be aggregated by number and total dollar volume.

The purpose of the question is to:

- Determine the extent of interest capitalization.
- Identify loans with potentially poor credit quality.
- Identify credit practices that may distort past-due information.
- Identify practices that may adversely affect the quality of the institution's reported earnings.

Forward affirmative answers to examiners reviewing loans. An excessive number of these loans may distort the institution's financial position by overstating earnings and understating the past-due ratios. If there is a lengthy response to this question, it may be appropriate to include comments regarding the accuracy of the past-due ratios on the RMA page. Excessive use of these practices may warrant an ECC page comment.

Question 2

List all extensions of credit secured by stock of other financial institutions, or financial institution holding companies, or their affiliates where the total of all shares held as collateral represents five percent or more of the entity's outstanding shares. Provide the following information for each listing:

- Name and location of entity
- Name of stockholder and borrower
- Number of shares held as collateral
- Percentage of ownership
- Certificate number(s)
- Original amount
- Current balance
- Origination date
- Maturity date
- Interest rate
- Purpose

The purpose of the question is to:

- Assist in determining compliance with the reporting requirements of Section 7(j) of the FDI Act.
- Assist in determining or assessing the extent of interbank activity, and assist in understanding relationships between entities and their management teams.
- Review insider relationships, when applicable.
- Assist in determining or assessing direct or indirect control issues, asset quality, and dividend requirements of other entities.
- Generate information necessary for bank correspondence cross-referencing and verifying the accuracy of information at other institutions.

References:

- Section 7(j) of the FDI Act
- Section 23A of the Federal Reserve Act
- Bank Holding Company Act
- Manual Section 4.3, Related Organizations

Question 3

List all extensions of credit made for the accommodation or direct benefit of anyone other than those whose names appear either on the note or on other related credit instruments. If any executive officer, principal shareholder, director, or their related interest (per Federal Reserve Board Regulation O definitions) is or was involved.

The purpose of the question is to:

- Determine compliance with applicable laws and regulations.
- Assist in reviewing legal lending limits.
- Assist in determining asset quality.
- Assist in determining concentrations.
- Assist in reviewing potential conflicts of interest.
- Identify straw borrowers, also known as bogus or pass-through borrowers. If loan proceeds went to the benefit of a person other than the person named on the note, or otherwise disclosed in bank records, it should be applied to the benefiting parties' aggregate debt for legal lending limit purposes.

References:

- Federal Reserve Board Regulation O
- Part 353 of the FDIC Rules and Regulations
- Manual Section 4.5, Violations of Laws and Regulations

Question 4

List all extensions of credit made by the bank (or its subsidiaries) to the officers, directors, (or their related interests) of other financial institutions or their affiliates. Provide the following information for each listing:

- Name and title of director, officer, or related interest
- Name and location of the entity
- Original amount
- Original date
- Current balance
- Maturity date
- Interest rate
- Security
- Purpose

The purpose of the question is to:

- Allow for the appropriate cross-referencing of files and verification of data at other institutions.
- Determine compliance with applicable laws and regulations.
- Assist in reviewing potential conflicts of interest and preferential treatment.
- Assist in determining the extent of such activities, and assist in better understanding the entities' business relationships with each other.
- Assist in reviewing asset quality.
- Assist in determining concentrations in this type of lending.

Reference: Section 106(b)(2) of the Bank Holding Company Act

Question 5

List all transactions between the institution and any of its executive officers, principal shareholders, directors, or their related interests, except for:

- Loans
- Deposits
- Bonuses
- Salaries
- Director fees

Include the insider's name, as well as the date and nature of the transaction.

The purpose of the question is to:

- Determine the extent, and allow for the review, of insider transactions.
- Assist in determining whether insider transactions harmed the institution.

Reportable transactions may involve equipment leases, leasing of bank premises, or insiders providing institution-related services such as appraisals, IT services, legal services, or insurance.

References:

- Manual Section 9.1, Fraud and Insider Abuse
- Manual Section 4.5, Violations of Laws and Regulations
- Manual Section 4.1, Management

Question 6

List any oral or written agreements with correspondent depository institutions that establish balances to be maintained, or other similar consideration, in connection with loans to either institution's directors, officers, employees, or principal shareholders.

The purpose of the question is to:

- Assist in reviewing potential conflicts of interest.
- Assist in determining if such transactions have an adverse effect on the institution.
- Assist in reviewing potential misapplication of funds.
- Assist in determining tying arrangements per Section 106 of the Bank Holding Company Act of 1956.
- Assist in assessing practices related to establishing or maintaining relationships via oral agreements, if any.

Reference: Manual Section 4.3, Related Organizations

Question 7

List all extensions of credit to accountants, lawyers, consultants, appraisers, or other similar individuals (including their related interests) who have provided professional services to the institution since the last FDIC examination. Exclude loans to directors, officers, or employees who perform these services, if such loans have been disclosed to examiners in other documents. Provide the following information for each listing:

- Name of borrower
- Borrower's relationship with the institution
- Current Balance

The purpose of the question is to:

- Assist in reviewing potential conflicts of interest.

Question 8

List all arrangements where the institution is obligated to make payments to a former institution-affiliated person (per Section 3 of the FDI Act) who has left the institution's employment, or has otherwise terminated his/her affiliation with the institution. Provide the following information for each listing:

- Name of person receiving payments
- Total amount of payments
- Basis for payment
- Explanation of the type of agreement (such as severance pay or deferred compensation)

If more than one person is covered by a single agreement, list the plan only once and summarize the plan's coverage.

The purpose of the question is to:

- Determine compliance with applicable laws and regulations regarding severance agreement payments.
- Identify poorly designed compensation structures that misalign incentives and induce excessive risk-taking.
- Determine potential abuse resulting from excessive compensation.
- Determine potential adverse effects on profitability.
- Assist in checking the accuracy of accounting issues and financial statements (that is, if the institution has booked appropriate liabilities).

This question looks for potential payments that may meet the definition of a golden parachute payment as defined by Section 18(k) of the FDI Act. Such payments might be prohibited if the institution becomes troubled. Examiners can also use the information provided in the response to review for excessive compensation.

References:

- Section 18(k) of the FDI Act
- Part 324 of the FDIC Rules and Regulations (Prompt Corrective Action)
- FIL-66-2010 Guidance on Golden Parachute Applications
- Part 364 of the FDIC Rules and Regulations
- Manual Section 4.1, Management

Question 9

List any written or oral contract or agreement (not included in responses to questions five and eight above) that obligates the institution to pay more than ten percent of its current equity capital over the life of the contract or agreement. Provide the following information for each listing:

- Name of the counter party or payee
- Date of the contract or agreement
- A brief description of the purpose, terms and conditions

The purpose of the question is to:

- Assist in identifying undesirable lengths of contracts and potential excessive liabilities.
- Assist in determining any impairment of capital.
- Review for adverse termination clauses.
- Determine impact on the institution's future profitability.
- Assist in assessing practices related to establishing or maintaining relationships via oral agreements, if any.

Use the Regulation O definition of equity capital when determining ten percent of equity capital.

This question is intended to identify contracts that may adversely affect the safety and soundness of the institution. Appropriate management review and approval should be recorded for large contracts.

Reference: Section 30 of the FDI Act

Question 10

List any director who has been ineligible or disqualified from serving as a director at any time. Also, furnish the reason for his/her ineligibility or disqualification.

The purpose of the question is to:

- Determine compliance with applicable state laws and regulations.
- Verify the directors' continued eligibility to serve on the bank's board. For example, many states require a director to own and maintain qualifying shares of stock in the institution. In addition, some state laws prohibit individuals from serving as a director, if their loan(s) have been adversely classified. State laws generally govern the meaning of disqualification for the response to this question. However, any current director that was ever deemed ineligible from serving as a director at an insured depository institution due to statutory or regulatory guidelines (state or federal), or internal (bank) restrictions, should be identified. Cross-check responses here with responses in question No. 12 for possible tie-ins.

Question 11

List all instances where a director, officer, or employee has committed a crime involving the institution's funds or property, including any funds or property for which the institution is responsible. Provide the following information for each listing:

- Name(s) of all individuals involved
- Date and nature of irregularities
- Extent of restitution made, if any
- Whether the proper law enforcement authorities and the fidelity bond carrier were promptly notified

If either law enforcement officials or the bond carrier was not notified, explain the situation in a separate memorandum to the examiner-in-charge.

The purpose of the question is to:

- Determine compliance with applicable laws and regulations.
- Ensure notification was given to proper authorities.
- Assist in reviewing recovery potential from the bonding company.
- Indicate possible internal routine and control deficiencies.

References:

- Section 8(e) of the FDI Act
- Part 353 of the FDIC Rules and Regulations
- Manual Section 4.5, Violations of Laws and Regulations

Question 12

List any director, officer, or employee who has been convicted of, or who is presently under indictment or similar action for, or has agreed to enter into a pretrial diversion or similar program in connection with the prosecution for any criminal offense involving dishonesty, breach of trust, or money laundering. Briefly describe the situation.

The purpose of the question is to:

- Determine compliance with applicable laws and regulations.
- Assess conformance with corporate codes of conduct and bank ethics policies
- Assess UFIRS Management component

References:

- Sections 8(e), 8(g), and 19 of the FDI Act
- FIL 105-2005, Corporate Codes of Conduct, Guidance On Implementing An Effective Ethics Program
- Manual Section 4.1- Management

Question 13

List all assets of value the institution owns but does not show on its books.

The purpose of the question is to:
- Assist in ensuring proper internal control and accounting over such items.
- Assist in determining the institution's capital position.

This question may encompass a variety of answers. Typical answers include charged-off assets of undetermined value.

Reference:
- Manual Section 2.1, Capital
- Manual Section 3.7, Other Assets and Liabilities
- Manual Section 4.1, Management
- Manual Section 4.2, Internal Routine and Controls

Question 14

If the institution is a defendant in any lawsuit, provide the following summary information:
- Names of the plaintiffs
- Amount sued for
- Nature of, or basis for, litigation
- Expected result, including any probable loss

If necessary, provide full details to examiners, in a separate memorandum.

The purpose of the question is to:
- Determine the impact of contingent liabilities, the likelihood of contingencies becoming direct liabilities, and the potential impact on capital.

In some instances, institutions incur significant costs in obtaining a formal attorney's letter. As such, examiners should not specifically request or require such a letter as a means of answering this question. Nonetheless, many institutions will obtain an attorney's letter. Normally, a summary should be provided here, and the attorney’s letter(s) should be retained in the examination workpapers. If the letter(s) are being included in the Report (with the Officer's Questionnaire), include the letters on a continuation page.

References: Manual Section 2.1, Capital - Contingent Liabilities

Question 15

List all organizations that are directly or indirectly affiliated with, or otherwise related to, the institution in any way, including fiduciary relationships. Related organizations may be corporations, partnerships, business trusts, or any similar organization. Provide the following information for each listing:
- Name of affiliate or related entity
- Location
- Type of business
- Current balance of all direct and indirect extensions of credit to the affiliate (per Section 23A of the
- Federal Reserve Act)
- Current balance of all loans to third parties, where the loans are collateralized with securities issued by the affiliate

The purpose of the question is to:

- Identify affiliated or related organizations.
- Identify loans to affiliates or related organizations.
- Reveal trust powers and the extent to which trust powers are exercised.
- Ensure all contingent liabilities are reviewed.

References:

- Section 303.7 of the FDIC Rules and Regulations
- Section 23A of the Federal Reserve Act
- Manual Section 4.3, Related Organizations
- Manual Section 12.1, Applications
- Trust Examination Manual, Section 10, Other Trust Matters

CONFIDENTIAL – SUPERVISORY SECTION

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Purpose

The purpose of this page is to communicate non-public information to regulatory personnel. Generally, information on this page should not duplicate information in the open section of the Report. Use descriptive headings to separate topics and improve readability.

Mandatory Comments

Institution Control and Relationships - Concisely identify the individuals or organizations that control the institution, material subsidiaries, and affiliates. Such information is important in tracking chain bank organizations and updating holding company records.

Examiners should interpret the word "controlled" broadly. Control may exist in an individual or group, through stock ownership, or other means. Depending on the situation, ownership of varying percentages of stock may result in control. In a mutual institution, effective control may exist in the form of a board, committee, or dominant individual. A concentration of decision-making power and a lack of oversight or accountability are keys to determining the level of control.

References:

- Change in Bank Control - Section 7(j) of the FDI Act

Part 362 - Activities of Insured State Banks and Insured Savings Association

Director Involvement **–** Prepare a brief statement of any Director contacts with the examiners outside of the exit/board meetings. If no such contact takes place, no comment is necessary.

Dominant Management **–** Identify the dominant officials, if any, and describe the dominant official's influence and effect on the institution, the board's independence and oversight, and the effectiveness of mitigating controls, if no concerns are identified. If there is a dominant official, ensure this is indicated on the SAER page. If there is no dominant official present, indicate such on the SAER page and no comment is required in the confidential pages.

Examination Scope – Prepare a brief comment addressing any deviations greater than 15% between projected and actual hours or any material change in examination scope or procedures. If there are no significant deviations or any material changes, then no comment is necessary.

If applicable, address within the examination scope comment any increased Bank Secrecy Act/Anti-Money Laundering or Office of Foreign Asset Control risk that should be reviewed at subsequent examinations and/or address significant or material changes in examination scope or examination procedures. If there are no increased risks and/or significant variances from the original scope did not occur, no comment is necessary.

Specialty Examinations (Including Information Technology, Trust, Registered Transfer Agent, Government and Municipal Securities Dealers) **–** Comments should include:

- Specialty examination numbers (used for hours tracking)
- Discussion and explanation of any material change in examination scope or procedures, or deviations between projected and actual hours of 15% or greater.
- For Information Technology, note any participation by other regulatory agencies in the IT examination, including the name of the agency and examination hours, if applicable. Comments should also include a listing of serviced institutions, if applicable.
- For Trust examinations, note the component ratings and list any unique characteristics of the client base or services, unless already addressed elsewhere in the ROE.

Capital Enhancement Sources – This section is applicable if not addressed within the ECC pages and earnings retention of the bank is significantly insufficient to maintain adequate capital, and the sale of new equity may be necessary to address capital needs. This section would primarily address potential capital resources, including the perceived capacity and willingness of potential investors to purchase stock. The following items may also be addressed at the examiner's discretion:

- A complete list of present shareholders detailing the amount of stock held and their financial worth (small holdings may be aggregated if a complete listing is impractical),
- Individual director's capacity and willingness to purchase stock,
- A list of prominent customers and depositors who are not shareholders but who may be interested in acquiring stock,
- A list of other individuals or possible sources of support in the community who, because of known wealth or other reasons, might want to subscribe to new stock, and
- Any other information regarding new capital sources, along with the examiner's opinions regarding the most likely prospects for the sale of new equity.

Optional Comments

Questionnaires and Work Programs – Prepare a summary comment if any findings from a Questionnaire or Work Program completed during the examination identifies an increased risk or some other item that should be reviewed at a subsequent examination.

Express Determination Letters **–** Include a brief comment if management requests, and is provided or denied, an express determination letter for tax purposes. For additional details, refer to Section 3.2 (Loans), of the Manual.
Additional Items – The following topics may be addressed if relevant:

- Information supporting examination comments, recommendations, ratings, and/or sensitive information regarding management, strategic plans, offices, products, or services.
- Comments reconciling apparent discrepancies between the assigned rating and recommended supervisory actions (or lack of recommended actions),
- Sensitive or nonpublic information such as planned management changes and merger discussions, and other issues such as a lack of cooperation from management.
- Noting the name of the acting EIC if the examination served as a practice job

Suggestions and Comments for Future Examinations

Comments may include the following:

- Special Expertise requirements (e.g., capital markets experts),
- Dress code and locations and business hours,
- Records maintained at locations other than the main office,
- Working space limitations, and
- Any other information that may improve examination efficiencies.

Recommendations for Administrative Actions

Do not reference administrative actions on the Confidential Page. Address, in a separate memorandum, actions such as: (1) imposing or not imposing civil money penalties, (2) terminating insurance, (3) issuing a Cease and Desist Order or other formal action, (4) issuing a Memorandum of Understanding or other informal action (Board Resolution), and (5) releasing an institution from outstanding action.

When administrative action is contemplated, remember that Confidential-Supervisory Section comments may be a matter of record at an administrative hearing. All comments must be accurate, well supported, and able to withstand cross-examination.

DIRECTORS/TRUSTEES AND OFFICERS

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Purpose

This confidential page provides information of interest to nonbank users of the ROE. The information assists Case Managers, other field, regional, or Washington Office management, and other regulatory authorities in their case management, applications processing, ROE review, and general bank supervision duties.

General

List all directors, executive officers, and principal shareholders (as defined in Federal Reserve Regulation O) under those respective subtitles. Other officers or employees (such as officers who head functional areas or the internal auditor) may be included at the discretion of the examiner-in-charge. Generally, detail functional responsibilities, banking experience, and post-secondary education for all officers listed. For directors, include their occupation, banking experience, and any other significant information relating to their contribution to the institution. When relevant, identify the related interests of all directors, executive officers, and principal shareholders.

Include holding company officers or directors who exert significant control over the institution's affairs (for example, when a holding company treasurer manages a subsidiary institution's investment portfolio), even though they are not official officers/directors of the institution.

While inclusion of this page in the ROE is discretionary, the information must be gathered and input into the automated examination tool for transmittal to reviewers. Retain copies of source documents in the workpapers.

Other

Net Worth - Directors' net worth should be obtained and included when relevant (for example, when an institution's capital position is inadequate and directors may be a source of additional capital). When estimated net worths are obtained, footnote the Date of Statement column to indicate the source of information (for example, net worths estimated by President Smith).

Attendance at Board Meetings - Board meeting attendance figures shown should be since the previous FDIC or state examination, unless otherwise noted.

Parent Company Ownership - If a holding company owns the institution, note ownership in the holding company. If relevant, examiners may include the percentage of shares owned below the number of shares owned. When informative, total the Number of Shares Owned column. Show the percentage of shares controlled by the directorate as a whole.

Salary and Bonus - Footnote the dates of salary and bonus information if it is not the current annual salary or most recent annual bonus.

Home Addresses of Directors - List the directors' complete home addresses here or on a separate continuation page when the following conditions exist:

- Formal or informal administrative action is contemplated,
- The institution is rated a composite 3, 4, or 5, or
- Civil money penalties may be recommended.

Memoranda - Note the following information:

- Number of board meetings since the previous FDIC or state examination
- Memberships in important committees (particularly audit)
- Directors' fees for board and committee meetings

APPENDIX A – ABBREVIATIONS

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The following are the principal abbreviations used in this Report of Examination.

et al	And Others
a/k/a	Also Known As
ABS	Asset-Backed Securities
ACH	Automated Clearing House
ACI	Adversely Classified Items
ACL	Allowance for Credit Losses
ADC	Acquisition, Development, and Construction
AFS	Available-for-Sale
AGI	Adjusted Gross Income
AL	Acres of Land
ALCO	Asset/Liability Committee
ALLL	Allowance for Loan and Lease Losses
AML	Anti-Money Laundering
AOCI	Accumulated Other Comprehensive Income
AP	Accounts Payable
AR	Accounts Receivable
ARM	Adjustable Rate Mortgage
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
ATM	Automated Teller Machine
AV	Appraised Value
AVP	Assistant Vice President
BIA	Business Impact Analysis
BCP	Business Continuity Plan
BHC	Bank Holding Company
BOLI	Bank-Owned Life Insurance
bp	Basis Point(s)
BSA	Bank Secrecy Act
BV	Book Value
Call Report	Reports of Condition and Income
CCO	Chief Credit Officer
CD	Certificate of Deposit
CDD	Customer Due Diligence
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CF	Cash Flow
CFP	Contingency Funding Plan
CFPB	Consumer Financial Protection Bureau
CFR	Code of Federal Regulations
C&I	Commercial and Industrial
CIP	Customer Identification Program
CISO	Chief Information Security Officer
COO	Chief Operations Officer
CRA	Community Reinvestment Act
CRE	Commercial Real Estate
CTR	Currency Transaction Report
CPA	Certified Public Accountant
CSV	Cash Surrender Value
DDA	Demand Deposit Account
DDoS	Distributed Denial of Service
DSC	Debt Service Coverage
DTA	Deferred Tax Asset
DTL	Deferred Tax Liability
d/b/a	Doing Business As
DPC	Debts Previously Contracted
DT	Deed of Trust
EBITDA	Earnings Before Interest, Taxes, Depreciation, and Amortization
EFT	Electronic Funds Transfer
EIC	Examiner-in-Charge
EVE	Economic Value of Equity
EVP	Executive Vice President
FA	Fixed Assets
FASB	Financial Accounting Standards Board
F&F	Furniture and Fixtures
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FHA	Federal Housing Administration
FHLB	Federal Home Loan Bank
FHLMC	Federal Home Loan Mortgage Corporation
FinCEN	Financial Crimes Enforcement Network
f/k/a	formerly known as
FNMA	Federal National Mortgage Association
FRB	Federal Reserve Bank
FS	Financial Statement
FSA	Farm Service Agency
FS-ISAC	Financial Services - Information Sharing and Analysis Center
FV	Fair Value
GAAP	Generally Accepted Accounting Principles
GNMA	Government National Mortgage Association
Gty	Guaranty or Guarantee
HTM	Held-to-Maturity
HVCRE	High Volatility Commercial Real Estate
ID	Income Data
Inc	Incorporated
IPO	Initial Public Offering
IRR	Interest Rate Risk
IRS	Internal Revenue Service
ISO	Information Security Officer
ISP	Information Secuirty Program
IT	Information Technology
JM	Joint Maker
LAN	Local Area Network
LLC	Limited Liability Company
LOC	Line of Credit

LP	Limited Partnership
LS	Livestock
LTV	Loan-to-Value
M	Thousands
M&E	Machinery & Equipment
MBS	Mortgage-Backed Security
MMDA	Money Market Deposit Account
MRBA	Matter Requiring Board Attention
MSA	Mortgage Servicing Asset
Mtg	Mortgage
MV	Market Value
NI	Net Income
NII	Net Interest Income
NIM	Net Interest Margin
NNCFD	Net Non-Core Funding Dependence
NOI	Net Operating Income
NOL	Net Operating Loss
NOW	Negotiable Order of Withdrawal
NP	Notes Payable
NR	Notes Receivable
NW	Net Worth
OD	Overdraft
OFAC	Office of Foreign Assets Control
ORE	Other Real Estate
PCA	Prompt Corrective Action
PD	Past Due
P&I	Principal & Interest
P&L	Profit & Loss Statement
PV	Present Value
RE	Real Estate
ROA	Return on Average Assets
RBC	Risk-Based Capital
RE	Real Estate
REM	Real Estate Mortgage
SVP	Senior Vice President
SA	Security Agreement
SAR	Suspicious Activity Report
SBA	Small Business Administration
SEC	U.S. Securities and Exchange Commission
SFR	Single-Family Residence
SLOC	Standby Letter of Credit
TA	Total Assets
TDR	Troubled Debt Restructure
TE	Tax Equivalent Basis
TL	Total Liabilities
TR	Tax Return
UBPR	Uniform Bank Performance Report
UCC	Uniform Commercial Code
USDA	United States Department of Agriculture
VA	Veteran's Administration
VOIP	Voice Over Internet Protocol
VP	Vice President
WAN	Wide Area Network
YTD	Year-to-Date

APPENDIX B – GRAMMAR AND PUNCTUATION GUIDE

←

The general rules and standards contained in this appendix are applicable only to the Report of Examination. The rules and standards cover matters commonly encountered in Report comments and are intended to promote consistency. The general rules are not a substitute for writing and grammar guides. Refer to those resources for formal guidance.

HYPHENATION - ADJECTIVES:

General Rule: Two- and three-word modifiers that express a single thought should be hyphenated when they precede a noun (an out-of-date policy).

Do not use a hyphen if each of the words can modify the noun without the aid of the other modifying word or words (a new digital computer).

Do not hyphenate words that follow the noun they modify (the policy is out of date).

<u>Examples:</u>

A full-scope examination began on June 30.

The loan is secured by a single family residence.

The apartment complex has 50 units.

HYPHENATION - PREFIXES:

General Rule: Words containing prefixes generally do not require hyphens. Include the hyphen after the prefix if not doing so would cause confusion in sound or meaning.

<u>Examples:</u>

nonaccrual nonperforming subtotal

HYPHENATION - COMPOUND VERBS:

General Rule: Compound verbs can be separate, solid, or hyphenated. If you do not find a compound verb in a dictionary, write the components as separate words.

<u>Report standards:</u>

charge off paid off write off/ up/ down

HYPHENATION - COMPOUND NOUNS:

General Rule: Compound nouns may be separate, solid, or hyphenated. If you are not certain whether a compound word should be hyphenated, check a dictionary. If you do not find a compound noun in a dictionary, hyphenate the components.

Report Standards: charge-off pay-off write-off/-up/-down examiner-in-charge

HYPHENATION - SUSPENDING HYPHEN:

General Rule: When a series of hyphenated adjectives has a common basic element, and the element is shown only with the last term, insert a suspending hyphen after each of the incomplete adjectives to indicate a relationship with the last term.

Examples:

long- and short-term securities
private- and public-sector partnerships

HYPHENATION - ADVERBS:

General Rule: If the first word is an adverb ending in "ly," do not use a hyphen.

Examples:

publicly held widely held wholly owned

CAPITALIZATION:

General Rule: There are numerous exceptions to basic capitalization rules. The most important rule is to be consistent throughout a Report. Examiners may deviate from the following standards as long as they are consistent.

Report Standards: Do not capitalize bank unless it is used with the full name of the institution.

Capitalize Board of Directors, Board, or Directors when referring to a specific board.

Capitalize Call Report, Call Report Instructions, and Consolidated Reports of Condition and Income.

Do not capitalize examiner-in-charge unless it is followed by a specific person's name.

Capitalize account titles (for example, Other Borrowings).

Capitalize the word federal.

Capitalize only the word Federal in Federal funds sold or purchased (unless referring to an account title).

Capitalize Regional Director and Regional Office.

Capitalize Report of Examination and Report when referring to a specific report.

Do not capitalize the word State unless referring to a specific public agency or the word is being used in the same sentence as Federal.

Capitalize Substandard, Doubtful, Loss, and Special Mention when referring to FDIC asset classification titles.

Capitalize the specific titles of formal institution policies (for example, the Loan Administration Policy vs. the loan policy).

Capitalize the titles of specific institution committees (for example, the Audit Committee).

DATES:

Report Standard:	A comma precedes and follows the year when the month and day precede the year. However, when the date consists only of month and year, commas are not necessary.
Examples:	The examination that began on December 2, 1998, was completed in two weeks. The report is due in January 1999.

NUMBERS:

General Rule:	Write out numbers below 10. Use figures for numbers 10 and above. Regardless of the number's size, use figures if they are followed by a unit of measure. Write out numbers that begin a sentence. Do not begin a sentence with a large number.
Examples:	The bank employs five people. The examiners cited 14 deficiencies. Twenty-six examiners attended the field office meeting.

SPELLING:

Report Standards:	installment	totaling	totaled

INTERNATIONAL REPORT PAGES

GENERAL INSTRUCTIONS

←

Purpose

Examiners use international report schedules to document the level of foreign exposure risk, the adequacy of risk management systems for controlling country exposures, the risks associated with commonly controlled foreign institutions, and the effect of international activities and risk management practices on the institution's overall condition.

When to Include

Examiners should complete these schedules if the level of country risk is material or the composition of international operations changed significantly since the previous examination.

General

Complete the following ROE report pages and include them after the domestic Items Listed for Special Mention page:

- Transfer Risks Subject to Classification
- Analysis of the Country Exposure Management System
- Selected Concentrations of Country Exposure
- Parallel-Owned Banking Organizations (PBO)

The first three pages listed above focus on an assessment of the impact of country risks and the adequacy of country risk management systems. The PBO page should be completed when the examiner determines the institution is part of a PBO. Refer to RMS Manual Section 11.1, International Banking, for information and guidance on PBOs.

Instructions for completing the schedules listed above are discussed on the following pages. In addition, the International Workpapers section contains instructions for completing a series of optional workpapers that may assist examiners in reviewing specialized areas of an institution's international operations (e.g., foreign exchange trading). The workpapers are not part of the ROE, but if completed, should be retained in the workpapers.

Note: Insert International report pages in the order shown above after the Items Listed for Special Mention page, and use the EDR (International) page in lieu of the standard EDR page in the core section of the Report.

INTERNATIONAL REPORT PAGE

TRANSFER RISKS SUBJECT TO CLASSIFICATION

←

Purpose

The purpose of this page is to identify assets that are adversely classified because of transfer risk considerations.

When to Include

Include this page when the institution has claims subject to transfer risk. The amount extended for adverse classification or comment should be as of the asset review date if possible, particularly if there has been a material change in the outstanding exposure balance since the date of the last quarterly Country Exposure Report (FFIEC Form 009).

General

In general, countries are adversely classified for transfer risk when an interruption in payments has occurred or appears imminent. The Interagency Country Exposure Review Committee (ICERC) makes the decision to adversely classify countries for transfer risk. If a financial institution has claims extended to entities within a classified country, the claims (e.g., loans) are subject to transfer risk and classified accordingly. Examiners have the discretion to assign a more severe classification than assigned by the ICERC when appropriate, but cannot assign a less severe classification. The ICERC also prepares the ROE write-ups supporting the adverse transfer risk classifications. Adverse transfer risk classifications used by ICERC are Substandard, Value Impaired, or Loss. For additional information on the committee's policies, practices, and procedures, refer to the most recent Guide to the ICERC Process (www.fdic.gov/regulations/safety/guide/Icerc.pdf). For assistance, contact the International Affairs Branch of the Division of Insurance and Research.

Write-ups are available through the FDIC representative to ICERC and generally should be included in the ROE. Include a paragraph detailing the composition of the institution's claims subject to transfer risk. Report exposures alphabetically by country and total each classification category. Examiners should follow the same instructions contained in the Items Subject to Adverse Classification page as a guide to determine when the transfer risk write-ups can be omitted from the ROE. If transfer risk write-ups are omitted from the ROE, examiners should provide the write-ups to bank management during the examination.

Some or all of the assets adversely classified for transfer risk may also be adversely classified for credit risk. Duplicate classifications should be eliminated on an asset-by-asset basis, or through a single line item at the end of page(s) detailing the adverse classifications. In all cases, the most severe criticism should prevail. For example, if an asset is classified Doubtful for credit risk and Substandard for transfer risk, make the adjustment for the duplication before calculating a total for adverse classification due to transfer risk. Apply the same procedure if both transfer risk and credit risk bear the same adverse classification. For example:

TRANSFER RISK	SUB STANDARD	VALUE IMPAIRED	LOSS
Subtotal assets classified due to transfer risk	5,000,000		
Less-amount classified due to commercial credit risk Total adversely classified assets due to transfer risk	500,000 4,500,000		

On the other hand, if the transfer risk classification is more severe, eliminate the amount classified for transfer risk from the Items Subject to Adverse Classification page(s) where credit classifications are calculated, and list the amount classified for transfer risk on this page. In addition, examiners should reduce the amount extended for classification by the amount of the allocated transfer risk reserve (ATRR). *Note: Manual adjustments to automated examination tools may be necessary to net the ATRR from the amount extended for adverse classification.* Exposures adversely classified due to transfer risk (less duplication adjustments) are included in the Asset Quality section of the Examination Data and Ratios page, under a separate line item, Other Transfer Risk.

When evaluating an institution's asset quality and other measures of financial soundness, including capital adequacy and ALLL sufficiency, examiners should combine classified credits with exposures that have been adversely classified due to transfer risk. Certain types of exposures in a given country (e.g. trade credit) may not be rated or adversely classified, while other portions (e.g. term loans) might warrant adverse classification. To facilitate uniform treatment, ICERC has defined *short-term credit* as credits maturing within one year, and *trade credit* as credit extensions that are directly related to imports and exports and will be liquidated through the proceeds of international trade (e.g. commercial letters of credit, acceptances, etc.). Past due or extended acceptances are considered loans.

Report split designations under the proper columns. Extend for adverse classification, all contingent liabilities subject to transfer risk (including commercial and standby letters of credit, as well as loan commitments) that will result in a concomitant increase in an institution's assets if the contingencies convert into an actual liability. Classify contingent liabilities extended for adverse classification according to the type and tenor of the asset that would result from conversion of the contingency into an actual liability. For example, classify commercial import/export letters of credit the same as trade credit, and classify commitments to fund long-term project loans the same as long-term loans. In cases where the type or tenor is not easily discernible and exposure is accorded a split classification, the more severe classification should prevail.

Commitments include the institution's obligations to participate in debt facilities (e.g., underwriting bonds) and syndicated credits that are managed by other institutions. Commitments should only include those for which a legally binding commitment exists, a commitment fee charged, or other consideration given. Adversely classified underwriting commitments should be shown net of firm third-party commitments to purchase the assets without recourse within a short period. Similarly, when adversely classifying syndicated loan commitments, extend only the institution's proportional share of the commitment.

(Continued on next Page)

Allocated Transfer Risk Reserve

Pursuant to the International Lending Supervision Act (ILSA), the federal banking agencies require institutions to establish and maintain a special reserve when:

(1) The value of international loans has been impaired by the protracted inability of the borrowers in a country to make payments on external indebtedness, or

(2) No definite prospects exist for orderly restoration of debt service.

In either case, these assets are typically classified as Value Impaired. Determination of the level of the special reserve, known as the Allocated Transfer Risk Reserve (ATRR), is the responsibility of the ICERC.

The ATRR is a contra-asset to the international asset, and must be established by a charge to current income and segregated from the institution's general allowance for possible loan losses. The ATRR should be netted from amounts extended for adverse classifications. Do not include the ATRR as a part of bank capital. The institution has the option to charge off the required amount rather than set up the ATRR. Examiners should ascertain whether the appropriate percentage ATRR, or charge-off, of outstanding Value Impaired exposures has been made. The amount of charge-off or ATRR required is the amount equal to the appropriate percentage of outstanding exposures, as illustrated in the following examples:

	EXPOSURE TO COUNTRY X	EXPOSURE TO COUNTRY Y
Outstanding Balance	1,000,000	3,000,000
Previous ATRR (ICERC set a 15% requirement for Country X)	150,000 (ATRR or Charge-off)	
New ATRR (ICERC sets a 10% requirement for Country Y)		300,000
New ATRR (ICERC increases ATRR requirement for Country X to 20%)	50,000 (ATRR or Charge-off)	
Final ATRR (These are the only amounts that should be reflected in the ROE)	200,000 (ATRR or Charge-off)	300,000 (ATRR or Charge-off)

If an ATRR or charge-off for the required amount has not been established by the bank, the amount should be deducted on the Capital Calculations page. This deficiency should be addressed on the Examination Conclusions and Comments page and cited on the Violations of Laws and Regulations page (refer to Part 347 of the FDIC Rules and Regulations).

The required ATRR or charge-off is based on the original amount of exposure to a country less payments received. Loans extended after the initial amount, as determined for ATRR purposes, are generally not subject to an ATRR or charge-off if the new money was extended pursuant to economic reforms and if the credits are performing.

INTERNATIONAL REPORT PAGE

ANALYSIS OF THE COUNTRY EXPOSURE MANAGEMENT SYSTEM

←

Purpose

The purpose of this schedule is to present analysis of the institution's system for monitoring and controlling country exposure.

When to Include

Complete this schedule when the institution has material cross-border exposures and examiners conduct an analysis of its country risk management systems. Guidelines for conducting such analysis are incorporated in the RMS Manual, Section 11.1, International Banking. Also, the joint Statement on Sound Risk Management Practices (FIL 23-2002), describes the elements of an effective country risk management process and the leading factors affecting country risk.

General

The analysis should include evaluations of the institution's:

- Procedures for measuring exposure,
- System for establishing country lending limits,
- Ability to analyze country risk, and
- Adherence to internal policies in this area.

The evaluation of the institution's international loan portfolio (including loans made to domestic borrowers to facilitate international transactions) and the institution's country exposure management program may warrant commentary on the Examination Conclusions and Comments page. Examples might include excessive concentrations of transfer risk in one or more countries, concentrations in certain classes of countries, such as emerging economies, large amounts of assets classified because of transfer risk, or an ineffective country exposure management system.

INTERNATIONAL REPORT PAGE

SELECTED CONCENTRATIONS OF COUNTRY EXPOSURES

←

Purpose

The purpose of this schedule is to present concentrations in crossborder exposures that are considered large relative to the institution's capital, or of special interest in terms of the economic, social, political, or geographical circumstances. The latter may include countries experiencing adverse events, countries with developing economies, countries with membership in troubled monetary unions or economic blocks, countries located within a region of special interest, etc.

When to Include

Use this schedule when the institution's exposure in any given country exceeds 25 percent of Tier 1 Capital. Examiners should also consider listing any countries of significance or special interest where exposures exceed 5 percent of Tier 1 Capital. In addition, list all exposures to adversely classified countries regardless of the percentage of Tier 1 Capital.

General

Schedule the exposures by country in alphabetical order and add any necessary explanatory remarks, including the percentage of Tier 1 Capital, reason for presenting the concentration, and any concerns regarding individual country risks or circumstances.

The Country Exposure Report (FFIEC 009), which is filed quarterly, provides detailed information on the bank's exposures by individual country. If the institution is required to prepare the report, obtain the information from the most recently filed report. Compiling the required data as of the examination start date is unnecessary unless the institution's exposure has changed materially since the last quarterly report. Examiners may wish to verify the accuracy of the report against internal bank records by sampling the data provided for one or more of the countries reported by the bank.

Some banks have significant country exposures but are not required to submit the FFIEC 009 report because the institution does not maintain a foreign office (i.e. branch, subsidiary, Edge Act or Agreement subsidiary, international banking facility, etc.). However, institutions are required to file monthly reports with the U.S. Treasury, under the Treasury International Capital System, if they have international claims to one country in excess of $25 million, or aggregate claims in excess of $50 million to all countries. These reports may be useful when determining the volume of foreign lending activity and concentrations of country exposures.

Examiners should describe concentrations of country exposure and assess related risk management practices on the Examination Conclusions and Comments page. The placement and length of comments should be commensurate with level of exposure(s) and any related examination recommendations. Also, examiners should include concentrations of country exposure on the appropriate lines of the Summary Analysis of Examination Report (SAER) page.

INTERNATIONAL REPORT PAGE

PARALLEL-OWNED BANKING ORGANIZATIONS

←

Purpose

The purpose of this schedule is to detail the information used in ascertaining whether a parallel-owned banking organization (PBO) exists and to document any concerns noted with the organization or commonly controlled foreign institutions. The fundamental risk presented by these organizations is that they may be acting in a de facto organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision.

When to Include

Complete this schedule when the institution and at least one foreign bank appear to be controlled either directly or indirectly by the same person or group of people and the organizations are not subject to comprehensive consolidated supervision. Examiners should consider whether a person or group of people control an institution if the person or group controls 10 percent or more of any class of voting shares of the depository institution.[1] (Refer to the International Banking section of the RMS Manual and the Joint Agency Statement on Parallel-Owned Banking Institutions (FIL-35-2002) for additional information.) This schedule must be included in the ROE if control equals or exceeds 25 percent of any class of voting stock. In situations where control is rebuttable, inclusion of this schedule is discretionary; however, if the examiner concludes that a PBO does not exist, this page should be maintained in the examination workpapers to document the basis of that conclusion.

General

The FDIC does not typically request or review information on foreign banks or foreign bank holding companies during the examination process. However, examiners should consider all of the issues detailed in the Parallel-Owned Banking Organizations page when determining if a PBO exists. If a PBO relationship is suspected, the examiner should request and review information to ensure they understand the ownership/control structure of any foreign entities. The requested information about foreign banks or foreign bank holding companies may include, but is not limited to:

- Shareholder list of the foreign bank(s) and any of the companies that own/control it,
- Minutes of the most recent shareholder meeting(s),
- Annual reports,
- Composition of the board(s) of directors and executive management,
- Organizational charts,
- Website addresses,
- Policies that the bank in the U.S. has been instructed to follow,
- Products or services that the bank in the U.S. has been instructed to offer, and
- Cross-border transactions or services.

Bank And/Or Bank Holding Company Information

The first section of this schedule instructs examiners to list the bank(s) and bank holding company(s) within the PBO. Information for U.S. bank(s) should be listed first and then the foreign entities in the PBO. The examiner may add rows to the table to accommodate the requested information. Alternatively, the examiner may limit the list to key organizations; however, examiners must footnote the schedule with the basis of any omissions. For example,

[1] Note: PBOs do not include structures in which one depository institution is a subsidiary of the other, or the organization is controlled by a company subject to the Bank Holding Company Act.

examiners may include a footnote for organizations that regularly engage in transactions with the U.S. bank and list the name, city, and country of those entities. The examiner may also footnote the schedule for any bank or bank holding companies that are wholly owned subsidiaries.

Stock Ownership

Detail the stock ownership of the bank(s) and bank holding company(s) in the U.S. and foreign country that provide the primary connection for the PBO. Since the connection may contain more than one bank or bank holding company, the examiner may need to add rows to the table. To the right of the labels *U.S. Name* and *Foreign Name*, list the name of the entity for which information on beneficial ownership is being provided. To the right of the *Beneficial Owner* label, list the owner's name and corresponding ownership information (number of shares owned, percentage of ownership, and type of control). Footnote any pertinent information, for example, indirect control of ownership shares.

Factors Considered

Comment on each of the factors or attributes that are listed on the PBO page. These factors, in addition to common stock ownership, help the examiner determine if sufficient control is exercised to conclude that a PBO relationship exists. If items are not applicable, so state.

Summarize The Examination's Findings

Detail any affiliate or insider relationships (as defined by Section 23A of the Federal Reserve Act and Regulation O). Cross-reference any concerns or criticisms here and on the appropriate ROE page(s). Additionally, discuss the availability and quality of financial information for the other parallel-owned banks and note any apparent concerns with their financial condition. Refer to the International Banking section of the RMS Manual for additional information.

Confidential Information

The examiner should use discretion in detailing information on this page. If the information provided is of a sensitive nature, or obtained through confidential sources (e.g., foreign regulators), the information should not be included in the open section of the ROE.

INTERNATIONAL WORKPAPERS

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The **optional** workpapers discussed below may assist examiners in forming conclusions about the institution's international activities. If used, the workpapers should be retained, but not included in the Report of Examination. Address any material issues identified on the ECC, RMA, or other appropriate ROE page(s).

- International Loans, Acceptances, and Letters of Credit - Distribution
- International Loans, Acceptances, and Letters of Credit - Questionnaire
- Eurocurrency Operations
- Foreign Exchange Activities
- Position Analysis - Major Currency Positions
- Position Analysis - Other Currencies
- Maturity Distribution (GAP) Analysis
- Revaluation and Income/Loss Analysis
- Income Loss Schedule
- Policy and Procedures
- Audit and Internal Controls - Audit
- Audit and Internal Controls - Internal Controls

INTERNATIONAL WORKPAPER

←

INTERNATIONAL LOANS, ACCEPTANCES, AND LETTERS OF CREDIT-DISTRIBUTION

This schedule is intended to help the examiner identify the level of lending, letters of credit, and acceptance financing between the institution and obligors and/or guarantors living outside the U.S., its territories, and possessions. The inclusion of obligations guaranteed by foreign-domiciled individuals or entities in this definition is based on the concept that ultimate liability for repayment rests with the guarantor. Therefore, the basic objective is to designate transactions where repayment channels cross international boundaries. This approach is consistent with the method used in the Country Exposure Report (FFIEC 009) to reallocate claims to the country of the individual or entity ultimately liable for repayment.

For this schedule, guaranteed instruments are those for which a third party legally obligates itself to repay the institution's claim on the direct obligor if the latter fails to do so. Documents such as *comfort letters* or *letters of awareness* or *intent* are not considered guarantees for this schedule. The term *guaranteed* covers collateralized instruments if the collateral meets the following requirements:

- The collateral is liquid and readily realizable, and
- Realizable outside of the country of residence of the borrower.

Using the foregoing guidelines, include in the schedule obligations of residents or entities domiciled in the U.S. bearing a guarantee from a resident or entity in a foreign country. Similarly, exclude from the schedule direct obligations of foreign residents or entities with guarantees from domestically domiciled residents or entities.

Loans:

Base the distribution of loans in this schedule on the nature of the direct obligor on the indebtedness.

Mortgage loans include liens or deeds of trust on real property, aircraft, or ships. Shipping loans included in this category will be secured by first or second preferred-ship mortgages. Exclude loans collateralized solely by bareboat, time, or consecutive charter agreements, which are more properly shown in the *Loans to commercial, industrial, and agricultural interests* category.

Other Loans (Describe) should include credits not properly categorized in the five preceding captions in the workpapers that are made to obligors with similar characteristics and represent a material percentage of total international loans (approximately 10 percent of international loans is a reasonable criteria).

Use the footnote "Loans to U.S. subsidiaries of foreign corporations not included above." to show the aggregate of loans to borrowers that are not shown in categories above in the Distribution schedule.

Other:

Syndication and consortium financing should include the institution's investment in syndicated credits. These loans differ from the customary participation loan as multiple institutions participate at the outset and are known to the borrower. As such, the loan must be structured to meet both the requirements of the participating institutions and the needs of the borrowing entity. The function of packaging the credit to satisfy the needs of all parties to the transaction is the responsibility of the syndicate leader.

Other (Describe) is for special types of international lending or financing activity deemed worthy of separate listing. For example, a separate listing of the aggregate volume of syndicated loans originated by the institution as syndicate leader or loans in certain geographic areas may be warranted.

INTERNATIONAL WORKPAPER

←

INTERNATIONAL LOANS, ACCEPTANCES, AND LETTERS OF CREDIT-QUESTIONNAIRE

The questions in this workpaper are intended to assist examiners with identifying risk management weaknesses in a bank's international operations. Significant concerns should be addressed on the ECC, RMA, or other appropriate ROE page (e.g. the Analysis of the Country Exposure Management System page).

INTERNATIONAL WORKPAPER

EUROCURRENCY OPERATIONS

←

The questions in this workpaper are intended to assist the examiner with identifying risk management weaknesses in the bank's international operations. Significant concerns should be addressed in the ECC, RMA, or other appropriate ROE page (e.g. the Analysis of the Country Exposure Management System page).

INTERNATIONAL WORKPAPER

FOREIGN EXCHANGE ACTIVITIES

←

This workpaper should be used in conjunction with other workpapers that address risks associated with foreign exchange activities. Other workpapers might include Position Analysis - Major Currency Positions, Position Analysis - Other Currencies, Maturity Distribution (GAP) Analysis, Revaluation and Income/Loss Analysis, and the Income/Loss Schedule. Significant concerns should be addressed in the ECC, RMA, or other appropriate ROE page(s).

INTERNATIONAL WORKPAPER

←

POSITION ANALYSIS - MAJOR CURRENCY POSITIONS

This worksheet may be useful for determining the institution's position in various currencies, calculating unrealized profits or loss, and assessing foreign exchange policies and risk management practices. Significant concerns should be brought forward as needed to the ECC, RMA, or other appropriate ROE page.

Position Analysis

If an institution has assets or liabilities denominated in a foreign currency, or the institution has commitments to purchase or sell foreign exchange with a future delivery date, a net position for each foreign currency must be calculated. This calculation facilitates the analysis of exposure to fluctuations in exchange rates and aids in determining unrealized profits or loss. Further, the position analysis enables examiners to ascertain the institution's practice of periodically adjusting U. S. dollar equivalents of foreign currency accounts.

To analyze the position on each foreign currency, make a trial balance of each asset and liability account denominated in a foreign currency. Asset accounts (long position) include, but are not limited to, foreign currency on hand, due from bank accounts (nostro), demand and time loans, investments, accrued interest receivable, and commitments to purchase exchange on a spot or future basis. Liabilities (short position) include due to accounts (vostro) with other institutions (including nostro overdrafts), demand and time deposits, cash collateral, accrued interest payable, accounts payable, and commitments to sell exchange on a spot or future basis. These accounts or subsidiary records will normally contain both the amount of foreign currency and an equivalent amount expressed in U.S. dollars. The examiner's trial balance of foreign currency should prove to the institution's position sheet, and dollar equivalents should correspond to the general ledger. Certain transactions, such as the previous day's spot or future exchange transactions may not have been recorded on the institution's books. Obtain these *holdover items* from the foreign exchange trader, and include them in the calculation of the currency position.

Major Currency Position

This schedule is reserved primarily for the currency posing the greatest exposure to the institution's total capital and reserves. If the institution maintains substantial positions in several currencies, the schedule should be completed separately for each currency.

Derive the entries for foreign currency and dollar equivalents for each asset and liability category from the institution's records (using the examination as of date). **Do not revalue these accounts at current exchange rates.** Deduct the lesser of long/short position from the larger figure to arrive at the net position in foreign currency and dollar equivalent. The net-position dollar equivalent should be evaluated in comparison to capital and reserve levels.

INTERNATIONAL WORKPAPER

←

POSITION ANALYSIS - OTHER CURRENCIES

This worksheet may be useful for determining the institution's position in various currencies, calculating unrealized profits or loss, and assessing foreign exchange policies and risk management practices. Significant concerns should be addressed as needed to the ECC, RMA, or other appropriate ROE page.

Position Analysis

If an institution has assets or liabilities denominated in a foreign currency, or the institution has commitments to purchase or sell foreign exchange with a future delivery date, a net position for each foreign currency must be calculated. This calculation facilitates the analysis of exposure to fluctuations in exchange rates and aids in determining unrealized profits or loss. Further, the position analysis enables examiners to ascertain the institution's practice of periodically adjusting U. S. dollar equivalents of foreign currency accounts.

To analyze the position on each foreign currency, prepare a trial balance (using the examination as of date) of each asset and liability account denominated in a foreign currency. Asset accounts (long position) include, but are not limited to, foreign currency on hand, due from bank accounts (nostro), demand and time loans, investments, accrued interest receivable, and commitments to purchase exchange on a spot or future basis. Liabilities (short position) include due to accounts (vostro) with other institutions (including nostro overdrafts), demand and time deposits cash collateral, accrued interest payable, accounts payable, and commitments to sell exchange on a spot or future basis. These accounts or subsidiary records will normally contain both the amount of foreign currency and an equivalent amount expressed in U.S. dollars. The examiner's trial balance of foreign currency should prove to the institution's position sheet, and dollar equivalents should correspond to the general ledger. Certain transactions, such as the previous day's spot or future exchange transactions may not have been recorded on the institution's books. Obtain these *holdover items* from the foreign exchange trader, and include them in the calculation of the currency position.

Other Currencies

For each currency, aggregate the assets and purchase commitments (long position) and the liabilities and sale commitments (short position) and deduct the smaller figure to arrive at the net position for each currency. The net dollar equivalent should be evaluated in comparison to capital and reserve levels.

If the foreign currency total is net long and the U.S. dollar equivalent is net short, a split position exists. This so-called split position usually results from a heavy volume of activity flowing through the institution's nostro accounts, which will subsequently require adjustment to restore balance to the relationship between the foreign currency and U.S. dollar equivalent.

In calculating the aggregate position (U.S.) for all currencies, add all U.S. equivalent figures regardless of sign (that is, short positions are added to long positions as a positive number).

QUESTIONS 1a. and 1b.

These questions help determine whether the institution's net position appears unwarranted, excessive, or speculative. The following criteria may be used in evaluating the institution's position:

- Competency of the trading and executive officers,
- Purpose of the position,
- Volatility of the individual currencies,
- Volume of business in the country, and
- Size of the institution.

Negative responses to these questions may suggest the need for commentary in the ROE.

INTERNATIONAL WORKPAPER

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MATURITY DISTRIBUTION (GAP) ANALYSIS

When using this worksheet, examiners should complete a maturity distribution for all major currencies outlined in the Position Analysis - Major Currency Positions worksheet. At the discretion of the examiner, material currency positions enumerated in the Position Analysis - Other Currencies worksheet may be detailed. Show each currency on a separate form. Question No. 2 at the bottom of this Maturity Distribution worksheet applies to all currencies listed.

In arranging the maturity distribution, it is recommended that at least the first two weeks of activity subsequent to the examination start date be detailed on a daily basis. (In active departments, a daily enumeration for the first month following the examination start date may be appropriate). Thereafter, semi-monthly or monthly intervals may be used depending on the institution's method of pricing forward commitments and the volume of activity. Longer-range maturities may be grouped by years.

The preparation of this schedule requires the inclusion of all currency ledger accounts. Show ledger accounts not bearing a maturity date in the first day's maturities. Show spot contracts as of the date the settlement is expected to occur. The total of assets and purchases (long), liabilities and sales (short), and the net amount of these two columns should correspond to the foreign currency amounts shown in the position sheet. Compare the net gap for each period to limits imposed by institution management. Further, review the cumulative gap position (the addition of gaps for each time interval) for conformance to policy and the incidence of excessive periods of positive or negative gaps. Such events may require comment if potential exposures appear excessive in relation to liquidity, earnings, or capital.

It is normally unnecessary to complete a profit and loss revaluation on this worksheet (in the right three columns) unless a position results in a material profit or loss. Refer to the example in the Revaluation and Income/Loss Analysis worksheet instructions. Price future contracts at the given premium or discount rate. Price spot contracts and ledger accounts at the spot rate. When one or more rates are used to price a position at a point in time, type *various* in the Spot Rate column. All swap contracts should be removed before valuing the position since the profit/loss is fixed at the time of the transaction and reflected in the return on the asset for which the swap was effected. In any event, the schedule can be used as a workpaper to calculate the future profit/loss adjustment in the Revaluation and Income/Loss Analysis worksheet.

INTERNATIONAL WORKPAPER

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REVALUATION AND INCOME/LOSS ANALYSIS

The purpose of this worksheet is to determine the unrealized profit or loss for the institution in connection with positions undertaken in foreign currency. The computation is based on the assumption that the entire position will be liquidated (that is, all long foreign currency positions will be sold and all short positions will be covered).

The primary input for this schedule comes from the Position Analysis - Other Currencies schedule. List each currency under the Monetary Unit column. Insert in the Book Value column the institution's net position in the foreign currency amount and U.S. dollar equivalent less any swap contracts included in the position. (Refer to the following paragraph for an explanation of these transactions). Obtain the spot exchange rate from the Wall Street Journal or similar publications containing foreign exchange rates. Express the exchange rates in terms of the U.S. dollar cost per unit of foreign currency (for example, one Euro sells for $x.xxxx) with the values carried to four decimal places or four-digit level of significance (i.e., one Japanese yen equals $.004560). Multiply the net amount of foreign currency by the spot rate to arrive at the current market value of the position. Apply the following rules when determining the spot rate profit or loss on each position:

1. Long foreign currency position combined with long U.S. dollar equivalent: profit is excess of market value over book value; loss is the excess of book over market.
2. Long foreign currency position combined with short U.S. dollar equivalent: profit is the current market value plus the short U.S. dollar book value.
3. Short foreign currency position combined with short U.S. dollar equivalent: profit is the excess of book value over current market value; loss is the excess of market value over book value.
4. Short foreign currency position combined with long U.S. dollar equivalent: loss is the current market value plus the long U.S. dollar book value.

Rules No. 2 and No. 4 refer to split positions discussed in the Position Analysis - Other Currencies worksheet instructions for calculating the net open position. In rule No. 2, the position can only result in a profit. In rule No. 4, the position can only result in a loss.

A financial swap combines a spot purchase or sale of a foreign currency and a forward sale or purchase of the currency. Through this arrangement, the institution effectively locks in the potential gain or loss by entering into a transaction involving the temporary movement of funds into another currency and back again. For example, the institution has an investment opportunity to lend 1,000,000 pounds sterling for three months. The institution will purchase necessary exchange spot for $1.8660 per pound sterling ($1,866,000) to make the loan. Simultaneously, the institution will enter into a forward exchange contract to sell 1,000,000 pounds sterling at the anticipated maturity date for $1.8690 per pound sterling ($1,869,000). Customarily, the institution will sell forward the expected interest income as well. Accordingly, the institution has realized a $3,000 profit on the transaction at the inception of the loan. Customarily, the profit (or alternatively cost) is applied to the rate of interest on the loan to determine the true yield on the investment. The profit (or loss) is accrued to income and expenses monthly. In these circumstances, it is inappropriate to allocate the profit to the exchange function. A review of the institution's records will facilitate the identification of swap transactions and, as previously stated, these amounts should not be included in the revaluation schedule.

Adjust the spot-rate profit (loss) for discounts or premiums on forward exchange contracts, which are included in the net currency position. A discount is a rate of exchange lower than the spot rate expressed in terms of percentage per annum or points on which a dealer buys or sells foreign exchange for forward delivery. For example, if a dealer quotes $186 and $191 (bid and asked) for spot sterling, and the discounts for six-month forward exchange contracts are .0300 and .0275, the forward quotes would be modified to $183 and $1.8825. In most cases, the discount reflects an interest rate differential in the U.S. vis-à-vis the U.K., although in periods of downward market pressure on a currency a discount may indicate market anticipation of a lower price for the currency. A premium is a rate of exchange higher than the spot rate. Again, interest rate trends and upward market pressure will play a role in this situation. The premium situation works exactly opposite to the discount example. That is, premium quotes are added to the applicable spot rates quoted.

The calculation of future profit (loss) adjustments will require the listing of all contracts by maturity or value dates from near-term to longer-term. Certain contracts are made on an option basis because of uncertainty as to the date when foreign currency will be received or needed. In option contracts involving the purchase of exchange, list contracts with premiums at the earliest date and contracts with discounts as of the latest date. Conversely, show contracts involving the sale of exchange at premiums at the latest date and those at a discount at the earliest date. The format of the maturity distribution will depend on the system used by the institution in providing future rates. A summary of contracts on a monthly basis can be prepared provided the rates supplied by the institution are based on a monthly scale. If rates are on a semi-monthly basis, prepare the summary figures by the first and second halves of the month. To calculate the profit and loss on futures, the following rules apply:

1. A long position at a discount reflects a loss.
2. A short position at a discount reflects a profit.
3. A long position at a premium reflects a profit.
4. A short position at a premium reflects a loss.

In the absence of a significant profit or loss from the revaluation of the foreign currencies, it is not necessary to adjust book capital.

Question 3 - Significance Of Profit Or Loss

In weighing the significance of profit or loss from foreign exchange operations, it is important to consider the amount in relation to the capital account of the institution, the volume of exchange activity, and the institution's history in sustaining profits and/or losses. The criteria enumerated as guidance in responding to questions 1a and 1b of the Position Analysis - Other Currencies worksheet would also warrant consideration.

INTERNATIONAL WORKPAPER

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INCOME/LOSS SCHEDULE

This worksheet is self-explanatory. Information required to complete the worksheet should be readily available from the bank's financial records.

INTERNATIONAL WORKPAPER

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POLICIES AND PROCEDURES

These nine questions discuss the institution's policies, reporting mechanisms, and procedures in relation to foreign exchange activities. Significant concerns should be addressed as needed on the ECC, RMA, or other appropriate ROE page.

INTERNATIONAL WORKPAPER

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AUDIT AND INTERNAL CONTROLS-AUDIT

This section of the workpaper is primarily designed to assist examiners evaluate the institution's audit function. The questionnaire is designed for use at institutions with relatively sophisticated trading operations.

Examiners should consider an institution's risk profile, size, and complexity when assessing the overall adequacy of audit programs. Additionally, examiners should consider the cost and effectiveness of an audit or control feature before making recommendations to add or improve features, especially at institutions with less complex trading operations.

Nevertheless, all institutions should implement appropriate audit programs and internal controls to prevent, identify, and/or report irregularities. Basically, all of the audit and control standards and procedures used in domestic departments apply to the foreign exchange function. Examiners should bring forward address any significant concerns with the institution's international audit program on the ECC, RMA, or other appropriate ROE page.

Reference: Manual Section 4.2, Internal Routine and Controls

INTERNATIONAL WORKPAPER

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AUDIT AND INTERNAL CONTROLS-INTERNAL CONTROLS

This section of the workpaper is primarily designed to assist examiners evaluate the institution's internal controls. The questionnaire is designed for use at institutions with relatively sophisticated trading operations.

Examiners should consider an institution's risk profile, size, and complexity when assessing the overall adequacy of internal control programs. Additionally, examiners should consider the cost and effectiveness of controls before making recommendations to add or improve controls, especially at institutions with less complex trading operations.

Nevertheless, all institutions should implement appropriate internal controls to prevent, identify, and/or report irregularities. Basically, all of the control standards and procedures used in domestic departments apply to the foreign exchange function. Examiners should address any significant concerns with internal controls on the ECC, RMA, or other appropriate ROE page.

Reference: Manual Section 4.2, Internal Routine and Controls

INTERNATIONAL WORKPAPER

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PRE-EXAMINATION QUESTIONNAIRE

Examiners can use this optional questionnaire, in whole or part, during the pre-examination to facilitate their preliminary risk assessment. This workpaper includes a list of questions that examiners can ask management to help identify international activities, develop document request lists, and scope examination activities.

Briefly summarize significant discussion topics in the pre-examination planning memorandum. Summarize items such as material changes since the prior examination, economic conditions in the institution's area of operation, new products or services, and areas of perceived risk. Include any other information useful for allocating examination resources. Document the name and title of any officer with whom disccusion(s) were held, and note the discussion date(s).

The Bank of Anytown illustrates the application of ROE instructions when presenting examination findings. The Bank of Anytown does not cover all possible examination circumstances and should not be used as boilerplate language. The Bank of Anytown is not intended to inhibit examiner judgment in situations that require other presentation methods due to unique situations.

BANK OF ANYTOWN

ANYTOWN ANYCOUNTY ANYSTATE

Region:	Any Region	Certificate Number:	99999
Examiner-In-Charge:	Sandra E. Smart		
Examination Start Date:	August 01, 20x6		
Examination As Of Date:	June 30, 20x6		

All dollar amounts are reported in thousands, unless otherwise indicated.

Abbreviations within the report are included inside the back cover and can also be found at https://www.fdic.gov/regulations/safety/manual/section16-1.pdf

The following practices or financial conditions or operations require Board attention and corrective actions. Unsatisfactory conditions and practices identified during this examination, and recommendations from the previous examination that were not satisfactorily addressed, are described more fully throughout this Report of Examination (ROE).

MEMORANDUM OF UNDERSTANDING

The Memorandum of Understanding (MOU) provisions relating to the Allowance for Loan and Lease Losses (ALLL), Reports of Condition and Income (Call Report), and credit extensions to borrowers with charged-off loans remain outstanding and uncorrected. Failure to satisfactorily address the MOU provisions will likely impede progress in returning the bank to a satisfactory condition. The Board should take additional action to ensure full remediation of the unsatisfactory conditions addressed by the MOU.

ALLOWANCE FOR LOAN AND LEASE LOSSES

The ALLL is underfunded by $325M due to elevated loan losses and deficiencies in the methodology for establishing the ALLL. The Board's attention is needed to ensure a sound process for maintaining an appropriate ALLL is developed and implemented to protect the institution and accurately report earnings and capital.

INTERAGENCY GUIDELINES ESTABLISHING SAFETY AND SOUNDNESS STANDARDS - APPENDIX A OF PART 364 OF THE FDIC RULES AND REGULATIONS

The institution is not in conformance with established safety and soundness standards contained in Appendix A of Part 364, in the areas of internal controls and information systems, internal audit system, loan documentation, credit underwriting, and asset quality. Failure to appropriately address these deficiencies and improve risk management practices may result in further deterioration in the bank's financial condition. In particular, the Board's attention is necessary to ensure the following inadequate risk management practices are corrected to prevent future financial deterioration:

- Asset Quality, Credit Administration, and Loan Underwriting: Inaccurately graded credits contributed to the inadequately funded ALLL. In addition, poor credit administration practices (relating to weak participation loan underwriting, the lack of construction loan inspections, and lack of on-going cash-flow analysis for commercial real estate loans) inhibit management's ability to make sound credit decisions, hamper collection efforts, and could lead to further loan losses. Also, procedures to identify and monitor asset concentrations are inadequate. Poor controls over concentrated asset positions can lead to disproportionately higher losses in the event of problems.

- Internal Controls and Internal Audit: Internal controls have not been sufficient to provide for operations in compliance with rules and regulations. For example, the Board approved loans in apparent violation of the Federal Reserve Board's Regulation O, and senior management purchased investments above its Board-approved investment authority. Moreover, the internal audit function lacks independence, as the internal auditor reports directly to the bank's president. Weak internal controls prevent the Board and management from adequately identifying, monitoring, and controlling risks, potentially exposing earnings and capital.

STRATEGIC PLANNING

Despite the continued decline of the local fishing industry and the increase of local financial service providers, the bank's strategic plan does not adequately address regional economic conditions or local competition. Therefore, the plan may not provide the Board or management with adequate information to assess business opportunities or to adjust strategies and practices in light of changing conditions. The Board should direct correction of the deficiencies in the strategic plan and ensure supporting data is current and comprehensive.

SUMMARY

The Board should address the weaknesses and recommendations highlighted above. The FDIC and Any State will monitor the remediation of these matters between examinations.

For additional details, including management's responses to these matters, refer to related comments included in this ROE.

Uniform Financial Institutions Rating System

	Current Exam	Prior Exam	Prior Exam
Examination Start Date	08/01/20x6	11/13/20x5 / S	10/21/20x4
Examination As Of Date	06/30/20x6	09/30/20x5	09/30/20x4
Composite Rating	**3**	**3**	**3**
Component Ratings:			
Capital	**3**	**2**	**2**
Asset Quality	**4**	**4**	**3**
Management	**3**	**3**	**3**
Earnings	**4**	**4**	**3**
Liquidity	**2**	**2**	**2**
Sensitivity to Market Risk	**2**	**2**	**2**
Information Technology	**2**	**1**	**2**
Trust	**2**	**2**	**2**
Compliance[1]	**2**		
Community Reinvestment Act[1]	**S**		

1 Examination dated xx/xx/xxxx

SUMMARY

This $80 million community bank is a locally owned, full-service commercial bank offering traditional deposit and credit products with particular focus on customers directly and indirectly reliant upon maritime-related businesses. The trade area is centered in a regional economic area heavily dependent upon a depressed fishing industry. Assets consist primarily of commercial and real estate loans to small, local businesses. Similarly, the bank's depositors are mostly business loan clients and local retail customers. In efforts to diversify from maritime-related businesses, management has purchased commercial loan participations, primarily from Other Bank, Othertown, Other State. In addition, the bank has a trust department that manages approximately $3.3 million in assets, most of which is in non-discretionary accounts.

The bank remains in less than satisfactory condition due to the lingering effects of poor risk selection and underwriting during an aggressive growth campaign in commercial real estate (CRE) and particularly acquisition development and construction (ADC) loans identified at the previous examination. Significant and increasing weaknesses in the local economy have further exacerbated credit risk problems. Numerous workout credits and further deterioration in CRE due to poor credit administration have resulted in an underfunded ALLL and have negatively impacted earnings. Capital levels are less than satisfactory in relation to the heightened risk profile. Management needs to make additional efforts to comply with the outstanding Memorandum of Understanding (MOU). Information Technology, Trust, and Bank Secrecy Act (BSA)/Anti-Money Laundering programs are adequately managed as findings identified during the examination are limited and correctable in the normal course of business. Compliance and Community Reinvestment Act programs are also satisfactory.

MEMORANDUM OF UNDERSTANDING

The bank entered into a MOU on January 21, 20x5, based on the October 21, 20x4, FDIC examination findings. Management and the Board have not fully addressed three MOU provisions, relating to the appropriateness of the Allowance for Loan and Lease Losses (ALLL), accuracy of the Reports of Condition and Income, and documentation for credit extensions to previously classified borrowers. Refer to the Compliance with Enforcement Actions page for additional details.

ASSET QUALITY - 4

Asset quality remains weak and is the primary impediment to improving the bank's overall financial condition. As reflected on the Examination Data and Ratios page, the volume of adversely classified items (ACI) has decreased by 12 percent since the prior examination, with the volume of adversely classified loans dropping by 24 percent. Despite these improvements, adverse classifications still represent 84 percent of Tier 1 Capital and the ALLL. Additionally, the volume of Loss classifications increased from $194M at the 20x4 examination to $1,015M at the current examination. (Asset Review Date: 6/30/20x6.)

Loans

Examination classifications are centered in the CRE portfolio. Loans adversely classified Loss (portions of three relationships totaling $890M) are CRE loans that were adversely classified Substandard at the prior examination. Most troubled credits reflect liberal lending practices exacerbated by the depressed regional economy, particularly the local fishing industry. In response to past regulatory criticisms, management has taken affirmative steps to strengthen credit administration by tightening overall underwriting standards, strengthening collection efforts, decreasing CRE advance rates from 90 percent to 75 percent, and avoiding financing for speculative real estate acquisition and development projects. These actions have longer-term positive implications, but present credit quality remains hindered by numerous workout situations and the deterioration of existing credits not previously subject to adverse classification. Moreover, underwriting weaknesses are evident in participations purchased, and credit administration weaknesses were noted in the areas of construction loan inspections and cash-flow analysis. Additional details regarding trends in the level of adversely classified loans are included on the Analysis of Loans Subject to Adverse Classification page.

Loan Review and Internal Grading System

The institution's internal loan review and grading program is not producing timely or accurate information about the condition of the loan portfolio. Management has been unable to comply with internal review frequency standards due to elevated personnel demands associated with problem asset workouts. Assigned credit grades for several larger credits were inaccurate, as exemplified by examiner identification of the partial Loss classification of the Irma Deat, Ltd. and Last Chance Motel credits. In both cases, the credits were internally rated Substandard. Additionally, several credits adversely classified Substandard by examiners were internally rated Watch. Failure to accurately grade credits on a timely basis has resulted in inadequate funding of the ALLL and may hinder management's ability to take appropriate and timely corrective action. To address this issue, management needs to provide additional resources to improve performance of this function.

President Allie C. Lincoln stated that management would add staff by year-end 20x6, and meet review frequency standards by mid-20x7.

Allowance for Loan and Lease Losses

The ALLL is inadequate by at least $325M, primarily due to inaccurate internal credit grading. Additionally, the ALLL allocation for non-watch list credits is inadequate based upon recent loan loss experience on non-watch list loans. Specifically, the institution's average loss rate on non-watch list loans since 20x4 is 0.75 percent; however, management only allocates 0.1 percent for residential mortgages and 0.5 percent for all other non-watch list loans.

Institutions are expected to maintain an ALLL methodology in accordance with Generally Accepted Accounting Principles (GAAP), which reflects consideration of the risk profile of the loan portfolio. Moreover, due to the deficiencies in the loan grading system, earnings and capital could be exposed should future loan and lease loss provisions prove inadequate. Refer to the Risk Management Assessment page for additional details. Additionally, management may refer to the Interagency Policy Statement on the Allowance for Loans and Lease Losses for additional information regarding internal loan grading systems and ALLL methodologies.

President Lincoln indicated management intends to file amended June 30, 20x6, Reports of Condition and Income to address reporting issues (see comments below) and will include a $325M loan loss provision in the amended filings. President Lincoln also initiated a review of the loan grading system during the examination and stated that all existing loss-rate percentages would be reviewed and updated to ensure full conformance with GAAP.

Credit Underwriting and Administration

Credit underwriting and administration, although improving, requires further attention. The Robert Rain, LLC., credit is representative of deficiencies in the monitoring of construction loans and performing cash flow (CF) analysis; refer to the Items Listed as Special Mention for further details. As detailed on the Assets with Credit Data or Collateral Documentation Exceptions pages, the number of loans possessing potential weaknesses and documentation exceptions remains high. In particular, the following underwriting and credit administration weaknesses should be promptly addressed:

- *Credit Analysis on Participations Purchased* - The bank does not perform pre-purchase credit analysis on participations purchased. Pre-purchase analysis is necessary for management to assess the repayment capacity of the borrower(s) and assign an appropriate loan grade. An institution purchasing all or part of a loan should perform the same degree of independent credit analysis as if it were the originator.

- *Financial Statements (FSs)* - Loan officers have not obtained updated FSs from all repayment sources to perform global CF analysis and verify assets of guarantors. Obtaining current FSs allows a loan officer to analyze and document a guarantor's source of strength to a loan or borrowing relationship.

- *Inspections and Lien Waivers* - The bank does not perform inspections or obtain mechanic's lien waivers prior to making construction loan advances. Timely inspections and lien waivers protect the institution's collateral and lien positions and allow management to make informed decisions regarding the ALLL, particularly if required to individually test these loans for impairment under Accounting Standards Codification (ASC) 310.

- *Rent Rolls* - Loan officers do not obtain rent rolls and vacancy figures on an ongoing basis for loans secured by CRE. Rent rolls and vacancy information allow management to properly monitor these types of loans if conditions are changing, understand any changes in the condition, and make informed and timely credit decisions.

- *Lien Perfection* - The bank periodically allows perfected interests in collateral to lapse by not filing timely Uniform Commercial Code (UCC-1) continuation statements. Use of a system to assist in keeping filings current protects collateral positions determined to be appropriate in original loan underwriting.

President Lincoln stated loan officers would immediately begin performing pre-purchase analyses on participations purchased. She also stated that the volume of documentation deficiencies is primarily due to understaffing and indicated management is in the process of hiring an additional loan clerk to assist in this area.

Other Real Estate (ORE)

Management maintains appropriate policies and procedures for acquiring, holding, and disposing of ORE. However, due to deterioration in existing credits, the dollar volume of adversely classified ORE increased $535M, or 78 percent, since the previous examination. The ORE portfolio primarily consists of CRE previously written down to fair value. The $100M ORE Loss classification reflected in this Report is based on the recently obtained (August 3, 20x6), appraised value of the Rolly property.

Concentrations

Several asset concentrations, including a fishing industry concentration, are listed on the Concentrations page. Management does not currently have procedures in place to adequately identify and monitor such concentrations. Concentrations that are not monitored and managed through sound risk management practices can expose a bank's capital and earnings to disproportionately higher losses in the event of a borrower's financial problems or an industry downturn, such as is currently being experienced by the local fishing industry. Given the potential for increased risk posed by asset concentrations, appropriate policies and procedures should be established to ensure these risks are properly identified, monitored, and managed.

President Lincoln indicated that management will develop procedures for identifying, monitoring, and managing the risk of concentrations and present them to the Board for its review and approval by year-end 20x6.

Disposition of Assets Classified Loss

President Lincoln stated that assets classified Loss totaling $1,015M will be charged off by September 30, 20x6.

EARNINGS - 4

Earnings performance remains poor. As detailed on the Analysis of Earnings page of this Report, the bank experienced significant operating losses in 20x4 and 20x5. Although the bank shows net operating income of $103M for the first six months of 20x6, profits are substantially overstated due to inadequate provisions for loan losses. As reflected in the footnote on the Examination Data and Ratios page, the bank will show a negative 0.58 percent Return on Average Assets, based on a net operating loss of $222M, after amending the June 30, 20x6 Call Report for the additional $325M ALLL provision.

The poor earnings performance is a direct result of persistent poor asset quality and increasing ORE levels. Although improving, the high level of nonperforming assets has required high ALLL provisions and increased overhead expenses. In spite of the volume of nonaccruals and other nonearning assets remaining high, the net interest margin for the first six months of 20x6 improved to 4.74 percent from 4.37 percent at year-end 20x5. This improvement is primarily the result of management's ability to maintain average interest rates in the loan portfolio above 8 percent, while reducing the average cost of funds to below 3 percent.

Total Noninterest Expense as a percentage of Average Assets has steadily increased over the last three years and reached 3.82 percent as of June 30, 20x6. Overhead expenses are nearly 100 basis points above comparable institutions, primarily due to expenses associated with ORE. Given the composition and level of problem assets, management does not expect ORE-related expenses to diminish in the near future. Overhead expenses will also increase due to the planned hiring of additional credit administration personnel. However, in an effort to reduce overhead, management plans to close the institution's only branch office on September 30, 20x6.

The 20x6 budget forecasts net income of $226M. With the exception of inaccurate assumptions related to the level of provision expense, the budgeting process is adequate and the assumptions used are reasonable. Future profitability is primarily dependent on improved asset quality and controlled overhead expenses.

Chairman of the Board White stated that the directorate and senior management would revise the budget to depict provision expense levels more accurately. He directed President Lincoln to have the revised budget ready for Board review and approval at the November 20x6 Board meeting.

MANAGEMENT - 3

The overall performance of senior management and the Board of Directors remains less than satisfactory. The bank's weak financial condition is primarily the result of liberal lending policies and poor credit administration practices. As documented in prior examination reports, the present management team aggressively pursued loan growth without regard for prudent lending standards and, ultimately, asset quality. Although initial signs of more prudent loan underwriting and improved credit administration are evident, asset quality remains weak and significant aspects of the credit function remain deficient.

Board Supervision

A director's duty to oversee the conduct of a bank's business necessitates that each director exercise independent judgment in evaluating management's actions and competence. Directors need to critically evaluate the issues before them, rather than routinely deferring to management. However, Board minutes lack evidence to demonstrate that directors are exercising their independent judgment. Instead, Board minutes indicate that Chairman White and President Lincoln dominate policy discussions and decisions. Moreover, Director Michael D. Brown attended only 5 of the 12 Board meetings held since the previous examination. Regular attendance at Board and committee meetings is a prerequisite to fulfilling the duty to oversee the conduct of the bank's business, and directors who are unable to meet this obligation should consider resignation. Weaknesses in the strategic planning process and the inadequacy of certain written policies are additional indicators that the Board needs to improve its oversight of the bank's operations and management's actions.

Chairman of the Board White indicated that directors are more engaged in discussions regarding the bank's business than is reflected in the minutes and that future minutes will be more descriptive regarding the input

from various directors. Director Brown stated that he frequently travels out of town on business; however, he committed to attending Board meetings on a more regular basis.

Apparent Violations of Laws and Regulations

Examiners cited apparent violations of the Treasury Department's BSA regulations for late currency transaction report (CTR) filings, the Federal Reserve Board's Regulation O for two insider loans that did not receive full Board approval, and exceeding the state's legal lending limit statute. An apparent violation of the BSA was also cited at the last FDIC examination, and although the number of late filings of currency transaction reports (CTRs) has declined, repeat infractions reflect unfavorably on the Board and management. The Board of Directors should implement improved controls and procedures to ensure timely CTR filings, appropriate Regulation O loan approvals, and identification of concentrations of loans to one borrower. Additionally, the institution is in nonconformance with multiple parts of the Interagency Guidelines Establishing Standards for Safety and Soundness, Appendix A to Part 364 of the FDIC Rules and Regulations.

Chairman of the Board White committed to improve BSA and Regulation O controls and promised future conformance with all Safety and Soundness standards detailed in Appendix A to Part 364.

Strategic Planning

The 20x4 five-year strategic plan has not been updated, and is therefore inconsistent with the present condition of the bank, the regional economy, and the local competitive environment. Specifically, the plan's assumptions do not consider the continuing decline of the local fishing industry, the potential impact of a new commercial bank in town, or the recent merger of two local savings and loan associations. Based on these factors, many of the goals and strategies in the plan may be unrealistic. Setting a bank's strategic focus, in conjunction with executive management, is one of the key responsibilities of a bank's Board. An effective strategic planning process provides for regular reviews to determine whether assumptions and strategies remain valid or should be revised. The Board and management should update the strategic plan to reflect current conditions and should adopt a process to periodically review the plan going forward.

Chairman of the Board White stated that the strategic plan would be reviewed and updated before the end of 20x6 and annually thereafter.

Audit and Internal Control

The audit and internal control functions lack independence. While the scope and frequency of the internal audit program are adequate, Internal Auditor Mary Jackson reports directly to President Lincoln. Since President Lincoln is ultimately responsible for most of the day-to-day operations reviewed by the internal auditor, this situation compromises the independence of the internal audit program. The internal auditor should report directly to the Board of Directors or the Audit Committee of the Board to ensure the independence and effectiveness of the audit function. President Lincoln is also a member of the Audit Committee, which oversees the external audit function. Her presence on the committee further limits audit independence. Lack of independence in the internal control structure exposes the institution to operational and financial risks and could impact management and the Board's ability to appropriately control risks. Several outside directors are qualified to serve on the Audit Committee, and it is recommended that the Board strengthen the audit function by limiting committee membership to outside directors.

Several internal control deficiencies are detailed under Item 5 of the Risk Management Assessment section of this Report. While these deficiencies are relatively minor, management incorrectly reported that two of these items were corrected in the response to the last internal audit. Failure to accurately monitor and track corrective actions of audit findings decreases the Board's ability to fulfill their oversight responsibilities.

Chairman of the Board White stated that the Board would consider these recommendations at its next meeting. He also stated the internal control deficiencies would be addressed by the end of 20x6.

<u>Reports of Condition and Income (Call Report)</u>

Material errors were noted in the last three quarterly Reports of Condition and Income. In numerous cases, examiners were unable to reconcile bank records with the quarterly filings. The most significant errors relate to inaccurately reported interest and fee income on loans, the inappropriate inclusion of gains on the sale of repossessed assets in interest and fee income, and the shortfall in the ALLL. These errors misrepresent financial performance and negatively affect management's ability to make informed decisions. Management should investigate these errors and amend prior Reports of Condition and Income as appropriate.

Executive Vice President/Cashier John M. Gutierrez stated he will file amended June 30, 20x6, Reports of Condition and Income, prior to September 30, 20x6, to address these issues.

<u>Bank Secrecy Act (BSA)</u>

The BSA program is generally satisfactory; however, examiners cited apparent violations of Title 31 C.F.R. Chapter X Section 1010.306(a)(1) of the Treasury Department's BSA regulations. The apparent violations relate to CTRs that were not filed within prescribed periods; refer to the Violations of Laws and Regulations page for additional details. Management should establish procedures to ensure CTRs are filed within prescribed timeframes.

President Lincoln indicated procedures would be implemented within 90 days to ensure CTRs are submitted in a timely manner.

<u>Office of Foreign Assets Control (OFAC)</u>

Effective policies, procedures, and controls are in place to ensure satisfactory compliance with OFAC regulations.

CAPITAL - 3

Capital is less than satisfactory in relation to the bank's risk profile. The ACI Coverage Ratio remains high at approximately 84 percent. In addition, after adjustments for provisions to fund the ALLL appropriately, the bank has had net operating losses over the past two and a half years. The existing concentration in fishing industry loans, considering the industry's current depressed condition and anticipated continuing decline, adds to capital concerns. The Leverage Capital ratio of 7.44 percent, detailed on the Examination Data and Ratios page, reflects current examination adjustments for assets classified Loss and the provision expense needed to fund the ALLL appropriately.

President Lincoln stated that dividends have not been paid for five years. She further stated that no dividends would be paid until the Tier 1 Leverage Capital ratio exceeds eight percent and earnings become positive and stable.

LIQUIDITY - 2

The bank's liquidity position is satisfactory. Asset growth has been minimal since the prior examination and the loan portfolio is shrinking. Management has increased the volume of investments in mortgage-backed securities, with the portfolio maintaining slight appreciation. Non-core funding has increased slightly but management is using these funds appropriately. Management could further strengthen funds management practices by developing a written funds management policy and a contingency funding plan (CFP) commensurate with the bank's risk profile. Clearly articulated policies reflective of the bank's characteristics help ensure that the institution is operating within Board-approved risk tolerances, which can mitigate the negative impact of overreliance on volatile funding sources in an adverse economic environment. Off-balance sheet commitments are minimal.

President Lincoln stated a written funds management policy and a CFP would be developed.

SENSITIVITY TO MARKET RISK - 2

Sensitivity to market risk is moderate and risk management practices are satisfactory. Funding sources reasonably match the bank's asset repricing structure, and the loan portfolio includes a high volume of adjustable-rate commercial loans. Over the past two years, depositors have moved funds out of maturing time deposits and into money market demand accounts. Management actively manages rates on these deposits, as the local market is very competitive. The bank does not engage in off-balance sheet derivative activity.

Management regularly monitors the bank's rate sensitivity position using income simulations and an economic value of equity model, and presents detailed quarterly reports to the Board. However, the Board and management should establish interest rate risk (IRR) policy limits. If not properly controlled, IRR can impact an institution's earnings, capital, and its underlying economic value. Setting policy limits helps control this risk by establishing a baseline for the institution's tolerance for interest risk. Monitoring compliance with these limits ensures that the level of IRR is maintained at prudent levels and in accordance with the Board's expectations. Refer to the Risk Management Assessment page for additional details.

For additional information on prudent IRR management principles, refer to the Joint Agency Policy Statement on Interest Rate Risk.

Chairman of the Board White stated that management and the Board would establish IRR policy limits by year-end 20x6.

TRUST - 2

The Board and management's performance and risk management practices are satisfactory relative to the size of the department and the complexity of trust activities. Only moderate weaknesses are present and within management's ability to correct.

Account administration is generally in compliance with originating documents. However, potential conflicts of interest exist from the trust department using own-bank deposits, as well as from holding stock of the parent holding company and an affiliate in one trust account. Trust Officer Hancock surveys local deposit rates to ensure competitive rates are being paid on deposits, but does not maintain documentation of her surveys. Appropriate policies, procedures, and practices should be developed and implemented to effectively control conflicts of interest and manage own-bank deposits and stock holdings. Without proper policies, procedures, and practices, the bank is exposed to potential litigation risk, which could negatively affect earnings and capital.

Trust Officer Hancock stated she would maintain documentation of comparable rates in the future.

Asset management practices are generally satisfactory. All account transactions, including discretionary disbursements, are included in monthly Board reports, and the Board reviews all accounts annually. However, management should annually document its needs assessment for each applicable account and/or beneficiary, and indicate whether the account's investment mix is meeting those needs. Failure to adequately document needs assessments, evaluate the mix, and document the review exposes the bank to litigation risks.

Trust Officer Hancock committed to documenting annual needs assessments for each trust account.

INFORMATION TECHNOLOGY - 2

Overall, IT operations, risk management practices, and cybersecurity are satisfactory. The IT audit program is generally adequate. Management and Board oversight of IT programs are generally satisfactory demonstrated by adequate policies and risk management practices. The bank is in general conformance with Appendix B to Part 364 - Interagency Guidelines Establishing Information Security Standards. Management adequately assesses its cybersecurity risk exposure including its inherent risks, and cyber maturity levels.

While the overall IT department is satisfactory, minor exceptions were noted related to:

- Audit reporting lines and scoping,
- Patch Management,
- Financial and audit review of critical vendors,
- Control assessments on third party providers,
- Detail in project documentation, and
- Business Continuity Plan parameters.

Findings of the IT examination were discussed in detail on August 27, 20x6, with Information Technology Manager William Robbins and President Lincoln.

Management indicated agreement with all findings. Refer to the Information Technology Page for details on the exceptions and management commitment and timeframes for corrective action.

MEETING WITH THE DIRECTORATE

A Board of Directors meeting was held on September 18, 20x6. All directors were present with the exception of Director Henry P. Black. William E. Smith, partner in the bank's auditing firm, was also present. Deputy Commissioner of Banking Cynthia B. Jones represented the State Department of Banking. Field Supervisor

James D. Gilmore, Examiner-in-Charge Sandra E. Smart, and Financial Institution Examiner Monica D. Powers represented the FDIC. All matters listed above were discussed with the Board. Most of the discussion concerned the increase in severity of adverse classifications, the need to improve the ALLL methodology, and management's efforts to improve loan administration procedures. The Directorate and management's commitments for corrective action are noted within this report. Chairman of the Board White asserted that because of the improvement in the bank's overall condition, the MOU should be removed.

DIRECTORATE RESPONSIBILITY

Each member of the Board of Directors is responsible for reviewing this Report of Examination. Each Director must sign the Signatures of Directors page, which affirms that he or she reviewed the Report in its entirety.

Examiner (Signature)	Reviewing Official (Signature) and Title
Sandra E. Smart	Dale K. Watson, Assistant Regional Director

A Memorandum of Understanding (MOU) between the FDIC and the bank became effective on January 21, 20x5. Provisions of the MOU that require further efforts or are of a continuing nature are detailed below.

2(b). The bank shall maintain an Allowance for Loan and Lease Losses at an appropriate level.

Based on this examination's findings, the ALLL is underfunded by at least $325M.

3(a). The bank shall maintain a Leverage Capital ratio equal to or greater than 7 percent.

As of June 30, 20x5, the Leverage Capital ratio, adjusted for the additional $325M provision for loan and lease loss expense, approximates 7.44 percent.

3(d). The bank shall maintain a Total Capital ratio equal to or greater than 10 percent.

As of June 30, 20x6, the Total Capital ratio, adjusted for the additional $325M provision for loan and lease loss expense is 11.75 percent.

4. The bank shall file accurate Call Reports.

Examiners noted significant errors in the December 31, 20x5, March 31, and June 30, 20x6, Call Reports which require amendments.

5. The bank shall not extend or renew, directly or indirectly, credit to, or for the benefit of, any borrower who has a loan or other extension of credit with the bank that has been charged off or classified, in whole or in part, Loss, Doubtful, or Substandard, unless rationale for the extension is noted in the official Board minutes and the appropriate credit file.

On January 30, 20x6, the bank extended a $50M loan to U. R. Worth. The borrower was adversely classified Loss at the previous examination. The Board did not specifically document the reason(s) for the extension in the official Board minutes or in the appropriate credit file.

6. The bank shall not declare or pay any dividends without the written consent of the FDIC.

No dividends have been declared or paid since the previous examination.

1. **Are risk management processes adequate in relation to economic conditions and asset concentration levels?**

No. As discussed on the Examination Conclusions and Comments (ECC) pages, the Board's strategic plan is outdated and does not reflect the institution's current condition or operating environment. In addition, management does not adequately identify, evaluate and monitor asset concentrations as exemplified by the deficiencies noted in managing the correspondent bank, fishing industry, and individual borrower concentrations identified in this report. Establishment of appropriate concentration risk policies and procedures would enhance the management's ability to identify and control risks and avoid potential violations of law. Refer to the Concentrations pages for additional details.

President Lincoln stated that management will develop procedures to identify, evaluate, and monitor concentrations.

2. **Are risk management policies and practices for the credit function adequate?**

No. Internal credit review and grading procedures are weak, and credit administration practices are deficient. Recommendations for improvement are included under Asset Quality on the ECC page.

Due to the deficiencies noted in the institution's internal credit grading system and the use of inaccurate loan loss rates, the ALLL is insufficient. In addition, management utilized an inappropriate loan loss experience to establish a reserve rate for its non-watch list loans, which contributed to the insufficient ALLL level. Management should ensure controls are in place to consistently determine the ALLL is maintained in accordance with GAAP and should maintain supporting documentation for the techniques used to develop the historical loss rate for each group of loans and the resulting estimated credit losses.

For additional information, refer to the Interagency Policy Statement on the Allowance for Loan and Lease Losses.

President Lincoln committed to filing Call Report amendments prior to the September 30, 20x6 submission and to reviewing the loan grading system.

Additionally, although the bank's loan policy is generally adequate, it does not address the following matters:

- *Participation Loans* - The bank regularly purchases loans or portions of loans from other institutions. These specialized lending activities are not covered in the loan policy.

- *Construction Loans* - The bank finances the construction of 1- to 4-family residences and mixed use commercial property. While practices are generally adequate, a large construction loan listed for Special Mention reflects several weaknesses in construction lending. The policy lacks specific guidelines pertaining to construction lending.

Development of comprehensive loan policy guidance provides management and staff with clear expectations for administering the lending function and facilitates sound risk management practices.

President Lincoln stated that management would develop guidelines for purchased loans and construction lending and revise the loan policy by December 31, 20x6.

3. Are risk management policies and practices for asset/liability management and the investment function adequate?

Generally, yes. Management's liquidity management practices are generally adequate; but could be improved by implementing a formal funds management policy or a CFP. Overall practices for Sensitivity to Market Risk are generally adequate; however, policy parameters should be established that reflect the Board's tolerance for IRR. The Board should establish and guide the bank's tolerance for IRR, including approving relevant risk limits and other key policies, identifying lines of authority and responsibility for managing risk, and ensuring adequate resources are devoted to IRR management. Implementing appropriate limits strengthens management's ability to manage IRR and monitor actual risk taking activity.

President Lincoln stated that IRR policy limits would be established by year-end 20x6.

Investment policy guidelines are adequate; however, management's adherence to its written investment policy is inconsistent. On at least three occasions since the previous examination, President Lincoln exceeded her purchasing authority when she purchased securities over $250M without prior Board approval. Failure to adhere to Board approved purchasing authority could increase the risk profile of the institution above Board approved risk tolerances.

The Board should ensure management purchases investments in conformance with existing policy standards or determine if it would be prudent to revise the standards to meet purchasing needs.

President Lincoln stated that she was presented with the opportunity to purchase these securities at a good price and could not wait for Board approval. She further stated she would comply with the policy in the future or discuss modifying the policy with the Board at the next Board meeting.

4. Are risk management processes adequate in relation to, and consistent with, the institution's business plan, competitive conditions, and proposed new activities or products?

No. As discussed on the ECC pages, risk management practices regarding the credit portfolio are insufficient for the institution's business model and risk profile.

5. Are internal controls, audit procedures, and compliance with laws and regulations adequate (includes compliance with the Bank Secrecy Act [BSA] and related regulations)?

No. As indicated on the ECC page, apparent violations of BSA regulations, Regulation O, and the state legal lending limit were cited during this examination. Additionally, the bank is not in conformance with the Interagency Guidelines Establishing Safety and Soundness Standards. Full details of these citations can be found on the Violations of Laws and Regulations pages. In addition, the audit and internal control functions lack independence.

<u>Internal Controls</u>

Examiners noted the weaknesses below in the bank's system of internal controls. Maintaining strong internal controls helps ensure the integrity of operations and discourages potential insider abuse.

- *Vacation Policy* – The bank's vacation policy requires employees to be absent from their normal duties for an uninterrupted period of two weeks each calendar year. Executive Vice President Leslie S. Cook did not remain absent during her two-week vacation in 20x5 as she returned daily to reconcile the Federal funds sold account. Management should enforce the policy, particularly for employees who are responsible for sensitive transactions.

- *Reconcilement of Correspondent Bank Accounts* – Management has not reconciled the correspondent bank accounts for the past three months. While personnel reconciled these accounts during the examination, they should be reconciled at least monthly.

President Lincoln stated she would take action to address these deficiencies before year-end 20x6.

6. Is Board supervision adequate, and are controls over insider transactions, conflicts of interest, and parent/affiliate relationships acceptable?

No. Board supervision is less than satisfactory. Numerous underwriting weaknesses and credit administration deficiencies remain uncorrected from prior examinations, and the Board has not established an effective independent internal audit function. Refer to comments under Management on the ECC page for more details. Additionally, examiners cited two loans as apparent violations of the Federal Reserve Board's Regulation O because management did not obtain the prior approval of the Board on loans to the related interests of President Lincoln and Director Larry G. Green. Refer to the Violations of Laws and Regulations page of this Report for details.

APPARENT VIOLATIONS OF LAWS AND REGULATIONS

BANK SECRECY ACT

Title 31 C.F.R. Chapter X Section 1010.306(a)(1) of the Treasury Department's Bank Secrecy Act regulations requires a covered financial institution to file a CTR (FinCEN Form 104) within the prescribed period.

Examiners identified numerous instances where CTRs were not filed within the required 15-day period. This infraction was also cited at the previous FDIC examination. Between October 20x5 and July 20x6, 289 of 944 CTRs (31 percent) were filed late. In many cases, CTRs were signed by the approving official more than 15 days after the transaction date. The time between the transaction date and receipt by the Treasury Department on these late filings was generally around 20 to 25 days, with a few exceeding 70 days.

BSA Officer Donna Ludlow stated that some of the late CTRs were filed after an internal audit noted that the forms had not been submitted; however, she could offer no explanation as to why the remaining CTRs were filed late. President Lincoln stated that new procedures would be implemented within 90 days to ensure all CTRs are submitted in a timely manner in the future.

REGULATION O

The Federal Reserve Board's Regulation O, which implements Section 22(h) of the Federal Reserve Act and is made applicable to insured nonmember institutions by Section 18(j)(2) of the Federal Deposit Insurance Act, covers transactions with bank insiders. Section 215.4(b)(1) of Regulation O requires extensions of credit by an institution to a director or related interest exceeding the greater of $25M or five percent of unimpaired capital and surplus to have prior approval by a majority of the institution's board of directors.

The bank is in apparent violation of this section for extending the following loans with the prior approval of the Executive Loan Committee, which is composed of only three Board members, rather than prior approval by a majority of the Board.

Borrower	Date of Note	Original Amount
Lincoln, Allie C.	12/11/20x5	$500M
Any Body, Inc.	12/28/20x5	$250M
(A related interest of President Lincoln and Director Green.)		

President Lincoln stated that these exceptions were the result of oversight. She further indicated that bank policy requires that all insider loans receive the prior approval of the full Board. Examiners noted that all other insider loans received prior Board approval. President Lincoln and the Board of Directors promised future compliance.

LEGAL LENDING LIMIT

Section 1127 of the State Banking Code provides that the total direct or indirect loans and extension of credit or lease by a bank to one obligor or guarantor at no time shall exceed 15 percent of "statutory capital" (equivalent to total capital) of the bank, except upon approval by two-third vote of its board of directors, the limit may be increased up to 25 percent of the statutory capital of the bank. On January 2, 20x6, the bank extended an additional $650M to J&M Realty Trust, guaranteed by John and Mary Smith, which increased total outstanding debt to the Smiths and their companies to $1,950M, or 31 percent of statutory capital. The extension of additional credit was made without approval by the board of directors, and represents an apparent violation of Section 1127.

President Lincoln stated that the extension of credit over the lending limit was the result of oversight.

NONCONFORMANCE WITH GUIDELINES INCORPORATED INTO REGULATIONS

INTERAGENCY GUIDELINES ESTABLISHING STANDARDS FOR SAFETY AND SOUNDNESS APPENDIX A TO PART 364 OF THE FDIC's RULES AND REGULATIONS (APPENDIX A)

Appendix A sets out the safety and soundness standards that the FDIC uses to identify and address problems at insured depository institutions before capital becomes impaired. The institution is in nonconformance with the following sections of the Operational and Managerial Standards of Appendix A to Part 364.

A. Internal controls and information systems. An institution should have internal controls and information systems that, in part, are appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for timely and accurate financial, operational, and regulatory reports and compliance with applicable laws and regulations.

> Material errors were noted in the institution's quarterly Call Report filings over the last three quarters, which necessitates restatement of the institution's most recent Call Report. Additionally, three apparent violations of laws and regulations were noted, including a repeat violation regarding untimely CTR filings.

B. Internal audit system. An institution should have an internal audit system that is appropriate to the size of the institution and the nature and scope of its activities and that provides for, in part: independence and objectivity; adequate testing and review of information systems; and adequate documentation of tests and findings and any corrective actions.

> The audit and internal control functions lack independence, which jeopardizes the effectiveness of the internal audit program. Further, the lack of independence coupled with inadequate monitoring of audit findings status reports resulted in previously identified deficiencies being inaccurately reported as corrected.

C. Loan documentation. An institution should establish and maintain loan documentation practices that, in part: enable the institution to make an informed lending decision and to assess risk, as necessary, on an ongoing basis; identify the purpose of a loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner; ensure that any claim against a borrower is legally enforceable; and demonstrate appropriate administration and monitoring of loans.

> Credit administration, although improving, remains deficient. Noted weaknesses include lapses in UCC-1 filings, absence of inspections or mechanic's lien waivers prior to construction advances, and absence of rent roll information. As noted on the Assets with Credit Data or Collateral Documentation Exceptions page, one-third of the dollar volume of loans reviewed had documentation exceptions that impaired management's ability to make an informed lending decision and to assess risk, as necessary on an ongoing basis.

D. Credit underwriting. An institution should establish and maintain prudent credit underwriting practices that: are commensurate with the types of loans the institution will make and, in part, provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed; establish a system of independent, ongoing credit review and appropriate communication to management and to the board of directors; and take adequate account of concentration of credit risk.

Management does not conduct pre-purchase credit analysis for participations purchased, which precludes its ability to evaluate the underlying creditworthiness of these credits and the borrower's ability to repay. Additionally, inadequate staffing of the credit review function contributed to inaccurate loan grading for several large credits. Moreover, management does not have adequate procedures in place to identify and monitor concentrations.

G. Asset quality. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should, in part, estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses.

As detailed on the ECC page, inaccurate internal loan grading resulted in an underfunded ALLL.

President Lincoln stated that all noted deficiencies will be added to the Audit Findings Tracking Report and that applicable executive officers would begin action to address deficiencies immediately.

Uniform Rating System for Information Technology

	Current Exam	Prior Exam	Prior Exam
Examination Start Date	08/01/20x6	11/13/20x5 / S	10/21/20x4
Composite Rating	**2**	**1**	**2**
Component Ratings:			
Audit	**2**		
Management	**2**		
Development & Acquisition	**2**		
Support & Delivery	**2**		

Overall, IT, operations, risk management, and security are satisfactory. Management's attention is directed to the items below.

Audit - 2

The IT audit program is generally adequate, and internal auditors promptly identify and report deficiencies and risks. Identified issues are formally tracked and resolved in a timely fashion, and the IT audit plan is based on a thorough risk assessment of IT assets and internal and external threats.

The majority of critical IT areas were reviewed in recent IT audits; however, examiners identified a concern with the current audit scope. Specifically, patch management and cybersecurity are not included in the bank's IT audits. Management should ensure all critical IT areas are included in the scope of IT audits, with the frequency being based on the audit risk assessment. Including all critical IT areas in the internal audits may have reduced the number of items noted in the recent external vulnerability assessment and will help ensure operations continue functioning as needed going forward.

Examiners also noted a concern with the audit reporting structure. At present, internal auditors report to President Lincoln rather than the Board's Audit Committee. In order to increase the auditors' independence and help ensure the Board is able to fulfill its oversight responsibilities, the internal auditors should report directly to the Board's Audit Committee.

President Lincoln stated that the omission of patch management and cybersecurity from the recent IT General Controls audit was an oversight and agreed to include the areas in future audits. President Lincoln also stated that she would recommend to the Board that they modify the IT audit reporting structure so auditors report directly to the Board's Audit Committee.

Management - 2

Overall IT management provides adequate guidance and direction. The oversight and supervision of the information security program and related practices are supported by adequate Board approved policies and risk management practices. Managers are well qualified and tenured for their respective positions.

<u>Vendor Management</u>

Overall, management monitors service providers to confirm they satisfied their contractual obligations; however, management did not review the financial statements or the Statement on Standards for Attestation Engagements (SSAE 16) reports of two critical service providers. To help ensure all service providers are appropriately monitored and to improve the effectiveness of management's monitoring activities, management should formally document all required reviews.

President Lincoln indicated the missing reviews were an oversight and stated that a tickler system would be developed to remind the vendor -review officer of upcoming vendor reviews.

Conformance with Information Security Standards

Management is in general conformance with Appendix B to Part 364 - Interagency Guidelines Establishing Information Security Standards, of the FDIC Rules and Regulations. Management identified the location of all non-public personal information, both electronic and hard copy. Threats to each type of information were identified, adequate controls are in place, and an annual report of the program is presented to the Board. While the overall program is adequate, management did not conduct control assessments on all third-party providers that obtain, use, or process non-public personal information. Management should expand the scope of the control assessments to include all applicable third-party providers. Including all applicable third parties in the assessments will help ensure the providers are appropriately identified and risk rated, and will help confirm third parties have adequate internal controls to protect non-public information.

President Lincoln stated that the vendor management program would be updated to identify all vendors with access to non-public personal information and that control assessments would be conducted on all identified vendors before March 31, 20x7.

Cybersecurity Preparedness

Management's assessment of the bank's cybersecurity risk exposure appropriately identifies inherent risks; however, cybersecurity preparedness could be strengthened by determining whether cyber-related controls are sufficient. By identifying cyber-related controls and determining whether they mitigate the identified inherent risks to an acceptable level, management will be better able to identify cybersecurity weaknesses and implement appropriate controls.

President Lincoln indicated that the assessment process would be expanded to include targeted maturity levels by June 30, 20x7.

Development and Acquisition - 2

Development and acquisition practices, which include hardware and software implementation and change-management practices, are appropriate for the institution's size and complexity. Overall, project management processes are adequate and provide sufficient guidance to manage projects. Currently, any project exceeding $20M is rated as a major project and requires specific project documentation. However, not all project documentation complies with the internal bank guidelines. For example, the documentation of three recent projects did not include reviews of alternative project solutions or explanations of why the solutions recommended in the project proposals were the most appropriate solutions. Management should comply with internal bank guidelines to ensure project requirements are met and consistent project documentation is in place.

President Lincoln indicated the project management program was relatively new and that project requirements were being introduced in a phased approach so as to not overwhelm employees. However, she agreed to follow internal project guidelines on future projects.

Support and Delivery - 2

Overall computer operations and information security practices are adequate, and management has improved its business continuity and disaster recovery plans. Management established an information security group to set standards, monitor trends, and review system logs and alerts. Although overall operations are adequate, examiners identified areas that require management's attention such as system-log monitoring, vulnerability assessments, patch management, and business continuity planning.

Logging and Monitoring

Management uses different logging platforms for firewalls, internal servers, and routers, and data are not shared or correlated among the logging systems. While servers and base operating systems are logged, logging is not enabled for virtual operating system environments. Management should review its current logging program to ensure all critical systems are included and that there is sufficient data correlation between the systems. Improving the logging program will help ensure all necessary information is obtained and provide the information security group with data in a more effective, centralized format.

Vulnerability Assessments

Management contracts an outside third party to conduct annual, internal vulnerability assessments as part of an overall security review. The scope of the vulnerability assessment is adequate; however, having only one assessment per year could result in vulnerabilities not being promptly identified. Management should review the frequency of its vulnerability assessment to ensure the frequency of the assessments is based on appropriate risk analysis.

President Lincoln committed to revisiting the logging and monitoring program to ensure that all needed information is logged and, to the extent possible, centralized. Additionally, she stated that management would review the frequency of the vulnerability assessments and conduct more frequent assessments based on appropriate risk analysis. President Lincoln stated the reviews would be completed by the end of 20x6, and appropriate corrective actions would be implemented by March 31, 20x7.

Business Continuity Planning (BCP)

Management changed the structure of its BCP this year. Most elements of the new program are adequate, but some should be improved. The areas of business impact analysis (BIA) and disaster recovery (DR) testing require further refinement.

The BIA and risk assessments are out-of-date, but are being updated to include new recovery time objectives (RTO) and to identify reasonably foreseeable threats, including cybersecurity threats. Currently, the shortest RTO is 24 hours. The 24-hour RTO may be too extended for the application, and there are several systems that may benefit from RTOs of four hours or less. The current extended RTOs may significantly affect multiple business lines and the institution's ability to restore critical systems after a disaster. Management should ensure RTOs are appropriate so that critical operations can be restored promptly after a disaster or business interruption. While some disaster recovery (DR) testing has occurred, management has not sufficiently tested a few critical systems. Management should review its testing universe and implement a risk-based testing approach to ensure all necessary testing is completed in a timely manner. Failure to conduct appropriate tests could result in material delays in restoring critical systems if a disaster occurs.

President Lincoln agreed to conduct the BIA and risk assessments, review RTOs, and implement risk-based DR testing by March 31, 20x7.

ASSET QUALITY		ADVERSELY CLASSIFIED			
		Substandard	Doubtful	Loss	Total
Loans and Leases		4,290	140	890	5,320
Securities		45			45
Other Real Estate Owned		1,125		100	1,225
Other Assets				25	25
Other Transfer Risk					
Subtotal		5,460	140	1,015	6,615
Contingent Liabilities		230			230
Totals at Exam Date	06/30/20x6	5,690	140	1,015	6,845
Totals at Prior Exam	09/30/20x5	7,345	220	194	7,759
Totals at Prior Exam	09/30/20x4	6,655	177	67	6,899

	Exam Date 06/30/20x6	Prior Exam 09/30/20x5 (S)	Prior Exam 09/30/20x4
Total Special Mention	854	515	
Adversely Classified Items Coverage Ratio	84.41	102.71	94.92
Total Adversely Classified Assets/Total Assets	8.21	9.93	8.20
Past Due and Nonaccrual Loans and Leases/Gross Loans and Leases	6.74	8.42	9.12
Adversely Classified Loans and Leases/Total Loans	9.86	12.68	11.30
ALLL/Total Loans and Leases	3.67	3.15	2.50

CAPITAL	Exam Date 06/30/20x6	Prior Exam 09/30/20x5 (S)	Prior Exam 09/30/20x4
Tier 1 Capital/Average Total Assets[(1)]	7.44	7.55	7.67
Common Equity Tier 1 Capital/Risk-Weighted Assets[(1)]	10.48		
Tier 1 Capital/Risk-Weighted Assets[(1)]	10.48	9.88	9.90
Total Capital/Risk-Weighted Assets[(1)]	11.75	8.42	11.40
Prompt Corrective Action Capital Category	W	W	W
PCA Categories: W – Well-capitalized, A – Adequately capitalized, U – Undercapitalized, S – Significantly undercapitalized, C – Critically undercapitalized			

	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Retained Earnings/Average Total Equity	3.37	9.32	(2.05)	(3.86)
Asset Growth Rate	2.66	6.78	0.42	0.20
Cash Dividends/Net Income		32.65		

EARNINGS	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Income (After Tax)/Average Assets [(2)]	0.27	1.03	(0.15)	(0.30)
Net Interest Income (TE)/Average Earning Assets	4.74	4.64	4.37	4.64
Total Noninterest Expense/Average Assets	3.82	2.90	3.62	3.54

LIQUIDITY	Period Ended 06/30/20x6	Peer 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Non-Core Funding Dependence[(3)]	14.71	1.02	8.69	6.66
Net Loans and Leases/Assets	64.45	66.20	68.79	69.24

(1) Capital ratios reflected in the example above are truncated at two decimals (not rounded). Call report instructions require banks to report capital ratios, which are used for determining the PCA capital category, as a percentage, rounded to four decimal places.
(2) After management's planned $325M adjustment to the ALLL, the 6/30/20x6 Ratio will drop to (0.58)%.
(3) Ratio reflects time deposits exceeding the $250M deposit insurance limit as non-core funding.

	06/30/20x6	12/31/20x5
ASSETS		
Total Loans and Leases	53,931	55,545
Less: Allowance for Loan & Lease Losses	1,979	1,748
Loans and Leases (net)	51,952	53,797
Interest-Bearing Balances	20	
Federal Funds Sold and Securities Purchased Under Agreements to Resell	4,000	9,100
Trading Account Assets		
Securities: Held-to-Maturity (at Amortized Cost)	2,787	5,993
Available-for-Sale (at Fair Value)	10,888	
Total Earning Assets	**69,647**	**68,890**
Cash and Noninterest-Bearing Balances	5,895	4,743
Premises and Fixed Assets	2,530	2,709
Other Real Estate Owned	1,225	690
Intangible Assets		
Other Assets	1,307	1,175
TOTAL ASSETS	**80,604**	**78,207**

LIABILITIES		
Deposits	67,815	66,221
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	441	516
Other Borrowed Money	5,857	5,136
Other Liabilities	301	307
Subordinated Notes and Debentures		
Total Liabilities	**74,414**	**72,180**
EQUITY CAPITAL		
Perpetual Preferred Stock		
Common Equity Capital	6,190	6,027
Includes net unrealized holding gains (losses) on available-for-sale securities.		
Other Equity Capital		
Total Bank Equity Capital	**6,190**	**6,027**
Minority Interest in Consolidated Subsidiaries		
Total Equity Capital	**6,190**	**6,027**
TOTAL LIABILITIES AND EQUITY CAPITAL	**80,604**	**78,207**

DERIVATIVES AND OFF-BALANCE SHEET ITEMS		
Unused Commitments	4,333	5,893
Letters of Credit	209	824
Other Off-Balance Sheet Items		
Notional Amount of Derivative Contracts		
Appreciation (Depreciation) in Held-to-Maturity Securities	56	

Footnotes:

Date: 06/30/20x6

Category:	Amount	Percent
Real Estate Loans	21,938	40.53
Installment Loans	7,058	13.04
Credit Card and Related Plans	90	0.17
Commercial Loans	22,292	41.18
All Other Loans and Leases	2,753	5.09
Gross Loans and Leases	54,131	100.00

PAST DUE AND NONACCRUAL LOANS AND LEASES

Date: 06/30/20x6

Category	Past Due 30 through 89 Days and Accruing	Past Due 90 Days or More and Accruing	Total Past Due and Accruing	Percent of Category	Nonaccrual	Nonaccrual Percent of Category
Real Estate Loans	800	44	844	3.85	1,402	6.39
Installment Loans	125		125	1.77	107	1.52
Credit Card and Related Plans	3		3	3.33		
Commercial and All Other Loans and Leases	626		626	2.50	554	2.21
Totals	1,554	44	1,598	2.95	2,063	3.81
Memorandum Restructured Loans and Leases Included in the Above Totals						

Footnotes:

Description	HELD-TO-MATURITY		AVAILABLE-FOR-SALE	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. Treasury securities	1,537	1,593		
U.S. Government agency obligations Issued by U.S. Gov't agencies Issued by U.S. Gov't-sponsored agencies			2,550	2,554
Securities issued by U.S. states & political subdivisions	250	250		
Mortgage-backed securities (MBS) Residential pass-through securities: Guaranteed by GNMA Issued by FNMA and FHLMC Other pass-through securities Other residential MBS (inc. CMOs, REMICs, & stripped MBS): Issued or guaranteed by U.S. Government agencies or sponsored agencies Collateralized by MBS issued or guaranteed by U.S. Government agencies or sponsored agencies All other residential MBS Commercial MBS Commercial mortgage pass-through securities: Issued or guaranteed by FNMA, FHLMC, or GNMA Other pass-through securities Other Commercial MBS: Issued or guaranteed by U.S. Government agencies or sponsored agencies All other commercial MBS			7,322	7,415
Asset-backed Securities (ABS) and structured financial products Asset-backed securities Structured financial products: Cash Synthetic Hybrid				
Other Debt Securities Other Domestic Debt Securities Foreign Debt Securities	1,000	1,000		
Equity Securities Investments in Mutual Funds and Other Equity Securities with Readily Determinable Fair Values not held for trading			919	919
Totals:	2,787	2,843	10,791	10,888

SECURITIES APPRECIATION (DEPRECIATION)

Description	Held-to-Maturity	Available-for-Sale	Total
Securities Appreciation (Depreciation)	56	97	153
As a Percent of Amortized Cost	2.01	0.90	1.13

Footnotes:

These sample write-ups do not reflect required or preferred formats, but simply illustrate various ways to present the required analytical elements.

LOANS

500	(1)	Nonaccrual	96 Days Past Due	
<u>250</u>	(2)	Nonaccrual	96 Days Past Due	
750				750

AMHILL TOOL & DIE, INC.
By: Robert E. Hill, President
Gty: Roger S. Barrett

Amhill Tool & Die, Inc. manufactures custom plastic-forming dies and provides injection-molding services.

(1) Note originated 1/7/20x2 at $500M to refinance a $450M mortgage on the obligor's manufacturing plant and provide $50M working capital. The note matures 1/7/20x9 and requires interest-only payments, with principal due on demand. (2) Term note originated 6/10/20x3 at $280M, matures 6/11/20x0, and was extended to refinance a working capital note at another financial institution. The primary source of repayment for both notes is operating CF.

The loans are cross collateralized by a first mortgage on the manufacturing plant, located in Anytown, Anystate, and a first security interest in all business assets. A 12/7/20x1 appraisal reflects a property value of $625M; however, the valuation appears stale given downward trends in local RE values. As of 12/31/20x5, management estimated the value of account receivables and inventory at $100M and assigned an estimated liquidation value of $125M to machinery and equipment. Reliance on the machinery and equipment as a secondary repayment source is restricted by their highly specialized nature and limited marketability.

Amhill Tool & Die, Inc. has been negatively impacted by cancelled contracts and high employee turnover. Weak CFs have caused on-going delinquency problems and management placed the notes on nonaccrual on 3/31/20x6. The obligor's 12/31/20x5 income statement reported gross income of $800M and a NOI of $100M. Gross sale revenues declined steadily since year-end 2012 and operating losses of $123M and $234M were reported as of 12/31/20x3 and 12/31/20x4, respectively. NW declined to $125M at year-end 20x5, and DSC was calculated at 0.91 as of 12/31/20x5. The guarantor's 12/31/20x4 personal FS reflects liquid assets of $30M, a NW of $375M, and TA of $890M centered in his ownership interest in Amhill Tool & Die, Inc.

EVP/SLO Leslie S. Cook indicated managerial conflicts contributed to the loss of several lucrative contracts and numerous highly trained employees; however, he stated production output is increasing due to the addition of two knowledgeable managers and improved employee training. He also stated management intends to obtain a new property appraisal, restructure the notes to better match the corporation's cash flows, and to require principal and interest payments on the modified mortgage note.

Debts classified Substandard based on inadequate cash flows, continuing delinquencies, and marginal collateral protection.

Internal Rating: 6 (Watch)
Originating/Servicing Officer: Cook
Examiner: T. Hinojosa

340	BROOKS, JAMES	200	140	
1,250	IRMA DEAT, LTD.	750		500
290	KING, CHRISTOPHER Gty: Sam King, Inc.	290		
865	LAST CHANCE MOTEL, INC.	500		365
275	RAMIREZ, PETER	250		25
1,550	EIGHT LOANS LESS THAN $250,000 List left with management.	1,550		
	TOTAL ADVERSELY CLASSIFIED LOANS	4,290	140	890

SECURITIES

45	ANYCOUNTY MUNICIPAL GENERAL OBLIGATION	45		
	TOTAL ADVERSELY CLASSIFIED SECURITIES	45		

OTHER REAL ESTATE OWNED

550	ONE WAY HOME, INC. PROPERTY	550		
675	ROLLY PROPERTY	575		100
	TOTAL ADVERSELY CLASSIFIED ORE	1,125		100

OTHER ASSETS

25	SUN, RAYMOND Repossessed Heavy Equipment			25
	TOTAL ADVERSELY CLASSIFIED OTHER ASSETS			25

CONTINGENT LIABILITIES

230	KING, CHRISTOPHER	230		

Amount represents unfunded portion of loan commitment for construction of a single-family residence.

TOTAL ADVERSELY CLASSIFIED CONTINGENT LIABILITIES	230		
TOTAL ADVERSELY CLASSIFIED ITEMS	5,690	140	1,015

LOANS

854	854

RAIN, ROBERT, L.L.C.
GTY: Robert Rain

Debt represents the balance outstanding on a $1,600M construction/permanent facility, dated 3/7/20x6, to refinance an existing $1,200M loan at subject bank granted 1/5/20x5. The original loan was granted to develop a 3-story mixed-use commercial and apartment building in Neighboring Town. The new loan provided the borrower with an additional $400M in funds to accommodate a revised construction budget stemming from plan modifications. Loan terms require interest-only payments at 4.375% for a 10-month period. Principal and interest payments of $8,231 based on a 25-year amortization are to commence on 1/7/20x7, with the loan to mature in 20x1. Collateral consists of a first mortgage on the property under construction appraised at $1,000M "as is" and $2,000M "as complete."

The following credit concerns are associated with the indebtedness:

- The project encountered numerous delays due to difficulty in obtaining permits resulting from the changes in construction plans and due to the need for additional financing.
- Guarantor analysis is inadequate, as liquid assets were not verified and a global CF analysis was not prepared.
- Monitoring of the project has been weak. As a result, the loan has been 53 percent funded, but the project is only 40 percent completed, with the difference representing construction funds used for soft costs.
- No feasibility analysis was performed to support the 20x5 origination.
- The guarantor's experience as a construction manager is questionable considering the delays, revisions, and cost overruns.
- The appraised value may need to be updated, as it is based on the project being completed within the revised budget and assumes that projected operating results will materialize.

Given the concerns noted above and weaknesses associated with this indebtedness, a Special Mention designation is warranted. To strengthen the credit, close management oversight and monitoring is required, along with the following actions:

- Monitor construction progress and compare to budget to ensure percentage completion is brought in line with funding.
- Verify the guarantor's liquid assets and obtain financial information to perform a global CF analysis.
- Obtain an updated appraisal if actual rental rates significantly diverge from the appraisal's projections, if project costs outstrip the revised budget, or if further delays ensue.

Internal Rating: 3
Originating/Servicing Officer: Cook
Examiner: V. Stewart

TOTAL LOANS LISTED FOR SPECIAL MENTION	854

DESCRIPTION	SUBSTANDARD	DOUBTFUL	LOSS	TOTAL
Book Value at Last Examination: 09/30/20x5	6,641	220	176	7,037
Reductions:				
Payments	1,030	58		1,088
Not Now Adversely Classified	955	162		1,117
Now Classified Substandard				
Now Classified Doubtful	140			140
Now Classified Loss	890			890
To Other Real Estate or Other Assets				
Charged-Off	209		176	385
TOTAL REDUCTIONS	3,224	220	176	3,620
Additions:				
Not Adversely Classified Previously Further Advances – Loans	873			873
Not Adversely Classified Previously Further Advances – Loans				
Adversely Classified Previously				
Credits Newly Extended				
Previously Classified Substandard		140	890	1,030
Previously Classified Doubtful				
Previously Classified Loss				
TOTAL ADDITIONS	873	140	890	1,903
Book Value at This Examination: 06/30/20x6	4,290	140	890	5,320

DESCRIPTION	SUBSTANDARD	DOUBTFUL	LOSS	TOTAL
Book Value at Last Examination: 09/30/20x5	672		18	690
Reductions:				
Not Now Adversely Classified				
Sales With Outside Financing				
Sales With Financing Provided By Subject Institution				
Now Classified Substandard				
Now Classified Doubtful				
Now Classified Loss	100			100
Charged-Off			18	18
TOTAL REDUCTIONS	100		18	118
Additions:				
Not Adversely Classified Previously	550			550
Further Advances - ORE or Loans Not Adversely Classified Previously				
Transferred from Previously Adversely Classified Loans				
Further Advances - ORE or Loans Adversely Classified Previously	3			3
ORE From Credits Newly Extended				
Previously Classified Substandard ORE			100	100
Previously Classified Doubtful ORE				
Previously Classified Loss ORE				
TOTAL ADDITIONS	553		100	653
Book Value at This Examination: 06/30/20x6	1,125		100	1,225

LOANS

AMHERST, MARY	400	None	7
BODY, CHARLES	1,932	12/31/14	7
C&C MARINA	1,973	06/30/14	7
GOETZ, MICHAEL	1,538	None	1
IRMA DEAT, LTD.	750		4, 6
JENNINGS, JENNIFER	1,906		5, 6
KING, CHRISTOPHER	290		4, 5, 6
Gty: Sam King		None	7
LAST CHANCE MOTEL, INC.	500		3, 4, 6
TOTAL	9,289		

Total represents 33 percent of the dollar volume of loans reviewed.

OTHER REAL ESTATE OWNED

ONE WAY HOME, INC. PROPERTY	550		5
TOTAL	550		

Total represents 45 percent of the dollar volume of ORE reviewed.

DESCRIPTION	DETAIL	AMOUNT EXTENDED

CORRESPONDENT BANK CONCENTRATIONS

FIRST NATIONAL BANK
Anothercity, Anotherstate

Due From Account	3,025	
Federal Funds Sold	4,000	
		7,025

- Concentration to First National Bank (FNB) represents 124 percent of Tier 1 Capital plus the allowance for credit losses for loans and leases.
- Aggregate monthly balances have averaged over $7 million for the past six quarters.
- Management does not formally measure or track the level of this concentration.
- Management does not perform formal financial analysis of FNB.

- Management stays abreast of the FNB's financial condition through routine business contacts and review of publicly available financial data.
- The overall health of regional banks is satisfactory.
- Credit risk is relatively low due to FNB's current financial strength.
- Concentration risk is moderate due to a lack of formal monitoring procedures.
- Deterioration in FNB's financial position could negatively affect daily operations as the Bank of Anytown uses the Due From FNB account to clear transactions and the federal funds sold account is a primary liquidity source.
- Policies and procedures for ensuring compliance with the Federal Reserve's Regulation F are satisfactory; however, management has not established formal guidelines for identifying or limiting overall correspondent concentrations.

Summary

This correspondent bank concentration presents moderate risk to the institution and is generally adequately managed, though President Lincoln indicated that more formal correspondent bank risk management guidelines would be developed. See Question 1 on the Risk Management Assessment Page.

INDIVIDUAL BORROWER CONCENTRATION

John and Mary Smith Relationship

John and Mary Smith		
RE mortgage	400	
JMS Corporation		
JM: John and Mary Smith		
Secured commercial loans (3)	685	
Commercial letters of credit (2)	215	
J&M Realty Trust		
Gty: John and Mary Smith		
Commercial RE mortgage	650	
		1,950

The Smiths own JMS Corporation (JMS), which repairs and resells used wood pallets, and J&M Realty Trust, which holds their commercial property. This credit concentration represents 31 percent of Tier 1 Capital (T1C) plus the allowance for credit losses for loans and leases.

The wood pallet industry is facing increased competition from the plastic pallet industry. However, JMS's recycling of scrap wood has allowed it to maintain solid sales and profitability levels to offset the effect of the increased competition. The borrowers have had a very positive, long-term credit relationship with the bank, the notes are well collateralized by diverse and marketable collateral, and the concentration poses limited risk to the bank.

The Loan Policy includes appropriate credit limits to one borrower, and management reports large credit relationships to the Board each month. However, the Smith's residential mortgage was not identified in the bank's relationship analysis and the Smith relationship has not been reported to the Board as a concentration. The most recent annual loan review for this credit relationship included adequate analysis of the economic and competitive factors that may affect this concentration's risk profile, and the internal risk rating is appropriate. However, the origination of the J&M Realty Trust mortgage on 1/2/20x6, caused the outstanding balances for this relationship to exceed the Anystate legal lending limit statute, as discussed previously on the Violations of Laws and Regulations page for further discussion.

Summary

The concentration poses limited risk to the institution. However, concentration identification and reporting practices need improvement. See Question 1 on the Risk Management Assessment Page.

INDUSTRY CONCENTRATION

Shellfish Fishing Industry (NAICS Code 114112)	8,694

Identification - This credit concentration consists of loans to borrowers who specialize in shell fishing or the sale of customized fishing vessels and equipment. Although loans to the shell fishing industry represent 137 percent of T1C plus the allowance for credit losses for loans and leases, management does not measure or track the credits as a concentration of risk.

Economic and Competitive Factors - Management stays abreast of general factors and economic trends relating to the industry through local news reports and discussions with borrowers. However, management does not maintain a formal process for obtaining and disseminating economic, competitive, or regulatory information to the Board or loan staff. Given the informality of the process, management was unaware of some key factors adversely affecting the industry, such as federal efforts to reduce overfishing through lower fuel subsidies and State proposals to reduce daily catch limits and shorten permissible fishing hours.

Risk Stratification and Vulnerability Assessment - Most of the borrowers are fishermen that share the same fishing grounds, as there are no alternative grounds readily available. The collateral consists of specialized fishing vessels and equipment that are not easily converted to other purposes, thereby limiting their marketability.

Borrower CF is heavily influenced by catch volumes, market price, and operating costs. Although sustained demand has contributed to higher per-pound prices, lower catch volumes and higher fuel costs have reduced profitability levels and increased repayment risk associated with this industry.

Underwriting standards are heavily reliant on collateral values, with limited analysis of projected CFs. Delinquencies remain relatively low, but have been increasing. Internal risk ratings, which appear to accurately reflect the characteristics of individual loans, have not been aggregated for analysis of the fishing portfolio. Additionally, as management does not formally monitor industry risks, there has been no analysis of the potential impact to the institution's asset quality, earnings, or capital if adverse trends continue.

Risk Management and Control Processes - Management relies on general loan delinquency reports and periodic discussions with borrowers to monitor loans to the fishing industry. Although the strategic plan identifies fishing as an important factor in the local economy, it does not address any of the unique risks or mitigating risk management practices associated with lending to this industry. Also, as noted above, management has not established formal procedures to identify, aggregate, or track loans to the fishing industry, and the loan policy does not address portfolio concentration limits.

<u>Summary</u>

Monitoring of this concentration has been relatively informal, given management's long term experience in lending to this industry, but given the size of the concentration and vulnerabilities in the industry, risk management should be more robust. President Lincoln stated that plans are to continue to lend in this industry at the current levels; however, she stated that oversight and administration of the concentration would be strengthened. See Question 1 on the Risk Management Assessment Page.

COMMON EQUITY TIER 1 CAPITAL (CET1)

Common Stock and Surplus net of Treasury Stock and unearned ESOP shares	6,027	
Retained Earnings	103	
Accumulated Other Comprehensive Income	60	
Common Equity Tier 1 Minority Interest includable in Common Equity Tier 1		
Subtotal: Common Equity Tier 1 Capital Before Adjustments and Deductions		6190

Adjustments and Deductions to CET1

Less: Goodwill net of Associated Deferred Tax Liabilities		
- Intangible Assets (other than Goodwill and Mortgage Servicing Assets), net of associated deferred tax liabilities		
- Deferred Tax Assets that arise from net operating loss and tax credit carryforwards, net of any related valuation allowances and net of deferred tax liabilities		
- AOCI-related Adjustments[1]	60	
- Unrealized net gain (loss) related to changes in the fair value of liabilities that are due to changes in own credit risk		
- All other deductions from (additions to) CET1 capital before threshold-based deductions		
- Non-significant investments in the capital of unconsolidated financial institutions in the form of common stock that exceeds the 10 percent threshold for non-significant investments		
- Significant investments in the capital of unconsolidated financial institutions in the form of common stock, net of associated DTLs that exceed the 10 percent CET1 capital deduction threshold		
- MSAs, net of associated DTLs that exceed the 10 percent CET1 capital deduction threshold		
- DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTLs that exceed the 10 percent CET1 deduction threshold		
- Amount of significant investments in the common stock of unconsolidated financial institutions, net of DTLs; MSAs net of DTLs; and net DTAs from temporary differences that could not be realized through NOL carrybacks; that exceeds the 15 percent CET1 capital deduction threshold		
- Deductions for insufficient amounts of Additional Tier 1 and Tier 2 capital to cover deductions		
Subtotal: Adjustments and Deductions to CET1		60

Less: Assets Other than Held-for-Investment Loans and Leases Classified Loss	125	
- Additional Provision to be Transferred to Tier 2 for an Inadequate ALLL	325	
- Other Adjustments to and Deductions from Common Equity Tier 1 Capital[2]		
Subtotal: Other Adjustments and Deductions to CET1		450
Common Equity Tier 1 Capital		5,680

ADDITIONAL TIER 1 CAPITAL

Noncumulative Perpetual Preferred Stock and related Surplus		
Non-qualifying capital instruments subject to phase-out from Additional Tier 1 capital		
Tier 1 Minority Interest not included in CET1 Capital		
Subtotal: Additional Tier 1 Capital before Deductions		
Less: Additional Tier 1 Capital Deductions		
Additional Tier 1 Capital		
Tier 1 Capital		5,680

TIER 2 CAPITAL

Tier 2 Capital instruments and related surplus		
Non-qualifying capital instruments subject to phase-out from Tier 2 Capital		
Total capital minority interest that is not included in Tier 1 capital		
Allowance for Loan and Lease Losses	1,979	
Less: Held-for-Investment Loans and Leases Classified Loss	890	
Add: Additional Provision Transferred from Common Equity Tier 1 Capital	325	
Adjusted Allowance for Loan and Lease Losses	1,414	
Less: Excess Allowance for Loan and Lease Losses (If Applicable)	728	
Allowance for Loan and Lease Losses Includable in Tier 2 Capital	686	
Unrealized Gains on Available-For-Sale Equity Securities Includable in Tier 2 Capital		
Subtotal: Tier 2 Capital Before Deductions	686	
Less: Tier 2 Capital Deductions		
Tier 2 Capital		686
TOTAL CAPITAL		6,366

RISK-WEIGHTED ASSETS AND AVERAGE TOTAL ASSETS CALCULATIONS

Risk-Weighted Assets Before Deductions for Excess Allowance for Loan and Lease Losses and Allocated Transfer Risk Reserve	55,920	
Less: Excess Allowance for Loan and Lease Losses[2]	728	
Less: Allocated Transfer Risk Reserve		
Less: Risk-Weighted Asset Amounts Deducted from Capital	1,015	
Total Risk-Weighted Assets		54,177
Average Total Assets	76,803	
Less: Deductions from Common Equity Tier 1 Capital and Additional Tier 1 Capital[2]	450	
Average Total Assets for the Leverage Ratio		76,353

MEMORANDA

Capital Conservation Buffer (beginning January 1, 2016)		N/A
Securities Appreciation (Depreciation)		1,126
Contingent Liabilities/Potential Loss	130,787 / 0	

Footnotes:

(1) Includes AOCI adjustments by banks making the AOCI opt-out election and the adjustment for certain accumulated gains (losses) on cash flow hedges by banks not making the AOCI opt-out election as outlined in Part 324.

(2) Includes adjustment for financial subsidiaries as defined by the Gramm-Leach-Bliley Act of 1999, if applicable.

Comparative Statement of Income

	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Interest Income	2,519	5,582	7,329
Interest Expense	894	2,452	3,850
Net Interest Income	1,625	3,130	3,479
Noninterest Income	304	589	643
Total Noninterest Expense	1,467	2,902	2,904
Provision for Loan and Lease Losses	300	1,025	1,580
Securities Gains (Losses)	15	48	
Net Operating Income (Pre-Tax)	177	(160)	(362)
Applicable Income Taxes	74	(36)	(117)
Net Operating Income (After-Tax)	103	(124)	(245)
Extraordinary Credits (Charges), Net			
Net Income	103	(124)	(245)
Other Increases/Decreases	60		
Includes changes in the net unrealized holding gains (losses) on Available-For-Sale Securities			
Cash Dividends			
Net Change in Equity Accounts	163	(124)	(245)

Reconcilement of Allowance for Loan and Lease Losses

	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Beginning Balance	1,748	1,407	950
Gross Loan and Lease Losses	181	884	1,274
Recoveries	112	200	151
Provision for Loan and Lease Losses	300	1,025	1,580
Other Increases (Decreases)			
Ending Balance	1,979	1,748	1,407

Other Component Ratios and Trends

Ratio	Period Ended 06/30/20x6	Period Ended 12/31/20x5	Period Ended 12/31/20x4
Net Interest Income (TE)/Average Earning Assets	4.74	4.37	4.64
Total Noninterest Expense/Average Assets	3.82	3.62	3.54
Net Income/Average Total Equity	3.39	(2.05)	(3.87)
Net Losses/Average Total Loans and Leases	.025	1.24	1.88
Earnings Coverage of Net Losses (X)	6.70	(1.19)	(1.08)
ALLL/Total Loans and Leases	3.67	3.15	2.50
Noncurrent Loans and Leases/ALLL	106.47	143.88	100.64

Footnotes:

ITEMS	06/30/20x6	12/31/20x5	12/31/20x4
INTEREST INCOME:			
Interest and fee income on loans	2,185	4,826	6,305
Income from lease financing			
Interest on balances with depository institutions			
Income on Federal funds sold and repos	66	350	512
Interest from assets held in trading accounts			
Interest and dividends on securities	268	406	512
Other Interest Income			
TOTAL INTEREST INCOME	2,519	5,582	7,329
INTEREST EXPENSE:			
Interest on deposits	858	2,434	3,832
Expense on Federal funds purchased and repos	5	18	18
Other interest expense	31		
TOTAL INTEREST EXPENSE	894	2,452	3,850
NET INTEREST INCOME	1,625	3,130	3,479
NONINTEREST INCOME:			
Services charges on deposit accounts	234	461	415
All other noninterest income	70	128	228
TOTAL NONINTEREST INCOME	304	589	643
NONINTEREST EXPENSE:			
Salaries and employee benefits	750	1,422	1,342
Premises and fixed assets expense (net of rental income)	271	549	584
Amortization expense of intangible assets (including goodwill)			
Other noninterest expense	446	931	978
TOTAL NONINTEREST EXPENSE	1,467	2,902	2,904
Provision for loan and lease losses	300	1,025	1,580
Securities gains (losses)	15	48	
NET OPERATING INCOME (PRETAX)	177	(160)	(362)
Applicable income taxes	74	(36)	(117)
NET OPERATING INCOME (AFTERTAX)	103	(124)	(245)
Extraordinary credits (charges) net of income tax			
NET INCOME	103	(124)	(245)
Other increases in equity capital accounts	60		
Other decreases in equity capital accounts			
Cash dividends declared on common stock			
Net change in equity capital accounts for the period	163	(124)	(245)
Equity capital accounts at beginning of the period	6,027	6,151	6,396
Equity capital accounts at end of the period	6,190	6,027	6,151

Footnotes:

HOLDING COMPANY RATIOS AND TRENDS

	HOLDING COMPANY		
CONSOLIDATED HOLDING COMPANY	(Date)	(Date)	(Date)
Net Operating Income to Average Assets			
Total Risk-Based Capital Ratio			
Leverage Capital Ratio			
This Institution's Assets to Consolidated Holding Company Assets			
PARENT ONLY			
Pre-Tax Operating Income and Interest Expense to Interest Expense (X) (Fixed Charge Coverage)			
Operating Income - Tax + Non-Cash Items to Total Operating Expense and Dividends Paid (Cash Flow Match)			
Total Liabilities to Equity			
Equity Investments in Subsidiaries to Equity (Double Leverage)			
Equity Investment in Subsidiaries - Equity Capital/Net Income - Dividends (Double Leverage Payback in Years)			

EXTENSIONS OF CREDIT TO AFFILIATED ORGANIZATIONS

DESCRIPTION	DIRECT	INDIRECT	TOTAL
A. Affiliated organizations including securities issued by affiliated organizations.	250		250
B. Indebtedness of others, or portions of such indebtedness, collateralized by securities issued by affiliated organizations.			0
Total	250	0	250
Less duplications within and between groups			0
Net Total	250	0	250

Comments:

HOLDING COMPANY

Any Company, Inc.
Anytown, Anystate

SUBSIDIARY

Any Time, Inc.
Anytown, Anystate

OTHER AFFILIATES

Any Body, Inc.
Anytown, Anystate

Description		Total
A. Executive Officers and their related interests		1,200
B. Directors/Trustees and Principal Shareholders and their related interests		250
TOTAL		1,450
Less duplications within and between groups		250
NET TOTAL		1,200
Capital and unimpaired surplus as of last Call Report date (Per Regulation "O")		7,094
Net total insider borrowing as a percentage of unimpaired capital and surplus		16.92%
NAME AND COMMENTS (Designate all duplications with a "D")	Detail	% of Unimpaired Capital & Surplus

GROUP A

LINCOLN, ALLIE C. Director and President	500	7.05%
GUTIERREZ, JOHN M. Executive Vice President and Cashier	450	6.34%
ANY BODY, INC. Duplication debt guaranteed by President Lincoln and Director Green.	250 D	3.52%
TOTAL	1,200	

GROUP B

ANY BODY, INC. A related interest of President Lincoln and Director Green. Both individuals guarantee the debt.	250 D	3.52%

Safety and Soundness

Composite 3. Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Information Technology

Composite 2. Financial institutions and service providers rated composite "2" exhibit safe and sound performance but may demonstrate modest weaknesses in operating performance, monitoring, management processes, or system development. Generally, senior management corrects weaknesses in the normal course of business. Risk management processes adequately identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are defined but may require clarification, better coordination, or improved communication throughout the organization. As a result, management anticipates, but responds less quickly to changes in market, business, and technological needs of the entity. Management normally identifies weaknesses and takes appropriate corrective action. However, greater reliance is placed on audit and regulatory intervention to identify and resolve concerns. The financial condition of the service provider is acceptable and while internal control weaknesses may exist, there are no significant supervisory concerns. As a result, supervisory action is informal and limited.

Trust

Composite 2. Administration of fiduciary activities is fundamentally sound. Generally, no component rating should be more severe than 3. Only moderate weaknesses are present and are well within management's capabilities and willingness to correct. Fiduciary activities are conducted in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Compliance

Composite 2. An institution in this category is in a generally strong compliance position. Management is capable of administering an effective compliance program. Although a system of internal operating procedures and controls has been established to ensure compliance, violations have nonetheless occurred. These violations, however, involve technical aspects of the law or result from oversight on the part of operating personnel. Modification in the bank's compliance program and/or the establishment of additional review/audit procedures may eliminate many of the violations. Compliance training is satisfactory. There is no evidence of discriminatory acts or practices, reimbursable violations, or practices resulting in repeat violations.

Community Reinvestment Act (CRA)

A CRA rating of "**Satisfactory**" is assigned. An institution in this group has a satisfactory record of helping to meet the credit needs of its assessment area, including low- and moderate income neighborhoods, in a manner consistent with its resources and capabilities.

Refer to *http://www.fdic.gov/regulations/examinations/ratings/index.html* for definitions of all composite ratings.

We the undersigned directors/trustees of Bank of Anytown, Anytown, Anystate, have personally reviewed the contents of the Report of Examination dated June 30, 20x6.

Signatures of Directors/Trustees	**Date**
HENRY P. BLACK	
MICHAEL D. BROWN	
LARRY G. GREEN	
KERRY A. JONES	
ALLIE C. LINCOLN	
JAIME S. MARTIN	
JOHN D. SCOTT	
ROGER WHITE	

NOTE: This form should remain attached to the Report of Examination and be retained in the institution's file for review during subsequent examinations. The signatures of committee members will suffice only if the committee includes outside directors and a resolution has been passed by the full board delegating the review to such committee.

CONTROL AND RELATIONSHIPS

Any Company, Inc., a one-bank holding company, continues to own 100 percent of the bank's common stock. Bank directors own or control a combined 908,584 shares or 56 percent of holding company stock. President Lincoln is the largest individual stockholder, controlling 500,326 shares or 31 percent of the outstanding stock. Any Time, Inc. is a subsidiary of the bank and holds title to ORE. Any Body, Inc., is an on-premise insurance agency owned by President Lincoln and Director Green that sells credit life, auto, fire, and disability insurance. but does not utilize bank employees or equipment. President Lincoln stated that no ownership or management changes are planned. President Lincoln notified the bonding company of the nonbank activity being conducted on the premises and received an acknowledgement letter from the bonding company dated November 9, 20x5. On January 20, 20x6, the board of directors of Any Company reviewed the operations of Any Body, Inc., and approved its continued operations and lease of bank space for another year.

DIRECTOR INVOLVEMENT

One of the bank's directors contacted the EIC during the examination to discuss his concerns with the current committee structure of the bank. Director John Scott indicated that he felt the Loan Committee membership should be expanded and that the committees were dominated by Chairman White and President Lincoln.

DOMINANT MANAGEMENT

Chairman of the Board Roger White and President Allie Lincoln exhibit a dominant influence over the bank's affairs. Their dominance over policy discussion and decisions has negatively impacted the institution as noted throughout the examination. Both Chairman White and President Lincoln were responsive to regulatory concerns and promised prompt corrective actions to implement the current exam recommendations and outstanding MOU.

EXAMINATION SCOPE

Examination Number 12345

The examination scope was expanded from the pre-exam planning (EP) memo in the following areas:

- *Construction Lending* – Expanded due to administrative problems identified in the original loan sample. Ten additional construction loans serviced by the two construction lenders and originated in 20x6 were reviewed.
- *BSA Review* – Expanded to include a review of all Currency Transaction Reports filed in 20x6 due to indications that they were being filed late.
- *Call Report Review* – Expanded to include year-end 20x5 in response to the volume of errors noted with the original review.

As a result, examination hours, totaling 760, are 150 over budget (25 percent). Other examination procedures were not modified from those identified in the EP memo and no significant variances between projected and actual examination hours, scope, or procedures were noted in the BSA/AML (Exam #12346), Trust (Exam #12347), or IT (Exam #12348) reviews.

SUGGESTIONS FOR FUTURE EXAMINATIONS

There is sufficient working space for seven examiners.
Management accommodated working hours of 7:30am to 5:30pm.
The examination crew should contain at least one examiner with experience in construction loan analysis.

List alphabetically all directors/trustees, senior officers, and principal stockholders. Also indicate their titles. Number of shares owned is not rounded. (J – indicates stock jointly owned; P – indicates preferred stock owned; H – indicates holding company stock owned; C – indicates stock controlled but not owned)

Names and Comments	Net Worth		Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
	Amount	Date of Statement					

Biographical and background information on directors, officers, and other key management officials listed on this page should be prepared in accordance with the Report of Examination Instructions.

<u>DIRECTORS/TRUSTEES</u>							
BLACK, HENRY P. Attorney *Address*	501	3/1/20x5	1980	1961	12	50,992 (H)	
BROWN, MICHAEL D. Commercial RE Consultant (1) *Address*	7,890	6/1/20x5	1983	1959	5	5,005 (H)	
GREEN, LARRY G. Automobile Dealership Owner (1) *Address* *Estimated by President Lincoln.	10,000	8/1/20x6*	1981	1955	12	200,150 (H)	
JONES, KERRY A. Retired Doctor *Address*	2,500	6/1/20x5	1979	1933	12	1,010 (H)	
LINCOLN, ALLIE C. President (1)(2) *Address*	1,357	2/1/20x5	1982	1951	12	500,326 (H)	100 25(B)
MARTIN, JAIME S. Economist *Address*	3,565	3/1/20x5	1981	1950	11	150,500 (H)	
SCOTT, JOHN D. Certified Public Accountant (2) *Address*	7,234	8/7/20x5	1982	1954	11	101 (H)	
WHITE, ROGER Chairman of the Board (1)(2) *Address* *Estimated by Money Magazine.	5,000	6/24/20x6*	1980	1960	12	500 (H)	24(B)
<u>OFFICERS, NOT DIRECTORS/TRUSTEES</u>							
COOK, LESLIE S. Executive Vice President - Commercial Lending (1)			1983	1960			85

Names and Comments	Net Worth		Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
	Amount	Date of Statement					
GUTIERREZ, JOHN M. Executive Vice President / Cashier (2)			1983	1958			70
PRINCIPAL SHAREHOLDERS, NOT DIRECTORS/TRUSTEES OR OFFICERS							
ANY COMPANY, INC. Anytown, Anystate						162,247	

(1) Loan Committee
(2) Investment Committee

Total Holding Company shares owned by the Directorate: 908,584
Percentage Holding Company ownership by the Directorate: 56 percent

There have been 12 regular Board meetings since the last regulatory examination.
Director fees are $250 per Board meeting attended.
Committee fees are $100 per committee attended.

DISCLAIMER This section of the Bank of Anytown provides sample comments for International pages in the Report of Examination. The information on the pages is not intended to tie directly with information in other sections of the Bank of Anytown Report of Examination.

BANK OF ANYTOWN

ANYTOWN	**ANY COUNTY**	**ANYSTATE**

Region:	Any Region	Certificate Number:	99999
Examiner-In-Charge:	Sandra E. Smart		
Examination Start Date:	August 1, 2015		
Examination As Of Date:	June 30, 2015		

INTERNATIONAL REPORT PAGES

Description	Detail	Not Rated	Substandard	Value Impaired	Loss
Anycountry					
November 13, 2015					
Performing Short-Term Trade Credits		15			
Performing Short-Term Bank Credits		10			
All Other Exposures	250				
Less: Loss Classification on Credit Risk	-150				
Net Exposure			100		

In December 2014, the Anycountry government defaulted on $50 billion of bonds held by foreign creditors and subsequently imposed strict capital controls that severely limited the ability of private borrowers to service their external liabilities. Private borrowers from Anycountry have accumulated significant interest and principal arrears to external creditors. Prior to the present interruption of external debt service, the country had been current on payments since completing a restructuring of bank debt in the early 1990s.

U.S. banks cut their exposures to Anycountry sharply in 2014, reflecting material reductions in business activities/lending and significant write-offs. In June 2015, U.S. banks' cross-border exposure totaled $6.2 billion, down roughly 44 percent from a year earlier. Locally funded business fell by over two-thirds, to $3.3 billion.

Amount scheduled as Substandard represents exposure to the Anycountry Distillery Corporation. Another facility to the Anycountry Oil Corporation is not adversely classified for transfer risk as it is subject to a credit risk classification of Loss.

Insert the actual transfer risk write-up provided by the Interagency Country Exposure Review Committee. Adjust the comments if more severe adverse classifications (based on credit risk) are scheduled in the ROE.

Note: Countries and amounts provided are for illustrative purposes and do not reflect actual classifications.

Management of the country risk process is satisfactory. Senior management and the Asset/Liability Management Committee continue to closely monitor the economic and political stability of countries where the bank maintains international transaction activity. Due to deteriorated economic and political situations in certain countries where the bank conducts business, there has been a reorientation of business strategy. The Board has strategically decided to focus future business development on its domestic banking market and to reduce its overall risk emanating from transfer risk exposure. As a result, the bank has substantially reduced the level of approved country limits, and it has frozen most assigned limits, and the resulting level of net transfer risk exposure.

Refer to additional guidance for completing this page contained in the ROE Instructions and the Interagency Statement on Sound Country Risk Management Practices.

Note: Countries and amounts provided are for illustrative purposes and do not reflect actual classifications. Amounts shown do not correspond with other information in the Bank of Anytown ROE.

Description	Detail	Amount Extended
Argentina		
Value Impaired	980	
Less: ATRR	-784	
Net Amount	196	

The concentration represents 1.00 percent of Tier 1 capital. All credits are rated Value Impaired and subject to an ATRR of 80 percent.

Ecuador		
Transfer Risk Claims	580	
Less: Performing Short-Term Trade and Bank Credit	-80	
All Other Credit - Substandard		500

The concentration represents 2.55 percent of Tier 1 capital. Performing short-term trade and bank credit is not rated.

United Kingdom		
Transfer Risk Claims		6,325

The concentration represents 32.27 percent of Tier 1 capital. The amount is listed for informational purposes.

Refer to specific guidance for completing this page contained in the Report of Examination Instructions section of the Manual.

Note: Countries and amounts provided are for illustrative purposes and do not correspond with other information in the Bank of Anytown ROE.

DISCLAIMER: This information is provided to illustrate a relatively complex PBO. It does not correspond to other ownership/control information provided in the Bank of Anytown.

List the following information for the bank(s) and/or bank holding company(s) in the PBO.

U.S. Name: Demo International Bank[1]
City, Country: Miami, FL
Number of Outstanding Shares: 1,000,000

Foreign Name: Demo International, C.A.
City, Country: Caracas, Venezuela
Number of Outstanding Shares: 50,000

Foreign Name: Demo Bank Venezuela[2]
City, Country: Caracas, Venezuela

Foreign Name: Demo Bank do Brazil[3]
City, Country: Brasillia, Brazil

Foreign Name: Demo Bank Mexico
City, Country: Mexico City, Mexico
Number of Outstanding Shares: 100,000

[1] Of the ten entities that compose the PBO, only the three foreign banks and the foreign bank holding company that actively engage in transactions with Demo International Bank, Miami, Florida are detailed above. The remaining five entities within the PBO structure include Demo Holdings, Caracas, Venezuela, which wholly owns Demo Bank International, Panama City, Panama; Demo Finance Company, Caracas, Venezuela, which wholly owns Demo Bank International, Guayaquil, Ecuador and Demo Bank Interandino, Lima, Peru.
[2] Wholly owned subsidiary of Demo International, C.A., Caracus, Venezuela.
[3] Wholly owned subsidiary of Demo Bank Venezuela, Caracas, Venezuela.

Detail the stock owned by the beneficial owner(s) whose direct/indirect control forms the nexus of the PBO.

U.S. Name: Demo International Bank	**Number of Shares**	**Percent Owned**	**Type of Control**
Beneficial Owner: Demo Family Trust (Jose Demo controls 100%)	750,000	75.00%	Direct
Beneficial Owner: Example Family Trust (Juan Example controls 100%)	250,000	25.00%	Direct

Foreign Name: Demo International, C.A.	**Number of Shares**	**Percent Owned**	**Type of Control[1]**
Beneficial Owner: Jose M. Demo[4]	5,000	10.00%	Direct
Beneficial Owner: Carlita S. Demo[4]	12,500	25.00%	Direct
Beneficial Owner: Paco M. Demo	7,500	15.00%	Direct
Beneficial Owner: Juan H. Example	12,500	25.00%	Direct
Beneficial Owner: Demo Family Members	12,500	25.00%	Direct

[4] Mr. Jose M. Demo has indirect control of the shares owned by his wife, Ms. Carlita S. Demo.

Foreign Name: Demo Bank (Mexico)	**Number of Shares**	**Percent Owned**	**Type of Control[1]**
Beneficial Owner: Jose M. Demo[5]	50,000	50.00%	Direct
Beneficial Owner: Carlita S. Demo[5]	25,000	25.00%	Direct

[5] Mr. Jose M. Demo has indirect control of the shares owned by his wife, Ms. Carlita S. Demo.

Discuss the factor(s) or combination of attributes (besides or in addition to common stock ownership) that was considered in determining whether a PBO relationship exists. Consider whether an individual or a group of individuals (e.g., family members, business partners, or any other group) acting together (directly or indirectly):

1) **Constitute a quorum or a significant presence on the board of directors of both the U.S. depository institution and the foreign bank or the foreign bank holding company.**

   The members of the Demo family listed above serve as the chairman, vice chairman, or director for seven of the banking entities. However, none of the individuals are on the board of directors of Demo Bank International, Panama. Their membership does not constitute a quorum on any of the three foreign or U.S. bank boards, but does constitute a quorum on the board of the foreign bank holding company, Demo International, C.A.

2) **Controls, in any manner, the election of a majority of the directors of the U.S. depository institution and the foreign bank or the foreign bank holding company.**

   The shareholder-meeting minutes for electing the directorate for Demo Bank Venezuela were not available for review. However, Mr. Jose Demo and his family members control the election through their ability to vote a majority of the holding company's stock. Mr. Jose Demo's ability to vote the majority of Demo International Bank's stock indicates that he controls the election of its directorate.

3) **Constitutes a quorum or a significant portion of the executive management of both the U.S. depository institution and the foreign bank or the foreign bank holding company.**

   The members of the Demo family listed above serve as the president, vice president or cashier of Demo International Bank, Demo International, C.A. and at the seven foreign banks, except Demo Bank International, Panama. Their positions constitute a quorum of the executive management at Demo International, C.A., (Venezuela) but not the other banks, but they do occupy critical positions on those teams.

4) **Exercises a controlling influence over the management and/or policies of both organizations.**

   Mr. Jose Demo is chairman of Demo International Bank and president of Demo Bank Venezuela, which enables him to exert a controlling influence over the management and policies of both organizations.

5) **Engages in an unusually high level of reciprocal correspondent banking and/or other transactions or facilities between the U.S. depository institution and the foreign bank.**

   The banks primarily engage in correspondent bank services, dollar clearings, letters of credit, and trade related transactions. Fee income from transactions with the three foreign banks equaled over 40 percent of the total fee income generated by Demo International Bank in 2011. The U.S. bank also extended a $5 million line of credit secured by a $5 million certificate of deposit to Demo Bank Venezuela, Caracus, Venezuela.

6) **Obtains financing to purchase the stock of either the U.S. depository institution or the foreign bank or the foreign bank holding company from, or arranged by, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan.**

   None noted.

7) Requires the U.S. depository institution to adopt particular/unique policies or strategies similar to those of the foreign bank, such as common or joint marketing strategies, cross-selling of products, sharing of customer information, or linked web sites.

The Demo International Bank's website is linked to Demo Bank Venezuela's website. Both offer similar loan and deposit products and banking services.

8) Names the U.S. depository institution in a similar fashion to that of the foreign bank.

The titles of the banking organizations use similar naming conventions.

9) Presents any other factor(s) or attribute(s) that affected the conclusion.

None known.

Summarize the Examination Findings

The review determined that a PBO relationship exists between Demo International Bank and three foreign banks and a foreign bank holding company through the common control of the Demo family, primarily through Mr. Jose Demo's ownership/control of the Demo International Bank in Miami, Florida; Demo International, C.A. in Caracas, Venezuela (foreign bank holding company); and Demo Bank Mexico in Mexico City, Mexico. Each of the affiliated foreign banks has audited annual reports for the most recent fiscal year.

Demo Bank do Brazil reported a negative 0.3 percent return on average assets for the most recent fiscal year because of elevated credit losses. Its book capital (minus goodwill) declined to 5 percent of total assets as of December 31, 2015. Other foreign financial affiliates had positive net income and at minimum, a book capital to assets ratio of 10 percent as of December 31, 2015.

Bank management acknowledges that the institutions are under common control and actively monitors all transactions with affiliated entities. No adverse trends were noted relating to transactions with foreign banking affiliates. Refer to the Related Organizations page and the Risk Management Assessment page for additional information.

Return to top.

INTERNATIONAL WORKPAPERS

An international loan, acceptance, or letter of credit is defined as any such instrument between this bank and a resident or entity domiciled outside the United States, District of Columbia, Puerto Rico or other United States Territory or Possession.

DISTRIBUTION

Description	Amount
Mortgage loans (Including Ship loans of $2,327)	8,732
Loans insured or guaranteed by the U.S. government or its agencies	14,065
Loans to foreign governments, agencies thereof and central banks	15.971
Loans to financial institutions other than central banks	500
Loans to commercial, industrial and agricultural interests	41,689
Other Loans (Describe) Loans to religious institutions	8,572
All other loans	1,171
Total International Loans*	90,700
*Does NOT include loans to U.S. subsidiaries of foreign corporations	12,444

Description	Amount
Participation loans and paper purchased	41,505
Placed paper, direct loans and participation loans sold	5,365
Syndication and consortium financing	5,000
International acceptances outstanding	1,489
International letters of credit outstanding	7,836
Other (Describe)	

1. **Are duties and responsibilities for the conduct of international operations clearly defined? Comment briefly.**

Yes. The bank's Board of Directors has approved a satisfactory, written policy statement setting forth the various duties and responsibilities of the operating entities within the international division.

2. **Does the bank have a definite international lending policy? If "yes", summarize such, state whether it has been approved by the board of directors/trustees, and indicate extent of compliance.**

Yes. The bank's Board of Directors, in line with the directives of the parent bank, has delineated specific guidelines on clientele to be served, limits on country exposure both in the aggregate and by maturity within those limits and risks to be undertaken. Officers submit recommendations to the international loan committee, which has authority to approve loans up to $5 million. Larger loans require senior loan committee approval. In all cases, these policies are adequate for the bank's needs and have been appropriately followed.

3. **(a) Comment upon policy guidelines in effect regarding country risk assets and volume limitations imposed thereon. (b) How often are guidelines reviewed? (c) Does the bank have any country risk concentrations of credit? If "yes", list the country and percentage of such extensions of credit to the bank's total capital and reserves.**

(a) The policy requires all extensions of credit (including bank placements, formal loan commitments, and foreign exchange lines) to be included within country limits. Claims are reallocated to the country of guarantor or the country where collateral is realizable. Sub-limits are provided by maturity of the obligation. Separate limits are provided for each of the 15 countries where lending is permitted.
(b) Reviewed quarterly.
(c) Yes, Japan 84%, France 40%, Federal Republic of Germany 59%, United Kingdom 39%.

4. **Are guarantees of other banking institutions and/or parent or affiliated organizations of borrowers required on certain loan obligations? If "yes", under what circumstances and in what form are such guarantees extended?**

Yes. Letters of Guarantee from two European banks have been furnished as support to financially weak borrowers. The parent bank has extended guarantees in the form of letters of credit essentially to provide additional protection to the subject bank's position. The parent's guarantee was not relied upon as a primary source for repayment of the loan.

5. **(a) Describe the general nature and character of collateral pledged, and (b) comment upon the adequacy of supporting documentation.**

(a) Collateral includes first preferred ship mortgages, notes and bond obligations of various foreign governments, time deposits, commodities, stocks, and UCC filings.
(b) Supporting documentation appeared in order.

6. Is credit information timely in content and available in sufficient readable detail?

Credit information on loans originated at the Nassau Branch continues to be inadequate. Deficiencies include a lack of current and complete financial information on the obligor and guarantor, an absence of thorough credit analysis, and a lack of complete information on country conditions. Management initiated a project (and hired two new credit analysts at the Nassau Branch) during the examination to enhance the availability and sufficiency of credit information on loans originated at the Nassau Branch.

7. (a) Describe the general nature and types of acceptance financing extended, and (b) the general lines of business involved.

(a) The bank is primarily involved in acceptance financing in connection with international trade activity.

(b) The acceptance financing involves manufactured goods, commodities, and exchange activities of central banks.

8. (a) Describe the general nature and types of letter of credit accommodations offered, and (b) the general lines of business involved.

(a) The bank issues documentary letters of credit to importers, confirms other banks' letters of credit for export customers and, to a limited extent, engages in deferred payment letter of credit financing. Standby letters of credit are undertaken only for prime customers.

(b) The letters of credit involve manufacturers, machinery exporters and importers, commodity importers, and foreign governments and agencies.

9. Describe the provision for repayment of (a) acceptances, and (b) drafts drawn under letters of credit. Include comment regarding extent of refinancing.

(a) and (b) Provisions for repayment are arranged prior to issuance and vary as individual conditions warrant. Repayment is generally accomplished by charge to customer's account or by loan accommodation under approved credit lines in the case of acceptances and by charge to the customer's account or acceptance with respect to letters of credit. In certain situations, refinancing is permitted, generally for short periods.

1. Comment on the general nature and volume of present Eurocurrency operations.

Eurocurrency operations are conducted through the Nassau Branch. Investments are primarily loans to South American corporations and central governments, securities of foreign governments and bank placements. Sources of funding are individual, partnership, corporation, bank, and affiliate time deposits. As of the examination date, Eurocurrency loans, securities, and bank placements totaled $325 million with approximately 98 percent of the placements funded by Eurocurrency time deposits.

2. Describe the procedures followed and guidelines utilized in establishing lines of credit and making and approving due to (takings) and due from (placements). Comment on the adequacy of procedures enabling senior management to ascertain compliance with guidelines and directives.

The parent bank has issued adequate guidelines to be considered before establishing lines of credit and bank relationships. With respect to banks, these criteria center on the obligor's capital resources, country risk, and type of institution. Bank and nonbank clientele analysis includes consideration of volume and maturity factors, as well as a review of financial responsibility and reputation. Senior management receives weekly reports.

3. (a) Comment on the maturity composition of present Eurocurrency takings and placements and the effect of such on the bank's liquidity position. (b) Are asset and liability maturities reasonably matched?

(a) On the examination date, Eurocurrency takings totaled $285 million, while placements aggregate $195 million. All placements and 74% of takings ($210 million) mature within 90 days with no adverse effects on the bank's liquidity position.

(b) Both near-term and longer-term maturities are reasonably matched.

4. Are all interbank placements confirmed at inception and, thereafter, subject to periodic direct verification audits?

Yes.

NOTE: A negative answer below (questions 2 through 8(e)) may be indicative of a condition in need of correction. Such answers may call for comment, or expanded treatment, below or elsewhere in the examination report.

DESCRIPTION	YES	NO
1. Is the bank engaged, in any manner, in foreign exchange activities? If "Yes", answer the following questions:	X	
2. Is the net open position of each foreign currency reasonable in relation to the bank's total capital and reserves?	X	
3. Is the aggregate net open position of all foreign currencies reasonable in relation to the bank's total capital and reserves?	X	
4. Are the future maturities of foreign currency assets, liabilities, and contracts reasonably matched with respect to long and short positions in all time periods?	X	
5. Does a current revaluation of the bank's foreign currencies reflect an insignificant profit or loss?	X	
6. Has the directorate and/or head office imposed reasonable guidelines and limits with respect to foreign exchange operations?	X	
7. Are guidelines and limits being adhered to by active management?	X	
8. With respect to foreign exchange operations, are the following adequate:		
(a) recording procedures?	X	
(b) bookkeeping procedures other than 8(a)?		X
(c) contract confirmation procedures?	X	
(d) internal routines and controls other than 8(c)?	X	
(e) audit procedures?	X	

8(b) Refer to comments under Audit and Internal Controls.

Country United Kingdom	Monetary Unit Pound Sterling			
Description	Assets and Purchases (Long Position)		Liabilities and Sales (Short Position)	
	Foreign Currency	U.S. Dollar Book Value	Foreign Currency	U.S. Dollar Book Value
Cash	1,000	2,600		
Demand Balances Due (Nostro)	50,000	19,800		
Loans	1,000,000	2,500,000		
Securities	100,000	275,800		
Deposits of Banks (Vostro)			100,000	242,000
Other Deposits			400,000	1,040,000
Spot Contracts	1,300,000	3,120,000	1,400,000	3,346,000
Forward Contracts				
Holdovers				
Other: (Specify) Accrued Interest Receivable	10,500	25,200		
Accrued Interest Payable			3,000	7,200
Gross Position	2,461,500	5,943,400	1,903,000	4,635,200
Less: Long/Short	1,903,000	4,635,200		
Net Position	558,500	1,308,200		
Net position as a % of the bank’s total capital and reserves:	2.90%			

OTHER CURRENCIES								
		Long		Short		Net Position		(%)*
Country	Monetary Unit	Foreign Currency	U.S. Dollar Book Value	Foreign Currency	U.S. Dollar Book Value	Foreign Currency	U.S. Dollar Book Value	Net Position
Australia	Dollar	24,600	27,900			24,600	27,900	0.06%
Canada	Dollar	66,000			90,000	66,000	(90,000)	0.20%
France	Franc	1,000,000	210,000			1,000,000	210,000	0.47%
Germany	Mark	693,000	215,000	203,000	61,000	490,000	154,000	0.34%
Italy	Lire	27,873,600	30,500	54,344,500	59,500	(26,470,900)	(29,000)	0.06%
Switzerland	France					0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
Subtotal (U.S.)						0	536,200	0.00%
Plus: Major Currency (U.S.)							1,308,200	
Aggregate Position (U.S.)						0	0	
* as a percentage of the bank's Total							1,844,400	3.88%
Capital and Reserves.								

DESCRIPTION	YES	NO
1a. Is the net open position of each foreign currency reasonable in relation to the bank's total capital and reserves?	X	
1b. Is the aggregate net open position of all foreign currencies reasonable in relation to the bank's total capital and reserves?	X	

MATURITY DISTRIBUTION SCHEDULE

Monetary Unit	Maturity Dates	Assets and Purchases Long	Liabilities and Sales Short	Net Gap for Period Long/Short	Spot Rate P = Prem. D = Disc.	Profit	Loss
		F.C.	F.C.	F.C.		U.S.	U.S.
Pound (UK)	5/15	51,000	100,000	(49,000)			
	5/16	25,000		25,000			
	5/17	25,000		25,000			
	5/18	35,000		35,000			
	5/19	50,000	40,000	10,000			
	5/22		50,000	(50,000)			
	5/23	50,000	75,000	(25,000)			
	5/24	100,000	50,000	50,000			
	5/25	50,000		50,000			
	5/30	50,000	75,000	(25,000)			
	5/31		100,000	(100,000)			
	June	110,500	100,000	10,500			
	July	125,000	203,000	(78,000)			
	August	175,000	110,000	65,000			
	September		75,000	(75,000)			
	October	245,000	225,000	20,000			
	November	175,000	100,000	75,000			
	December	325,000	200,000	125,000			
	20X6	370,000	300,000	70,000			
	20X7	150,000	50,000	100,000			
	20X8	250,000	50,000	200,000			
	After	100,000		100,000			
	TOTALS	2,461,500	1,903,000	558,500		0	0
				Less:	Profit/Loss		
				Future	**Adjustment**	0	0
						YES	**NO**
2. Are future maturities of foreign assets, liabilities, and contracts reasonably matched with respect to long and short positions in all time periods?						X	

Monetary Unit	Book Value of F.C.	Net Position U.S.	Exam Date Spot Rate	Current U.S. Market Value (F.C. x Spot)	U.S. Spot Rate Profit (Loss)	U.S. Future Profit (Loss) Adjustment	U.S. Net Profit or (Loss)
Australia $	24,600	27,900	1.149500	28,300	400		400
				0	0		0
Canada $	66,000	(90,000)	0.868300	57,300	147,300	(500)	146,800
				0	0		0
France Franc	1,000,000	210,000	0.219100	219,100	9,100		9,100
				0	0		0
German Mark	490,000	154,000	0.493800	242,000	87,700		87,700
				0	0		0
Italian Lira	(26,470,900)	(29,000)	0.001176	(31,100)	(2,100)		(2,100)
				0	0		0
Swiss Franc	(60,700)	(25,300)	0.532800	(32,300)	(7,000)		(7,000)
				0	0		0
UK Pound	558,500	1,308,200	2.222000	1,241,000	(67,200)	1,000	(66,200)
				0	0		0
				0	0		0
				0	0		0
				Total	168,200	500	168,700

Does not include $ profit (loss) attributable to outstanding SWAP transactions

$ has already been taken into income/expense through accrual accounting

	YES	NO
3. Does a current revaluation of the bank's foreign currencies reflect an insignificant profit or loss?	X	

Previous Calendar Year	Amount or Percent
Quarterly Average of Gross Assets	562,500,000
Total Foreign Exchange Income	1,000,000
Net Foreign Exchange Income (Loss)	550,000
% of Total Foreign Exchange Income to Average Gross Assets	0.18%
% of Net Foreign Exchange Income (Loss) to Average Gross Assets	0.10%
Year to Date	**Amount or Percent**
Total Operating Income (Bank)	25,156,300
Net Operating Income (Loss)	4,192,700
Total Foreign Exchange Income	735,200
Net Foreign Exchange Income (Loss)	404,400

1. **(a) Describe the net and aggregate position limits, maturity exposure limits, and any other limits placed on foreign exchange operations by the board of directors/trustees. (b) Do such limits appear reasonable?**

(a) The bank's Board of Directors has authorized trading only in currencies listed in the position schedules. Overnight limits for each currency with the exception of the pound sterling are fixed at $250M; pound sterling limit is $1,500M. The aggregate position limit for all currencies is $2,000M. Maturity gaps are authorized only on major active currencies up to $100M not to exceed 3 months. Major active currencies have been described as having an active forward market.

(b) Limits appear to be reasonable.

2. **Describe the limits and guidelines established by the board of directors/trustees for dealing in foreign exchange with other banks and customers.**

Individual customer limits are approved by the bank's International Committee based on the customer's creditworthiness and the volume of its foreign currency needs. The bank's written internal credit policy pertaining to bank and nonbank customer foreign exchange lines is:

(a) 100% of the foreign exchange line may mature within 180 days,
(b) 50% of the foreign exchange line may mature within 360 days,
(c) 20% of the foreign exchange line is available for contracts with maturities up to 18 months, and
(d) no maturities may exceed 18 months.

Excesses must be approved in writing by the account officer who approved the customer line. Maximum daily delivery risk limits per customer are set at 20% of the aggregate limits approved.

3. **Fully describe any recent significant deviations by the bank from established limits and guidelines. Include in this description any significant deviations noted after completion of the Position Analysis, and the Maturity Distribution (GAP) Analysis.**

No deviations from bank policy were noted in preparing the position analysis. Two exceptions to bank policy on GAP exposure were in evidence due to an inability to obtain forward cover. These exceptions were approved by the International Committee. No other recent deviations were identified.

4. **(a) Describe the reports (i.e., position maturity, gap, revaluation, etc.) required by the directorate and senior management to ascertain compliance with bank policy. (b) Determine whether the directorate or senior management are notified when actions are taken which constitute deviation from policy? Describe and assess the approval procedures for such deviations from policy.**

(a) Net position reports enumerating all foreign currency balance sheet items, future contracts, and after-hour and holdover transactions are transmitted to the designee of the International Committee on a daily basis. Reports are prepared by the foreign exchange bookkeeping department and reconciled to the trader's blotter. Maturity gap reports are produced daily with the next month's transaction reflected on a daily basis and subsequent transactions grouped in two-week intervals. Revaluation reports detailing ledger accounts, spot contracts, and forward contracts are developed on a weekly basis.

(b) Bank's written policy provides for the immediate generation of exception reports where applicable limits are exceeded. Prior written approval of the account officer is required for deviation from customer limits. Deviation from other limits is not permitted under any circumstances without prior approval of International Committee.

5. If the bank is a subsidiary of a foreign bank, describe the controls and guidelines the parent has imposed on the bank's foreign exchange activities, and describe the foreign exchange reports prepared by the bank for the parent.

The aforementioned guidelines and limits have been implemented at the direction of the parent bank. All reports of the bank's audit department and the reporting mechanisms described in 4(a) are furnished to the parent bank for review prior to implementation.

6. Briefly describe the procedures used in the revaluation, including the frequency and responsible party. If forward contracts are not revalued at future rates, so indicate.

Revaluation is performed on a bi-weekly basis by the International Operations section. Actual realized profit or loss is calculated by applying current spot rates to balance sheet accounts, as well as contracts of very near maturities. Unrealized profit or loss on future transactions is determined by applying the appropriate forward rates to the net position for each future period in the bank's gap report.

7. Describe the general ledger accounts affected by the periodic revaluation and the journal entries used to effect changes in these accounts. If any accounts are being used to capitalize losses or defer immediate recognition of profit, so indicate.

Actual realized profit or loss is charged to the profit and loss account with offsetting entries to the applicable local currency ledger accounts. With respect to future transactions, the bank charges the "estimated profit(loss) on foreign exchange futures" account for the amount of the adjustment with an offset to the profit and loss account. Profits and losses are recognized at the date of revaluation.

8. (a) Approximate the volume of foreign exchange transactions the bank has with related companies or banks? (b) Determine whether the terms and conditions of such dealings vary from similar transactions with non-related companies and banks?

(a) During 2015, the bank entered into approximately $40,000M of forward contracts to purchase and sell foreign exchange with a related bank, First European Bank, London, England.

(b) Terms and conditions of contracts are substantially the same as transactions with non-related parties.

9. **Regarding holdover and/or after hour transactions, describe and assess the bank's system for controlling and recording such transactions. Indicate how management is informed of such transactions before recordation, and determine whether the system is correctly designed and adequately controlled?**

The foreign exchange control group prepares a list of holdover items. Holdover items are incorporated into the daily position sheet, which together with the holdover list, is furnished to management on a daily basis. Holdover items are posted as of the dates contracted. The system is considered adequately controlled.

NOTE: A negative response below may indicate a condition that requires correction and comment(s) below and/or in the report of examination.

AUDIT

			YES	NO
1		Have the directors/trustees made provision for an audit of the foreign exchange area?	X	
		If "Yes," indicate method utilized:		
	X	Employment of full time auditor.		
	X	Periodic employment of independent auditor.		
	______	Designation of an audit supervisor and an established program of internal audit by bank personnel.		
		Name of Audit Supervisor:		
2		If the answer to question 1 is "yes", does the audit program include the following:		
	(a)	Periodic proof of forward and spot contracts?	X	
	(b)	Periodic proof and/or reconcilement of foreign exchange general ledger accounts?	X	
	(c)	Periodic direct verification of forward and spot contracts?	X	
		Frequency: Annually Amount: $25,200,000		
	(d)	Review of management reports and adherence to guidelines?	X	
	(e)	Comparison of rate quotations in management reports and revaluations with outside sources?	X	
	(f)	Perusal of authorized signatures?	X	
	(g)	Briefly describe any other audit procedures conducted:		
3		If applicable, has the bank corrected major criticisms noted in the last independent audit report?		X
		Date of audit: 12/31/2014		
		Briefly describe major criticisms and/or recommendations in such report: The bank was criticized for not maintaining a complete and current set of instructional memoranda describing the information generated from the accounting system and the general and subsidiary ledger accounts affected by trading activity. This defect has been corrected. Deficiencies still exist with respect to confirmation procedures.		
4		Is the foreign exchange audit program adequate as to scope and frequency?	X	
5		Does the foreign exchange auditor or audit supervisor report regularly and directly to the bank's board of directors/trustees or a committee thereof?		
6		Is a written audit report of the foreign exchange area maintained by the bank?	X	

2(c) All outstanding spot and forward contracts as of the audit date are directly verified.

NOTE: A negative response below may indicate a condition that requires correction and comment(s) below and/or in the report of examination.

INTERNAL CONTROLS

		YES	NO
1	Are all contracts recorded on the date contracted?	X	
2	Is it a firm rule that all forward and spot contracts be confirmed at inception?	X	
3	Has the bank instituted an effective and current (within seven days) follow-up system regarding unconfirmed and/or incorrectly confirmed forward and spot contracts?		X
4	Are foreign exchange contracts and dealing slips prenumbered and used in such order?	X	
5	Does the bank have an effective system of controls over the trader and the trading environment?	X	
	A "Yes" answer to this question requires a "Yes" answer to each of the following: Is it a firm rule that:		
	(a) The trader not be allowed to receive confirmations on forward and spot contracts?	X	
	(b) The trader not be allowed to sign contracts?	X	
	(c) The trader be prohibited from initiating and receiving interbank funds transfers, opening current accounts, or receiving credits to current accounts?	X	
	(d) The trader not be involved in the revaluation procedure?	X	
	(e) Trading activities be segregated from other bank activities, in particular the accounting, confirmation, and report functions?	X	

2-3 Although the bank established guidelines regarding the confirmation of spot and future contracts, examiners observed that outgoing confirmations are frequently incomplete, with trade and value dates frequently omitted. Further, many entries in the confirmation exception logs are incomplete, and the log is not reviewed by an operations officer. These deficiencies were noted by both the bank's internal and external auditors; however, management has not yet corrected the deficiencies .

INTERNATIONAL PRE-EXAMINATION QUESTIONNAIRE

Examiners can use this optional questionnaire, in whole or part, during the pre-examination process as part of the preliminary risk assessment. This workpaper includes a list of questions that examiners can ask management to help identify international activities, develop document request lists, and scope examination activities.

Briefly summarize significant discussion topics in the pre-examination planning memorandum. Summarize items such as material changes since the prior examination, economic conditions in the institution's area of operation, new products or services, and areas of perceived risk. Include any other information useful for allocating examination resources. Document the officer's name and title, and note the discussion date.

INTERNATIONAL ACTIVITIES

1) Does the bank offer any international products or services? For example:
   - Cross-border loans or investments,
   - Loans to domestic borrowers that are part of an international supply chain or that are guaranteed by a foreign parent, or other foreign legal entity,
   - Trade financing,
   - Foreign wire transfers,
   - Foreign deposits or borrowings,
   - Loans to non-resident aliens (NRAs),
   - Private banking or wealth management for foreign nationals,
   - Foreign correspondent banking, or
   - Foreign exchange trading.

   If yes:
   - Provide a summary description of each activity,
   - Indicate where the activities are conducted within the organization, and
   - Provide the name and title of the person(s) responsible for each area.

2) Does the bank have an International Banking Facility (IBF)?

   (Note: An IBF is a set of asset and liability accounts segregated on the books and records of a depository institution, United States branch or agency of a foreign bank, or an Edge or Agreement corporation that includes only IBF time deposits and IBF extensions of credit.)

3) Does the bank have any representative office(s)?

   If yes:
   - Indicate where the office(s) are located,
   - Provide the name and title of the person(s) responsible for each office, and
   - Provide a summary of the activities conducted by the office(s).

4) Does the bank maintain any foreign branches or subsidiaries, control a foreign organization, or have 20 percent or more of the organization's voting equity interests in a foreign organization?

   If yes:
   - What records and record keeping policies does the bank maintain to ensure compliance with the provisions of Section 347.116 of the FDIC Rules and Regulations?

FOREIGN BANKING ORGANIZATION (FBO)

5) Is the bank part of a FBO?

(Note: An FBO is a U.S. banking operation owned by a foreign banking organization. An FBO's operations may encompass a variety of banking and nonbanking activities conducted through subsidiaries, branches, agencies, or representative offices.)

If yes:

- Describe the organizational and ownership structure of the FBO.
- Summarize transactions or agreements of the FBO with its parent/controlling institution, and
  - o Include a list of transactions conducted with the parent institution (participations purchased, participations sold, fund transfers, etc.), including the volume and approximate number of transactions, dollar amount, and percentage of income derived from such transactions.
  - o Include a list of services provided to or received from the FBO (rental space, correspondent services, auditing, IT-related services, etc.).
  - o Indicate fees paid or received for services rendered.

PARALLEL BANKING ORGANIZATION (PBO)

6) Is the bank owned or controlled, directly or indirectly, by an individual, family or group of individuals that are closely associated in their business, or otherwise acting in concert, that also own/control at least one foreign banking institution?

If yes:

- Provide a list of all relationships and international affiliations within the PBO, and
- Summarize transactions or agreements with the international relationships or affiliates listed, including the volume and approximate number of transactions, dollar amount, and percentage of income derived from such transactions.

7) Do any bank insiders, as defined by Regulation O, have cross-border related interests?

If yes:

- Describe the type of transactions between the bank and the related interests.

CORRESPONDENT BANKING

8) Does the bank have any foreign correspondent bank relationships?

If yes:

- Summarize the nature of the relationships and services offered (clearings, deposits, loans, trade financing, etc.), and
- Describe the due diligence conducted on each foreign correspondent.

COUNTRY EXPOSURE

9) Does the bank's present or future business strategy include cross-border lending or investment activities, in particular with emerging markets and other notable countries and regions?

If yes:

- Describe the bank's systems and controls over their country exposure, and
- Describe the process management uses to monitor economic and political situations in countries where the bank has exposure (either directly or through NRA relationships).

10) Does the bank file FFIEC Form 009 and/or Treasury International Capital (TIC) forms?

FOREIGN DEPOSITS

11) Does the bank accept foreign deposits?

If yes:

- Describe the bank's foreign deposit gathering activities or programs.

12) Are deposits referred to the bank by affiliates or other related foreign organizations?

If yes:

- Describe the process of how deposit accounts are referred by affiliates or related foreign organizations.

13) Does the bank use independent agents to acquire foreign deposits?

If yes:

- Describe how foreign deposit accounts are acquired through independent agents, and indicate if a fee is paid for deposit referral services.

GENERAL INSTRUCTIONS

These instructions provide general guidance for conducting field investigations and preparing the Report of Investigation (ROI). Since each application has unique characteristics and often involves special circumstances, examiners should consult the references below and discuss issues or questions with the appropriate Case Manager. The examiner should look beyond the surface of the proposal and address the likelihood of success or failure. The final report should be comprehensive, well supported, and address any atypical attributes.

REFERENCES

Use the following reference material in preparing the ROI:

- The instructions contained herein
- Statement of Policy on Applications for Deposit Insurance (SOP)
- FDIC Rules and Regulations Part 303, Subpart B, Deposit Insurance, and Federal Deposit Insurance Act sections 5 and 6
- Section 19 of the FDI Act and the Statement of Policy for Section 19 of the FDI Act
- Statement of Policy Regarding use of Offering Circulars in Connection with Public Distribution of Bank Securities
- Statement of Policy on the National Historic Preservation Act of 1966
- Applicable State Statutes and Regulations
- Case Managers Procedures Manual
- DSC Manual of Examination Policies
- Examination Documentation (ED) Modules
- Electronic Data Processing Examination Handbook
- Outstanding Applications memoranda and directives
- Questions and Answers on Stock Benefit Plans
- Division of Insurance and Research (DIR) – Statistics on Depository Institutions
- Uniform Bank Performance Report (UBPR)
- DSC and Risk Management & Applications Section Websites

APPLICATION PROCESSING

The FDIC is responsible for approving or denying all applications for deposit insurance, regardless of the type of institution or fund affiliation. In addition to proposed state nonmember banks, mutual savings banks, and industrial banks, the FDIC acts on any application for deposit insurance from a proposed national bank, member bank, district bank, trust company, Federal or State savings association, or savings and loan. Applications for de novo institutions are filed with the chartering authority and the FDIC using the *Interagency Charter and Federal Deposit Insurance Application*. To ensure interagency applications go smoothly, examiners should contact the chartering agency as soon as possible to coordinate a joint field investigation and reduce regulatory burden.

Generally, examiners should attend any pre-filing or other meetings held by the chartering agency with the applicant. Application processing timelines vary among the banking agencies, therefore close coordination with the chartering agency is necessary. Duplication of work should be avoided such as conducting background checks on proposed officers and directors. Normally, in an application for a thrift or national bank charter, the OTS or OCC conduct the background checks.

REPORT OF INVESTIGATION PROCEDURES

Reports of Investigation often vary in content and structure and emphasis should be placed on producing a well-conceived final product rather than following any strict format. The Statement of Policy on Applications for Deposit Insurance (SOP) is the primary source document for the factors that should be considered during the investigation. These guidelines are designed to assure uniform and fair treatment to all applicants.

Examiners should review the entire application and business plan to identify potential problems, incomplete or inconsistent information, areas of non-compliance with the SOP and/or Federal and State banking statutes, and any other factors which will require additional attention. It is important to identify, early on in the process, any concerns that will require significant attention to ensure that they do not delay the timely processing of the report. Subject Matter Experts in areas such as Consumer Compliance, Information Systems, Trust, Capital Markets, and Specialized Lending should be involved in the investigation when deemed necessary to adequately assess a proposal.

Examiners should be aware that proposals not conforming to the SOP are not delegated to the Regional Office and will be forward to the Washington Office for final action. Further, applications involving foreign ownership of 25% or more (foreign ownership includes ownership by a foreign non-banking entity, a foreign bank, or person who is not a citizen of the United States) are also forward to the Washington Office for final action.

After a thorough review and Regional Office concurrence, examiners should contact the organizers to discuss the specific issues and request any additional information. The examiner should hold a board meeting with proposed directors and senior officers. At a minimum, the meeting should include a discussion of the FDIC's expectations regarding director supervision, conduct and ethics. A sample agenda with suggested topics is found in Appendix A. The organizers and proposed directors should be individually interviewed to determine the extent of their understanding of the responsibilities they are taking on as directors, their abilities to execute the business plan and their commitment to the proposed bank. A sample Management/Director Interview form is found in Appendix A.

Examiners should not discuss the probable outcome of the investigation with the applicants.

STATUTORY FACTORS

Sections 5 and 6 of the FDI Act specifically deal with the granting of deposit insurance. Section 6 identifies seven statutory factors that must be considered by the FDIC in determining the merits of an application. Those factors include:

1. Financial history and condition;
2. Adequacy of capital;
3. Future earnings prospects;
4. General character of management;
5. Risk presented to the insurance fund;
6. Convenience and needs of the community;
7. Consistency of corporate powers.

The Report of Investigation should detail the relevant facts pertinent to each of the statutory factors and state the examiner's opinion as to whether the criteria under each area has been met. Findings of Favorable Subject to the Imposition of Conditions are permissible if the reasons for such a finding are clearly supported. Narrative comments should fully support any negative finding and when possible, identify any corrective action that, if taken, would favorably resolve the concerns. Examples could be issues such as finalizing blanket bond coverage, obtaining an appraisal on the premises, finalizing stock sale, etc.

While all factors are important and must receive a favorable finding, the FDIC considers Management and Capital as being the two most important factors. The Investigation Report Conclusions and Recommendations page should include a description of the proposal, a summary of each factor, and an overall recommendation relative to the granting of insurance.

MISCELLANEOUS REPORT ISSUES

Generally, the public may inspect the non-confidential portions of an application. While the burden is on the applicant to request confidential treatment of certain application material, the following areas are generally considered confidential:

1. Personal information, the release of which would constitute a clearly unwarranted invasion of privacy;
2. Commercial or financial information, the disclosure of which would result in substantial competitive harm to the submitter; and
3. Information the disclosure of which could seriously affect the financial condition of any depository institution.

The public may obtain photocopies of non-confidential material through a Freedom of Information Act request and by an oral or written request to the Regional Office.

Financial numbers are rounded to the nearest thousand.

COVER – REPORT OF INVESTIGATION

Insert complete name of proposed bank, city, county, and state.

Insert Region, EIC, and type of charter.

- Date investigation commenced would be the date review began in the field office.
- Investigation closed date is date the report was mailed to Regional Office.
- Date of application is obtained from the application.
- Date application accepted is found on ViSION's Application Tracking (AT).

TABLE OF CONTENTS

The table of contents identifies the three major report sections: Conclusions and Recommendations; Assessment; and Other Information. Completion of all pages is mandatory. Examiners may create and add pages under each factor if it supports their conclusions and recommendations.

INVESTIGATION REPORT CONCLUSIONS AND RECOMMENDATIONS

This page should summarize the proposal with enough details to give the reader a complete understanding of the transaction. The investigating examiner should provide a brief summary of the proposed business plan under the "Description of the Transaction" heading. Each statutory factor and finding of Favorable, Unfavorable, or Favorable Subject to Conditions should also be summarized. The investigating examiner should conclude with an overall recommendation.

FINANCIAL HISTORY AND CONDITION

Generally, proposed financial institutions have no financial history to serve as a basis for determining qualification for deposit insurance. Therefore, the primary areas of consideration under this factor are the reasonableness of asset and liability projections and composition in relation to the proposed market, the level of investment in fixed assets, the ability of insiders to provide financial support to the institution, terms upon which transactions with insiders are granted, and whether adequate disclosure of insider transactions has been made.

- Assess the applicant's projected asset and deposit mix for reasonableness and as compared to the proposed business plan and an appropriate peer group.

- Using the financial statements contained in the business plan, construct the projected balance sheet for the first three years of operation. Discuss with the applicant, significant differences between the proposal's projections and yours. If necessary, the applicant should revise the projections. Projections that are not reasonable or unsupportable should lead to an unfavorable finding.

- Total direct and indirect fixed asset investment (including leases) should be reasonable in relation to projected earnings capacity and capital levels. A brief review should determine if the figures provided by the proponents are reasonable with regard to anticipated need and cost. Fixed asset schedules from other newly formed institutions can be used as a point of reference. Compliance with State law should be considered since most states impose a statutory limit on fixed asset investment relative to either capital or total assets.

- When real estate is to be purchased and a building constructed, the investigating examiner should review the cost of the land, estimated construction costs, the identity of the seller and general contractor, completeness of the title policy, and terms of any financing obtained. Part 323 of the FDIC Rules and Regulations is applicable to the purchase of real property, including leaseholds, and a qualifying appraisal is usually required. For leased premises, the terms and reasonableness of the lease should be discussed. Applicants are generally cautioned against purchasing any fixed assets or entering into any non-cancelable construction contracts, lease or other binding arrangements related to the proposal unless and until the FDIC approves the application.

- Any time assets are purchased or leased from insiders or when insiders are involved in providing contracted services, the transactions should be supported by an independent appraisal or competitive bid process. The organizers must substantiate that any transaction with an insider is made on substantially the same terms as those prevailing for comparable transactions with non-insiders and do not involve more than a normal degree of risk. Such transactions must be intended for the benefit of the institution and not entered into as an accommodation to the insider. All such transactions must also be approved in advance by a majority of the incorporators and fully disclosed to all proposed directors and shareholders.

- Organizers, including an affiliated holding company, must demonstrate the ability to provide on-going financial support. Analyzing the ability of the proponents to raise additional capital is important since new banks (operating at a loss) will often experience difficulty in attracting capital from outside sources. Analysis of this will be primarily dependent upon the financial statements submitted by the proponents or Uniform Bank Holding Company Reports when a holding company is involved. If reasonable, consideration should be given to the ability of the proponents to raise additional funds through the capital markets or the local community.

- Assess compliance with the security requirements of Part 326 of the FDIC Rules and Regulations.

- Assess compliance with the National Environmental Policy Act of 1969. The FDIC is responsible for making a determination whether certain decisions made by it constitute "major Federal actions significantly affecting the quality of the human environment" under this Act. Granting of approval for deposit insurance seldom constitutes a significant action requiring an environmental impact statement, but a threshold determination as to the probable effect upon the human environment must be made under the statute. The environmental factors to be considered include: (a) compliance with local zoning laws; (b) location; (c) traffic patterns including the adequacy of roads, parking places and traffic congestion; and (d) any favorable impact such as possible decrease in pollution or fuel consumption.

Compliance with zoning laws is generally the key determining factor for the FDIC since courts have ruled that compliance is an assurance that such environmental effects will be no greater than demanded by the residents acting through their elected representatives.

- Section 106 of the National Historic Preservation Act (NHPA) requires that a Federal agency having authority to license any undertaking shall, prior to issuing any license, take into account the effect of the undertaking on any district, site, building, structure, or object that is included in, or eligible for inclusion in, the National Register of Historic Places (National Register).

  At the time of filing an application for Federal deposit insurance, the proponents should have already been in contact with the appropriate State Historic Preservation Officer (SHPO) regarding whether the proposed main office (as well as any branch office) site is an historic property - that is, listed in, or eligible for listing in, the National Register. The FDIC generally relies on the SHPO's opinion regarding whether the proposed office site is historic and, if it is, what effect the Federal deposit insurance proposal will have on the property. If it is determined that the proposal will have an adverse effect on an historic property, then the FDIC (usually the RO staff) must work with the proponents, the SHPO, other consulting parties, and, in some cases, the Advisory Council, to develop and evaluate alternatives or modifications to the undertaking that could avoid, minimize, or mitigate the adverse effect.

  It is very important that the examiner advise the proponents that absolutely no site preparation work should be initiated until SHPO has been consulted and a determination has been made regarding whether the proposed office site is historic and, if it is, what effect the proposal will have on the historic property.

  For Federal deposit insurance applications that involve establishment of a new national bank or thrift, for which a charter application has been filed with the OCC or OTS, the FDIC may not have to determine whether the proposed office site is historic and how the proposal will affect an historic property, if the primary Federal regulator has assumed this responsibility. The examiner or the Case Manager should contact their counterparts at the Federal chartering authority in order to ascertain which agency will be responsible for complying with the requirements of the NHPA.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

ADEQUACY OF THE CAPITAL STRUCTURE

Normally, initial capital of a proposed institution should be sufficient to provide a Tier 1 capital to assets leverage ratio of at least 8% throughout the first three years of operation. In addition, the institution must maintain an adequate allowance for loan and lease losses. This means that the proposed institution **can not** inject the capital as it grows. Opening day capital must be sufficient to maintain at least an 8% Tier 1 Leverage ratio based on the three-year projections. Exceptions apply to new institutions formed by an eligible holding company (See section 303.22).

The adequacy of capital is closely related to the new bank's risk appetite, its deposit volume, fixed assets, and anticipated growth. Deposit projections made by the applicant must be fully supported and documented. Projections should be based on identifiable patterns in the target market. Special purpose institutions (such as credit card banks) should provide initial capital commensurate with the type of business to be conducted and the potential for growth of that business. Additional discussion of unique capital proposals such as contribution of in-kind capital as part of initial capitalization, and capital adequacy of new institutions organized to facilitate and carry on an existing business line is presented below. Examiners are reminded that these types of proposals and others presenting a higher risk profile may warrant a leverage capital ratio greater than 8%.

- Using capital data contained in the application, construct the Proposed Capital Structure table.
    - “Minimum Statutory Requirements” line should include any minimum capital required by the chartering agency.
    - “Amount indicated on Application” should reflect capital allocations shown in the application excluding any adjustments made by the examiner. All components of this line should be based on applicant’s projections.
    - “Revised Proposal” line is used only when the organizers present a revised capital proposal.
    - “Recommendation of Examiner” line may or may not be the same as applicant’s proposal; however, it must agree with final projections used throughout the report.
    - “Retained Earnings” column is the cumulative 3-year net income.
    - “Third Year Average Assets” column comes from the business plan projections and examiner’s estimates.

- The examiner should assess the deposit forecasts and make any necessary adjustments. The proponents should have a good feel for the deposit potential of their market. However, if growth projections are inconsistent with the size of the market, with current economic conditions, or with the overall business plan, adjustments should be made along with the examiner’s rationale. Examiners could consult any number of sources including the Uniform Bank Performance Report and DIR’s Statistics on Depository Institutions, for supporting data.

- If available, review the stock offering circular, stock solicitation material and related documents. The Washington Office’s Registration, Disclosure and Securities Operations Unit normally reviews both private and public offering materials and is available for assistance. All stock of the same class should be offered at the same price, and have the same voting rights. Arrangements that give insiders greater rights or more favorable pricing are not acceptable. A price disparity may allow organizers to gain control disproportionate to their investment and may promote excessive risk taking. In addition, such arrangements are analogous to compensating or paying a fee to organizers solely for their efforts in establishing the institution. Stock price disparities may also be used to hide excessive reimbursement to organizers. Another example of price disparity is offering stock warrants to investors who purchase a large volume of shares in the stock offering. Closely assess the appropriateness of stock offerings that award incorporators warrants to acquire additional shares. Stock warrants to insiders or investors that are beyond the guidance contained under the management factor of the SOP are not acceptable.

- If the institution is being established as a wholly owned subsidiary of an eligible holding company (as defined in part 303, subpart B) consider the financial resources of the parent organization in assessing the adequacy of the initial capital. In some cases, DSC may find favorably with respect to the capital factor when initial capital is sufficient to provide a Tier 1 leverage capital ratio of at least 8% at the end of the first year of operation, based on a realistic business plan, or initial capital meets the $2 million minimum standard set in the SOP, or any minimum standards established by the chartering authority, whichever is greater. The holding company must also provide a written commitment to maintain the Tier 1 leverage ratio at no less than 8% throughout the first three years of operation.

- Stock financing arrangements by proposed officers, directors, and 10% shareholders should be carefully reviewed. Financing arrangements are only acceptable if the investor can clearly demonstrate the ability to service the debt without undue reliance on dividends or other forms of compensation from the new institution. Normally the direct or indirect financing of 75% or more of the purchase price by an individual or the financing of 50% of the purchase price by all insiders in the aggregate will require supporting justification. Ensure that the applicant bank did not agree to maintain compensating balances with the lender in order to procure financing. Also, the proponents should be made aware that such loans can not be refinanced by the applicant bank.

- Watch for voting trust arrangements. Generally, these agreements are discouraged in new banks because of control issues (insiders gaining control disproportionate to their investment), but are not prohibited per se. Review the agreements for any unfavorable features, such as control issues, or hampering sale of additional stock. Examiners should consult with the case manager and/or a regional attorney to obtain additional guidance.

- The stock subscription list should be reviewed to ensure that control issues have been identified and resolved, and to determine the likelihood of a successful offering.

- Cash dividends during the first three years of operation should only be paid from cumulative net operating income and only after an appropriate allowance for loan and lease loss has been established and overall capital is adequate.

Unique capital proposals and capital for institutions organized to facilitate and carry on existing business lines.

The SOP is silent on the issue of organizing an institution with in-kind capital. Likewise, it does not address how the FDIC will assess proposals that entail a new institution organized to facilitate and carry on an existing business line. Nonetheless, the FDIC has been presented with applications containing both proposals. In-kind capital contributions have been in several forms including, but not limited to, real estate, fixed assets, loans, leases, and mortgage banking operations. Existing business lines proposed in prior applications included equipment lease financing, credit card operations, and mortgage banking operations. These proposals present unique risks deserving close scrutiny. Examiners should also evaluate possible 23A and 23B implications and limitation from Part 325 capital calculation. The following points address prior instances where in-kind capital and existing business lines were part of applications.

- In applications where the FDIC will not be the primary regulator, the examiner should participate in the primary regulator's investigation.

- When loans or leases are proposed to be contributed as initial capital, the examiner should conduct a review of the loans and leases comparable to that completed during a traditional safety and soundness examination in order to assess asset quality. The sample should be large enough to assess loan or lease mix, underwriting standards, valuation and residual values, and proper documentation. Valuations should be supported by proper market value analysis such as discounted cash flow analysis. The examiner should strive to obtain an independent physical inspection of the assets in the sample. In lieu of a physical inspection, the examiner may rely on an independent audit confirmation of the assets in question.

- Tangible assets such as real estate and fixed assets contributed as part of initial capital present two main questions: valuation and insider involvement.

    - In the case of real estate, organizers must have an independent appraisal performed by certified or licensed appraisers (see Part 323 of the FDIC Rules and Regulations). The appraisal should conform to generally accepted appraisal standards and arrive at a fair market value. Fixed asset values should be supported by independent market valuations performed by experienced appraisers. Review the appropriateness of scheduled depreciation. A longer than normal depreciation period could overstate book value and earnings. Total fixed asset investment must also conform to State limitations.

    - Transactions involving organizers, directors, officers, or principal shareholders (insiders) should be closely reviewed to determine fairness and proper disclosure. For example, a contribution of bank premises under construction by an insider or related interest should not contain unfavorable features. Proper disclosure to other shareholders, written construction contracts based on a competitive bid process, and independent appraisals should be required.

    - In-kind capital contributions may be proposed in the form of the market value of an existing business such as a mortgage company. Proposals such as this should be fully supported by at least two appraisals of the company's fair market value. Examiners should ensure that the appraisals are independent, current (within 6 months) and based on recognized valuation methods.

Proposals for new institutions organized to facilitate and carry on an existing business line also provide special capital considerations. Contribution of the business as initial capital may or may not be a part of the proposal; however, recent cases have contained both. These include:

- An institution organized with a leasing company to provide equipment lease financing.
- An institution partly capitalized with seasoned auto loans, specializing in direct purchase of dealer-originated auto loans and from an affiliate credit finance company.
- An institution formed by an energy company, capitalized with in-kind contribution of consumer loans and will specialize in providing loans for energy-related home improvements.
- An institution formed by a farm equipment retailer to acquire its credit card receivables and continue origination and servicing company branded credit cards.
- An institution formed by a company that provides capital lease financing for small to medium sized businesses over the Internet. New bank to provide retail funding and lease financing.

Examiners should look to the prior performance of the business and the character of the management continuing on with the institution. The management group should be sufficient to satisfy the management factor. The business line should be financial in nature, and not expose the institution to undue risk. The business plan should be reasonable and the projections should be well supported by historical performance and sound analysis. Examiners should use all available information such as Dun & Bradstreet reports, SEC filings, independent audit reports, public recordings, and credit rating agency reports to verify data. If deemed necessary, an on-site visit to review the existing business' operations should be conducted.

When assets are proposed to be contributed as capital or purchased from organizing group or affiliate, values should be supported by independent appraisals. Asset quality should be assessed the same way credit reviews are conducted, i.e. sample by risk, volume, delinquency, underwriting, etc (refer to ED risk focus modules). If the business has not had a recent audit, or credit or collateral documentation is not complete, an independent verification or inspection of assets should be obtained.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

EARNINGS PROSPECTS

Construct the "Estimated Income and Expense", and the "Estimated Average Deposits and Average Earning Assets" schedules using the financial statements contained in the Business Plan.

The examiner should determine whether the proposed bank is likely to be profitable within a reasonable period of time, usually three years. The main concern is whether the applicant's projections are realistic and supportable. The earnings should be sufficient to provide an adequate profit. When projections are not reasonable or deficiencies are material, revisions should be requested from the proponents. Examiner-derived estimates can be incorporated into the report; however, comments should clearly address the differences between the examiner's estimates and those of the organizers. Common shortcomings in projections include, but are not limited to:

- Unreasonable earning asset yields
- Unreasonable interest expense factors
- Overstated earnings factors (NIM, ROAA)
- Underestimating data processing costs
- Understated overhead costs
- Inadequate loan loss provisions
- Failure to write-off organizational expenses during the first year of operations

Items to be considered include projected loan growth relative to other new banks and that of competing institutions, likely structure of the deposit base, investment objectives, estimated asset and liability mix, reasonable noninterest income, and probable provision expense. Consideration should also be given to ensure consistency with other projections such as deposit growth and personnel expense. Projections and assumptions should be consistent with the overall business plan.

The UBPR generally provides sufficient data to assess the line items contained in the projections. Financial data from recently formed institutions should prove to be the most beneficial. Peer data is also available for all new banks established within three years and under $50 million in assets. Peer data for established community banks also warrants review especially when serving the same general area or market niche. Examiners should be aware that using peer ratios of established banks might result in some differences since new banks generally have a larger percentage of assets funded by capital. This results in higher margins during the early years. Examiner's selection and use of Peer data should be fully discussed and supported.

Loan loss provisions should be closely reviewed. Niche or special purpose banks that engage in higher risk lending, such as subprime loans and high loan to value lending, should fully support their loan loss reserve methodology, estimated losses and provisions. The methodology should account for replenishing the reserve to an adequate level after charge-offs.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

GENERAL CHARACTER OF MANAGEMENT

Management is often the most important factor. Although the SOP indicates that evidence should support a management rating tantamount to a "2" rating or better under the Uniform Bank Rating System, this is somewhat difficult to determine without an operating record as a management team. As a result, the assessment of management should center on an evaluation of the individual's background in relation to their proposed duties and responsibilities. Consideration should be given to the following:

- Financial institution experience
- Other business experience
- Personal and professional financial responsibility
- Reputation for honesty and integrity; and
- Familiarity with the economy, banking needs, and general character of the community in which the bank will operate.

Examiners should provide an overall assessment of the management team and board of directors on the General Character of Management page. Address each proposed officers and directors' qualification on the biographical section of the report. Comments should also include any prior experience that may reflect positively or negatively on the individual, any serious business failures or compromising of debts and length of residence in the community or trade area. All entities in which the proposed officer or director has a financial or other significant interest should also be identified.

The examiner should normally conduct personal interviews with all of the organizers, senior management, and directors. Any pertinent information derived should be included with the individual's biographical information. Current and former employers may also be contacted unless a prospective officer raises a valid objection (current employers may not know officer is seeking other employment and contacting them may cause the officer harm). Prior employer's concerns over privacy laws, however, may prevent them from divulging much information. At a minimum, a former employer should be able to tell you the individual's title, and whether the individual is eligible for rehire.

The biographical and financial information (FDIC 3064-0006, Interagency Biographical Financial Report) submitted as part of the application serves as the primary tool in assessing financial standing and responsibility. All questions should be answered and fully supported. These forms should disclose any prior bankruptcies or the compromise of any debt. The forms should also include information on contingent liabilities, civil litigation, prior criminal convictions, administrative proceedings, and other matters involving a breach of trust.

A section 19 application will be necessary if an employee, officer, director, controlling shareholder or Institution Affiliated Party has been convicted of a criminal offense involving dishonesty or breach of trust, money laundering or has entered into a pretrial diversion in connection with a prosecution of such an offense. The Applicant must obtain the FDIC's written consent under section 19 of the FDI Act before any such person may serve in one or more of those capacities.

Significant assets in the form of closely held corporations, partnerships, or sole proprietorships should be supported by detailed financial statements on these entities. Net equity positions should be reviewed to determine the reasonableness of the carrying value and the potential impact of related debt. In addition, if an individual's financial standing is largely dependent upon appreciated value of real estate or closely held companies, the basis for valuation of the assets should be sought.

For state nonmember charters, background checks are normally requested by the Regional Office and if necessary and available, forwarded to field personnel for review during preparation of the investigation report. Such information provides an independent, third party check that can be used to verify the applicant's stated financial position, credit history, and confirm the absence of public filings and judgements. Liens, lawsuits, wage assignments, defaults, and public filings such as bankruptcies and judgements will be shown. The major credit reporting agencies also provide an additional service that automatically alerts the requester to possible false social security numbers and high risk addresses such as post office boxes, and multiple business addresses.

If necessary, additional information can be requested through the Regional Office, including Nexis/Lexis. These systems feature searches that can be conducted by key words or names. Nexis provides access to numerous news service publications and Lexis allows for a search of legal databases containing final case law from Federal and State courts. Finalized civil and criminal proceedings as well as bankruptcy cases are listed. Also, a background check can include a search of State Corporation Commission records, Dun & Bradstreet, and county and other State records. The Federal Reserve also maintains information on international and foreign companies.

Be cautious of bank ownership that is restricted to a single individual or entity, or a small group of individuals who lack broad-based financial strength. Also identify any proposed directors that have little or no prior financial institution experience, minimal financial interest in the proposal, or are poorly equipped to contribute to policy formation or adequate supervision. Determine whether senior officers lack necessary experience, or have not served in senior management positions, which provide adequate insight into proposed roles. The SOP requires at least a five-member board of directors. At a minimum, an even mix of directors with and without banking experience is preferred. The proposed board should provide for officer/director continuing education, and a management succession plan.

The SOP requires that the proposed full-time chief executive officer be made known to the FDIC. If the proposed CEO has not served in a similar capacity, it is important to determine whether the individual has the technical competence to fulfill the responsibilities of the position. Further, the proposed CEO's expertise and experience should correlate with the proposed business plan. Knowledge of such areas as lending and investments, interest rate risk management, internal controls, and bank regulations should be considered.

The proposed operating policies and strategic plan should be reviewed in assessing management. Inadequate policies may be an indication of a weak management team. Written investment, loan, funds management, and liquidity policies should be reviewed and comments should be made regarding their soundness and acceptability. The CEO is also expected to be a qualified and experienced lending officer. If not, an explanation should be provided and the name of the proposed chief lending officer should be furnished.

While conditional approval can be granted prior to the selection of a chief executive officer or primary lender, this is allowable in only very limited circumstances. An example is where the new bank will be owned by an "eligible holding company" as defined in section 303.22 of the FDIC's regulations. Ultimately, prior to opening, these individuals should be identified and their abilities assessed. Any changes in the directorate, active management, or 10% shareholders prior to the bank's opening must also be disclosed to the FDIC in writing.

When it appears that an unfavorable ruling will be made regarding an individual's qualifications or fitness to serve, the examiner should consult with the responsible Case Manager. The examiner should thoroughly support any negative assessment by:

- Conducting an adequate investigation into the individual's qualifications;
- With the concurrence of the Case Manager, give the individual the chance in an interview or letter to respond to any objections raised;
- Checking any files to which the FDIC has access before making an adverse determination regarding the individual;
- To the extent possible, attempting to locate documentary evidence rather than relying on oral opinions.

All information relied upon should be maintained. When information is obtained from an outside source, every effort should be made to obtain such information in writing and verify through a secondary source.

Organizational expenses should be reviewed for reasonableness. Prudent management would not commit a bank to excessive expenses, the existence of which may be indicative of a management deficiency, even if the fees or costs were approved by formal action of the incorporating shareholders. This applies to all costs, organizational expenses, and legal fees. Identify and assess the source of funding; start-up cash, personal or bank loans.

Review expenses for professional or other services rendered by insiders for any indication of self-dealing to the detriment of the institution or its shareholders. The FDIC expects full disclosure to all directors and shareholders of any arrangement with an insider.

Employment agreements should be reviewed to ensure that the contracts limit severance pay to a duration of one year. Under Part 359 - Golden Parachutes, severance payments are limited to one year in the case of troubled institutions. While not applicable to non-troubled institutions, the one-year guideline should be used as a benchmark. Section 359.1(f)(2)(v) states payments pursuant to a nondiscriminatory severance plan should not exceed the base compensation during the twelve months immediately preceding termination. Employment contracts that contain severance payments exceeding one year of compensation should be assessed for appropriateness and supported by extraordinary factors.

Stock Options and Warrants

Organizers/incorporators (incorporators) may propose establishing stock benefit plans, including stock options, stock warrants, and similar stock based compensation plans. Participants may include officers as well as directors, although the FDIC anticipates that such plans will focus primarily on active officers. Stock benefit plans may also be established to compensate incorporators who place funds at risk to finance the organization or who provide professional or other services during the organizational phase. Stock option/warrant plans are also found in both private and public stock offering material.

Management stability is generally an essential element for the ultimate success of a de novo institution. Therefore, the structure of the stock benefit plans, whether available to active management or incorporators, should encourage the continued involvement of the participants and serve as an incentive for the successful operation of the institution. Satisfactory management should not commit the bank, directly or indirectly, to plans that result in excessive compensation to insiders, place undue incentives on short-term performance (at the potential expense of long-term safety and soundness), or present other unfavorable features.

The SOP describes features that are required in order for stock benefit plans to be deemed acceptable, and sets forth certain unacceptable features. In considering whether stock benefit plans are acceptable, each case should be reviewed independently. Stock benefit plans involving only a nominal percentage of ownership in the proposed institution need not be subjected to in-depth scrutiny.

Guidance provided in the SOP distinguishes between two types of award plans:

1. Options/warrants granted to directors and active management to reward future performance. (Type 1)
2. Options/warrants granted to incorporators as compensation for financial risk borne during the organizational phases or as compensation for professional or other services rendered in conjunction with the organization. (Type 2)

Type 1 plans for active directors and officers must include the following provisions and should be reviewed as part of the total compensation package:

- disclosure,
- duration limits (maximum 10 years),
- vesting requirements (generally, a minimum of three years, in equal amounts),
- transferability restrictions (not transferable),
- exercise price requirements (not less than fair market value at time of grant),
- rights upon termination (expire within a reasonable time), and
- an "exercise or forfeiture" clause (in the event capital falls below regulatory minimums).

Examiners should refer to FASB Statement No. 123, “Accounting for Stock-based Compensation”, which provides guidance on calculating fair market value of stock options.

Type 2 plans do not require vesting, transferability restrictions, or continued association with the institution, but would require equal restrictions regarding disclosure, duration limits, strike price requirements, and an "exercise or forfeiture" clause.

Type 2 plans for incorporators not continuing as directors or officers should serve as compensation for services rendered or "seed" money placed at risk. Typically, it is the latter since professional services (accounting, legal, etc.) are normally paid for in cash. Incorporators often receive a proportional amount of stock after the bank is established as "repayment" of their initial financial contribution. In addition to stock acquired in this manner, incorporators may also receive some proportional volume of stock options/warrants as compensation for financial risk borne during the organizational phase of the bank.

The following summarizes the plan types:

Type 1 Plans

- **Directors and officers who are not incorporators** may participate in prospective management incentive plans. Such plans should be reviewed as part of the total compensation package offered to the individuals involved.

- **Incorporators who are also directors and officers** are allowed to receive a maximum of one option/warrant for each share of stock for which they subscribed in the initial offering. An incorporator who will also be a senior executive officer may receive additional options as part of a prospective management incentive plan. The volume of additional options/warrants proposed beyond that based on stock subscribed should be reviewed for reasonableness on a case-by-case basis, giving consideration to the individual's financial commitment, time, expertise, and continuing involvement in the management of the proposed institution.

Type 2 Plans

- **Incorporators who are not continuing as directors or officers** are allowed to receive a maximum of one option/warrant per share received for "repayment" of seed money and do not qualify for options/warrants based on additional stock subscribed beyond that which is a return of seed money.

- **Incorporators who are not continuing as directors or officers** who agree to accept shares of bank stock as payment for professional services (which otherwise would have been purchased from non-insiders) are also allowed to receive a maximum of one option/warrant for each share received as payment for professional services. The value of such professional services should be supported by proper documentation.

RED FLAGS. Stock appreciation rights, phantom stock, and other similar plans that include a cash payment to the recipient based directly on the market value of the depository institution's stock are unacceptable. These plans have the potential of removing an undetermined amount of cash from the bank's capital accounts, in contrast to option plans that provide an infusion. Under a cash-less exercise of options plan, a broker lends funds to exercise the options and immediately sells the shares to repay the loan. This discourages insiders from retaining the stock and having an on-going stake in the bank. Further, the bank should not be assuming responsibility for paying any of the taxes associated with exercise of the options. These types of options are objectionable in the formative years of a new bank when there is often a need to preserve capital during a period of rapid growth and operating losses.

If the proposal involves the formation of a de novo holding company and a stock benefit plan is being proposed at the holding company level, that plan will be reviewed by the FDIC in the same manner as a plan involving stock issued by the proposed institution. Many de novo banks are organized as subsidiaries of a bank holding company whose only substantive function is to own the stock of the proposed bank. If the FDIC did not assert its right to set standards on stock benefit plans sponsored by de novo shell holding companies organized to sponsor new banks, the FDIC would in essence be giving up its ability to review stock benefit plans in new banks since the agency's requirements could easily be avoided by organizing a bank holding company.

The FDIC does not assert the right to regulate stock benefit plans for *operating* holding companies or holding companies with other material businesses. Additionally, the above criteria relating to stock benefit plans should not be applied to operating institutions but rather only to de novo institutions.

Finally, the following documents provide good guidance and resource on the subject of stock options; Fairmark Press Tax Guide for Investors http://www.fairmark.com/execcomp the Foundation for Enterprise Development http://www.fed.org and the National Center for Employee Ownership http://www.nceo.org .

Fidelity bond coverage and excess employee dishonesty bond coverage should equal or exceed $1 million if the primary blanket bond is less. It is helpful if a binder or commitment letter is obtained; however, approval may be conditioned upon acquisition of adequate coverage prior to opening.

Applicants are expected to commit to obtain an opinion audit by an independent public accountant annually for at least the first three years. The requirement for an external audit is a standard condition of the FDI Order granting deposit insurance. When the applicant is owned by a holding company, a consolidated audit of the holding company will generally suffice.

The proposed management structure should be reviewed to ensure that no management interlocks exist as defined in Part 348 of the FDIC Rules and Regulations.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

RISK TO THE FUNDS

Assess the proposed institution’s business plan, particularly addressing any unsound activities, practices or other issues. Any high-risk activity to establish market share, attain growth, or provide for profitable operations should be discussed. Business plans that are not commensurate with management's capabilities, should be addressed here as well. Operating plans that rely on high risk lending, niche marketing or significant funding from sources other than core deposits or that diverge from conventional banking will require substantial documentation as to the suitability of the proposed activities. Extensive documentation will also be necessary when economic conditions are marginal. The business plan should demonstrate a reasonable ability to achieve sustainable market share, generate earnings, and attract and maintain adequate capital.

Industrial Loan Companies (ILC) and Special Purpose Banks (SPB)

Industrial loan companies and special purpose banks are unique in that neither are considered “banks” under the Bank Holding Company Act. As such, parent and affiliated entities are not regulated by Federal or State supervisory agencies.

Currently, states offering the ILC charter include California, Colorado, and Utah. The charters typically allow institutions to be organized and owned by commercial enterprises, including retailers and manufacturers. Special purpose banks can include credit card issuers organized under the Competitive Equality in Banking Act (CEBA) and trust companies. Because these charters allow institutions to export rates and terms, the formats can provide for a single platform from which to operate in all 50 states. The charters also provide access to the payment system and additional sources of funding.

However, the ILC charter also presents a potentially significant limiting factor that emanates from the stated intention of serving the working class within an institution’s defined market area. To encourage ILC’s to maintain this focus, institutions are prohibited from accepting demand deposits if total assets exceed $100 million, generally. Although not restricted by regulation, in practice, special purpose institutions might limit their deposit activities.

In general, ILC’s and special purpose banks limit their deposit activities to money center operations or brokered deposits; retail accounts might be limited to time deposits and accounts securing outstanding credit lines. In certain operations, including credit card and trust operations, deposit activities might be limited to a single account from the parent organization – a $500,000 deposit that, under the FDIC’s General Counsel’s Opinion, qualifies as “being in the business of accepting deposits.”

Regardless of the form of charter, ILC’s and special purpose charters present unique characteristics that must be fully considered during the investigation. As noted, these include the absence of a regulatory regime outside the insured entity and unique limitations or practical restraints on deposit activities. When coupled with the broad powers conferred, examiners must be particularly cautious in reviewing management competencies, corporate structures and relationships, and the underlying business plans.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

CONVENIENCE AND NEEDS OF THE COMMUNITY TO BE SERVED

Discussion of this factor should begin with a description of the primary trade area, including its location and population. A drive through the neighborhood surrounding the proposed location may be beneficial in determining the visibility, proximity to potential customers, accessibility, and immediate competition. A general discussion of land development in the immediate trade area may also be pertinent. Any differences between the examiner's perception of the trade area and that of the proponents should be discussed.

Also provide a general discussion of the relevant economic conditions, primary industries, and employers. Economic data should be limited to relevant information and relate a general understanding of the vitality and composition of the local economy. Population figures are particularly relevant (especially growth rates) and data establishing trends and projections should be provided if available. Several sources of economic data that provide insight into the economic conditions of the State, county or MSA are available. These include the Federal Reserve Quarterly Economic Review, the FDIC's statistical publications and databases, and other economic periodicals published by creditable sources.

Detail competition, both bank and non-bank, if applicable. Usually this is provided by the organizers, but driving through the surrounding area or consulting data that provides a summary of branches can be beneficial.

Finally, consider the services to be offered by the applicant and how they differ from those presently available including physical convenience. Consult with the responsible Case Manager to determine CRA requirements.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

CONSISTENCY OF CORPORATE POWERS

This factor was originally intended to eliminate institutions with broad-based charters that permitted the applicant to engage in unusual or risky forms of business. However, most states have issued statutes that preclude granting any powers inconsistent with the FDI Act. If any doubts exist, the Legal Division should be contacted. Pursuant to Section 24 of the FDI Act, no insured bank may engage in any activity that is not permissible for a national bank unless the FDIC has determined that the activity would not pose a significant risk to the fund and the institution is in compliance with applicable capital regulations. Applicants are also prohibited from exercising trust powers without the written approval of the FDIC; most States also require written approval.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

OTHER MATTERS

Currently, it is the responsibility of the examiner to evaluate the applicant's Articles of Incorporation and Corporate Bylaws. Of particular importance is a review of the director indemnification, to ensure that the agreements are not overly liberal. Liberal clauses, which include protection against gross negligence and fraud, should be closely scrutinized. The FDIC has taken the position that such broad agreements are not acceptable. With case manager concurrence, consult with a Regional Office attorney.

Review the offering circular when securities are to be offered to the public. The goal is to ensure that de novo financial institutions comply with the anti-fraud provisions of the Federal securities laws that require full and adequate disclosure. Flawed disclosures may expose the institution to litigation and serious capital loss. Refer to the FDIC Statement of Policy Regarding Use of Offering Circulars in Connection with Public Distribution of Bank Securities. The Washington Office's Registration, Disclosure and Securities Operations Unit normally reviews both private and public offering materials and is available for assistance.

The review should insure that the circular provides sufficient disclosure of all material facts. SEC Rule I Ob-5 makes it unlawful to employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact or to omit a material fact in connection with an offering of any security.

In most cases, when securities are offered to the public an attorney specializing in securities law is employed. This usually ensures that the basic disclosures are made.

Offering circulars may also disclose proposed stock option plans, employment agreements, and issuance of stock warrants that should be closely reviewed.

Officials of area depository institutions should be contacted during the investigation and given an opportunity to express their opinions regarding the application. Opinions of other business and community leaders may also prove beneficial. Any formal objections should be investigated and appropriate comments set forth in the report. Sole reliance upon the opinions of competitors should be avoided and impartial conclusions should be reached. A sample Community/Competition Interview form is found in Appendix A.

For applicant's proposing to deliver services over electronic channels, such as the Internet or wireless devices, the examiner should assess the information systems infrastructure, policies and security. An information systems subject matter expert should be required to participate in the investigation, depending on the complexity of the proposed delivery channel.

INVESTIGATION REPORT SUMMARY

Detail the applicant's designated contact person, including title, mailing address, email address, fax and phone number.

APPENDIX A

PROPONENTS/ORGANIZERS MEETING AGENDA SAMPLE

AND

MANAGEMENT/DIRECTOR INTERVIEW FORM

AND

COMMUNITY/COMPETITION INTERVIEW FORM

ANYWHERE BANK (PROPOSED)
MEETING WITH PROPONENTS
MAY 15, 2002

AGENDA

I. Opening Remarks

A. Acquaint Directors With Their Responsibilities and Liabilities
B. Apprise Organizers of Regulatory Involvement and Concerns

II. Directors Responsibilities

A. Sound, Independent Business Judgment
a. Candid, Open Discussion of Bank Business
b. Documentation of Decisions and Expression of Dissent Within the Board Minutes
c. Confidentiality and Integrity
B. Informed of All Facets of Bank, Operations, Regulatory Environment, Competitive Environment
a. Management, Reports, UBPRs
b. Report of Examination and Visitation
c. Internal and External Audit Reports
d. Trade Publications, Seminars, Meetings
C. Direct the Bank in a Prudent Manner
a. Establish goals, policies and strategies
b. Hire Suitable Management to Implement Goals
c. Monitor Management's Compliance with Board Directives
d. Discipline or Dismiss Management as Necessary
D. Build Business for the Bank
E. Ethical Conduct and Policy
a. Regulation O
b. Represent the Bank in Your Community

III. Director Liability

A. Can be Personally Liable for Losses Arising From
a. Legal lending Limit Violations
b. Insider Transactions
c. Bank Failures
B. Civil Money Penalties

C. Civil Suites (Shareholders) for Breaches of

a. Duty of Care
b. Duty of Knowledge
aa. Willful Ignorance is not a Defense Against Liability for Negligence
D. Board Minutes are Legal Record and Vehicle for Expressing Dissent

IV. Ongoing Regulatory Involvement

A. Pre-opening Visitation
B. New bank Visitation
C. Examinations
a. Safety and Soundness
b. IS/Other Specialty
c. Compliance

V. Why Banks Fail

A. Bad Loans – Poor underwriting, selection of risk, etc..
B. Poor Funds Management
C. Pursuit of Earnings with High-Risk Lending and Investment
D. Bad Management; Lack of Board Supervision

MANAGEMENT/DIRECTOR INTERVIEW FORM

Proposed Bank: ____

Location: ____

Director/Officer's Name: ______________________ Born:______________

Resident Of: ______________________________ Years: ______________

Principal Business: ____

# of Shares Subscribed:__________________ % of Subscription financed:__________

Stock Payment Method:____

Reasons for becoming a Director/Officer?: ______________________________

____

____

____

How associated with proposal?: ______________________________

____

____

____

Previous experience as financial institution Director/Officer (If yes, when and where): ____________

____

____

____

____

Why does community need this Bank?:______________________________

____

____

____

What strengths/contributions will you bring to Board/Bank?:__________________

____

____

____

How long have you known other Director/Officers?:__________________

____

____

____

Management/Director Interview Form
Page 2

Impressions of other proponents as individuals and as a working team?: ______________________________

Is any one proponent Dominant? Passive? :______________________________

How much loan/deposit business will you bring to the bank in the first year?:______________________________

Ever been denied credit for reasons of credit problems?:______________________________

Ever been indicted/convicted of a felony?:______________________________

Questions/Comments:______________________________

COMMUNITY/COMPETITION INTERVIEW QUESTIONNAIRE

Date:____________________

Interviewee Name:________________________
Location: _______________________________

Need for an additional bank?:____

Economy and outlook of the market/trade area?:____

Deposit growth in the market/trade area and at your institution?: _______________________________

Impressions and reputation of organizers/CEO?:____

Percentage of the market the new bank can expect to achieve?: _________________________________

Loan rates at your institution? (Ask for a loan rate schedule in order to compare):____________________

Deposit rates? (Ask for a deposit rate schedule): ____

Any official protest or objection to the proposal?:____

FDIC

Report of Investigation

THIS REPORT OF INVESTIGATION IS STRICTLY CONFIDENTIAL

BANK OF ANYTOWN

ANYTOWN **ANYCOUNTY** **ANYSTATE**

Regio
n: Any Region

harter:

Investigation Commenced:	11/30/2001	Date of Application:	09/25/2001
Investigation Closed:	02/06/2002	Date Application Accepted:	10/22/2001

FEDERAL DEPOSIT INSURANCE CORPORATION

FDIC 6510/10 (02-2002)

TABLE OF CONTENTS

This Report of Investigation consists of three major sections: Conclusions and Recommendations; Assessment; and Other Information. Investigating examiners should refer to the FDIC Statement of Policy on Applications for Deposit Insurance and Part 303 Subpart B – Deposit Insurance, of the Rules and Regulations for guidance. In considering applications for deposit insurance for a proposed depository institution, the FDIC must evaluate each application in relation to the factors prescribed in section 6 of the FDI Act. In general, the application will receive deposit insurance if all the statutory factors plus the considerations required by the National Historic Preservation Act and the National Environmental Policy Act of 1969 are resolved favorably.

CONCLUSIONS AND RECOMMENDATIONS

ASSESSMENT

OTHER

INVESTIGATION REPORT CONCLUSIONS AND RECOMMENDATIONS

Description of the Transaction

Applicant is a Federally chartered National Association in organization and as such, has no financial history. Proponent *originally* applied to the Office of the Comptroller of the Currency (OCC), its primary regulator, for permission to organize as a National Association on August 23, 2000.

However, due to the volume of substantive deficiencies in the Application, the OCC and Federal Deposit Insurance Corporation, requested additional supporting information during the Fall of 2000. In summation, these deficiencies emanated from the lack of supporting documentation regarding critical business model assumptions including but not limited to, customer acquisition rates as well as, deposit/loan growth composition and volumes. Other material weaknesses included the absence of profitability within the formative stages and independent market research supporting the feasibility of the nontraditional delivery channels proposed {non-branch kiosk}. Weaknesses emanating from the original proposal were never satisfactorily resolved and the Applicant withdrew the proposal on April 16, 2001.

Applicant, after substantive modifications to the business model and management team, resubmitted the proposal on October 9, 2001. The proposal calls for the Applicant to be part of a two-tier holding company structure. The United States (US) based holding company and initial-tier will be Holding Company-2, Incorporated, Anytown, Anystate. It will be a wholly owned subsidiary of Holding Company-1 plc, London, England, the top-tier holding company. Both holding companies are active and fully operational as of the date of application. The Applicant intends to file an application with the Federal Reserve Bank for the formation of a bank holding company.

The Applicant's business model espouses the use of multiple delivery channels (integrated model) to service its customer base including: a traditional retail bank site and supermarket branch network, as well as, a fully transactional web site and customer call center.

Financial History and Condition

The Applicant has provided reasonable support for asset and liability projections. Moreover, the proposed investment in fixed assets is within regulatory guidelines. Organizational expenses, while seemingly excessive, are fully covered by the initial level of capital. While the finding on this statutory factor is ***favorable***, one open supervisory item remains. This pertains to the submission of acceptable agreements covering the two proposed related party transactions. Said related party transactions should ensure that the resulting expenses to the insured institution are on terms prevailing in the market for similar services performed and/or due not result in any economic disadvantage or consequence. Related party transactions are summarized on page 8 of this Report.

Adequacy of the Capital Structure

The Applicant has provided for a strong initial capitalization base. Such capital is commensurate with the inherent risks of the business plan and sufficient for the projected growth of the institution. Year three proforma leverage ratio amounts to 8.82%. While the finding on this factor is ***favorable,*** it is contingent on the execution of the licensing (lease) agreements for the in store branches with Albertsons, Inc.

Future Earnings Prospects

The Applicant's business model suggests that it can attain adequate profitability. This profitability is based viable assumptions, which are comparable to various banking peer groups. The finding on this factor is ***favorable.***

General Character of Management

The general character of the proposed management team appears fundamentally sound and consistent with a rating of "2" under the Uniform Financial Institutions Rating System. Proposed management's aversion for risk is suggested by the concentration of less risky residential real estate during the formative years. While the finding on this factor is ***favorable***, one open supervisory item remains pending. To date, the Applicant has not submitted any stock benefit plans/agreements on its executive officers or directors. In light of exceptions taken during the prior proposal on the extent of option grants to certain executive officers, appropriate due diligence should be accorded prior to chartering.

Risk to the Fund

The proposal does not appear to present any undue risk to the insurance fund. This determination is based on the business model's strong initial capitalization base, seemingly conservative management team and investment philosophy, as well as, the viable and multi-faceted branch network strategy. The finding on this factor is ***favorable***.

Convenience and Needs of the Community

Given the extent of competition and available market share, the Applicant would not adversely impact competition or the delivery of financial services within the market area. The finding on this factor is ***favorable.***

Consistency of Corporate Powers

The finding on this factor is ***favorable***.

Recommendation

The Examiner has concluded that all seven statutory factors have been favorably resolved. However, three open supervisory items remain and should be satisfactorily addressed prior to chartering.

Examiner

FINANCIAL HISTORY AND CONDITION

Assess the reasonableness of asset and liability projections, and composition in relation to the proposed market. Assess the financial condition of parent company and its significant subsidiaries, if applicable. Asses the investment in fix assets. The applicant's aggregate direct and indirect fixed asset investment, including lease obligations, must be reasonable in relation to its projected earning capacity, capital, and other pertinent matters of consideration. Proposed fixed asset investments should conform to applicable State law limitations. Assess compliance with security requirements of Part 326 and with the National Historic Preservation Act. Evaluate any financial arrangement or transaction involving the applicant and an insider(s). The transaction should demonstrate that: (1) the proposed transaction is made on substantially the same terms as those prevailing at the time for comparable transactions with non-insiders, and does not involve more than normal risk or present other unfavorable features; and (2) the proposed transaction must be approved in advance by a majority of the incorporators. In addition, full disclosure of any arrangements with an insider must be made to all proposed directors and prospective shareholders. An insider is a person who is proposed to be a director, officer, or incorporator, a shareholder who directly or indirectly controls 10 percent or more of a class of the applicant's outstanding voting stock; or the associates or interest of any such person.

Summary and Findings

Proposed Retail Bank Site and Supermarket Branch Network

Retail Bank Site

Holding Company-2 (USA), the initial-tier holding company, has leased approximately 6,100 square feet of ground floor space in a five story commercial office building located at 2001 Palm Blvd., Anytown, Anystate. This site serves as the headquarters to Holding Company-2 and retail banking location of the proposed institution. It formerly served as a site for another financial institution and thus contains a vault and drop box area. The current building contains a certain amount of unoccupied space to accommodate the Applicant's future growth needs. An option on this additional space has been structured and provided for within the lease. The site is located within Metropolitan, AnyCounty, and on a heavily traveled boulevard adjacent to a major intrastate highway (I-95). The service area within the immediate vicinity, contains numerous commercial office buildings, service establishments, a shopping mall, financial institutions, as well as, nearby residential developments and condominiums.

Lease Agreement - Retail Bank Site

An office building lease was executed between 2001 Partners, L.C. and Holding Company-1 plc, London, England, the top-tier holding company. It contains an initial three-year lease provision, as well as, certain options. The tenant may extend subject lease for two (2) five (5) year periods under the same terms and conditions. In addition, tenant may also exercise an option for an additional 4,800 square feet within the building under similar terms and conditions. Rent is payable monthly and subject to annual increases based on the lesser of 5% or the percentage rise in the Consumer Price Index. The current rent within the lease includes real property taxes based on 1999 estimates. Any subsequent increases in said taxes are based on the tenant's pro rata share. No bankruptcy or dissolution clause was noted. A security deposit of $19,000 was collected.

Supermarket Branch Network

The organizers intend to operate a total of twelve supermarket branches during the first year of operation with Albertsons, Inc. as its host retailer. Eleven of the twelve branches were fully operational units that were closed July 2001 by Wachovia, NA, following its acquisition of Republic Security Bank, Anytown, Anystate. Albertsons will open the last supermarket branch (twelve) in November 2002. The proposed supermarket branch network will have seven locations in two counties, and will be located within heavily populated cities and townships.

Lease Agreement – Supermarket Branches

Albertsons and the Applicant have yet to complete and execute a contract on the twelve store locations proposed. Currently, Albertsons has submitted a proposal to the Applicant for all twelve stores. While no contract exists yet, proposed CEO Hamm has made assurances that Albertsons management has reserved said branches for the Bank and removed them from their branch availability list. All eleven existing banking facilities (one in process of construction) have been vacant since July 2001. Albertsons' legal counsel is presently preparing a License Agreement for execution, which may reportedly include the following terms and conditions.

Each License (lease) term will be for a minimum of five years, and include two five-year options. Initial license fees will be $30,500 annually ($2,541/mo.+ ATM fees of $250/mo) with modest increases for each successive option term. While the branches are essentially complete, any additional remodeling and/or modification related expenses will be borne by Applicant. All personal and real property taxes are the responsibility of the host, Albertsons.

Branch Network Host – Albertson's Inc. (NYSE: ABS)

Albertson's Inc, a national supermarket operator, is one of the world's largest food and drug retailers, with annual revenue of approximately $37 billion. The company is based in Boise, Idaho and operates more than 2,500 retail stores in 36 states. The company has a market capitalization of nearly $13 billion and holds a credit rating[1] for its outstanding senior notes and debentures of BBB+ (investment grade rating).

Recently Albertsons issued a press release (November 29, 2001) reaffirming the company's intent of preserving Anystate as a strategic market. This release was in response to securities analyst reports that the company had weak market share in many Anystate, cities and was potentially planning an exit out of the entire state. Such a decision would have serious repercussions for the Applicant's deposit assumptions considering the supermarket channel's relative importance to customer and deposit acquisition. The press release stated that the company was attempting to increase operating efficiencies by closing under-performing stores but will invest $125 million throughout the state for new store construction and remodeling. The capital expenditure represents a 25% increase over the prior year. Proposed CEO Hamm stated that company officials have not identified any of the eleven supermarket branch locations in subject proposal for closure.

Asset and Deposit Funding Projections

Deposit Growth Considerations – Prevailing Market Share, Competitive Factors & Recent Denovo Activity

Statistics delineating all FDIC insured institutions with offices located in Anycounty-1 and Anycounty-2, Anystate, suggests that there is intense competition for existing market share. Competition comes from three distinct sources; (1) retail branches within the both county's market, (2) Internet divisions of retail banks, and (3) banks/thrifts operating exclusively on the Internet.

As of June 30, 2001, there were a total of 450 banking offices located within Anycounty-1 with aggregate deposits of $22.4 billion, representing a nearly 5% year over year (YOY) deposit increase. For the same period, Anycounty-2 reflected 405 banking offices with aggregate deposits of $23.9 billion, or a 5.5%YOY increase.

The bulk of the market share within both counties is held by the branch offices of larger out of state regional and super-regional holding companies. Despite the extent of competition, the organizers believe that they can differentiate their proposed institution by delivering high quality service via multiple delivery channels. The Applicant will employ marketing strategies professing same and will stimulate growth through the strategic pricing of deposits and efficiency of service.

Denovo Institutions – Traditional

A review of denovo institutions, which have opened in Southeastern Anystate suggests that nearly all have experienced a certain degree of success in attracting funding. This has occurred despite intense competition by local and out of area institutions within those respective markets. Contributing factors to their success include all and/or a combination of the following: (1) favorable state/local economy and area demographics (2) an existing and vast deposit base (3) overall negative consumer perceptions about larger institutions and their inability to provide adequate service and (4) ability of local directors and executive officers to leverage their existing community contacts in order to attract new business.

[1] Standard and Poors Corporation; Bond Guide, December 2001.

The following table depicts the recent experience of certain Denovo institutions within select Anystate markets.

Institution Total Assets – Latest Qtr. Available 9/01- $000	Insured Date Charter Type Business Model	Volume of Total Deposits After Year 1 - $000 **v**. Projections	Volume of Total Deposits After Year 2 - $000 **v**. Projections
Grand Bank Anytown, Anystate $95,313	Feb. 1999 State Traditional Retail	$51,422 * $18,500	$65,663 $32,752
Landmark Bank, NA Anytown, Anystate $145,450	Aug. 1998 National Traditional Retail	$20,701 * $13,800	$39,930 $26,900
Marine Bank & Trust Anytown, Anystate $65,011	Jul. 1997 State Traditional Retail	$24,149 * $15,000	$36,799 $28,000
Independent Community Bank Anytown, Anystate $33,815	Oct. 1998 State Traditional Retail	$13,625 * $25,000	$27,153 $35,000
First Peoples Bank Anytown, Anystate $35,352	Apr 1999 State Traditional Retail	$18,110 * $20,000	$24,115 $27,500
Gulfstream Business Bank Anytown, Anystate $99,701	May 1999 State Traditional Retail	$33,542 * $20,152	$43,747 30,736
Flagler Bank Anytown, Anystate $33,501	Apr. 2000 State Traditional Retail	$10,795 * $10,330	$28,503 $18,210
Transcapital Bank Anytown, Anystate $93,097	Jul 1999 State Traditional Retail	$41,228 * $27,280	$77,199 $48,430

Projections obtained from respective Reports of Investigation, Summary of Investigation Report, and/or supporting Regional office data when available. * Represents less than twelve months from insured date unless a later opening date is specified.

<u>Deposit Projections & Assumptions</u>

As depicted on page 12 of this Report, the Applicant projects total deposit volumes of $95.1 million, $164.5 million, and $202.8 million, within the first three years, respectively. Additional key assumptions include the following:

- Customer funding will come from the following sources: Branch network 81.5%, 13% Internet, Other (executive officer call program, customer call center, promotional/event kiosks, referrals) 5.5%.

- The distribution channels above project to achieve customer volumes of 9,124, 15,004, and 17,932 during the first three years, respectively. Within this assumption, Applicant further assumes that each customer will have two accounts. This translates to yearly total account volumes of 18,248; 30,004; and 35,864, respectively.

FINANCIAL HISTORY AND CONDITION (Continued)

- In arriving at total deposit volumes, the Applicant estimated that each account would retain an average balance of between $5.2M to $5.6M. The table on the subsequent page summarizes these calculations.

	Year 1	Year 2	Year 3
Deposit Customer Volumes – Cumulative	9,124	15,004	17,932
Account Volumes – Cumulative	18,248	30,008	35,864
@ average Balance of $5,216 Y1, $5,481 Y2, and $5,657 Y3 = Year-end Deposit Volumes	$95.1 MM	$164.4MM	$202.8 MM

With regard to the *Retail Branch* delivery channel, the Applicant assumes that its twelve supermarket branch network and traditional retail office will generate a sustainable deposit base during the formative years. The Applicant argues that eleven of the twelve proposed supermarket branch locations were profitable and viable branches when they were closed just six months ago by Wachovia Bank, following its acquisition of Republic Bank. According to proposed CEO Hamm, Wachovia's decision to close the branches, was driven primarily by philosophical differences and Wachovia's general unfamiliarity over that particular retail distribution channel.

Mr. Hamm stated that the branches are supported by Albertsons' extensive market research. As a matter of necessity and prudent retail practices, Albertsons will assess and enter new store markets only when certain favorable economic and demographic factors prevail. These factors include densely populated areas, traffic patterns, competition, and household income profiles. The favorable outcome of these studies will determine ultimate capital investment and store locations. Mr. Hamm argues that this research is critical to the proposal and a reason why the former branches were successful when owned by Republic Bank. The table below depicts the branch network's one-year history in attracting core funding. Results for December 2000 reflect nearly a 50% rise in funding from the previous period. Applicant projects that it can regenerate at least 65% {$78MM} of the balances existing at year-end 2000 during its formative first year.

Anycounty-2 Stores (7)		Dec-99	Jun-00	Sep-00	Dec-00
Total $ Mil.		**54.5**	**58.4**	**62.1**	**67.1**
Average		7.8	8.3	8.9	9.6

Anycounty-1 Stores (4)		Dec-99	Jun-00	Sep-00	Dec-00
Total $ Mil.		**25.7**	**41.8**	**47**	**53.1**
Average		6.4	10.5	11.8	13.3

Totals All 11 Branches	80.2	100.2	109.1	120.2
Average/Branch	7.3	9.1	9.9	10.9

In addition to the actual experience of the former branches, in-store branch projections have also been based on studies from two credible market sources, specializing in supermarket branches and alternative delivery systems; National Commerce Bank Services (NCBS), Memphis, TN., and International Banking Technologies (IBT) Norcross, GA. A 2000 NCBS study of 61 financial institutions covering 148 in-store branches resulted in the following average branch (NCBS owned branches) statistics below.

- Total accounts: 1,523
- Total Deposits: $11,906M
- Checking: $1,896M {16% of total – Average Balance (AB) $2,243}
- Savings/MMDA $4,532M {38% of total – AB of $10,739}
- CDs: $5,478M {46% of total – AB $21,317}

IBT, one of the largest retail consulting companies in the industry, has market data on clients ranging in size from, $21 million to $600 billion. It categorizes the performance of supermarket branches into high, median, and low. The Proposal's assumptions on the next page are compared with IBT's *median* supermarket branch performance measures (per branch). Applicant projections are also included for its one main office and traditional retail branch.

Period	IBT Median SM Branch Statistics	Applicant Projections – 12 Supermarket	Applicant Projections – 1 Main Office
Year 1	1,800 new accounts – Total Deposits $6.3MM	1,115 new accounts – TDs $5.8MM	3,346 new accounts – TDs $17.5MM
Year 2	1,440 new accounts – Total Deposits $12.7MM	672 new accounts – TDs $9.5MM	2,016 new accounts – TDs $28.3MM
Year 3	1,200 new accounts – Total Deposits $19.0MM	355 new accounts – TDs $11.8MM	1,066 new accounts – TDs $35.3MM

Actual branch history and empirical data, as well as, market research from both NCBS and IBT lend credence to the subject proposal's supermarket branch assumptions. Remaining branch assumptions for the main office appear reasonable and attainable based on recent denovo experience, relatively modest volume expectations in relation to total deposits, and intangibles such as the proposed CEO's following within the community.

With regard to the *Internet* channel, the Applicant projects an account acquisition rate of 7 per day and 12 accounts per day for years 2 and 3. As support for these assumptions, the Applicant stated that since inception, its corporate web site has averaged 184 visitors per day (well over the 31,389 reported during the previous investigation) with over 879 registered parties. It is uncertain as to whether these "hits" are attributable to the interest regarding the Applicant's pending application for Federal deposit insurance or merely concerned investors (which number in the thousands) seeking additional financial information. Notwithstanding, the projections appear plausible considering information provided by Anybank, a pure play denovo internet bank in Anytown, Anystate. According to the bank's chairman, Anybank was recently experiencing traffic of over 2,500 visitors per day and adding an average of 20 deposit accounts per day. During its first year, Anybank was adding an average of 50 accounts daily. Anybank reported recent average account balances of $5M for DDA, $40M for MMDA, and $60M for CDs. It is important to note however, that Anybank has been highly aggressive with respect to deposit pricing during its formative months. Applicant deposit projections for this channel appear reasonable based on existing site traffic and recent competitor experience.

Asset Projections and Assumptions

Applicant's loan projections are largely supported by qualitative factors including the proposed CEO's following in the community given his executive position (Chief Credit Officer) with the former Anybank, Anytown, Anystate. In addition, he reportedly knows a network of real estate and commercial lenders, many of whom were reportedly direct reports while at Anybank. Mr. Hamm stated that he has kept in close contact with several lenders who reportedly hold considerable portfolios of high-quality performing loans and are seeking other employment opportunities.

During the formative stages, the projections call for a conservatively weighted real estate portfolio. Year 1 projections assume a 77% real estate weighting with 58% comprising single family mortgage and home equity loans to prime borrowers. A meaningful portion of the residential portfolio will be purchased via established brokers known to both the proposed CEO and senior lending officer. Mr. Hamm reportedly has vast experience in purchasing mortgage pools with favorable yield and prepayment characteristics. This strategy will be important to the Applicant during the first year given its needs to deploy excess liquidity into higher yielding instruments. Commercial loans will focus on small business and SBA loans. Mr. Hamm stated that these products were successfully delivered and managed by he and the proposed senior lending officer while at Anybank. In light of the proposed CEO's experience and reputation in the market, no exceptions were taken to the loan projections scheduled.

Fixed Assets and Organizational Expenses

Capital Investments

The Applicant's investment in fixed assets is within existing OCC statutory limitations, which permit total fixed asset investment of up to 100% of total capital. The total proposed investment in fixed assets to initial capital is 15%. Two insider or related company transactions were disclosed and noted below.

Total investment in fixed assets at inception is proposed as $4,099M versus actual expenses (as of 11/30/2001) of $1,700M. Approximately 77% {$2,984M} of the net investment pertains to the Applicant's technology platform. This includes computer hardware, software, and associated networks. The remaining 27%{$1,115M} investment pertains to the Applicant's customer call center as well as associated expenses and holdings of furniture and fixtures. Capitalized assets are being depreciated utilizing the straight-line basis over a five-year schedule. The only material capital investment subsequent to opening will be the costs incurred to re-establish the in-store branches estimated at $60M per branch.

Related Party Transactions

Front-End Web Application Design and Deployment

Holding Company-1 plc, London, England (the top-tier holding company; refer to page 14 for organizational structure) will provide the insured bank with the initial front-end web application. This technology service will result in a one-time charge to the proposal of $90M and an additional investment of $20M in year one. A license agreement was not available for review during the Application process. Applicant stated that the service will be commensurate with the prevailing market, observe existing arms-length guidelines for related party transactions, and will be independent of the services provided by the Chief Technology Officer (CTO) Frank Gray.

Dual Employees

Proposed CFO Nigel Newbury and CTO Frank Gray will perform their duties in a dual capacity for both the top-tier holding company in London and the proposed national bank. During the formative years, the CFO and CTO will spend approximately 50% and 90% of their time respectively at the proposed West Palm Beach main office. A service agreement will be executed between the bank and holding company at a salary level commensurate with their roles and the exact time they allocate to the proposal. Currently, salaries allocated to the respective executives to be borne by the proposed institution are $55M per annum. A formal agreement was not yet formalized and/or submitted for review.

Organizational Expenses

The Applicant's organizational expenses are *substantial.* Problems with the original business plan, lack of initial fiscal prudence and length of time are all contributing factors. Since the original application of August 2000, which began during Q4 1999, organizers have withdrawn the Application for Deposit Insurance (April 2001), refilled a new proposal (October 2001) with a notably different business model and delivery modes, replaced various board members and certain key executives and hired new replacements. In the process, the Applicant restructured and incurred costs by reducing staff that was prematurely added by the previous CEO. During the previous application, extensive expenses were incurred for salaries (volume of staff) as well as, legal, professional and advisory fees. These fees have continued to accrue, although at a lesser extent since the arrival of proposed CEO Hamm.

The following table outlines the proposed pre-opening expenses versus actual expense items incurred in connection with the chartering process. The actual expenses from the previous submission are shown for illustrative purposes and to identify any large variances subsequent to that time. The Applicant has included expenses from the original submission inasmuch as previous costs/expenses are directly or indirectly related to the current proposal. The Applicant asserts that errors made previously have resulted in a benefit gained during the current Application.

Expense Category	**Application Projection**	**Actual Expense** 11/30/2001	**Actual Expenses @ Last Proposal – 12/31/2000**
Pre-opening Salaries & Benefits	$1,522M	$1,280M	$677M
Living/Relocation Expenses	$6M	$6M	$6M
Recruitment	$82M	$82M	$82M
Travel/Staff Related Expenses	$65M	$69M	$37M
Occupancy and Office Related	$563M	$473M	$156M
Attorneys & Professional Fees	$982M	$968M	$417M
Tax, Audit, Application, Dep, Other	$680M	$523M	$91M
Total Organizational Expenses	$3,900M	$3,401M	$1,466M

Pre-opening salaries are substantial and equal nearly 38% of total organizational expenses (year-to-date). The high volumes are attributable to the number of staff retained by the organizing group during the organizational phase, including that of certain highly compensated proposed officers. As of year-end 2000, the Applicant had hired and retained twenty employees. While this figure has since been reduced to eleven at year-end 2001, a high-level of expenses was still accruing throughout the first half of 2001 from the original higher staffing table. Since the arrival of proposed CEO Hamm, he has taken a proactive role in reducing these related expenses by releasing unwarranted and/or prematurely hired staff.

Attorneys, professional, and consulting fees are substantial and were highly criticized at the previous Corporation investigation. The criticism involved their excessive levels for the chartering of a denovo bank. It was argued that most of the expenses were discretionary and could have been controlled and managed in a more prudent and cost effective manner.

Included within the expenses are those associated with the Applicant's counsel/advisor. The Applicant retained the firm of Hodson & Hodson (HH), Washington, D.C., for legal and advisory services in connection with the chartering and application process. The engagement letter executed January 6, 2000 provides for an hourly billable rate ranging between $250 - $400. Overall fees for the chartering process were originally estimated by counsel to be between $250,000 and $300,000. In addition to this firm, the Applicant retained and incurred expenses with two other consultants that have since been discontinued under the current proposal. The high rate of legal and professional expenses billed from HH declined considerably after January 2001. Since proposed CEO Hamm's arrival, he has discontinued the previous practice of utilizing HH as regulatory liason during the current Application filing. Mr. Hamm stated that this has saved considerable monies and lowered the expense rate during Q3 and Q4 2001.

In addition to the legal and professional fees billed by HH, the pre-opening expense category includes consultancy fees billed by Holding Company-1 plc, in the amount of $428M. The fees pertain to the time commitment expended by several dual employees (employees of the holding company and proposed bank), which included the current officers (CFO Newbury, CTO Gray), certain software developers, and the former CEO and founder Casey Grant. The consulting fees constituted their salary calculated on a pro-rata basis for the amount of time expended during the organizing process, including application of an overhead component. The calculations were reportedly discussed with Holding Company-1's external auditor who assessed their reasonableness and accompanying tests for transactions with non-affitiliated parties. Documentation regarding this due diligence was not available for review during the Investigation process.

The last pre-opening expense item exhibiting a high variance was the "other" line item. Nearly the entire variance is represented by depreciation expenses associated with the Applicant's technology platform and very conservative prior depreciation schedule of three-years.

A key mitigating factor to the seemingly excessive pre-opening and organizational expenses pertains to the fact that the proposal has successfully raised capital during two separately underwritten offerings (see capital adequacy section on offerings and company structure). The holding company's equity position was recently reported at £19,137,532 or approximately $27.36 million. The proposal calls for an initial capital infusion of $26.9 million. The volume of capital from inception can absorb the high organizational expenses and support the proposed growth of the Applicant. Any actions by Regulatory Authorities to disallow certain organizational expenses above (from the previous submission) will simply result in the holding company having to absorb those costs. Considering the finite resources of the holding company and unlikely prospects of successfully executing a third capital offering, any organizational costs borne by the holding company will likely result in a lower initial capital infusion to the bank. Lower capital at inception would be offset by reduced organizational expenses, thus likely amounting to a wash or little financial impact.

Security Requirements & National Historic Matters

With regards to the proposal's security program, including compliance with Part 326 of the FDIC Rules and Regulations, organizers have committed to fully adhering to all applicable requirements. With regard to the National Historic Preservation Act, the State's Division of Historical Resources, corresponded with the Applicant on June 14, 2000. The department stated that the primary site (main office) would not interfere with any applicable historic sites and/or accompanying statutes. In regards to the retail supermarket branch network, all locations proposed are former branches of a federally insured institution. As such, no historic preservation or environmental impact concerns are anticipated.

Pending the submission of acceptable agreements covering two proposed related party transactions, the overall findings with regard to this factor is FAVORABLE.

FINANCIAL HISTORY AND CONDITION (Continued)

PROJECTED BALANCE SHEET			
	YEAR END BALANCE		
ASSETS	FIRST YEAR	SECOND YEAR	THIRD YEAR
CASH AND NONINTEREST BEARING BALANCES	3,816	5,940	6,893
INTEREST BEARING BALANCES			
SECURITIES – Held-to-maturity			
Available-for-sale	38,280	51,480	34,887
FED FUNDS SOLD AND REPURCHASE AGREEMENTS			
LOANS			
Construction and land development secured by real estate			
Loans secured by farmland			
Loans secured by 1-4 family residential properties	3,893	7,749	8,309
Junior lien loans secured by 1-4 family residential	34,915	44,848	56,463
Loans secured by multifamily (5 or more) residential properties			
Loans secured by non-farm non-residential properties	12,548	35,544	58,226
Credit card and related plans to individuals			
Agricultural loans and other loans to farmers			
Commercial and industrial loans	13,444	25,882	41,457
Loans to individuals for household and personal expenditures			
Other loans	2,075	5,738	11,332
LESS: Unearned income			
Allowance for loan and lease losses	836	1,497	2,197
NET LOANS	66,039	118,264	173,590
PREMISES AND FIXED ASSETS	4,015	3,054	2,202
ALL OTHER ASSETS	2,138	3,329	3,862
TOTAL ASSETS	114,288	182,067	221,434
LIABILITIES			
DEPOSITS			
Demand deposits and noninterest bearing deposits	7,007	12,652	15,463
Interest bearing deposits	49,461	85,363	106,529
Time deposits of less than $100,000	27,098	46,514	56,622
Time deposits of $100,000 or more	11,613	19,935	24,266
TOTAL DEPOSITS	95,179	164,464	202,880
FED FUNDS PURCHASED AND REPURCHASE AGREEMENTS			
BORROWINGS			
OTHER LIABILITIES	638	704	763
TOTAL LIABILITIES	95,817	165,168	203,643
EQUITY CAPITAL			
COMMON STOCK	1	1	1
SURPLUS	26,899	26,899	26,899
UNDIVIDED PROFITS	(8,429)	(10,001)	(9,109)
OTHER EQUITY CAPITAL			
TOTAL EQUITY CAPITAL	18,471	16,899	17,791
TOTAL LIABILTIES AND EQUITY CAPITAL	114,288	182,067	221,434
Tier 1 Leverage Capital Ratio	16.16%	9.28%	8.03%

ADEQUACY OF THE CAPITAL STRUCTURE

Generally, initial capital should be sufficient to provide for the maintenance of an 8 percent Tier 1 capital to assets leverage ratio (as defined in the appropriate capital regulation of the institution's primary Federal regulator) throughout the first three years of operation. The institution must also maintain an adequate allowance for loan and lease losses. Determine if the institution is being established as a wholly owned subsidiary of an eligible holding company (as defined in Part 303, subpart B). Assess the adequacy of proposed capital in light of projected deposits and growth, business plan risk tolerance, and the ability of proponents or parent company to provide additional capital. Special focus depository institutions (such as Internet or credit card banks) should provide projections based on the type of business to be conducted and the potential for growth of that business. All stock of a particular class in the initial offering should be sold at the same price, and have the same voting rights. Proposals which allow insiders to acquire a separate class of stock with greater voting rights or at a price more favorable than the price for other subscribers are not acceptable. Discuss financing arrangements for directors, officers, and 10 percent or more shareholders. Financing arrangements by insiders of more than 75% of the purchase price of the stock subscribed to by one individual or more than 50% of the purchase price of the aggregate stock subscribed by the insiders as a group should be supported to be considered acceptable. Insiders should demonstrate the ability to service the debt without reliance on dividends or other forms of compensation from the applicant.

PROPOSED CAPITAL STRUCTURE

ITEM	COMMON STOCK			SURPLUS	RETAINED EARNINGS	TOTAL	THIRDYEAR AVERAGE ASSETS	CAPITAL ASSET RATIO
	SHARES	PV	AMOUNT					
Minimum Statutory Requirements			0			0		%
Amount Indicated on Application	1,000	1.00	1,000	26,899,000	(9,109,000)	17,791,000	201,602,000	8.82%
Revised Proposal			0			0		%
Recommendation of Examiner	1,000	1.00	1,000	26,899,000	(9,109,000)	17,791,000	201,602,000	8.82%

SALE PRICE PER SHARE OF CAPITAL *(original proposal)*	*(revised proposal)*	FEES OR COMMISSIONS IN CONNECTION WITH SALE OF STOCK
IPO: 2p (£ .02 or 3¢) Secondary IPO: 20p or 30¢ Assumes exchange rate @ £1.00 : $1.50		0.00

Summary and Findings

Initial Capitalization

The top-tier holding company (see ownership structure) has successfully executed two capital offerings totaling £22 million or approximately $35.2 million. The proposal calls for a direct infusion from said holding company.

The organizer's general consensus is that the level of proposed capital will suffice. In the event that additional capital is required, the Applicant has stated that the feasibility of a third public offering (see ownership structure) will be largely contingent upon favorable conditions within the European equity markets. Proposed CEO Hamm suggested a possible listing application to a US stock exchange may be pursued to enhance the likelihood of additional capital sources and share liquidity.

Founding directors are listed as follows: Lance Price (HC Director), Casey Grant (former director/officer), Nigel Newbury (proposed CFO), Stephen Helm (former director/officer), John Wise, Hamilton Trustees Limited.

Top-tier Holding Company – Additional Information on Capital

Shares Authorized:	750,000,000
Shares Outstanding:	350,000,000
Par Value:	@ 50p or .75¢; assumes original exchange rate @ £1.00:$1.50
Principal Shareholders:	

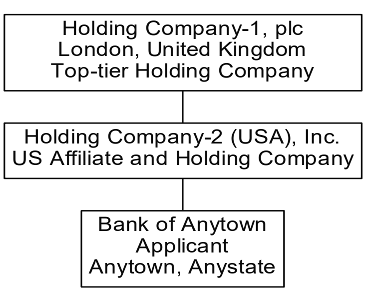
Shareholder	Category	Shares Held	Percent of Outstanding Shares
Casey Grant	Former Director	54,750,000	15.64%
Hamilton Trustees Limited	Institution	36,875,000	10.54%

Casey Grant, *former* proposed CEO of the bank and its holding company, is no longer affiliated with the proposal, other than as its single largest shareholder. Mr. Grant has requested two special board meetings to seek the voluntary dissolution of the holding company. Such proposal was soundly defeated by shareholders with over a 2:1 margin

Hamilton Trustees, Ltd. (10.5% shareholder) is reportedly a passive shareholder (no board or management representation) and trustee to certain trust funds. Hence, the beneficial owner of the shares is a trust, reportedly established to benefit certain charitable organizations. Per Mr. Newbury, no discussions have taken place with the Federal Reserve (as of January 7, 2002) to establish any element of control with respect to such party.

Ownership Structure

As depicted in the chart below, the top-tier holding company, Holding Company-1 plc, is headquartered in London and owns the Applicant via a United States (US) based holding company, Holding Company-2. The top-tier holding company, incorporated November 30, 1999, was established as a Public Limited Corporation (PLC). A PLC retains the status and functionality of a US based corporation and is the proper vehicle should the company wish to tap the country's capital markets. It is a registered entity within the UK, governed by prevailing regulations (Companies Act) including minimum capital requirements. In addition, the liability of its members is *limited* to the amount of shares held. According to proposed CFO Newbury, the top-tier holding company has no other operating subsidiaries besides the US holding company. It was reportedly evaluating other financial opportunities in the United Kingdom (UK) and elsewhere in an effort to establish alternative revenue sources. In this regard, Holding Company-1 plc, had reportedly met with officials of the UK's Financial Services Authority (FSA) with the intent on formally applying to become a UK Depository Institution. No formal applications have been made as of the Application date.



Holding Company-1 plc, is a publicly traded company, which was admitted and listed on the Alternative Investment Market (AIM – tantamount to the NASDAQ small capitalization equity market in the US) of the London Stock Exchange on December 16, 1999. It successfully completed an initial public offering during late 1999, raising £2 million (before associated expenses of £61,928) as well as, a fully underwritten secondary offering in February 2000, which raised an additional £20 million (also before associated expenses of £505,563). Total capital raised in US dollars approximated $35.2 million (before expenses).

Holding Company-1 plc – Financial Position

As of the most recent interim financial report (June 30, 2001), the entity held total assets of £19,581,817 or approximately $27.4 million. Total equity was £19,137,532 with cash representing the bulk at £18,231,943 or $25.5 million. Cash balances are invested within various European correspondents in short term, money market instruments and placements. For the same period above, operating losses after taxes totaled £1,250,942 or $1.7 million; a sharp rise (247%) over prior year losses. Reportedly, then eprime bank (in formation) incurred significant operating costs anticipating the issuance of a National Bank charter, which later failed to materialize. These higher operating costs, which included a high volume of staff were exacerbated by one-time restructuring charges related to personnel and other expense reductions programs. According to Mr. Newbury, the monthly cash "burn rate" or actual costs net of interest income was approximately $112M per month. Given the absence of dividends during the foreseeable period, the holding company will need to continue managing expenses and/or develop other revenue producing avenues to stem operating losses and its accompanying effect on capital.

According to proposed CFO Newbury, the company's stock retains five market makers and is held by over nine institutional investors (mainly mutual funds companies). In December 2001, the company possessed a market capitalization of approximately £8.75 million or approximately $12.3 million, thus representing a steep discount to June 2001's book value.

With a recent share price of 2.5p (£.03 or ¢3.57), the 52 week range consisted of 11.25p (£.11 or ¢16.09) to 2.25p (£.23 or ¢3.21). At this price, the stock was trading nearly 78% off its yearly high. The holding company's low, which it reached in October 2001, was attributable to a combination of the failed charter attempt, as well as, adverse market conditions.

Capital Adequacy Assessment

Proposed Business Model

The proposal calls for launching an integrated model leveraging technology and a traditional physical branch network. These multiple channels include one traditional retail banking office, a network of twelve convenience-driven supermarket branches, a fully transactional website and customer call center. The model attempts to focus on the efficient delivery of banking products with superior customer service. The in-store supermarket branch network will be employed within a large regional supermarket host located in heavily populated and demographically favorable service areas, cities/townships. The proposal also seeks to target the growing Hispanic community within Anycounty-1 and Anycounty-2 and will deliver products and services (Web/phone) in a bilingual format.

Projected Growth and Business Model Risks

Capital levels in light of projected growth and prevailing business model risks appears satisfactory. The business plan's overall risk assessment appears Low to Moderate.

On the asset side of the balance sheet, the proposal seeks considerable loan growth. This loan growth however, appears to be conservatively weighted towards the real estate sector in general and within products secured by primary residences (conventional/prime SFRs and HELs). Refer to the previous comments (page 8) regarding Asset Projections and Assumptions. The proposed loan mix represents a notable reduction in risk versus the previous proposal which was focusing extensively on higher yielding commercial loans. The ability to generate loans during the formative years will be partly facilitated by residential portfolio loan purchases. This is reportedly an area of expertise of the proposed CEO and SLO. Risks in these products will seemingly be limited to the premium paid given the current interest rate environment and accompanying earnings risk (write-down of premium on the asset side) should these underlying assets pre-pay (interest rate risk). The extent of loan volume appears to be coming at the expense of liquidity, which is a little lower than would otherwise characterize a denovo bank (proforma Loan to Deposit Ratios 69%, 72% and 86%, for first three years, respectively). However, given the current interest rate environment and low yields on short term Federal Funds, many institutions are attempting to minimize said holdings in order to achieve a more optimal net interest margin.

With regard to the deposit side of the growth projections, risks have been reduced considerably versus the previous proposal given the adoption of an established and more traditional funding channel. The supermarket branch network proposed in the model has a prior history and reportedly held actual deposit volumes of $120 million as of the year-end 2000[2]. This proven channel along with the main office, transactional website, and business referral prospects of the proposed CEO and select board members should provide reasonable assurances to the proposal's deposit projections.

[2] Raw data from the former Republic supermarket branches were not available for Examiner review. Proposed CEO Hamm stated that internal RSB reports (now property of Wachovia) were proprietary and thus restricted.

ADEQUACY OF THE CAPITAL STRUCTURE (Continued)

Business model risks emanate primarily from the denovo's operating environment. The operating environment is currently faced with a yield curve, which while steep and historically beneficial for financial institutions, contains a very low short-term rate base. The risk, from an asset/liability management and earnings perspective, is that short-term rates remain at historical lows. As such, any additional rate declines (Federal Funds Target Rate and resulting Prime lending rate reductions) may result in a further compression of net interest margins. Short-term rate reductions were recently implied by the 30-Day Federal Funds Futures contracts, which settle in April 2002[3]. Ensuing rate reductions could make net interest income and profitability goals for the denovo more challenging thus increasing the operating losses. Other risks with regard to the operating environment pertain to the current state of the local, state, and national economies. Any prolonged national recession could begin to more negatively impact the State and the bank's proposed service areas. This risk would occur at a time when the bank could be ramping its loan portfolio. Mitigating factors to the economic environment include the apparent strength of the new management team (CEO Hamm, SLO Well and Directors Wart and Marcotte) and the higher concentration on less risky residential mortgage lending.

In the interim, the business model risks also include the current status of the lease or licensing agreements with the retail host, Albertsons. While the organizers contend that the twelve proposed branch locations have been reserved for the denovo bank, firm agreements have yet to be executed. The failure of procuring any or all of these proposed branch locations by the organizers could have a negative impact on the applicant achieving deposit and/or loan projections. While lower growth would result in generally higher capital ratios, it might impact earnings given the sizeable fixed charges and overhead that the Applicant would need to overcome to become profitable.

While the finding on this factor is FAVORABLE, it is contingent on the execution of the licensing (lease) agreements for the in-store branches with Albertsons Inc.

[3] Chicago Board of Trade; January 11, 2002 April Contract settlement price of 98.405.

FUTURE EARNINGS PROSPECTS

Assess the reasonableness of earnings projections and supporting assumptions of the business plan in relation to the economic environment and competition. Projected interest income, expense, non-interest income and expense, and provisions for loan and lease losses should be analyzed and compared to experiences of other new banks in the trade area or in a similar market. When necessary, the examiner should make adjustments to the applicant's projections and discuss the basis for the differences. Incorporators should demonstrate through realistic and supportable estimates that, within a reasonable period (normally three years), the earnings of the proposed institution will be sufficient to provide an adequate profit.

Summary and Findings

The Applicant projected a net operating profit (loss) of ($8,429M), ($1,573M), and $893M for the initial three years of operation, respectively or a cumulative operating loss of ($9,109M). These underlying projections were based on reasonable average earning assets to average assets assumptions (what-if scenario 5) of 89%, 92%, and 94% over the respective periods. Applicant asserts that the average earning asset assumptions are on the conservative range given the proposal's technology platform and lower emphasis on costly traditional retail branches and fixed assets. The Applicant argues that the assigned average earning asset assumptions represent the most conservative scenario possible and that higher earning asset utilization during the formative years are plausible based on peer group data. Any higher utilization may result in improved net interest margins and a higher operating profit in year three.

Margin Analysis

In light of the substantial interest rate volatility during calendar years 2000 (Central Bank tightening of the money supply) and 2001 (aggressive loosening and adding of system liquidity), any meaningful comparative analysis is better served by assessing the net interest income line as opposed to individual yield and cost factors. This facilitates analysis of the proposal's assumptions over varying interest rate environments.

The table below depicts the proposal's estimates for net interest income and non-interest income to average assets during the formative years. Comparisons for reasonableness include an Examiner calculated average of denovo institutions (Banks listed on page 6 of this report) as well as, various peer group and State averages for the period ending September 30, 2001.

Institution	Net Interest Income	Non-Int. Income	AEA/AA
Examiner Denovo Sample -Mean	3.71%	0.79%	93.91%
UBPR Peer Group 9	3.91%	0.74%	94.05
UBPR Peer Group 13	3.99%	0.70%	93.47
UBPR Peer Group 25	3.72%	0.57%	91.72
Mean – All Insured Banks – Anystate.	3.91%	0.83%	92.19%

National Bank Year 1	3.94%	0.38%	89.37%
National Bank Year 2	4.41%	0.54%	92.46%
National Bank Year 3	4.70%	0.55%	93.70%

Notes: Source: Uniform Bank Performance Reports; Peer Group 9=Banks with TA of $100-$300 million within Metropolitan Area; Peer Group 13=Banks with TA of $50-$100 million within Metropolitan Area; Peer Group 25= Banks established within last 3 years<=$50 million. AEA/AA represents Average Earning Assets to Average Assets.

Comparative analysis suggests that the Applicant's Net Interest and Non-Interest Income estimates appear reasonable during the first year of operation. During years 2 and 3, the Applicant's loan mix begins to shift from lower yielding residential and home equity loans (58% year 1 versus 43% and 38% years 2/3) to higher yielding commercial real estate products. While the changes in loan mix are ramped over a two-year period, the rising emphasis on the commercial real estate (19% year 1 mix, 30% and 33% years 2-3) category is accompanied by higher asset yields ranging from 100-125 basis points. This attempts to explain part of the expansion in the subject margins. Proposed CEO Hamm argues that the proposal's ability to underwrite fundamentally sound and higher- yielding commercial real estate loans is heightened by his previous relationships with many of the former lending officers of Anybank, Anytown. Said officers reportedly have established portfolios within the proposed service areas and are seeking other employment opportunities following Anybank's consolidation into Regionalbank.

On the funding side of the balance sheet, two factors emerge which seemingly justify lower cost of funds and consequently wider margins. First, the Applicant proposes to open with $26.9 million in capital or over 2 to 2.5 times the capital typically employed by denovo banks in Southern Anystate. The higher paid-in capital effectively lowers funding costs associated with initial balance sheet activity (loan/bond purchases and origination). Secondly, the proposal would be procuring funding liabilities in a very favorable interest rate environment. This environment characterized by historically low short-term interest rates enables the Applicant to attain a lower *average* cost of funds. This lower cost, coupled with the present steep yield curve, could justify the higher margins.

Of the eight denovos listed on page 6, Grand Bank in its third year of operation achieved a 4.44% net interest income (NII) to average assets ratio. This ratio, which is in the 75th percentile, occurred during an arguably more difficult interest rate environment (negative yield curve during 2H 2000) than the Applicant would likely experience. Nonetheless, the Examiner adjusted year 3 NII to average assets ratio to 4.44% to determine the impact on year three profitability and ensuing capital ratio. Despite the decline in margin, the Applicant would still exhibit profitability and a year 3 capital ratio of 8.56%.

Sensitivity Analysis

The Applicant submitted an analysis of the impact that certain scenarios would have on proforma earnings (Year 3 stress testing). These scenarios, which were part of the base plan, appear to be well formulated and realistic based on current market conditions and inherent risks within the Applicant's operating plan. The scenarios examined include the following:

- *Loan Growth would only amount to 75% of year 3 base forecasts.* Under this scenario, projected net loans would ramp at a slower rate of growth and culminate in 75% of the base plan. In this scenario, net loans and percentage of plan figures would equate to $58 million (88%), $94 million (80%), and $131 million (75%), during the three respective years.

- *Deposit Growth would only equate to 75% of original forecasts.* In this scenario, the Applicant would stress test the outcome of a less than favorable deposit gathering event. With regard to scenario 2, total deposits would amount to $71 million, $124 million, and $152 million, during the respective three years.

- *Failure to attain a lower-cost deposit mix.* Under this event, the Applicant examines the impact of achieving a less than optimal deposit mix or a high concentration of costlier time deposits. Specifically, time deposits would increase to 53% or more throughout the first three years versus original forecasts of 40-41%. This scenario assumes that marketing/pricing strategies would fail to generate the optimal level of generally less costly MMDAs.

- *Interest rate shocks of 100 basis points*. Applicant assumes parallel shifts in rates (upward/downward) and that the bank would be able to adjust rates paid on deposits to reasonably match the change in yield bearing instruments.

Net Income / Sensitivity Analysis $000	Year 3
Scenario One – *Slower Loan Growth*	$751M
Scenario Two – *Lower Deposit Growth*	<$100M
Scenario Three – *Higher Cost Deposit Mix*	$806M
Scenario Four – *Rate Rise 100 bps*	$1,449M
Scenario Four – *Rate Drop 100 bps*	$1,090M

The Applicant projects year 3 profitability in all scenarios tested. The highest risk to the business model is presented by scenario 2, slower deposit growth. Aside from actively managing its cost structure to minimize the probability of losses in year 3, proposed management is reasonably confident that it can attain 75% or more of the deposit forecasts reflected in the plan. Supporting arguments for its claim are (1) General success of denovos in the Southern Anystate market in attracting funding at a reasonable cost, (2) The level of reported public interest in the proposal to establish depository relationships prior to conditional approval. This includes various verbal commitments reportedly made from various organizations in Anytown to the Applicant. Additional deposit referral business (in excess of $10MM for DDA/NOW) has also been alluded by the Applicant's influential Anytown board members (Wart and Marcotte). (3) The success of the supermarket branch network as it existed twelve months ago. Applicant stresses the last factor adds considerable credibility to the deposit forecasts. Despite having been in the Anytown market for less than three years, the investigating Examiner believes that proposed CEO Hamm enjoys a relatively strong reputation in the banking community. This reputation and extent of contacts should greatly assist the Applicant in garnering deposits from both the supermarket network and the retail banking office.

The finding on this factor is <u>FAVORABLE.</u>

FUTURE EARNINGS PROSPECTS (Continued)

ESTIMATED INCOME AND EXPENSES			
	ESTIMATED AMOUNT		
DESCRIPTION	FIRST YEAR	SECOND YEAR	THIRD YEAR
Interest Income			
Real Estate loans	2,542	5,287	8,178
Installment loans	98	332	728
Credit Card loans			
Commercial and all other loans	614	1,611	2,758
Lease financing receivables			
Balances due from depository institutions			
Taxable securities issued by states and political subdivisions			
Tax-exempt securities issued by states and political subdivisions			
U.S. Government and other debt securities	954	2,683	2,556
Other securities			
Federal Funds sold and securities purchased under agreements to resell			
Total Interest Income	4,208	9,913	14,220
Interest Expense			
Transaction accounts (NOW, etc.)	60	175	242
Time Deposits of less than $100,000	448	1,307	1,831
Time Deposits of $100,000 or more	192	560	784
Money Market deposit accounts	432	1,245	1,752
Other savings deposits	33	95	133
Federal Funds purchased and other borrowings			
Total Interest Expense	1,165	3,382	4,742
Net Interest Income (NII)	3,043	6,531	9,478
NII % of Average Earning Assets	3.94%	4.41%	4.70%
Provision for Loan and Lease Losses	836	797	918
Non-interest Income	291	796	1,112
Non-interest Expense			
Salaries and Benefits	7,027	8,103	8,779
Net Occupancy Expenses			
Other Operating expenses:			
Advertising and Marketing			
Professional Services (legal, accounting, etc)			
Computer Services/Data Processing			
Miscellaneous			
Net organization expenses *(1st year only)*	3,900		
Total Non-interest Expense (NIE)	10,927	8,103	8,779
NIE % of Average Assets	14.14%	5.47%	4.35%
Income (Loss) before Income Taxes	(8,429)	(1,573)	893
Income Tax Expense			
Net Income (NI)	(8,429)	(1,573)	893
NI % of Average Assets	(10.91)%	(1.06)%	0.44%
Average Assets	77,277	148,135	201,602

Explain examiner adjustments made to applicant's projections.

FUTURE EARNINGS PROSPECTS (Continued)

ESTIMATED AVERAGE DEPOSITS AND AVERAGE ASSETS						
DESCRIPTION	AVERAGE DURING					
	FIRST YEAR	Yield or Cost	SECOND YEAR	Yield or Cost	THIRD YEAR	Yield or Cost
AVERAGE DEPOSIT AND BORROWINGS						
Transaction Accounts (NOW, etc.)	5,440	1.10%	12,505	1.40%	17,277	1.40%
Time Deposits of less than $100,000	16,133	2.78%	36,806	3.55%	51,565	3.55%
Time Deposits of $100,000 or more	6,914	2.77%	15,774	3.55%	22,100	3.55%
Money Market deposit Accounts	19,040	2.27%	42,930	2.90%	60,396	2.90%
Other Savings deposits	2,274	1.19%	6,353	1.50%	8,898	1.49%
Transaction Accounts (DDA Noninterest)	6,484	%	15,453	%	23,438	%
		%		%		%
Federal Funds Purchase		%		%		%
Total estimated average deposit/ borrowings	**56,285**		**129,821**		**183,674**	

AVERAGE ASSETS						
Real Estate loans	36,401	6.98%	69,626	7.59%	105,254	7.77%
Installment loans	1,372	7.14%	3,894	8.52%	8,508	8.54%
Credit card loans		%		%		%
Commercial and all other loans	8,892	6.92%	19,620	8.21%	33,598	8.20%
Lease financing receivables		%		%		%
Interest-bearing balances due from banks	2,552	%	4,882	%	6,417	%
Taxable securities issued by states and political subdivisions		%		%		%
Tax-exempt securities issued by states and political subdivisions		%		%		%
U.S. Government and other debt securities	22,988	4.15%	44,851	5.98%	43,393	5.89%
Other securities		%		%		%
Federal funds sold and securities purchased under agreements to resell		%		%		%
		%		%		%
		%		%		%
		%		%		%
		%		%		%
Total estimated average earning assets	69,070		136,827		188,911	

Explain examiner adjustments made to applicant's projections.

Note: Cost factors above are as a percentage of Average Interest Bearing Liabilities only.

GENERAL CHARACTER OF THE MANAGEMENT

Proposed management, including the board of directors or trustees, is evaluated against all factors necessary to operate the institution in a safe and sound manner, including the ability to identify, measure, monitor and control the internal and external risks presented by the proposed business plan. Proposed directors and officers should be evaluated on the basis of their financial institution and other business experience, duties and responsibilities in the proposed institution, personal and professional financial responsibility, reputation for honesty and integrity, and familiarity with the economy, financial needs and character of the trade area. Examiners should consider, at a minimum, proposed board oversight and support; management expertise and depth; proposed credit, funds management, interest rate risk and investment guidelines and internal and external audit programs. Comments should provide a forward-looking assessment of an institution's management team, including its operating philosophy and tolerance for risk-taking.

Summary and Findings

Meeting with Organizers

An organizer's meeting was held December 12, 2001 to discuss the application process, as well as, various other safety and soundness matters. Supervisory Examiner Ivie Smart attended on behalf of the Corporation.

Proposed Members of Active Management

Joe Hamm – Chairman/Chief Executive Officer (CEO)

Mr. Hamm's duties will include responsibilities for planning and establishing policy and ensuring all board objectives are executed. In addition, he will supervise senior officers, as well as establish parameters for profitability, business and strategic planning. While Mr. Hamm has not previously served in this capacity of an insured institution, he does possess extensive executive level leadership and credit experience. Previous roles have also included active participation on various board committees notably, strategic planning, executive, loan, and asset/liability management. His commercial credit experience in particular is viewed as a key strength within the organizing group. This experience, along with information obtained from available regulatory sources suggest that he will employ a conservative operating philosophy with regard to risk selection. Actions taken by Mr. Hamm during his brief association with the group appear to confirm this philosophy. During interviews with the undersigned examiner, Mr. Hamm stated he recognized the salient risks with the previous proposal and recommended that the operating plan be materially changed. In addition, he also recognized that HH's role in the regulatory application process should be reallocated to him as CEO. The latter has seemingly made the process more efficient from both a cost and regulatory perspective. Finally, Mr. Hamm eliminated the reliance on outside consultants (other than HH as Counsel) that were frequently employed by the previous CEO and President. He stated that it is his role to formulate a credible strategy, plan, and accompanying assumptions.

Nigel Newbury – Chief Financial Officer (CFO)

Mr. Newbury's proposed duties include supervising all internal management and financial reports, treasury function including asset allocation strategies, producing risk management and profitability reports and budgets, and participating in strategic planning. The position description defines that he will directly supervise the financial controller/treasurer. While Mr. Newbury has not served in this capacity within a commercial or community bank, he does possess a background in accounting and financial management at both a recognized public accounting firm and other large multinational corporations.

Frank Gray – Chief Technology Officer (CTO)

Mr. Gray will have direct oversight over the senior technology officer and development manager. The position's function includes overall responsibility for the design, implementation, and maintenance of all the Applicant's software, computer hardware, and technology infrastructure. Mr. Gray will also identify and recommend solutions to the Applicant's technology needs and problems. In summary, his responsibility is to manage the systems to ensure that efficient customer service is maintained. Mr. Gray appears to possess extensive experience for the proposed position. In the interview, Mr. Gray stated that the senior technology officer (his direct report) would be the US based technology officer, while Mr. Gray executes his other roles at the top-tier holding company in London.

John Well - Chief Lending Officer

Mr. Well's duties will encompass responsibility for loan growth and the preservation of asset quality. Inherent in this role will be the employment of conservative underwriting and risk management systems. His background contains considerable lending, credit administration and operations experience within both commercial and consumer portfolios, which appear compatible with the proposed Application and business model.

Proposed Board Members

The proposed board includes eight members, five of which are designated as non-executive (outside directors). The outside directors have a vast array of experience in banking and finance, law, communications, technology, and criminal investigations. A key improvement in the current management team over the prior proposal includes the addition of directors (either inside in the case of Mr. Hamm, outside with regard to Mr. Lamar) with previous commercial bank executive/board experience.

A second strength includes the addition of directors Wart and Marcotte. Both individuals appear to hold prominent roles in the community and may serve to provide meaningful business referrals for the proposal during the formative stages. Other strengths include Mr. Mason' background and appearances that he will ask the necessary questions from executive management. Based on the organizational minutes and discussion with other proponents, Mr. Mason is among the most vocal individuals on the board. In the interview, Mr. Mason stated that his residence in the Northeast would not preclude him from fulfilling his supervisory duties or attending board/committee meetings.

Proposed Operating Programs

According to information contained in the Application and Mr. Hamm, the Applicant will adopt comprehensive operating guidelines with regard to lending, funds management and interest rate risk, investments, and audit. A pre-opening visitation by the primary regulator should confirm and validate the appropriateness of these policies.

GENERAL CHARACTER OF THE MANAGEMENT (Continued)

List alphabetically, by group, all *Directors, Non-Director Officers, and Others owning 10% or more of total capital.* Indicate the status of each individual listed by checking the appropriate box *(D-Director; O-Officer; S-Shareholder).* Under "Summary and Findings" indicate *(a)* years and reputation in the community; *(b)* director or officer positions held in other banks and the names of such banks; *c)* dominant individuals and the extent, character, and effect of such domination; and *(d)* capabilities of each individual with reference to his duties and responsibilities, and the amount of time devoted to the institution.

<table>
<tr><td rowspan="3">NAME AND ADDRESS

Well, John
13821 Folkstone Circle
Anytown, Anystate</td><td>AGE
38</td><td colspan="3">RELATIONSHIP WITH BANK
☐ Director ☒ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES
139,084</td><td>NET WORTH
116,338</td><td>SHARES OF STOCK
140,500</td><td>ANNUAL SALARY
90,000</td></tr>
<tr><td colspan="4">TITLE
Proposed Chief Lending Officer</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Career Credit and Lending Officer</td></tr>
</table>

Summary and Findings

Mr. Well was born in Middletown, Connecticut and has resided in the area since 1999. He holds an undergraduate degree in economics from Dartmouth, College, Hanover, New Hampshire. Mr. Well has over fourteen years banking experience including senior level positions in lending and credit administration. He reportedly has considerable experience within consumer and commercial loan portfolios, policy formulation, credit scoring and loan pricing strategies, as well as, auditing, operations and retail branch oversight. He has spent nearly his entire banking career working under the tutelage and supervision of proposed CEO Hamm.

Banking Experience

From 1999 until his recent appointment, Mr. Well served as SVP and Senior Credit Officer of Anybank, Anytown, Anystate. In this position, he was responsible for credit quality of the bank's consumer, mortgage, and small business portfolios. Leading a staff of seventeen, Mr. Well established a Small Business Operation which generated monthly loan volume of $5 million. In addition, he managed the credit scoring process for small business and consumer lending including, validation and oversight of system parameters. Prior to that, he served ten years at Anybank, Anytown, Anystate, in several lending and managerial roles including VP and Consumer Credit Manager, Branch Manager, and Regional Consumer Loan Officer. Notable accomplishments included managing the bank's credit scoring system, managing a large loan staff, and successfully generating nearly $100 million in new loans during a three year period.

Interview Comments

Mr. Well became associated with the proposal at the request of Mr. Hamm, whom he reported to while employed at Anybank. He stated that he brings considerable experience with regard to commercial and consumer credit underwriting, portfolio and risk management. He added that these areas have been the cornerstone to his entire banking career. Additionally, Mr. Well stated he also has a perspective in audit and controls given his experience as a staff auditor. He added that he experienced the real estate recession in the Northeast and has an understanding and aversion for speculative transactions. While Mr. Well could not estimate the volume of loan business he would attract during the formative stages, he does know many seasoned lenders who retain established and profitable relationships. He anticipates, as does Mr. Hamm, employing former lenders who are actively seeking other opportunities. Mr. Well stated he was very involved in preparing the loan projections in the proposed business plan. He stated the projections were reasonable based on the proposed development officers and their respective portfolios, as well as, the generating ability of the former supermarket branches. He added that this two pronged approach is also enhanced by his experience in selectively purchasing high-quality consumer mortgage portfolios. Such activity, he said, could be employed to fill budget shortfalls and otherwise more efficiently employ earning assets during the first year. With regard to the former supermarket branches, Mr. Well stated that the eleven branches produced monthly consumer loan volumes ranging from $100M-$500M.

Financial Information and Stock Ownership

As of November 2001, Mr. Well's primary assets consisted of $38M in cash and a personal residence valued at $175M. Liabilities consisted primarily of a $126M mortgage payable. His $5000 investment in the proposal was reportedly purchased with cash.

<table>
<tr><td rowspan="3">NAME AND ADDRESS

Mason, Perry
130 Old Army Road
Anytwon, Anystate</td><td>AGE
62</td><td colspan="3">RELATIONSHIP WITH BANK
☒ **Director** ☐ **Officer** ☐ **10% Shareholder**</td></tr>
<tr><td>LIABILITIES
0</td><td>NET WORTH
3,213,000</td><td>SHARES OF STOCK
25,000</td><td>ANNUAL SALARY
0</td></tr>
<tr><td colspan="4">TITLE
Proposed Director (nonexecutive)</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Consultant. Retired executive credit officer for counterparty risk and former English trial lawyer.</td></tr>
</table>

Summary and Findings

Mr. Mason was born in Limassol, Cyprus and became a U.S. Citizen in 1989. He also holds citizenship in the United Kingdom. Mr. Mason received a Masters and Bachelor of Arts degrees in Law from Cambridge University, Cambridge, England and subsequently realized his Barrister-at-Law license in 1960. For nearly eight years prior to retiring in 1999, Mr. Mason served as Executive Vice President, Global Trading Credit Group at Anybank, Anytown, Anystate. Responsibilities included management of all counterparty credit exposure for the Derivatives Products Group. Additionally, he supervised and developed risk management systems for the trading group, and served on various committees including, Asset Liability Management, Credit Policy, and Payment Systems Risk. He held similar responsibilities for nearly five years as Managing Director while at Regionalbank, Anystate. Other notable responsibilities include various Vice President level assignments at Anybank, Anystate and London. These duties entailed the development of marketing and credit strategies, lending, and asset management, including trading assets within Europe, Pacific Rim and U.S.

Interview Comments

Mr. Mason became involved with the Applicant as a result of some consulting work he performed for Risk Management, plc, London, England, and its Chairman John Wise. Mr. Wise is also a 1.8% shareholder of Holding Company-1 and serves as a nonexecutive director. Mr. Mason stated that he has experience dealing with complex financial problems and understands how to manage risks. He stated that he would not be able to introduce many deposit or lending relationships given his lack of contacts within the market area. Mr. Mason acknowledged that he has little or no financial stake in the proposal, but views his reputation as a key contribution. In this regard, he would feel inclined to notify the Regulatory Authorities should any material supervisory issues become apparent. Mr. Mason is more enthusiastic and confident about the current proposal versus the previous model. He feels that the deposit base is better quantified given that many of the proposed branches were active and successful less than a year ago. In addition, he feels the proposal now has a more experienced board and executive management team given the addition of Messrs. Hamm (Proposed CEO) and Lamar (Outside Director).

Financial Information and Stock Ownership

As of August 2001, Mr. Mason reports no liabilities and liquid assets (bonds, equity securities and cash) of nearly $2,217M. Other material assets include his residence valued at $550M. According to Mr. Mason, his limited investment ($2,400) in the proposal was purchased with cash.

IV. GENERAL CHARACTER OF THE MANAGEMENT (Continued)

<table>
<tr><td rowspan="3">NAME AND ADDRESS

Marcotte, Janet
2 McCairn Court
Anytown, Anystate</td><td>AGE
49</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☐ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES
175,740</td><td>NET WORTH
821,946</td><td>SHARES OF STOCK
26,000</td><td>ANNUAL SALARY
0</td></tr>
<tr><td colspan="4">TITLE
Proposed Director (nonexecutive)</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Vice President and General Sales Manager, BellSouth.</td></tr>
</table>

Summary and Findings

Ms. Marcotte was born in Columbus, Ohio and has resided in Anytown for over 40 years. She holds undergraduate and graduate degrees in Business Administration from University of Anystate, Anytown and SouthEastern University, Anytown, Anystate, respectively. She currently holds a senior management level position with BellSouth, a company for which she has been employed with for nearly 30 years in various marketing capacities. In her current capacity, Ms. Marcotte is responsible for BellSouth's sales and technology operations, a regional business unit accounting for nearly $700 million in total revenues. She does not have any prior commercial/community banking experience.

Interview Comments

Ms. Marcotte became associated with the proposal through her civic relationships with proposed director Wart. She appears active in local community circles and serves on the board of the Anytown Economic Development Council. She stated that her community contacts and professional longevity within the county could assist in providing meaningful business opportunities for the proposal. Given her position with a technology-based company, Ms. Marcotte stated she could provide valuable insight into the needs of the bank's target market and potential internet users. She has reportedly gained extensive experience in marketing to a comparable demographic segment within her company and knows how to serve customer's technology needs. Ms. Marcotte stated that proposed President Hamm has crafted a credible business model; integrating a traditional retail site and supermarket branch banking with an internet component, within two high growth Markets.

Financial Information and Stock Ownership

As of December 2000, Ms. Marcotte reports liquid assets (cash and listed securities) of $238M and stock options with a estimated value of $460M. A personal residence valued at $300M represents her other primary asset. Liabilities consist primarily of a $165M mortgage payable. According to Ms. Marcotte, her limited investment ($1,000) in the proposal was purchased with cash.

IV. GENERAL CHARACTER OF THE MANAGEMENT (Continued)

<table>
<tr><td rowspan="3">NAME AND ADDRESS

Hamm, Joe
112 Olympic Circle
Anytown, Anystate</td><td>AGE
47</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☒ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES

415,400</td><td>NET WORTH

1,096,600</td><td>SHARES OF STOCK
665,000</td><td>ANNUAL SALARY
150,000</td></tr>
<tr><td colspan="4">TITLE
Proposed Chairman, President, and Chief Executive Officer</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Career Banker and Senior Lending Officer.</td></tr>
</table>

Summary and Findings

Mr. Hamm was born in Troy, New York and has resided in Anytown for over two years. He attended the Stonier Graduate School of Banking at the University of Delaware and State College, Antyown, Anystate. Mr. Hamm has over twenty-seven years of experience in the banking and financial services industry.

Bank Experience

Prior to joining subject proposal, Mr. Hamm served as Senior Executive Vice President and Chief Credit Officer at Anybank, Anytown, Anystate, a $3.4 billion state member bank, which was recently acquired by Regionalbank. In addition, he served as a member of the bank's Executive Committee, which was designed to establish near term strategic guidance and policy. While employed at Anybank (2-year tenure until acquisition by Regionalbank), he also served as Chairman of the Board of two of Anybank's wholly owned subsidiaries; First Financial, Inc., a national yacht finance company with annual loan volumes of $300MM. Reportedly, the company was the largest originator of yacht loans in the Nation, prior to Mr. Hamm's departure. His second Chairperson role was with Spectrum, a factoring entity generating annual receivable/inventory facilities of $120MM.

Prior to his role at Anybank, he served for eleven years as a Senior Vice President and Chief Corporate Lender and then as Executive Vice President and Chief Credit Officer at Financial Services Corp, Anytown, Anystate, the holding company for AnyNational Bank. While there, Mr. Hamm was responsible for a department of fifty credit and administrative personnel and a $1.4 billion commercial, mortgage, and consumer portfolio. Notable assignments and accomplishments during his eight year tenure was the operation and oversight of special assets and the reduction of non-performing assets from a high of 6.5% to 0.6%. Mr. Hamm also served on various board committees including, Executive, Strategic, Loan, Asset/Liability, and Human Resources. Prior to his EVP/SVP roles he served for five years as a VP and Regional Commercial Loan Officer within the same institution.

Additionally, he has approximately eight years of lending and related experience while employed by MoneyCenterBank, Anytown, Anystate. Mr. Hamm was active in the Anystate Banker's Association for nearly seventeen years and served as a member of the Association's Board of Directors. According to the association's CEO, Mr. Hamm was highly respected by colleagues and active as a Loan Quality instructor at the Anystate School of Banking.

Regulatory History and References

Available information from the Corporation's database suggests that Anybank and AnyNational Bank were fundamentally sound entity's during Mr. Hamm's tenure. Additionally, regulatory information from the Federal Reserve yielded no comments of any supervisory concern regarding his credit background or professional abilities. The undersigned examiner also contacted the State Comptroller's Office. The State's regulatory experience with Mr. Hamm was very favorable.

The undersigned examiner also interviewed the former Chairman and CEO of Anybank during Mr. Hamm's tenure. The former Chairman was very complimentary of Mr. Hamm's leadership skills and credit experience. According to him, Mr. Hamm was hired to ensure that asset quality and risk management systems were preserved during Anybank's growth phase. In this defined role, the former Chairman stated that he did an excellent job at executing and formulating policy.

Interview Comments

Mr. Hamm stated he was disenchanted with Regionalbank's methods of operation after its acquisition of Anybank and sought to pursue other opportunities. The denovo's legal counsel, Hodson & Hodson (HH), contacted Mr. Hamm about becoming an organizer shortly after the former president resigned from the group in April 2000.

Mr. Hamm stated he was skeptical about the prior proposal's business model as well as, the viability of the kiosk as a key delivery channel. His main issue with the kiosk strategy was that it had not been successfully executed within the market place. As a result, Mr. Hamm stated he recommended that the model be changed to incorporate more proven and traditional retail delivery channels. Another key change he recommended was the addition of other board members with strong community ties and/or previous banking experience (proposed director Wart, Marcotte, and Lamar). Mr. Hamm also sought to replace the previous proposed senior lending officer with one he viewed as possessing a stronger skill set and educational background.

Mr. Hamm indicated he has market intelligence over the success of the proposed supermarket branch network, inasmuch as eleven of the twelve branch sites were previous Anybank branch locations. He believes this aspect to be a key strength over the previous proposal. Mr. Hamm stated that despite his less than three years in Anytown, he has a sound foundation within the market area and has developed many contacts, which could lead to lucrative future business for the proposal. Regarding future lending, Mr. Hamm has retained a chief lender (Well) with whom he directly supervised while at AnyNational Bank and Anybank. In addition, other senior lenders have expressed a desire to join the group. Said lenders, according to Mr. Hamm, all would bring seasoned commercial and consumer portfolios generated from the former Anybank.

Financial Information and Stock Ownership

As of August 2001, Mr. Hamm reports a considerable liquid net worth, with $542M in cash and marketable securities. He reflects a personal residence with an assigned valued of $550M and deferred savings plan (401k/IRAs) assets of $420M. Liabilities consist primarily of a mortgage payable of $390M. Mr. Hamm's initial investment of $30M was reportedly purchased with his cash holdings.

NAME AND ADDRESS	AGE	RELATIONSHIP WITH BANK		
Newbury, Nigel 12 Circus St. Anytown, Anystate	42	☒ **Director** ☒ **Officer** ☐ **10% Shareholder**		
	LIABILITIES	NET WORTH	SHARES OF STOCK	ANNUAL SALARY
	177,000	2,218,000	7,366,665	55,000
	TITLE Proposed Chief Financial Officer			
OTHER BUSINESS AFFILIATIONS OR PROFESSIONS Accountant. Also serves as Financial Director and Director of Holding Company-1, London, England.				

Mr. Newbury was born in Hazelgrove Cheshire, England. He holds citizenship in the United Kingdom and also maintains temporary residency in Anystate. He attended Reading University in England and subsequently became a Chartered Accountant with the firm, Touche Ross, London.

From 1996 until his involvement with Applicant in 2000, Mr. Newbury served as Finance Director with Risk Management Systems, London, England. This firm, whose Chairman and founder John Wise is also an invester and noneceutive director of the Applicant's holding company in London, provides financial trading and risk management systems for financial institutions in Europe. They also provide training and advisory services related to risk management. For nine years prior to 1996, he served as Director and Chief Financial Officer for Knight Financial, Inc., in both London and New York, as well as, associated companies throughout Europe and Asia. In this capacity, he led the company's financial planning and accounting group. Mr. Newbury does not have any prior commercial/community banking experience in the UK or US.

Interview Comments

Mr. Newbury stated he collaborated with proposed CEO Hamm in revising the proposed business plan and accompanying financial projections. Mr. Newbury added that while he lacked direct banking experience, he attained a comprehensive finance and accounting background including financial institution auditing, while employed at Touch Ross. He indicated that he had a strong background in risk management practices and financial controls. As Mr. Newbury was one of the authors of the previous business plan and forecasts, which incorporated dubious assumptions and resulted in the Applicant's ultimate withdrawal, he was asked to compare and contrast the current proposal. Mr. Newbury stated that the revised business model emphasizes more traditional and proven delivery channels. He is especially pleased that eleven of the twelve proposed supermarket branches were viable deposit and loan production offices of the former Anybank. As such, he is more comfortable with the model's assumptions and accompanying financial forecasts.

Financial Information and Stock Ownership

As of August 2001, Mr. Newbury reported $22M in cash and $399M related to his equity holdings and warrants in the proposal. Other material assets include his residence in London valued at $1,033M as well as, pension plans and life insurance valued at $940M. Liabilities primarily consist of a mortgage payable with a balance of $163M. Mr. Newbury's investment in the proposal was reportedly purchased with cash and personal savings.

<table>
<tr><td rowspan="3">NAME AND ADDRESS
Gray, Frank
Morlich Lodge
Anytown, Anystate</td><td>AGE
38</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☒ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES
325,000</td><td>NET WORTH
314,000</td><td>SHARES OF STOCK
225,000</td><td>ANNUAL SALARY
55,000</td></tr>
<tr><td colspan="4">TITLE
Proposed Director and Chief Technology Officer</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Information Technology Professional & Software Designer. Also serves as an Officer of Holding Company-1, London, England.</td></tr>
</table>

Mr. Gray was born in Shropshire, England and holds British citizenship and residency. He is a graduate of Loughborough University, United Kingdom (UK) and received a degree in Mathematics and Engineering.

From 1995 up to his involvement in the proporsal (March 2000), Mr. Gray served as the Head of Front Office Technology/Europe for InternationalBank in London. In this role, he coordinated and led the Year 2000 project as well as, the Euro currency conversion. His primary responsibility, while at the institution was the development and implementation of front office trading systems for financial derivatives and fixed income securitites. Prior to this, Mr. Gray worked for nine years on numerous IT and software design projects including remote sensing technology (satalite systems) for end users such as the European Space Agency and Defense Research Agency in the UK.

Interview Comments

Mr. Gray stated his primary emphasis thus far has been on writing the Applicant's technology plan and designing and implementing the technology infrastucture. Mr. Gray stated he has extensive software design and project management experience and successfully recruited other highly talented designers from his previous employer, InternationalBank. He feels the current proposal offers a more viable business model, given its previous success with RSB. He also added that the Board has been strentghened considerably by the additions of former commercial bankers, Messrs. Hamm and Lamar.

Financial Information and Stock Ownership

As of June 2001, Mr. Gray' reported net worth, was primarily centered in his personal residence, with an assigned value of $547M. Liabilities of $325M consist of a mortgage payable on his residence in the UK. Mr. Gray' investment in the proposal of $9,900 was purchased with personal savings.

<table>
<tr><td rowspan="3">NAME AND ADDRESS
Lamar, Austin
12770 Jernigan Avenue
Anytown, Anystate</td><td>AGE
59</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☐ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES
290,000</td><td>NET WORTH
7,511,000</td><td>SHARES OF STOCK
110,000</td><td>ANNUAL SALARY
0</td></tr>
<tr><td colspan="4">TITLE
Proposed Director (nonexecutive)</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Retired Banker.</td></tr>
</table>

Summary and Findings

Mr. Lamar was born in LaGrange, Georgia and has resided in Anytown, Anystate for approximately one year. He is a graduate of Auburn University, Auburn, Alabama. Mr. Lamar recently retired from RegionalBank, an NYSE listed entity in Anystate, following its acquisition by ForeignBank. During his twenty-six year tenure at the state member bank, he served in a variety of executive and operational capacities.

<u>Bank Experience</u>

From 1990 to 2000, Mr. Lamar served in various executive roles including, RegionalBank's Vice-Chairman of the Board and Chief Financial Officer. At the time of its acquisition by ForeignBank, RegionalBank was an $11 billion commercial bank, operating in Anystate. Prior to that, Mr. Lamar served (1975-1990) at MidsizeBank, Anytown, Anystate, which was merged into RegionalBank in 1990. While at MidsizeBank, he served as a Director as well as its President and Chief Executive Officer (1988-1990). In addition to his executive officer roles during his tenure at MidsizeBank, Mr. Lamar served as CFO, Controller and Audit Manager.

<u>Regulatory History and References</u>

Available regulatory information (from FRB, State, and OCC) suggests that the institutions were fundamentally sound and operated. Contacts at the Federal Reserve Bank confirmed his executive level experience and had no supervisory concerns to report.

<u>Interview Comments</u>

Mr. Lamar became associated with the proposal through the Applicant's legal counsel, HH, an entity with whom he collaborated with on many issues while at RegionalBank. Mr. Lamar stated that he has considerable experience within finance, asset securitization, as well as, mergers and acquisitions. Regarding the latter, he stated he was involved in the acquisition of some forty or more institutions. He also stated that his institutions had experience with the supermarket branch delivery channel. While employed at RegionalBank, they operated over 20 rural supermarket branches with a moderate degree of success. He conveyed that the branches were profitable but did not enjoy the degree of returns as other parts of the institution. According to Mr. Lamar, the supermarket branches generally achieved $4-5 million in deposits and a loan to deposit ratio of 60% within 2 years of opening. He added that he is compelled by the more favorable demographics within the Anystate market, particularly the existing deposit base and retail branch networks employed by the myriad of institutions. This was an aspect that was far less prevalent in the rural areas of Anystate. Mr. Lamar stated that his residence's distance from the main office would not preclude him from being an active director.

<u>Financial Information and Stock Ownership</u>

Mr. Lamar's personal statement dated August 2001, reflected $80M in cash and $4,266M in marketable securities. Other material assets include residential properties valued at $650M and pension plans valued at $2,806M. Liabilities consist primarily of a mortgage payable of $240M. Mr. Lamar's $5,000 investment in proposal was reportedly made with cash.

NAME AND ADDRESS	AGE	RELATIONSHIP WITH BANK		
Miller, Dennis 5678 Muirfield Village Circle Anytown, Anystate	55	☒ **Director** ☐ **Officer** ☐ **10% Shareholder**		
	LIABILITIES	NET WORTH	SHARES OF STOCK	ANNUAL SALARY
	149,012	293,000	57,850	0
	TITLE Proposed Director (nonexecutive)			
OTHER BUSINESS AFFILIATIONS OR PROFESSIONS Retired Special Agent, Federal Bureau of Investigation (FBI).				

Summary and Findings

Mr. Miller was born in Dearborn, Michigan and has resided in Anystate since 1980. He received his Bachelors degree in Biological Sciences from Michigan Technological University, Houghton, Michigan.

Mr. Miller recently retired from the FBI in Anytown, Anystate. He has extensive experience with investigations involving white-collar crimes including, crimes against financial institutions. Particularly noteworthy is his experience regarding bank fraud, embezzlement, and Internet related financial crimes.

Interview Comments

Mr. Miller became associated with the proposal through Casey Grant's (Joe Hamm's predecessor who resigned during 1H2001) father, who resides in the same residential development. Mr. Miller stated that he has many years of experience investigating and prosecuting white-collar crimes in Anystate, particularly, money laundering, as well as, bank, mail and wire fraud. He is reportedly very knowledgeable of Internet related crimes. With regard to strengths he could bring to the Applicant, Mr. Miller stated he would add depth and experience to the audit committee. As a proposed director of the previous Application, Mr. Miller stated he is more comfortable with the supermarket branch network given it has had a proven record at Anybank.

Financial Information and Stock Ownership

As of September 2001, Mr. Miller's net worth was primarily centered in a deferred savings plan. As of the reporting period, the balance of this other asset (Federal Thrift Savings Plan) was $218M. Other material assets included his residence, with a value of $200M. Liabilities primarily consisted of a mortgage payable on his residence of $130M. Mr. Miller's investment in the proposal of about $5,500 was made with his personal savings.

<table>
<tr><td rowspan="4">NAME AND ADDRESS
Wart, Philip
118 Olympus Circle
Anytown, Anystate</td><td>AGE
46</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☐ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES</td><td>NET WORTH</td><td>SHARES OF STOCK</td><td>ANNUAL SALARY</td></tr>
<tr><td>921,896</td><td>1,661,484</td><td>250,000</td><td>0</td></tr>
<tr><td colspan="4">TITLE
Proposed Director (nonexecutive)</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Attorney. President and Managing Partner of the law firm, Wart, West, and West, P.A. (WWW).</td></tr>
</table>

Summary and Findings

Mr. Wart was born in Robana, Illinois and has resided in the Anytown area since 1984. He received an undergraduate degree in economics from Dartmouth College, Hanover, New Hampshire, and Juris Doctorate in law from University of Miami, Miami, Florida. Mr. Wart is a practicing attorney, specializing in corporate, real estate, banking, and securities law. Additionally, he is Chairman of the Anytown Development Board, a not for profit organization committed to advancing the county's business, technology, and educational endeavors.

Interview Comments

Mr. Wart became associated with the proposal through Joe Hamm, whom he advised on several lending transactions, while at Anybank. He stated he is an active member in the community and knows many influential business professionals who can serve as potentially lucrative deposit clients during the formative stages. In that regard, he specifically spoke of the New Technical School in Anytown. He anticipates being able to refer the School's operating account, which reportedly retains balances of $10 million.

Mr. Wart stated he has performed legal work for many financial institutions in Anystate. He was active in processing various regulatory applications for Anybank, in Anytown when he served as general counsel. Additionally, he represented Anybank on many real estate transactions. In addition to proposed CEO Hamm, Mr. Wart knows proposed director Marcotte, a fellow member of the Anytown Development Board.

With regard to the business model, Mr. Wart stated it was conceived on sound research and partly on the success of the eleven- branch supermarket network, while employed by Anybank. He cited the favorable deposit market share in AnyCounty-1 and AnyCounty-2, the depth of the Hispanic market, and relatively low cost structure of the supermarket branch vis a vis the traditional bricks and mortar retail branch site.

Financial Information and Stock Ownership

As of August 2001, Mr. Wart reported $163M in cash and marketable securities, as well as, $1,577M in residential and commercial real estate holdings. Other assets include his 43% interest in the law firm, WWW, with an assigned value of $600M. The firm WWW reported revenues of $3 million for the year ending 2000, representing a 54% increase over the previous year. Mr. Wart's liabilities consist primarily of three mortgage payables with an aggregate balance of $914M. He reports no contingent liabilities. According to Mr. Wart, his $10,000 investment in the proposal was made with cash.

GENERAL CHARACTER OF THE MANAGEMENT (Continued)

Discuss proposed board and management committees and their associated responsibilities. Assess the reasonableness of fees and other expenses associated with the application and organization, including insider involvement. Evaluate the reasonableness of stock benefit plans, including stock options, stock warrants, and other similar stock based compensation plans. The structure of stock benefit plans should encourage the continued involvement of the participants and serve as an incentive for the successful operation of the institution. Assess reasonableness of fidelity coverage. An insured depository institution should maintain sufficient coverage on its active officers and employees to conform with generally accepted industry practices.

Summary and Findings

Board Committee Structure and Fidelity Coverage

The organizers have provided for a usual and customary committee structure to assist in overseeing and managing the bank's operations. No exceptions were noted to these proposals and structures. Organizers stated that sufficient fidelity coverage would be procured and maintained.

Reasonableness of Organizational Expenses

Organizational and pre-opening expenses appear excessive for the formation of a denovo national association and do not reflect favorably on the Applicant.

Most of the responsibility for these high expenses can arguably be attributed to the previous leadership during the prior Application submission (August 2000). Casey Grant, the lead organizer and proposed Chairman/CEO displayed a lack of fiscal discipline during his tenure and was responsible for formulating the previous nontraditional and seemingly higher risk business model. This model was poorly supported and thus required extensive time to procure supporting documentaion and fesibilitiy studies. During this lengthy process, Mr. Grant relied extensively on legal cousel and consultants which added to the expense burden. Finally, Mr. Grant prematurely added a staff of twenty, including highly compensated officers, which impacted pre-chartering costs.

Since the previous management's departure and filing of the new Application, organizational expenses while high, appear to have moderated. Despite the high organizational expenses, management has been successsful, during two separaterly underwritten capital offerings, in forming a substantial amount of capital. It is believed this capital is sufficient to absorb the high costs and provide for the growth of the proposal.

Employment Agreements & Compensation

The Applicant anticipates negotiating employment agreements with several officers. The officers (to date) with corresponding annual salaries are as follows: Chairman/CEO Joe Hamm, $150M; CFO Nigel Newbury[*] $55M; CTO Frank Gray, $55M; CLO John Well, $90M. In addition, Controller Sue Herrera $65M; and Senior Technology Officer Brian Bain $110M will reportedly be under contract. The agreements generally include the following standard terms:

- Employment Term: Generally one year. Continues thereafter unless terminated by either party;
- Other Benefits: Medical, and participation in any existing stock benefit plan.
- Bonus: Sole discretion of Board of Directors
- Termination without Cause: Lump sum payment equal to the present value of the unexpired portion of the employee's term (effectively less than or equal to 1 year). Discount derived using the prevailing Federal funds rate.

<u>Stock Benefit Plan</u>

The Applicant intends to formulate a plan for certain executive officers, directors, and other employees. To date, this plan has not been formalized or submitted for Regulatory review. Organizers have committed to enacting a plan that is consistent with existing regulatory guidelines. Said plan should be scrutinized for reasonableness in light of exceptions taken by the Examiner during the prior

Messrs. Newbury and Gray' respective salaries represent the proposed bank's pro-rata expense only. Additional compensation of $55M for each will be paid by Holding Company-1, London, England. This represents compensation for services performed at the top-tier holding company level. Refer to biographical information for their respective roles.

Application. Exceptions involved excessive option grants to the proposed president, that were nearly 3x the volume of initial shares purchased.

Warrant Holders and Intrinsic Value

Based on the most recent bid of 2.5p (£0.03) per share (or ¢3.75), and existing strike price above of 2p, the intrinsic value of the Mr. Newbury's warrants is less than $50,000. Given the current pricing, this additional form of compensation does not appear unreasonable.

The overall finding on this factor is FAVORABLE, pending receipt of acceptable stock benefit plans.

RISK TO THE FUNDS

As a general matter, the FDIC interprets this factor very broadly, relying on any information available including, but not limited to the applicant's business plan. Assess the proposed institution's business plan. The business plan's goals should be commensurate with the capabilities of its management and the financial commitment of the incorporators. The business plan should demonstrate an ability to achieve a reasonable market share, reasonable earnings prospects, the ability to attract and maintain adequate capital, and demonstrate a responsiveness to community needs. The plan should also demonstrate adequate risk management policies. Business plans that rely on high risk lending, a special purpose market, or significant funding from sources other than core deposits, or that otherwise diverge from conventional bank related financial services require detailed analysis as to the suitability of the proposed activities for an insured institution.

Summary and Findings

The Applicant is proposing to execute a traditional integrated business model with respect to deposit acquisition and funding. Funding will primarily draw on two key delivery channels, a supermarket branch network and traditional retail banking office and to a lesser extent, a fully transactional web-site.

Business Model Strengths

The business model enjoys a strong initial capitalization base, a seemingly conservative management team and investment philosophy, a viable and multi-faceted branch network strategy, and a vast deposit market within its operating environment. These factors comprise the proposal's prevailing strengths.

The most integral change in the proposal versus the prior previous bank model consists primarily of the upgrade in the executive management team and secondly, the adoption of a more fundamentally sound and traditional business model. The new team is led by an executive (CEO Hamm) possessing an extensive commercial banking and lending background. Equally important has been the addition of seemingly strong outside directors, one of whom (Director Lamar) possesses previous executive and director level experience. The remaining new outside directors (Wart and Marcotte) appear to be very influential within various County economic development endeavors. By all accounts, the outside directors may be in a position to influence and stimulate the proposal's funding and business development initiatives. The proposed management's aversion for risk is best manifested in the proforma asset-mix, which is heavily weighted towards residential real estate during the first year of operation. With regard to funding, the business model is seeking to replicate the deposit generating success of the supermarket branch network once operated by Anybank. Its previous success within demographically favorable and densely populated towns and cities adds credence to the model's funding projections.

Business Model Risks

As depicted in the Applicant's sensitivity analysis and stress testing, the model is most vulnerable to a slower rate of deposit growth {Scenario 2} during the formative years. What-if scenarios depict an earnings risk should funding fall below 75% of original projections. A deposit shortfall without any commensurate and effective cost containment plans may adversely impact profitability and the model's ultimate success. In light of funding's importance during the formative stages, any shortfalls may induce management to compete more aggressively on price thereby jeopardizing margins, profitability or risk selection. Executive management's ability to attract funding at a reasonable cost will be critical to the model's success.

The finding on this factor is <u>FAVORABLE.</u>

CONVENIENCE AND NEEDS OF THE COMMUNITY TO BE SERVED

Discuss the proposed institution's primary trade area(s) including location and population. Address economic conditions, primary industries, and major employers. Assess trade area(s) population demographics and the proposed institution's willingness and ability to meet the deposit and credit needs of the community to be served. Assess the competitive dynamics of the market and how the proposed institution will compete for market share.

Summary and Findings

Proposed Service Areas

Per the Applicant, the primary trade areas are contained within AnyCounty-1 and AnyCounty-2, Anystate. A retail branch network encompassing one traditional branch (main office) as well, a supermarket branch network will form the bank's surrounding service areas. During the first year, a total of six branches (five supermarket and one main office) are planned for AnyCounty-1, while seven are envisioned for AnyCounty-2. Given the internet component of this business model, other market areas outside of the proposal could conceivably be pursued.

Community Growth and Demographic Indicators[4] – AnyCounty, Anystate - MSA

Item	2005 *Forecast*	2000	1999	1998
Population (000)	1,247.1	1,131.2	1,106.7	1,084.0
Residential Building Permits	7,637	6,769	6,428	6,387
Mortgage Origination ($Mil)	$6,207	$6,740	$6,946	$8,476
Unemployment Rate	5.1%	4.4%	5.0%	5.6%
Total Employment (000)	560.0	491.4	469.4	457.3
Gross Metro Product $Billion	$45.2	$37.7	$35.2	$33.3
Top Employers & Industries in Trade Area				
Name	**Business Type**	**Employees**		
Columbia Beach Health Care	Medical/Health	4,000		
Intracoastal Health Systems	Management Svc	3,200		
Motorola, Inc	Technology	2,300		
Power and Light	Utility	2,300		
Pratt & Whitney	Mfg./Technology	1,300		

Demographic and Economic Trends – Anytown - MSA

The overall Anytown market remains moderately strong due to the County's higher per capita income and strong job growth, particularly in the services and retail trade sectors. Real Estate markets and favorable adsorption measures (residential housing demand) have been driven by population growth, in-migration from the Southern State Counties, as well as, tourism.

Key short-term risks remain the weak national economy, which has been exacerbated post September 11, 2001. These factors have negatively impacted tourism and its accompanying service industries. In addition, segments of the County, including the Anytown area, have experienced very active new commercial real estate construction activity that has reportedly impacted rental rates for new space. While current vacancy rates of around 14%, are below the 30% prevailing nearly a decade ago, any prolonged recession could make it a more difficult environment for underwriting and funding quality commercial real estate credits. Manufacturing has endured considerable layoffs and remains a weak area for the County. Motorola, State's largest Technology employer, has experienced declining revenue, weakening margins, as well as market share erosion. As a result, substantial layoffs have occurred company wide in addition to its facilities in Anytown.

[4] Source: FDIC Division of Insurance

Community Growth and Demographic Indicators [5] – Anytown, Anystate - MSA

Item	**2005 *Forecast***	**2000**	**1999**	**1998**
Population (000)	1,786.9	1,623.0	1,588.7	1,555.2
Residential Building Permits	8,865	9,160	8,574	8,753
Mortgage Origination ($Mil)	$8,227	$9,159	$8,911	$10,453
Unemployment Rate	4.3%	3.7%	4.1%	4.5%
Total Employment (000)	755.4	676.0	652.7	639.5
Gross Metro Product $Billion	$54.8	$46.2	$43.4	$41.3
Top Employers & Industries in Trade Area				
Name	**Business Type**	**Employees**		
North Hospital District	Medical/Health	6,652		
Winn-Dixie, Inc.	Retail/Grocery	6,110		
American Express	Financial Svc.	4,700		
Publix Supermarkets, Inc	Retail/Grocery	4,200		
Motorola, Inc.	Technology	4,000		

Demographic and Economic Trends – Anytown, Anystate - MSA

Economic trends convey strong growth despite a weaker national economy. Growth has been led by the services, wholesale trade, and finance industries.

The residential housing market is particularly active. Tourism and leisure (hotel/cruise ship lines) remains one of the MSA's key economic drivers, However, its outlook has been impacted by the general state of the economy and September 11, 2001 attack on the US. In addition, international trade with Latin American trading partners may decline somewhat considering the adverse market conditions within Argentina, South America's second largest economy. Manufacturing risks are similar to the Anytown MSA in light of Motorola's size and scale within the area. With regard to commercial real estate, vacancy rates within the Broward office market rose significantly during Q2 2001 to 16.3% versus 9.3% for the same period a year ago[6]. Robust new construction activity, an increase in sublease space, weaker demand, and a softer economy appear to be contributing factors. These trends, should they continue, will pose the same lending risks and challenges previously cited.

Competition – Financial Services

The Applicant will encounter intense competition for funding within both market areas. The FDIC's Summary of Deposits Report for June 2001, indicates that the AnyCounty MSAs hold 450 and 405 banking and thrift offices with aggregate deposit shares of $22.3 and $23.9 billion, respectively. A compelling level of the market share (over 70% for both MSAs) is held by the offices of out of state regional and super-regional bank and thrift holding companies.

The Applicant professes that its multiple delivery channels coupled with attractive rates and efficient service will enable it to compete within the proposed PSA/MSA. The organizers also contend that the recent performance of the eleven supermarket branches as well as, contacts from several directors within the community will enhance the proposal's probability for successfully acquiring deposits within these markets.

The finding on this factor is <u>FAVORABLE.</u>

[5] Source: See Supra
[6] Grubb & Ellis Research , Second Quarter 2001; <u>Vacancy Rates Increase as Construction Continues., Page 1.</u>

CONSISTENCY OF CORPORATE POWERS

Discuss trust powers or any other corporate activities contemplated by the applicant, including those covered by Section 24 of the FDI Act. Address any problems with the Articles of Incorporation or the Bylaws.

Summary and Findings

There is nothing to indicate that the proposal's activities would be inconsistent with the purposes of the Federal Deposit Insurance Act.

The finding on this factor is FAVORABLE.

OTHER PERTINENT INFORMATION

If applicable, provide a summary of comments made by bankers and other interested parties. Address problems with stock offering circular. For applicants delivering services over electronic channels (such as the Internet or wireless devices) assess the information systems infrastructure, policies and security.

Summary and Findings

Summary of Banker Comments

<u>Loren Greene, President & CEO</u> – Anybank & Trust, Anytown, Anystate

Mr. Greene stated he knew proposed CEO Hamm by reputation primarily and suggested he was a very conservative banker. He knows about the proposed bank and opined that the discontinuance of the former delivery channels appeared to be a positive development. With regard to the operating environment, Mr. Greene stated that loan demand has picked up considerably in the county since late 2000, particularly in the SBA, commercial and residential real estate sectors. Funding has been relationship driven and continues to exceed expectations. According to Mr. Greene, the failure of Anybank, which retained a branch directly across from his bank and subject proposal, will assist in reducing the cost of funding for area banks. This is the case given Anybank's aggressiveness with regards to deposit pricing.

<u>Rick Savage, Executive Vice President, Lending</u> – Anybank & Trust, Anytown, Anystate

Mr. Savage served as proposed CEO Hamm's colleague while at Anybank in Anytown. As a Senior Lending Officer, he worked closely with Mr. Hamm who retained the title of Chief Credit Officer. Mr. Savage stated that Mr. Hamm had a strong credit and special assets background. In addition, he stated that Mr. Well (proposed Senior Lending Officer) was also a very competent lender and proficient in operational matters. Mr. Savage suggested that Mr. Hamm would need strong officer support in the operational areas of the bank.

<u>James Brown, Chairman & CEO</u> – Anybank, Anytown, Anystate

Anybank is a federally chartered thrift and a second year denovo. It operates a pure internet business model.
Mr. Brown stated that market acceptance over the bank's model had been positive since the bank's inception. However, according to him, the growth rate has been purely a function of pricing. He added that premium pricing across <u>all</u> deposit categories is what attracts the higher net worth Anytown clientele. The institution is currently experiencing a transaction/CD account mix of approximately 34%/66%. His experience has been that technology for this type of business model was costlier than perceived to be in the planning stages.

<u>Doug Jones, SVP/Retail and Alternative Delivery</u> – Anybank, Anytown, Anystate

Prior to its acquisition by RegionalBank, Anybank was an established National bank which operated 32 in-store retail branches throughout Anystate. The in-store branches are hosted within Albertsons Supermarkets.

Mr. Jones stated that Anybank started this program over four years ago. It is expected to be a profit center for the bank but requires loan production to achieve that goal. Not all locations have been successful thus far. He stated that clientele is very sensitive to deposit pricing and primarily drawn to the time deposit products. He estimates time deposit/MMDA mixes of up to 60%/20%. Given the configuration of their in-store facilities, their loan production mainly caters to consumer type products such as auto and HELs. Mr. Jones stated that customer acquisition becomes a delicate balance of pricing, customer traffic, and marketing abilities of the staff. He concluded that customer traffic was very important for the success of the in store branch. Their institution currently performs studies to locate retail stores which achieve average weekly store traffic of 28,000 shoppers.

Technology Platform and Ensuing Security Risks

Overview

The Applicant plans to offer banking services via multiple electronic delivery channels including the Internet, automated telephone, Customer Call Center (telephone, facsimile, secure web message, e-mail, and regular mail), WAP (handheld wireless), and traditional retail branches.

Services that will be offered are customer identification for account opening, bill pay, check printing, fulfillments, electronic funds transfer (EFT), item processing, AS/400 mainframe hosting, ATM and Visa checkcards. Internet banking will allow account review, bill pay, transactions entry, check order, statements, printing statements, on-line applications, and wire transfers. {A schematic rendering of the operational support service is provided on a subsequent page.}

Vendors/Service Providers

Aurum Technologies (MISER III), Orlando, Florida, will provide the CBS (Comprehensive Banking System) software for processing core banking applications, EFT, Visa checkcards, item processing, network services, Internet connection, VRU as well as, interface to De Luxe check printing, and Equifax credit scoring. Aurum Technologies will host and manage the bank's AS/400 server.

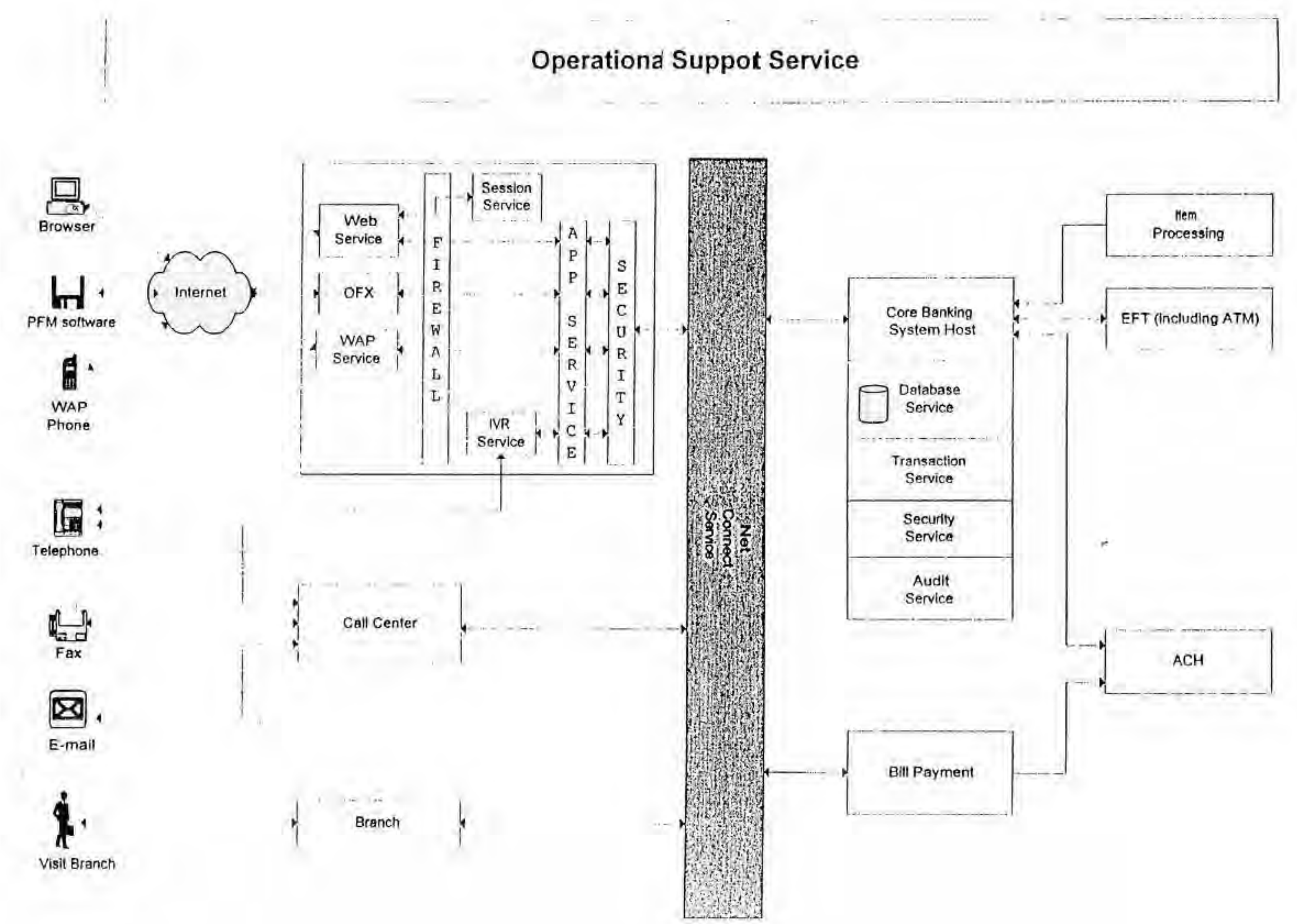
Equifax Credit Services, Inc., Atlanta, Georgia, will provide credit scoring and authentication using Decision Power and eID-Verifier, respectively. Shoreline Business Forms, Inc., Wallingford, Connecticut will provide ATM and Visa check cards. Checkpoint will provide network firewall maintenance. Princeton ecom Corporation, Princeton, New Jersey, will provide bill payments and collections.

Internet access is provided by UUNET through a 1.5 MB T1 line. Fuzion will provide a future second wireless service. There are two local area networks (LANs), located in the London office and in the Anytown office, which are to be joined by a virtual private network (VPN) connection, secured by Checkpoint network firewalls. The web site will be hosted (load balanced) jointly by Applicant and an external provider (Aurum).

According to proposed Senior Technology Officer Brian Bain, the proposed infrastructure retains the sufficient degree of scale and capacity to accommodate forecasted customer account volumes throughout the formative stages.

Facilities

The Applicant has dedicated T1 point-to-point links to Aurum Technologies, Charlotte, NC (hosting center) using redundancy circuits to ensure continuous service at all times. Disaster Recovery is with Sunguard, Philadelphia, Pennsylvania. Telecommunications connectivity was tested and the full system was restored successfully in September 2000. Additionally, the AS400 center in Charlotte is equipped with an emergency system consisting of an uninterrupted power supply (UPS), fire suppression, air conditioning and security access system.



Source: Application for Federal Deposit Insurance

<u>Audit</u>

In addition to monitoring logs; as further delineated within the Security section below, the Applicant will establish a Help Desk to catalogue and report incidents, as well as, follow-up escalation procedures when needed. A third party will be engaged to review all internal products, software and documentation, for compliance with internal standards and ensure that company procedures are implemented.

<u>Security</u>

The ability of the Applicant to provide secure data transmission over its proposed delivery channels will be of paramount importance. Its successful application and accompanying internal controls are believed critical to the success of the Internet as a proposed delivery channel and ultimately, overall customer acceptance.

OTHER PERTINENT INFORMATION (Continued)

In addition to the security measures delineated below, the Applicant is contracting with Aurum, an entity that has attained the requisite SAS 70 certification. This certification, rendered by an independent accounting firm, affirms that a provider's computer systems are being managed and operated in a manner consistent with accepted industry practices.

Security measures proposed for the fully transactional web channel include the following:

Encrypted Transactions

All banking and Internet communications will be encrypted. This will preclude sensitive financial data from being easily read and/or deciphered. Encryption will be accomplished via the use of Secure Sockets Layer Technology. This technology, considered the standard for encryption, is currently utilized by large nationally recognized web browsers. Data transmission from the Applicant's server and Aurum will be encrypted using Data Encryption Standard (DES) encryption, as further described below.

Secure Logon

To preclude the possibility of a third party downloading the Applicant's or a customer's password file, user identification and passwords will be encrypted and stored on a separate database server, not on the Internet or the web server. In addition, password parameters will be structured in a format, which makes the probability of randomly acquiring or guessing said password, extremely low.

Isolated Bank Server

The computer used to provide the Applicant's services would not be directly accessed via the Internet. It will be on a private connection, or intranet, that provides two-way communication between the isolated bank server and Internet server. Consequently, an Internet user will be prevented from accessing the computer that provides the Applicant's services. All banking services will be routed from the Internet server through a firewall. The firewall is a combination of software and hardware devices that specifically defines, controls, and limits access to internal computers from outside computers across a network. The firewall framework means that only authenticated bank customers or administrators may send or receive transactions through it. The firewall will also be immune to penetration from within the network. All messages transmitted or received between the Internet server and the operating server will be encrypted using DES encryption.

This consists of a symmetric key algorithm. Such technology is highly secure as it is not vulnerable to standard ciphertext attacks. Therefore, even if an individual was to route a message to the Applicant's server and through the firewall, the message could not be encrypted in a manner, which would be considered valid by the server. Consequently, the Applicant's server would reject the message.

Authenticated Session Integrity

An authenticated user pertains to any user who signs onto the Applicant's web site with a valid user ID and password. The Applicant's server will be configured to limit exposure to authenticated users who attempt to defraud it. If an authenticated user alters a command (URL), which is sent from the web browser to the server, in any way in an attempt to gain access to another user's account, the Applicant's server immediately detects that the session integrity variables have been violated. Once detected, the Applicant's server will terminate the session and record the unsuccessful attempt in a log so that staff can investigate.

Physical Security & Secure Modem Access

All servers and network computers will reside in secure facilities. Computer operations supporting the Applicant's internet access will also reside in secure back-up facilities. Only employees with a valid access card may enter the physical premises. Access to server systems will require further password authentication. A private line, which is not accessible by or from the public, will connect the Applicant's server with Aurum. A dial-up maintenance port will also permit access to the server. The modem that provides the only access to this port will be specially protected and will only be enabled when necessary.

Service Continuity & Monitoring

The Applicant's server will be "mirrored" so that any existing software and/or hardware bugs should cause no more than a few minutes of service outage. "Mirroring" means that the Applicant's server is backed up continuously so that all data is stored in two distinct physical locations. This level of redundancy is necessary to ensure that access to the Applicant's systems will be reliable. All customer transactions utilizing the Applicant's server will produce one or more entries within a transactional log. The Applicant will regularly review these logs, along with Aurum, to ascertain whether any unusual transactions have occurred.

INVESTIGATION REPORT SUMMARY

DESIGNATED CORRESPONDENT	
NAME Joe Hamm	TITLE President and CEO
COMPLETE ADDRESS *(Include ZIP code)* 2001 Palm Blvd, Anytown, Anystate	

WORKING HOURS					
HOURS EXPENDED				TRAVEL TIME	
EXAMINERS	INVESTIGATION	REPORT WRITING	TOTAL HOURS	DURING NORMAL WORK HOURS	OUTSIDE NORMAL WORK HOURS
Ivie Smart	45	106	151	3	6
			0		
			0		
			0		
			0		

Examiner Comments

None.

INTRODUCTION

This section describes the long standing philosophy and methods of the FDIC for examining institutions using a risk-focused, forward-looking approach. Each supervised institution is unique, based on its business model, complexity, and risk profile. Accordingly, examiners and case managers are expected to apply the instructions in this policy, as well as related instructions elsewhere in the FDIC's Risk Management Supervision Manual of Examination Policies (Manual) consistent with each institution's unique circumstances. The instructions set forth in this section are directed to FDIC supervisory personnel[1] in the conduct of supervisory activities and do not require action on the part of insured institutions. The principles discussed herein apply to both point-in-time and continuous examination approaches, though some specific activities discussed may differ.

Purpose of Examinations

An examination is the process whereby supervisory personnel of a regulatory agency evaluate financial institutions' conditions, management processes,[2] and future prospects; identify deficiencies that may threaten their soundness; assess their compliance with applicable laws and regulations; and develop recommendations for corrective action, as appropriate.

Consistent with its mission, the FDIC conducts financial institution examinations to ensure public confidence in the financial system and to protect the Deposit Insurance Fund. Maintaining public confidence in the financial system is essential because customer deposits are a primary funding source that depository institutions use to meet fundamental objectives such as providing financial services. Safeguarding the integrity of the Deposit Insurance Fund is necessary to protect customers' deposits and resolve failed institutions.

On-site examinations help ensure the stability of insured depository institutions by identifying undue risks and weak risk management practices. Additionally, examinations play a key role in the supervisory process by helping the FDIC identify the root cause and severity of problems at individual institutions and emerging risks in the financial-services industry. Accurately identifying existing problems and emerging risks helps the FDIC develop effective corrective measures for individual institutions and broader supervisory strategies for the industry.

Uniform Financial Institutions Rating System

The federal financial institution supervisory agencies endeavor to ensure that all financial institutions are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends. To promote this goal, the Federal Financial Institutions Examination Council (FFIEC) adopted the Uniform Financial Institutions Rating System (UFIRS) on November 13, 1979. The original rating system was designed to reflect, in a comprehensive and uniform fashion, an institution's financial condition, compliance with laws and regulations, and overall operating soundness.

The FFIEC revised the UFIRS on December 19, 1996, effective January 1, 1997.[3] The revised rating system, known as CAMELS,[4] reflects an increased emphasis on risk management processes. The Federal supervisory agencies historically considered the quality of risk management practices when applying the UFIRS, particularly in the management component; however, by 1996, changes in the financial services industry had broadened the range of financial products offered by institutions and accelerated the pace of transactions. Those trends reinforced the importance of institutions having sound risk management systems. Accordingly, the revised rating system added an explicit reference to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating descriptions.

Management practices, particularly as they relate to risk management, vary considerably among financial institutions depending on their size and sophistication, the nature and complexity of their business activities, and their risk profile. Each institution must properly manage its risks and have appropriate policies, processes, or practices in place that management follows and uses. Activities undertaken in a less complex institution engaging in less sophisticated risk-taking activities may only need basic management and control systems compared to the detailed and formalized systems and controls needed for the

[1] This term includes Risk Management Supervision staff such as examiners, field managers, case managers, and regional office management and is used throughout this document when a responsibility may be handled by varying parties based on regional management discretion.

[2] Management processes include an institution's corporate governance structure, policies, and procedures.

[3] See 62 Fed. Reg. 752, *January 6, 1997, effective January 1, 1997.*

[4] Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation of six financial and operational components, which are also rated. The component ratings reflect an institution's capital adequacy, asset quality, management capabilities, earnings sufficiency, liquidity position, and sensitivity to market risk (commonly referred to as the CAMELS ratings).

broader and more complex range of activities undertaken at a larger and more complex institution.

The UFIRS takes into consideration certain and compliance factors that are common to all institutions. Compliance with laws and regulations is considered under the management component. Specialty examination findings (Compliance, Community Reinvestment Act, Government Security Dealers, Information Technology, Municipal Security Dealers, Transfer Agent, and Trust (or Fiduciary)) and the ratings assigned to those areas are taken into consideration, as appropriate, when assigning a composite rating and component ratings under UFIRS.

Peer comparison data are not included in the rating system. The principal reason is to avoid over reliance on statistical comparisons to justify the component rating being assigned. Examiners are encouraged to consider all relevant factors when assigning a component rating. The rating system is designed to reflect an assessment of the individual institution, including its size and sophistication, the nature and complexity of its business activities, and its risk profile.

Over the years, the UFIRS has proven to be an effective internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern.

Risk-Focused Approach to Examinations

Risk-focused supervision was adopted by the FDIC, the Board of Governors of the Federal Reserve System, and the Conference of State Bank Supervisors on October 1, 1997, as a framework for carrying out examination activities. The FDIC described the then new framework as employing a tiered approach to supervision to assist examiners in establishing an appropriate examination scope and managing resources by focusing those resources on the areas in an institution presenting the greatest risks.[5]

The objective of a risk-focused examination is to evaluate the safety and soundness of the financial institution by assessing its risk management systems, financial condition, and compliance with applicable laws and regulations, while focusing on the bank's highest risks. The risk-focused examination process seeks to strike an appropriate balance between evaluating the condition of an institution at a certain point in time[6] and evaluating the soundness of the institution's processes for managing risk in all phases of the economic cycle. By evaluating an institution's risk management practices, examiners look beyond the financial condition of a bank at a point in time, to how well it can respond to changing market conditions given its particular risk profile. The UFIRS emphasizes the importance of sound risk management processes by including them as a significant factor in the definition for each component rating and the overall composite rating.

To achieve the risk-focused examination objective, FDIC supervisory personnel are expected to adhere to the following risk-tailoring principles and practices:

- Recognize there are financial institutions, or areas within institutions, that present low risk, and in those cases, minimum (or baseline) examination procedures are generally sufficient to assess the institution's condition and risks.
- Allocate more examination resources to higher risk areas and fewer resources to lower risk areas.
- Use data from the quarterly Call Report filings and other available information to monitor changes to the institution's business model, complexity, and risk profile between examinations.
- Leverage available information, including analyses and conclusions from ongoing off-site monitoring and previous examinations, to determine the financial institution's risk profile and the scope of the next examination or examination activity.
- Consider the financial institution's ability to identify and control risks when risk-focusing examinations.
- Tailor the pre-examination request list to the institution's business model, complexity, and risk profile.
- Contact the institution between examinations or prior to finalizing the scope of the examination to help inform an examiner's assessment of an institution's risk profile.
- Follow up between examinations on the institution's actions taken to address areas in need of improvement.

Further, FDIC personnel are expected to adhere to the following communication principles:

- Provide appropriate prior notification of the upcoming examination and address staffing and logistical issues.
- Tailor the examination request list and scope to the unique risk profile and business model of the institution.

[5] See FDIC 1997 Annual Report.

[6] In addition to point-in-time examinations, the FDIC utilizes targeted reviews conducted under a supervisory plan, guiding a continuous examination program for certain institutions. These other programs are generally warranted to ensure effective monitoring and examination activity related to larger and more complex institutions. While the supervisory plan and continuous examination processes and procedures may differ in some respects from the point in time approach, the principles contained within this section are applicable to examination activities for all institutions supervised by the FDIC.

- Facilitate the secure exchange of information between institution management and examiners.
- Inform institution management of areas under review and provide management the opportunity to communicate any additional information or clarification before the conclusion of the examination.
- Establish clear expectations regarding items and examination findings that the financial institution is expected to address.[7]

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RISK-FOCUSED, FORWARD-LOOKING EXAMINATION PROCEDURES

Section 10(b) of the FDI Act requires the FDIC to conduct full-scope, on-site safety and soundness examinations of its supervised institutions.[8] Risk-focused, full-scope examinations assess the types and extent of risks to which a banking organization is exposed, evaluate the organization's methods of managing and controlling its risk exposures, ascertain whether management and directors fully understand and are actively monitoring the organization's exposure to these risks, and evaluate compliance with banking laws and regulations. Risk-focused, full-scope examinations are forward looking in that they address weaknesses in risk management practices before they lead to financial deterioration or operational problems.

The risk-focused supervision approach to examinations is not composed of a fixed set of routine procedures. Rather, the procedures that constitute a full-scope examination depend on the nature and complexity of the institution's business activities, and its risk profile. At a minimum, however, full-scope examinations must include sufficient procedures to reach an informed judgment on the financial, managerial, operational, and compliance factors rated under the CAMELS rating system.[9] An examination meeting those requirements would meet the FDIC's definition of a full-scope examination.

Understanding the Institution

To conduct a risk-focused examination, examiners must understand the nature, scope, and risk of an institution's activities. The nature and scope of an institution's activities are commonly referred to as the institution's business model. The examiner will develop a written description of the bank's business model by identifying the activities in which a banking organization has chosen to engage.

The risk associated with an institution's business model is commonly referred to as the risk profile. The examiner will develop a written description of the bank's preliminary risk profile by determining the types and quantities of risks inherent in the bank's business model and the quality of the risk management practices used by bank management to control these risks.

A key component of both an institution's business model and risk profile is the complexity of its operations. The examiner will develop a written description of the complexity of an institution's operations through a review of its balance sheet structure and scope of operations.

Business Model – To evaluate and develop a written description of an institution's business model, an examiner will consider:

- The primary market area and customer base served;
- The organizational/ownership structure, strategic plan/focus, and philosophical approaches/risk appetite management is using to pursue its objectives;
- The primary lending activities and funding sources, including any concentrations;
- Any product line, activity, or service that represents a significant portion of assets or revenue;
- Any unique or niche characteristics;
- Any significant third-party relationships, including technology service providers; and
- Any significant use of new or emerging technologies to support customer products or bank operations, whether offered alone by the institution or offered with a third party.

Risk Profile – To evaluate and develop a written description of an institution's preliminary risk profile, the examiner reviews the bank's business model, its current financial condition, and trends in its financial condition.

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[7] The FDIC participated in the FFIEC Examination Modernization project to identify and assess ways to improve the effectiveness, efficiency, and quality of financial institution safety and soundness examination processes, with the expectation to help reduce unnecessary regulatory burden. Expectations for examiners to adhere to risk-tailoring and clear communications practices are part of the project. See FFIEC press releases related to Examination Modernization dated March 22, 2018 and November 27, 2018.

[8] Federal Deposit Insurance Act.

[9] This could include, as appropriate, risk management for Information Technology (IT), Bank Secrecy Act (BSA)/Anti-Money Laundering (AML)/Office of Foreign Assets Control (OFAC) reviews, Trust, Registered Transfer Agent, Municipal Securities Dealer, and Government Securities Dealer examination programs. These specialty examination areas are incorporated into CAMELS through the Management component rating, as outlined in the UFIRS. See 62 Fed. Reg. 752*, January 6, 1997, effective January 1, 1997.*

The examiner reviews information available within the FDIC, including prior Reports of Examination and workpapers, correspondence, applications and other filings, the Uniform Bank Performance Report, interim contacts, and off-site review reports. Further, the examiner communicates with the case manager and other FDIC stakeholders to obtain additional information.

The examiner also considers the quality of institution management's policies, practices, and processes in determining the risk profile of an institution. Such policies, practices, and processes are indicators of an institution's governance and risk management framework, and can provide information to evaluate the institution's ability to withstand and respond to internal and external challenges, including unforeseen scenarios (e.g., competition, adverse economic conditions).

The nature and scope of an institution's activities influence the robustness of risk management practices for mitigating credit, market, operating, or transaction, strategic, compliance, legal, liquidity, and other risks. The examiner considers the inherent risks of the bank's activities and the strength of risk mitigation practices when developing and documenting the current risk profile of the bank. This process enables the examiner to identify areas of greater risk that will be emphasized in conducting the examination.

Risk management practices are primarily assessed considering the guidelines for the safe and sound operation of banks set forth in Section II of Part 364 of the FDIC Rules and Regulations, Appendix A,[10] though other regulations are also considered These guidelines set out safety and soundness standards that the agencies use to identify and address problems at institutions before capital becomes impaired.[11] The guidelines are qualitative rather than quantitative; they establish the objectives of proper operations and management, but leave the specific methods of achieving those objectives to each institution. They are also designed to be flexible based on the nature of activities at the bank. The guidelines cover the following areas:

- Internal controls and information systems;
- Internal audit systems;
- Loan documentation;
- Credit underwriting;
- Interest rate exposure;
- Asset growth;
- Asset quality;
- Earnings; and
- Compensation, fees, and benefits.

Complexity – A key component of both the institution's business model and risk profile is the complexity of its operations. To determine complexity within an institution's products, services, and delivery channels, the examiner evaluates a combination of factors, including, but not limited to, the sophistication of a particular activity or business line, risk presented by the activity, volume and scope of the activity, and interconnectedness among various activities and business lines within the institution. The examiner also considers strategic initiatives of the institution that impact the business model, risk profile, and complexity of the institution. In describing complexity, the examiner considers:

- Structure – balance sheet composition, off-balance sheet activities, asset and funding concentrations, organizational and management structure, branching activities, merger and acquisition activities, and geographic footprint; and
- Operations – business lines, customer base, product and service offerings, number and type of deposit and lending transactions, delivery systems, international exposure, operational risk,[12] and specialty areas.[13]

Planning the Examination[14]

Section 21.1 entitled Examination Planning provides information in relation to preparing for a Risk-Focused, Forward-Looking Safety and Soundness Examination. This section notes that the purpose of the examination planning process is to ensure that the institution's operations and activities are understood prior to the start of

[10] See *Appendix A to Part 364 - Interagency Guidelines Establishing Standards for Safety and Soundness*.

[11] If an institution fails to meet a standard prescribed by guideline, the FDIC may request the institution to submit an acceptable plan to achieve compliance with the standard. The FDIC generally expects to request submission of a compliance plan from an institution whose failure to meet one or more standards is of such severity that it could threaten the safe and sound operation of the institution. In other situations, the FDIC may elect to rely on an existing plan or enforcement action to ensure that an institution achieves compliance with the guidelines, rather than requiring the submission of a separate safety and soundness compliance plan. The FDIC may also seek corrective action through a Matter Requiring Board Attention.

[12] Includes BSA/AML and IT, including cybersecurity.

[13] Includes trust and asset management, consumer compliance, Community Reinvestment Act, registered transfer agent, government-securities dealers, and municipal-securities dealers.

[14] For the purposes of this discussion, planning of targeted reviews conducted as part of a continuous examination approach focuses on the subject of the review, where the point-in-time examination would encompass all aspects of a full scope examination.

the examination, so that examination procedures can be appropriately tailored to the institution.

The Examination Planning process includes several key activities, including contacting the institution, developing an understanding of the risks, tailoring the request list, identifying on-site and off-site procedures, and developing a written examination plan.

Refer to Section 21.1 for additional details regarding examination planning.

Conducting the Examination

Prior to the on-site portion of the examination, the examination team conducts off-site examination activities to review and analyze available information, including materials provided by the bank. During this timeframe, the EIC updates the examination plan, factoring in the review of requested materials, and submits the plan to field management for final approval.

During the off-site examination process, or on the first day of the examination, the EIC invites board members to attend any or all meetings conducted during an examination. Their attendance often improves communication with outside directors and increases director knowledge of the examination process. These meetings also provide an opportunity for directors to discuss their views with examiners on bank-related matters, and give examiners the opportunity to gain further insight into the experience levels and leadership qualities of bank management. While encouraging participation in these meetings, the EIC should emphasize that attendance is voluntary and that a lack of participation will not be viewed negatively.[15]

As soon as practicable, on or after the first day of the on-site portion of the examination, the EIC and on-site portion of the examination team meet with appropriate institution management to open lines of communication, develop plans for ongoing communication during the examination, and discuss any other informational needs or other issues. The EIC describes how document request materials obtained from the institution are being used during the examination. Informal meetings are held as needed throughout the examination to discuss various topics, including but not limited to following up on previous examination issues, discussing strategic and business plans, discussing loan review results, and discussing other material preliminary findings.

The EIC is expected to coordinate regular communication among examination team members, such as examination team meetings, conference calls, or group emails, so that team members may share and discuss observations and findings. Team communication should occur at least once per week; more frequent communication may be appropriate if examination teams are dispersed.

Based on the risk presented by the institution, examiners are expected to perform an appropriate level of transaction testing to verify: the adequacy of and adherence to internal policies, procedures, and limits; the accuracy and completeness of management reports and financial reports; the adequacy and reliability of internal control systems; the effectiveness of the bank's risk management processes and practices; and compliance with laws and regulations.

Examiners have the flexibility, subject to appropriate concurrence, to adjust the examination scope at any point during the examination based on findings to date. The rationale for changes in the examination plan will be clearly communicated to institution management, along with any significant adjustments to the breadth or depth of procedures, personnel, and examination schedule.

Communicate Preliminary Findings

Sufficiently in advance of exit meetings with institution management, the EIC provides and discusses preliminary findings, ratings, and supervisory recommendations with the Field Supervisor and Case Manager.

Prior to the conclusion of the examination, examiners thoroughly discuss the tentative findings and supervisory recommendations with senior institution management, including the tentative CAMELS ratings assigned under the UFIRS, clearly indicating that ratings are subject to FDIC regional office review. Such meetings are critical in communicating tentative examination findings to institution management and providing management an opportunity to respond.

During exit meetings, the EIC fully apprises institution management of examination findings and conclusions, including explaining the reasoning for proposed ratings and supervisory recommendations that will be cited in the ROE. Examiners also describe how document request materials obtained from the institution were used during the examination to support findings.

Prepare the Report of Examination[16]

[15] See Risk Management Manual of Examination Policies, pages 1.1-14 -15.

[16] For targeted reviews where a full ROE is not to be issued, these concepts apply similarly to a supervisory letter.

The EIC prepares the ROE in accordance with the FDIC's ROE Instructions[17] contained within the Risk Management Supervision Manual of Examination Policies (Manual). Consistent with the forward-looking aspects of the risk-focused examination process, the ROE is designed to clearly convey issues that are cause for concern, explain the risks to the institution's operations or financial performance if not addressed in a timely manner, and recommend appropriate corrective/remedial action.

Within the ROE, supervisory recommendations are used to inform the institution of the FDIC's views about changes needed in the bank's practices, operations, or financial condition. Matters Requiring Board Attention (MRBA) is a subset of supervisory recommendations that need prompt action by the board of directors and senior management. The intent of supervisory recommendations and MRBAs is to establish clear expectations regarding items the institution should address in order to correct deficiencies before they cause deterioration in the bank's financial condition.

Meet with the Institution's Board of Directors

The FDIC conducts meetings with boards of directors to encourage director involvement in, and enhance director awareness of, FDIC's supervisory efforts and to increase the effectiveness of such efforts.[18] Such meetings also provide an opportunity to discuss and exchange views on bank specific and industry related issues that may be outside the scope of the examination, but are important for promoting safe and sound operations; examples include planned bank initiatives or new or proposed banking regulations.

The EIC meets with the board or a board committee during or subsequent to the examination when 36 months or more have elapsed since the last such meeting; the management component of the CAMELS rating is 3, 4 or 5; any other CAMELS performance rating is 4 or 5; or any two performance ratings are 3, 4 or 5. Other factors that may be relevant to the decision of holding a board meeting include whether:

- The ROE contains MRBAs;
- The institution has undergone a recent change in control, ownership, or top management;
- The institution is operating in adverse economic conditions;
- The institution's management or board has requested a meeting; or
- There exist any other unique conditions or trends pertinent to the institution.

An institution's composite rating is an important variable in determining regional office participation in a board meeting. While regional office participation in meetings with banks rated composite 1, 2, or 3 is at the regional director's discretion, the regional director or designee will participate in the board meeting of a bank with a composite rating of 4 or 5.

Submit the ROE for Regional Office Review and Issuance to the Institution

The EIC notifies institution management when the draft report is submitted to the assigned regional office case manager for review. The assigned case manager is expected to ensure that the ROE clearly identifies areas of risk and contains appropriate supervisory recommendations to mitigate those risks, supervisory recommendations address the causes of deficiencies, supervisory recommendations that warrant board attention are scheduled as MRBAs in accordance with existing Manual instructions, and CAMELS ratings are supported and are consistent with UFIRS definitions.

Supervisory personnel keep institution management informed of any changes made to the ROE findings that differ significantly from the initial findings disclosed at the exit meetings with institution management. Examples of significant changes include, but are not limited to, a revision to any rating or the addition or deletion of a supervisory recommendation or an apparent violation. FDIC supervisory personnel will explain the reasons for the changes to initial examination findings, and institution management will be given a reasonable amount of time to re-confirm or change responses and commitments, as appropriate.

The FDIC has established internal goals to ensure the timely sharing of information with financial institutions. These goals include transmitting Safety and Soundness ROEs to financial institutions within a median 75 days from the on-site examination start date and concluding regional office processing of Safety and Soundness ROEs within a median 45 days from the EIC's submission of the ROE to the regional office. The FDIC reports its performance relative to these goals on the FDIC's *Trust through Transparency* webpage. The case manager keeps institution management informed should unusual processing delays occur and provides the reasons for such delay.

The regional office transmits the ROE to the institution's board of directors with a letter summarizing the examination findings. In some cases, the transmittal letter

[17] See Risk Management Manual of Examination Policies, Section 19.1.
[18] Risk Management Manual of Examination Policies, page 1.1-16.

will also request that the board provide a written response to the examination. Institution management is also invited to complete a post examination survey after each examination.[19] The survey is part of the FDIC's continuing effort to improve the quality and efficiency of the examination process. Institution management is invited to complete the survey via a secure FDIC Website using an access code. The access code is included with an invitation letter accompanying each final ROE. All responses are submitted directly to the FDIC's headquarters office and will be confidential. The FDIC uses the survey results to identify ways to improve the examination process.

Post-Examination Responsibilities

Safety and soundness supervision is an ongoing process of planning and conducting examinations, following up on the resolution of supervisory findings and supervisory recommendations, and monitoring institutions between examinations.

Enforcement Actions

Should an enforcement action be deemed necessary to address deficiencies identified during the examination, regional office personnel, with input from the EIC, develop the appropriate level of supervisory action (formal or informal) and engage the board of directors and management to ensure understanding and procure adoption. Once an enforcement action has been adopted, case managers review implementation progress reports submitted under the enforcement action to monitor the institution's corrective actions.

Following up on Examination Findings

The institution's assigned case manager reviews institution management's response to the ROE, as applicable, and follows up on the disposition and resolution of MRBAs. Staff assigned to the Division Director will contact institution management in response to any request for post-examination contact within the post examination survey.

Ongoing Monitoring and Interim Contacts

The assigned case manager serves as the institution's point-of-contact within the FDIC and will conduct ongoing monitoring of the institution's risk trends and financial condition between examinations. Should the institution be flagged on any internal FDIC reports as an outlier based on quarterly Call Report data, the case manager reviews the data that caused the flag and may contact institution management, if needed, to obtain any additional information needed to review the matter. Further, the assigned case manager or field supervisor contacts institution management between examinations to inquire about any changes in institution operations, discuss topics of interest such as regulatory changes or industry trends, and answer questions from bank management.

[19] Post-Examination Survey.

Contents

PURPOSE OF PLANNING A RISK-FOCUSED, FORWARD-LOOKING SAFETY AND SOUNDNESS EXAMINATION

As described in Section 20.1 of the Risk Management Manual of Examination Policies - Risk-Focused, Forward-Looking Safety and Soundness Supervision, the objective of a risk-focused examination is to evaluate the safety and soundness of the financial institution by assessing its risk management systems, financial condition, and compliance with applicable laws and regulations, while focusing on the institution's highest risks. The risk-focused examination process seeks to strike an appropriate balance between evaluating the condition of an institution at a certain point in time and evaluating the soundness of the institution's processes for managing risk in all phases of the economic cycle. By evaluating an institution's risk management practices, examiners look beyond the financial condition of an institution at a point in time, to how well it can respond to changing market conditions given its particular risk profile.

Risk-focused supervision involves employing a tailored approach to each examination. The risk-focused supervision approach to examinations is not comprised of a fixed set of routine procedures. Rather, the procedures that constitute a full-scope examination depend on the nature and complexity of the institution's business activities and risk profile. At a minimum, full-scope examinations must include sufficient procedures to reach an informed judgment on the financial, managerial, operational, and compliance factors rated under the CAMELS rating system.[1] An examination meeting those requirements would meet the FDIC's definition of a full-scope examination.

The purpose of the examination planning process is to ensure that the institution's operations and activities are understood prior to the start of an examination, so that examination procedures can be appropriately tailored to the institution. By understanding the unique nature of each institution, examiners can evaluate fundamental risks of the institution's activities and the strength of management practices in mitigating those risks, and focus examination activities and procedures on risks that are not as well-mitigated or that have not been previously assessed because they are new.

Three Phases of Examination Planning

The examination planning process can be broken into three phases: initial contact, initial examination planning, and final examination planning and conducting off-site work.[2] Each of these phases is discussed below.

Phase 1: Initial Contact

The field supervisor (FS)/supervisory examiners (SE)[3] must develop a timeline of examination activities for the upcoming examination at least 90 days ahead of the projected start date of the examination. At this time, the FS/SE must contact institution management to inform them of the upcoming examination date. During this contact, the FS/SE will provide notice that profile scripts for general safety and soundness, which includes Bank Secrecy Act (BSA), and Trust (when applicable), and Information Technology will be sent to the financial institution. The FS/SE will explain that these scripts will help plan examination procedures based on the financial institution's business model, risk profile, and complexity and help to tailor a document request list for the institution. In addition, the FS/SE needs to ask institution management for the names and contact information (phone/email) of the institution's points of contact for BSA, IT, and Trust (if applicable) in order to facilitate the completion of required complexity tools. The FS/SE will then ensure that the start date is entered into the FDIC's database, which will initialize the request list and examination workpaper systems.

Immediately after contacting management, the FS/SE will generate an Examination Profile Script (EPS) and an Information Technology Profile (ITP). The EPS and ITP will be transmitted under the same cover letter to avoid creating burden and confusion for financial institution management via the FDIC's secure system of information exchange between institution management and the FDIC. Institution management will have approximately two weeks to complete the EPS[4] and ITP. Providing management with

[1] This could include, as appropriate, risk management for Information Technology, Bank Secrecy Act (BSA)/Anti-Money Laundering (AML)/Office of Foreign Assets Control reviews, Trust, Registered Transfer Agent, Municipal Securities Dealer, and Government Securities Dealer examination programs. These specialty examination areas are incorporated into CAMELS through the Management component rating, as outlined in the Uniform Financial Institutions Rating System. See *62 Fed. Reg. 752, January 6, 1997, effective January 1, 1997*.

[2] The principles discussed herein apply to both point-in-time and continuous examination approaches, although some specific activities discussed may differ.

[3] The FS/SE are responsible for scheduling, approvals, and the ordering of a digital circuit and thus responsible for the initial 90-day call. Other FS/SE duties can be delegated to other appropriate RMS staff, such as setting up the secure exchange of information with the institution.

[4] The FS/SE may provide institution management with the option of discussing the EPS items with the FS/SE, who then may complete the EPS on the institution's behalf.

the EPS and ITP well before developing the actual request list facilitates a more tailored request list.

Section 1 of the EPS is designed to collect information necessary to help the examiner understand material changes to the business model, risk profile, and complexity of the institution since the previous Safety and Soundness examination. Section 2 of the EPS is tied to scoping questions in the request list tool and helps examiners understand which products and services are applicable to the financial institution. Sections 3 (BSA) and 4 (Trust) of the EPS relate to the specialty examination scoping questions and help examiners understand the complexity of these activities. Similarly, the ITP identifies applicable IT activities, while also gathering information about the complexity of the institution's IT operations.

Sections 2, 3, and 4 of the EPS can be adjusted based on scoping questions within the request list tool. If examiners are already aware that an institution does, or does not, have a particular product or service, the examiner should answer the scoping question by selecting yes or no, and the item will not be added to the EPS. This is particularly important for Sections 3 and 4 of the EPS, as community institutions typically do not have complex BSA or Trust operations.

The information gathered from the completed EPS will then help examiners develop an examination plan and request list tailored specifically to the activities of the institution.

An example of a cover letter and EPS is available as Appendix A of this section.

The FS/SE will also evaluate options at the institution regarding remote connectivity. If it appears the connectivity options available will not be sufficient for a particular examination's needs, FDIC field management should request a digital circuit from FDIC technical staff.

The FS/SE should also inquire about loan imaging and various off-site loan review options. If institution management is willing and able to provide off-site access to loan files, the FS/SE should begin the coordination of logistical and technical arrangements between the institution and the FDIC well ahead of the examination start date in order to facilitate off-site loan review activities.

Lastly, the FS/SE will schedule examiners for Phases 2 and 3 of examination planning. In particular, the FS/SE will select the Examiner-in-Charge (EIC) and schedule the EIC for sufficient dedicated time in the field office to conduct all activities of Phase 2 (Initial Examination Planning) six to eight weeks prior to the start date of the examination. Additionally, appropriate personnel should be scheduled and provided sufficient dedicated time to perform specialty area examination planning activities,[5] including assessing specialty examination complexity, so that the results are finalized and ready for the EIC's review and consideration at the start of the initial Examination Planning. The EIC is to use the information on the institution's complexity to assist with the completion of the Examination Planning Memorandum (EP Memo) and tailoring the specialty area request lists.[6]

<u>Phase 2: Initial Examination Planning</u>

The goal of completing the initial planning six to eight weeks ahead of the examination start date is to allow the EIC sufficient time to learn about the institution and prepare an examination plan tailored to the institution's areas of greatest risk.[7] Attention to these activities at an early stage allows the examiner to make a more targeted information request to institution management, thereby reducing burden on the financial institution while ultimately providing for a more efficient and effective examination.

Understanding the Institution

To conduct a risk-focused examination, examiners must understand the nature, scope, and risk of an institution's activities. The nature and scope of an institution's activities are commonly referred to as the institution's business model. The risk associated with an institution's business model is commonly referred to as the risk profile. A key component of both the business model and the risk profile is the complexity of the institution's operations.

In order to get an understanding of the business model, risk profile, and institution's complexity, the EIC will review the institution's responses to the EPS and ITP; read prior Reports of Examination (ROEs); review correspondence, FDIC databases, and economic data; and review specialty area information and complexity assessments. Further, the EIC should contact the case manager (CM), the FS/SE, and the external auditor to gain additional insight and perspective on the institution.

[5] Refer to examiner instructions on each of the specialty complexity tools. Optimally, the FS/SE should assign the complexity tool responsibilities to the same individuals reviewing the specialty areas at the upcoming examination.

[6] FS/SEs are to schedule examination planning time for specialty area examiners.

[7] For the purposes of this discussion, planning of targeted reviews conducted as part of a continuous examination approach focuses on the subject of the review, where the point-in-time examination would encompass all aspects of a full-scope examination.

Based on the review of available information and discussions with others, the EIC will then develop (or update) preliminary written descriptions of the institution's business model, risk profile, and complexity following the considerations outlined in the Risk-Focused, Forward-Looking Safety and Soundness Supervision section of the manual.

Discussion with Institution Management/Tailoring the Request List

The EIC then contacts institution management to discuss the preliminary descriptions of the institution's business model, risk profile, and complexity, and to describe how those definitions are being used to determine the planned examination scope and request list content. The EIC should seek management's views regarding recent changes in operations, economic conditions, or competition, and answer any questions that institution management may have.

The EIC is expected to tailor the information request letter to include only those materials necessary to examine the institution based on its unique business model, risk profile, and complexity. The EIC sends the information request letter to institution management sufficiently in advance of an upcoming examination to allow ample time for management to compile and submit requested documents. The EIC establishes a due date for the materials sufficiently in advance of the anticipated start date of the examination to allow for off-site examination work prior to the on-site start date. Further, the EIC facilitates the secure exchange of information between institution management and the FDIC, by ensuring that the delivery method(s) used meet the security measures discussed in the FDIC's policies for the exchange, use, and storage of electronic information.

Identifying Off-site/On-site Procedures

During the examination planning stage, the EIC is expected to identify examination activities that are appropriate for off-site review and those that are better suited for on-site review. The EIC discusses these activities with field management and incorporates them into the written examination plan. The determination of the extent of off-site or on-site for each examination activity will depend, in part, on the type and extent of electronic information available and whether the activity requires interaction with institution personnel. Examiners are expected to consider conducting examination procedures off-site, to the extent reasonably possible, in order to minimize disruptions to an institution's normal business activities.

Examiners are encouraged to conduct the following portions of a financial institution examination off-site:

- Determine the scope of the examination and identify the loan review sample;
- Review historical financial and supervisory data and perform initial analysis of capital, earnings, liquidity, and sensitivity to market risk;
- Review the institution's internal reports;
- Review the institution's written policies and procedures;
- Review independent audits/reviews; and
- Complete financial schedules and certain other pages of the ROE.

Regarding credit review, typically the most labor intensive part of a financial institution examination, the examiner may conduct the following off-site:

- Review loan policies;
- Review performance report ratio data and management reports;
- Preliminarily review the methodology used for estimating loan losses;
- Determine the areas to be emphasized in the on-site review;
- Determine the loan sample to be reviewed, and select and assign individual credits;
- Group loans to related obligors; and
- Review credit and investment files for quality, documentation, and compliance with institution policy and laws and regulations, if information is available in a format for off-site review.

Examiners are expected to conduct the following examination activities on-site:

- Conduct in-depth discussions with management;
- Verify financial information;
- Observe and assess institution operations and internal controls;
- Collect follow-up documentation to complete the financial analysis;
- Review documents that would be inappropriate or impractical to provide off-site; and
- Conduct exit meetings with management.

Drafting the Examination Planning (EP) Memorandum

During Phase 2, the EIC is responsible for drafting an EP Memo. The EP Memo template and instructions for its preparation are included in Appendix B. The EP Memo outlines the examination activities and procedures deemed necessary to fulfill the statutory requirement to complete an on-site, full-scope examination of the institution, given the institution's business model, risk profile, and complexity. Further, as described in the attached instructions, the EP Memo will also outline the EIC's plans for loan review.

Discussing the Draft Examination Plan with the FS/SE and CM

Once the draft EP Memo is written, the EIC will provide the draft to the FS/SE and CM for discussion of the initial assessments of risk, anticipated procedures, and initial information requests. The EIC will provide an estimate to the FS/SE regarding projected examination hours (inclusive of anticipated training hours), staffing needs (addressing the need for specialists or subject matter experts), and the plan for on-site/off-site activities. The FS/SE and CM are to provide feedback on the draft examination plan to assist the EIC with finalizing the examination plan.

Based on discussions and review of the draft examination plan, the FS/SE will assign appropriate staff to the examination, including specialty areas.

Phase 3: Final Examination Planning and Conducting Off-Site Work

Supervisors are required to allocate appropriate time for the examination team to complete all examination planning activities, including the downloading, electronic filing, and reviewing of materials provided by the institution.[8] These other examination activities should begin at least one to two weeks prior to the on-site examination start date. In particular, the EIC must be scheduled sufficient time prior to the start date of the examination to review the request list response and finalize the Examination Plan and EP Memo. The finalization of the EP Memo includes determining staff assignments, as well as identifying any benchmark training needs of pre-commissioned team members. The EIC will submit the final EP Memo to the FS/SE for approval prior to the start date of the examination. Once approved, the EIC distributes the EP memo to the CM and the examination team.

In addition to examination planning, off-site work prior to the on-site start date will include the activities discussed previously in Phase 2. The FS/SE will provide additional staff, as available, prior to the start date to conduct off-site examination procedures. This additional staff, which can include both key roles such as Operations Manager and/or Asset Manager, as well as other staff, allows the examination team to become knowledgeable of the institution and begin their analysis prior to arriving on-site.

The FS/SE is expected to be mindful of an institution's space and personnel limitations when scheduling the number of examiners working on institution premises.

[8] The Phase 3 principles discussed herein also apply to specialty area EICs/examiners, including need for sufficient examination planning time and availability of performing some work off-site.

Contacting the Institution

After the EIC has reviewed the requested materials provided by the institution, the EIC contacts institution management again to discuss examination logistics, including the size of the examination team. The EIC also shares plans for work to be completed off-site and on-site. For example, the EIC could advise management that four examiners will review electronic loan files off-site for the first week and then come to the financial institution for loan discussions during week two of the examination.

Joint/Concurrent Examination Considerations

When examinations are conducted in a joint or concurrent capacity with the State authority, examiners are expected to coordinate and collaborate with the State EIC to ensure open and consistent communication throughout the examination planning process. The lead agency will guide the examination planning activities and process. The lead agency is determined through agreements between the State authority and FDIC managers. The FDIC EIC will work with the State EIC in accordance with their defined processes to ensure the planning and resource needs of each agency are being met, while being mindful that the non-lead agency may assist in the process, but may not provide the same level of resources as the lead agency.

State-Led Joint/Concurrent Examinations

For joint or concurrent examinations where the State is the lead agency, if the State has adopted Examination Planning as outlined in this chapter, then the FDIC and State should collaborate to accomplish the various tasks.

If the State in in the lead, but has not adopted Examination Planning (in whole or in part), the state agency will guide the examination planning activities and process. In such cases, the FDIC would still be responsible for collaborating with the State to ensure that certain Examination Planning activities are conducted, as follows:

Phase 1 (done in conjunction with, or soon after, the initial contact with the institution)

- Entering the start date into the FDIC's database;
- Ensuring a secure method is established for transmission of institution-requested materials;

- Scheduling appropriate personnel and providing sufficient dedicated time to perform examination planning activities;
- Obtaining the names and contact information (phone/email) of the institution's points of contact for BSA, IT, and Trust (if applicable) in order to facilitate the completion of required complexity tools; and
- Ensuring the ITP is sent to the institution.

Specialty Exam complexity tools

- Ensuring that the complexity tools for BSA/AML, IT and Trust (if applicable) are completed, with the results considered within the risk scoping process.

Phase 2:

- Reviewing available information;
- Discussing the upcoming examination with the case manager and field supervisor/supervisory examiner;
- Developing descriptions of the institution's business model, risk profile, and complexity;
- Ensuring the request list is tailored to the institution; and
- Identifying activities available for on-site and off-site work.

Phase 3:

- Reviewing institution-provided materials;
- Conducting off-site examination work prior to the start date;
- Participating in discussions with institution management;
- Finalizing an examination planning memorandum; and
- Providing finalized business model, risk profile, and complexity descriptions to the case manager (either via the examination planning memorandum or other means).

Other Exam Planning tasks not included above should still be conducted if these activities align and can be coordinated with the State-led examination planning process.

APPENDIX A -EXAMINATION PROFILE SCRIPT (EPS)

FDIC

Federal Deposit Insurance Corporation
Division of Risk Management Supervision
Address

xxxxxxxxx Field Office
Phone xxx-xxx-xxxx

DATE

CEO xxxxxxxx
Institution Name
Street Address
City, State Zip

Dear CEO **xxxxxxxxxx**:

A Safety and Soundness Examination of your institution is scheduled for DATE **20xx**. A concurrent Information Technology (IT) Risk Examination [and Trust Examination] will also be conducted.

The attached Examination Profile Script (EPS) and Information Technology Profile (ITP) have been developed to help examiners tailor their examination procedures to your institution's operations.

Comment boxes are available for items marked "yes" if you wish to provide additional information. Examiners will tailor the request list to exclude materials specific to items marked "no."

On March 13, 2020, the FDIC issued a statement entitled *Working with Customers Affected by the Coronavirus*, and on April 7, 2020, the FDIC, along with other regulators, issued a statement entitled *Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus (Revised)*. Both of these statements encourage financial institutions to work prudently with borrowers who are or may be unable to meet their contractual payment obligations because of the effects of COVID-19. The statements indicate that the FDIC and the other agencies will not criticize institutions for working with borrowers in a safe and sound manner. The statements go on to indicate that agencies' examiners will exercise judgment in reviewing loan modifications and will not automatically adversely risk rate credits that are affected by COVID-19, and even if modified loans are adversely classified, examiners will not criticize prudent efforts to modify the terms on existing loans to affected customers. Examiners will be reviewing risk management practices and policies regarding modifications during the examination as part of the FDIC's general review of loan administration policies and practices.

Supporting documentation is not needed at this time but will be requested via a risk-focused information request list that will be sent to your institution approximately six to eight weeks before the on-site examination.

Please submit your responses via FDIC*connect* by **XX/XX/XXXX**.

If you have any questions, please call me at the **xxxxxxxx** Field Office at **xxxxxxxxxx** or e-mail me at **xxxxxxxxx**.

Sincerely,
Name
Title
Federal Deposit Insurance Corporation

Enclosure

EPS SECTION 1

Please indicate 'yes' or 'no' if there have been material changes to the following items since the previous regulatory Safety and Soundness examination dated XX/XX/XXXX. If 'yes' is selected, please provide an explanation in the Comments box. The answers will help us tailor our list of items that we will request for the examination.

Organizational, Background, and Operating Environment	Yes	No
1. Organizational structure of the financial institution or holding company		
2. Strategic direction/plan or business model, including new or expanded products or services (e.g. loans, investments, deposits, funding)		
3. Ownership (shareholders owning 5% or more of controlling stock)		
4. Competitive factors impacting the financial institution		
5. Local economic factors (that impact or could impact financial institution performance)		
6. Local businesses or industries affecting a significant part of the financial institution's deposit or loan customer base		
7. Key role managers or Board composition		
8. Governance structure and authority levels		
9. Major policies or procedures		
10. Auditors or audit programs		
11. Management information systems		
12. Asset and/or liability structure		
13. Loan review programs		
14. Emerging technology or fintech initiatives (such as digital lending, digital-only deposit accounts, artificial intelligence/machine learning, application programming interfaces, distributed ledger technology, or digital tokens).		

Section 1 Comments:

EPS SECTION 2 – Safety & Soundness[9]

Please indicate 'yes' or 'no' if the financial institution has the following items or is involved in the following activities. If 'yes' is selected, please provide an explanation in the Comments box. The answers will help us tailor our list of items that we will request for the examination.

Lending Areas	Yes	No
1. Loans with delinquent real estate taxes or loans with negative balance escrow accounts		
2. Interest only or payment option residential mortgage loans		
3. Construction loans with cost overruns or insufficient funds to complete construction		
4. Floor plan lending		
5. Loan participations purchased and sold		
6. Loans made to facilitate the sale of bank owned other real estate		
7. Loans made to facilitate the purchase of the financial institution's stock or the financial institution's holding company stock		
8. Credit concentrations warranting portfolio level or portfolio segment stress tests or sensitivity analysis		
9. Government or guaranteed lending programs (e.g. USDA or SBA)		
10. Lease financing loans serviced or collected by the financial institution for other parties		
11. Please indicate whether the institution has engaged in loan modifications, extensions, or deferrals related to borrowers impacted by the COVID-19 pandemic (Y/N)		
Employee Incentives & Compensation	Yes	No
12. New employment contracts and/or deferred compensation agreements		
13. Incentive compensation programs		
14. Financial institution sponsored employee benefit plan		
Asset/Liability Management Items	Yes	No
15. Deposits accepted by the financial institution or its affiliate through third party (such as "affinity" groups) marketing arrangements		
16. Large depositors (greater than 2% of total deposits)		
Supplemental Activities	Yes	No
17. Third Party Payment Processing		
18. Related Organizations		

Section 2 Comments:

[9] Information Technology specific items will be covered in the separate Information Technology Profile script.

EPS SECTION 3 – Bank Secrecy Act/Anti-Money Laundering

Please indicate 'yes' or 'no' if the financial institution has the following items or is involved in the following activities for Bank Secrecy Act. If 'yes' is selected, please provide an explanation in the Comments box. The answers will help us tailor our list of items that we will request for the examination.

Most items will not be applicable for the typical BSA operations at community financial institutions. **All items checked "no" will be deleted from the tailored request list.**

Refer to FFIEC BSA/AML Glossary for definitions and explanations of BSA/AML terms.

Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Complex Areas	Yes	No
1. Correspondent Accounts – Domestic (Institution acts as correspondent)		
2. Correspondent Accounts – Foreign		
3. Sale of Insurance Products		
4. Concentration Accounts (Accounts established to facilitate the processing and settlement of multiple or individual customer transactions)		
5. Private Banking		
6. Professional Service Providers (Acting as liaisons for clients)		
7. Private-owned ATMs		
8. Nondeposit Investment Products		
9. Nonresident Aliens and Foreign Individuals		
10. Non-Bank Financial Institutions (includes Money Service Businesses)		
11. Business Entities as Customers (Including limited liability companies, corporations, trusts, and other entities that may be used for many purposes, such as tax and estate planning)		
12. Prepaid Access Products (including prepaid access cards or acting in concert with another party to provide prepaid access, such as for travel or public transportation programs)		

Section 3 Comments:

EPS SECTION 4 – Trust

Please indicate 'yes' or 'no' if the financial institution has the following items or is involved in the following activities for Bank Secrecy Act and Trust. If 'yes' is selected, please provide an explanation in the Comments box. The answers will help us tailor our list of items that we will request for the examination.

Refer to FDIC Trust Examination Manual Glossary for definitions and explanations of Trust terms.

Trust	Yes	No
1. Bank Sponsored Employee Benefit Plans		
2. Irrevocable Life Insurance Trusts (ILITs)		

Comments:

EPS SECTION 5 – Off-site Loan Review Options

For institutions that have imaged loan files, and are interested in having FDIC examiners review these files remotely, the FDIC has several potential options for such off-site review. Such options include Imaging Service Provider's Standardized Export of Image Data*, screen sharing/remote control capabilities, or an institution's own internal solution.

Please indicate 'yes' or 'no' to the following questions, or leave blank if not applicable. The Comments box may be used to indicate which option(s), if any, are preferred by institution management.

For more information on this option, please see Financial Institution Letter (FIL)-22-2018: Advisory: FDIC Conducting Testing of the Standardized Export of Imaged Loan Documents, and FIL-4-2019: Banker Webinar: Update on the Standardized Export of Imaged Loan Documents Initiative.

Off-site Loan Review	Yes	No
1. Are the institution's loan files imaged?		
2. If yes to #1, is management interested in having the FDIC conduct a portion of the loan review off-site?		

Comments:

EPS SECTION 6 – Examiner Connectivity to Internet

The FDIC relies significantly on Internet Connectivity to conduct examinations. The FDIC has several authorized potential options to support connectivity.

Please indicate 'yes' or 'no' regarding connectivity options, or leave blank if not applicable. The Comments box may be used for additional information.

Connectivity	Yes	No
1. Is strong cellular coverage available in the examination work room location(s)? (if yes, please indicate in the Comments section on what cellular provider(s) have strong coverage, if known)		
2. If no to #1, does the institution have a guest WiFi connection that the institution would like to make available to the examination team for examination-related activities?		
3. If no to #1 and #2, is the institution willing to allow the FDIC (at FDIC's expense) to have a temporary digital circuit (Internet line) installed for examination team use? (if yes, please indicate, in the Comments below, a contact person from your institution)		

Comments:

APPENDIX B -INSTRUCTIONS FOR COMPLETING THE EXAMINATION PLANNING MEMORANDUM

Examination Planning Memorandum (EP Memo). Insert institution-specific data and examination information.

Examination Ratings and Data. Document the ratings and data for the most recent examinations.

Examination Planning Ratios. List the specified ratios from the Uniform Bank Performance Report for the most recent quarter and the previous two year-ends.

Other Risk Measures. Briefly comment on each listed risk flag.[10] If elevated risk is identified in any of the below areas, these risks should be discussed in the Overview section. Additionally, comment on any other significant risk factors identified within internal FDIC outlier reports, tracking systems, and watch lists.

REST Score. Real Estate Stress Test (REST) is an estimate of the institution's potential vulnerability to a downturn in the real estate market. Comment on the risk level and driving factors for the score. Consider the REST score when scoping the asset review.

Internal Control Assessment Rating System (ICARuS). ICARuS provides a measure of a financial institution's potential susceptibility to fraud by assigning points to various identified risk indicators and calculating an institution's fraud risk-profile on a scale of 0.00 to 5.00. Certain risk-focused examination procedures are suggested to assess those risk indicators that generate an ICARuS score of 2.50 or higher. Comment on any ICARuS related activities to be performed.

IRRSA Red Flags. Interest Rate Risk Standard Analysis (IRRSA) produces a report that focuses on an institution's interest rate risk exposure. IRRSA calculates financial analysis measures derived from Call Report data and historical market interest rate information. Comment on any red flags noted for institution ratios that are outside benchmarks set within IRRSA. Consider any IRRSA Red Flags when scoping the examination.

SCOR. The Statistical CAMELS Off-site Rating (SCOR) system is designed to identify institutions that have experienced noticeable financial deterioration. Comment on any rating that has a significant probability for downgrade.

Preliminary Risk Assessment

Overview of the institution's business model, risk profile, and complexity. To conduct a risk-focused examination, examiners must understand the nature, scope and risk of an institution's activities. The nature and scope of an institution's activities are collectively commonly referred to as the institution's "business model." Develop a written description of the business model by identifying the activities in which a financial institution has chosen to engage.

The risk associated with an institution's business model is commonly referred to as the "risk profile." Develop a written description of the financial institution's preliminary risk profile by determining the types and quantities of risks inherent in the financial institution's business model and, based on past examinations and supervisory activities, the quality of the risk management practices used by financial institution management to control these risks.

A key component of both an institution's business model and risk profile is the complexity of its operations. Develop a written description of the complexity of an institution's operations through a review of its balance sheet structure and scope of operations.

Within the overview, briefly summarize significant discussions with institution management during Examination Planning. This summary should cover key topics such as: significant risk areas, management's concerns regarding economic conditions, and any other information meaningful to the planning process. Include the name and title of the institution official and the date on which the discussion was held.

Also within the overview, briefly summarize discussions with the case manager (CM), field supervisor (FS)/supervisory examiner (SE), and the institution's external auditor. The CM discussion should cover the areas of perceived risk, enforcement

[10] REST scores, ICARuS, and IRRSA Red Flags are available in FDIC's confidential internal supervisory data systems.

actions, application activity, and loan review scoping. Note that during this initial examination contact, the EIC and CM should establish a plan for discussing examination findings prior to the exit meeting. The FS/SE discussion should cover hours, staffing, and scheduling items including anticipated training, on-site/off-site activities, and any specialists/subject matter experts needed for the examination. The external auditor contact should summarize information gained on the institution's operations and condition and any recommendations to management.[11]

If the examination involves a Minority Depository Institution, a comment should be included noting that examiners will inform institution management of the availability of technical assistance.

Examination Areas and Planned Procedures. Comment on each CAMELS component, specialty examination area, and any other areas based on the preliminary review of available information (such as the UBPR, risk profile, and request list items) and discussions with the CM, FS/SE, and institution management. Provide direction to examiner(s) reviewing the area on the procedures to be performed to address identified risks. Note if additional procedures are being performed for training purposes.

Under the Asset Quality subheading, comment on the plan for loan review. Document the date of the asset review and the number of loans and credit relationships to be reviewed. The comment should describe the specific types of loans and/or risk characteristics planned for review based on the institution's business model, risk profile, complexity, and lending activities. Loan review should emphasize meaningful loan sampling for new or higher risk lending activities, notable concentrations, a review of the appraisal program, and follow-up on any previously identified underwriting deficiencies.

The Other subheading should include the examination plan for any specialized business lines or characteristics, as applicable. Such areas may include the following:

- Concentrations
- Dominant Management
- Mortgage Banking, particularly if coupled with rapid growth
- Subprime/Nontraditional Lending
- Securitization Activities
- International Banking
- Related Organizations
- Credit Card Related Merchant Activities
- Third Party Arrangements
- Government Assistance Programs (for example: TARP, SBLF, or loss share agreements)
- Commercial Real Estate (if workprogram being used)
- De novo Institution (Planned procedures should evaluate the institution's adherence to continuing conditions or requirements imposed through the order approving deposit insurance)
- Foreign Ownership (e.g. Foreign Banking Organization, Parallel Banking Organization)

Consider prior specialty examination or review findings (and ratings, when applicable), and complexity assessment scores during the Examination Planning process. In addition, include relevant comments for each type of specialty examinations or review being conducted concurrently. Refer to specialty examination or review instructions for required procedures to be performed. Also identify any specialty subject matter expertise needed to address notable risk areas listed in the business model/risk profile review.

Briefly discuss any outstanding supervisory action (formal or informal), including type, date, and provisions within the action. Also note any outstanding Matters Requiring Board Attention. Describe management's progress to date in addressing the action/MRBAs.

Staffing and Assignments. List examiners, their assigned roles, and location of examination work (on-site, off-site, or both). Briefly describe activities identified for off-site work. Note whether other agencies or divisions are involved.

[11] If the institution's management has not provided a copy of a management letter issued by the auditor in connection with the most recent financial statement audit and/or internal control attestation, confirm with the auditor whether a letter was issued. Regardless of the type of auditing work performed, if no management letter was issued, discuss any other type of verbal or written recommendations that the auditor may have provided to management.

Training. List pre-commissioned examiners, trainers, and the training benchmarks being addressed during the examination.

Logistical Information. Communicate key information to examination staff regarding location, work hours, dress code, connectivity, key management absences, and other examination logistics.

EXAMINATION PLANNING MEMORANDUM

	Examination Information
Name of Financial Institution:	
Location (City, State)	
Certificate Number	
EIC/Prepared By:	
As of:	
Start:	
Estimated End:	
Estimated Hours:	

EXAMINATION RATINGS and DATA

	Prior Examination (Date)	Prior Examination (Date)	Prior Examination (Date)
CAMELS Rating			
IT Rating			
Trust (if applicable)			
Compliance (rating/date)			
CRA (rating/date)			
Adv. Class/T1 + ALLL			

EXAMINATION PLANNING RATIOS

	Current Quarter Ratios (Date)	Year-end Ratios (Date)	Prior Year-end Ratios (Date)
Total Assets			
Tier 1 Leverage Ratio			
Asset Growth Rate			
Net Interest Margin			
Return on Avg. Assets			
Total PD*/Gross Loans			
ALLL/Total Loans			
Net Loans/Total Assets			
Net Non Core Dependency ($250M)			

*All past-due loans plus nonaccrual divided by gross loans

OTHER RISK MEASURES

Other Risk Flags	Comments
REST Score/Date: ___	
ICARuS Rating/Date: ___	
IRRSA Red Flags:___	

	C	A	M	E	L	S	Comp
SCOR:							
Probability of Downgrade (%):							

PRELIMINARY RISK ASSESSMENT
• *Provide a brief description of the institution's business model, risk profile, and complexity.* • *Summarize discussions held with institution management and case manager.* • *Briefly comment on risk for each examination area.* • *Discuss planned procedures and workpaper documentation, commensurate with the risk presented for each examination area.*

Overview of the institution's business model, risk profile, and complexity: ***Describe the institution's business model, including identification of the financial activities in which the institution has chosen to engage. Describe the risk profile through a determination of the types and quantities of risks to which the institution is exposed and the quality of the risk management practices used by institution management to control these risks. Describe the complexity of the institution's operations, including a review of its balance sheet structure and scope of the business lines, customer base, and product and service offerings.***

BUSINESS MODEL

RISK PROFILE

COMPLEXITY

Discussions: ***Include the date, names, and summary of discussions held with management. Also include the date, name, and summary of key risks discussed with the case manager, field supervisor(FS)/supervisory examiner(SE), and institution's external auditor.***

Examination Areas and Planned Procedures: ***Comment on CAMELS, specialty examinations, and other areas based on the preliminary review of available information (such as the UBPR, risk profile, request list items, etc.) and discussions with the case manager, FS, and institution management. Evaluate risk for each examination area. Provide direction on planned examination procedures, and describe procedures being conducted for training purposes, if applicable.***

CAPITAL

ASSET QUALITY (including loan scope)

MANAGEMENT

EARNINGS

LIQUIDITY

SENSITIVITY TO MARKET RISK

BANK SECRECY ACT (Including complexity assessment)

INFORMATION TECHNOLOGY (Including complexity assessment)

TRUST (if applicable) (Including complexity assessment)

OTHER (if applicable, including any specialized business lines or characteristics)

SUPERVISORY ACTIONS OR OUTSTANDING MRBAs (including dates, requirements, and progress in addressing those items)

STAFFING AND ASSIGNMENTS

Examiner	Assignment	Location (On-site/Off-site)
1	EIC	
2	OM	
3	AM	
4	IT	
5	BSA	
6		
7		
8		
9		
10		

Other Staffing Notes:

TRAINING

Pre-Commissioned Examiners	Trainer	Benchmarks
1		
2		
3		
4		
5		
6		
7		
8		
9		
10		

LOGISTICAL INFORMATION

	Information
Institution Address & Parking Info	
Working Hours	
Dress Code	
Connectivity Plan	
Key Institution Management Absences	
Other	

EIC	
FS/Designee Approval	**Date**

APPENDIX C - EXAMINATION PLANNING MEMORANDUM SAMPLE

	Examination Information
Name of Financial Institution:	Bank of Anytown
Location (City, State)	Anytown, Anystate
Certificate Number	99999
EIC/Prepared By:	Sandra E. Smart
As of:	June 30, 20x6
Start:	August 1, 20x6
Estimated End:	September 9, 20x6
Estimated Hours:	610

EXAMINATION RATINGS and DATA

	Prior Examination 11/13/20x5 (state)	Prior Examination 10/21/20x4	Prior Examination 4/16/20x3 (state)
CAMELS Rating	243422/3	233322/3	232322/2
IT Rating	1/2112	2/2212	2/2212
Trust (if applicable)	2	2	2
Compliance (rating/date)	2 (1/1/2016)		
CRA (rating/date)	S (1/1/2016)		
Adv. Class/T1 + ALLL	102.71	94.92	80.13

EXAMINATION PLANNING RATIOS

	Current Quarter Ratios (6/30/20x6)	Year-end Ratios (12/31/20x5)	Prior Year-end Ratios (12/31/20x4)
Total Assets	80,604	78,207	77,879
Tier 1 Leverage Ratio	7.44	7.53	7.64
Asset Growth Rate	2.66	0.42	0.20
Net Interest Margin	3.82	3.62	3.54
Return on Avg. Assets	0.27	(0.15)	(0.30)
Total PD*/Gross Loans	6.74	8.42	9.06
ALLL/Total Loans	3.67	3.20	2.75
Net Loans/Total Assets	64.45	68.79	69.24
Net Non Core Dependency ($250M)	14.71	8.69	6.66

*All past-due loans plus nonaccrual divided by gross loans

OTHER RISK MEASURES

Other Risk Flags	Comments
REST Score/Date: 2.8 - 6/30/20x6	The RE lending portfolio is 40.5 percent of total loans.
ICARuS Rating/Date: 2.90 6/30/20x6	A dominant President and Chairman of the Board, coupled with prior control weaknesses indicate additional internal control procedures will be performed.
IRRSA Red Flags: 2	The Bank has red flags for earnings and capital.

	C	A	M	E	L	S	Comp
SCOR:	**1.95**	**2.26**	**2.14**	**3.10**	**2.10**	**1.82**	**2.63**
Probability of Downgrade (%):	9	4	11	2	3	5	9

PRELIMINARY RISK ASSESSMENT
• *Provide a brief description of the institution's business model, risk profile, and complexity.* • *Summarize discussions held with institution management and case manager.* • *Briefly comment on risk for each examination area.* • *Discuss planned procedures and workpaper documentation, commensurate with the risk presented for each examination area.*

Overview of the institution's business model, risk profile, and complexity: ***Describe the institution's business model, including identification of the financial activities in which the institution has chosen to engage. Describe the risk profile through a determination of the types and quantities of risks to which the institution is exposed and the quality of the risk management practices used by institution management to control these risks. Describe the complexity of the institution's operations, including a review of its balance sheet structure and scope of the business lines, customer base, and product and service offerings.***

BUSINESS MODEL

This $80 million community bank is a locally owned, full-service commercial Bank offering traditional deposit and credit products with a particular focus on customers directly and indirectly reliant upon maritime-related businesses. The trade area is centered in Anytown, Anystate, and is a regional economic area that is heavily dependent upon a depressed fishing industry.

RISK PROFILE

Credit risk is elevated at Bank of Anytown; weak underwriting and poor loan administration practices have led to a large volume of classified credits. Credit risk problems have been exacerbated by significant and increasing weaknesses in the local economy. Additionally, management has struggled with operational and governance issues, such as problems with filing accurate call reports and failure to monitor President Lincoln's lending authority limits. Primarily as a result of asset quality issues, revenues and earnings have been weak and have not been sufficient to build capital. Loan growth has subsided as management has worked on problem asset resolution, and compliance with the outstanding Memorandum of Understanding (MOU)[1] has been progressing, although several provisions have not been met.

COMPLEXITY

Assets consist primarily of commercial and real estate loans to small, local businesses. The bank has attempted to diversify away from the maritime-related businesses that dominate the local economy by buying commercial loan participations, primarily from Other Bank, Othertown, Other State. Bank of Anytown's level of other real estate (ORE) has been increasing, as the bank has been working its way through loan problems. The securities portfolio is invested in mortgage-backed securities issued by government sponsored entities (GSEs) with various maturities. Deposits are gathered from business loan customers and local retail depositors, and the bank has one branch on the west end of Anytown. The trust department manages approximately $3.3 million in assets, most of which is in non-discretionary accounts. Information technology services are provided by Existing Service Company, and President Allie Lincoln indicated that no changes in the agreement or services have occurred since the previous examination.

Discussions: ***Include the date, names, and summary of discussions held with management. Also include the date, name, and summary of key risk discussions with the case manager, field supervisor(FS)/supervisory examiner(SE), and institution's external auditor.***

Bank Management: A discussion with President Lincoln was held on July 5, 20x6 to discuss the FDIC's views regarding the Bank's business model, current risk profile and any changes to the complexity of the organization. President Lincoln also indicated the following:

- Significant progress had been made in addressing previous examination findings and the outstanding MOU.
- Bank management remains concerned about the level of classified assets, and its ability to manage problem assets has been challenged by the increased level of ORE, which requires different skill sets.

[1] The Bank was placed under an MOU on January 21, 20x6 based on findings from the October 21, 20x5 examination. This MOU replaced a January 20x4 MOU that was issued to address problems noted at the October 20x4 examination.

- Challenges continue in the local economy, and a moderately large employer, Blue Boat Building, Inc., recently filed for bankruptcy. While Blue Boat is not a Bank customer, many of its customers and suppliers are bank customers.
- A desire for examiners to keep Chairman of the Board (COB) Roger White informed of examination findings and include him in meeting invites during the examination.

Case Manager: A discussion with Case Manager Melinda Gary was held on June 24, 20x6. She indicated the following:

- President Lincoln and COB White continued to dominate the management team of the Bank and she was concerned that the Board may not be effectively challenging the decisions made by those two individuals.
- President Lincoln had been very communicative since the prior examination and had been keeping the regional office updated on progress in complying with the MOU.
- Progress reports provided to the regional office are in RADD and should be reviewed off-site to identify the steps that management has taken to address outstanding issues.
- EIC Smart provides her updates on a weekly basis, given the risk profile of the institution. She also asked that she be provided ample notice about any exit meetings, as she would like to attend them telephonically.

External Auditor: On July 14, 20x6, EIC Smart held a phone conversation with CPA Michael Jones of Michael P. Jones and Associates, LLP. Mr. Jones indicated that although the Bank has had problems in the past with financial reporting, he believed that all of those issues had been corrected.

Field Supervisor: On June 20, 20x6, EIC Smart discussed the risk profile, examination plan, and staffing needs with FS Paul Roberts, Jr. FS Roberts and EIC Smart agreed that an allocation of 610 hours should be sufficient to examine the Bank given the risk profile. FS Roberts noted that pre-commissioned examiner George Woods had recently completed loan school and would need additional loan review and ALLL training. He also stated that the loan review scope should target new credits, as well as problem credits, given the history of poor credit underwriting and administration. He indicated that an examiner from another office would be requested to perform the trust examination due to limited trust experience in the office. FS Roberts confirmed that the State would not be joining the examination, but will participate in either the exit meeting or Board meeting at the conclusion of the examination.

Examination Areas and Planned Procedures: ***Comment on CAMELS, specialty, and other areas based on the preliminary review of the UBPR, risk profile, request items, etc., and discussions with case manager, FS, and institution management. Evaluate risk for each examination area. Provide direction on planned documentation procedures, and describe procedures being conducted for training purposes, if applicable.***

ASSET QUALITY (INCLUDING LOAN SCOPE)

Asset review date: June 30, 20x6
Relationships reviewed / number of loans: 57 / 100

Asset Quality will be the primary review area, due to negative portfolio performance metrics noted in the UBPR and adverse findings at the previous two examinations. During the previous FDIC examination, the loan scope was expanded during the examination due to significant administration and control problems that became evident during the loan review. At the current examination, the focus will be on newer originations, outstanding credits that could be impacted by the bankruptcy of Blue Boat Company, Inc., a sampling of larger loans and participations, and a review of all loans to insiders. Additionally, due to previous examination concerns with the credit rating system, internally classified loans of various sizes and grades will be sampled. Although the Loan Portfolio Audit Tool (LPAT) did not identify potential irregular and outlier credits, a sampling of loans originated by President Lincoln will be reviewed due to previous issues related to her lending authority. Additionally, the proceeds will be traced for those loans in President Lincoln's portfolio that recently paid off. Larger ORE properties and newly acquired parcels will be sampled. The Bank does not have loan file imaging, so all loan and ORE files will be reviewed on-site.

President Lincoln indicated that the loan policy has been updated, so a thorough review of each change will be completed. Although President Lincoln indicated a level of comfort with the level of the ALLL (3.67% of TL), the ALLL methodology and calculation will be subjected to in-depth review, due to problems consistently being noted in this area. The concentration in loans to borrowers in the shell fishing industry will be reviewed to assess risk management, monitoring, and control processes. Since the securities portfolio is entirely comprised of investments in GSE securities, investment policies have not changed, and adequate monitoring is evident in reports reviewed, no additional examination work will be performed in this area.

MANAGEMENT
The history of poor administration, controls, and governance at this institution warrants significant review of policies, procedures, and overall risk management practices for each of the CAMELS component areas, as well as transaction testing of internal controls. In particular, examiners will test the accuracy of several Call Report schedules. Since President Lincoln and Chairman White tend to dominate the affairs of the bank, all Board minutes since the previous examination will be reviewed off-site to determine the involvement and level of Board oversight. Examiners will review the strategic plan and all internal audits completed since the previous examination off-site. Additionally, an assessment of efforts to address the provisions of the MOU will be a priority of the examination.

EARNINGS
Poor asset quality has caused earnings performance to be less than satisfactory, though there are some improving trends. The ROAA has returned to a positive, albeit low level, and the NIM is also trending upward. Overhead expense has increased due to ORE holding costs and new loan workout staff hired to address problem credits. President Lincoln does not expect overhead expense to decline in the near term due to continued asset quality challenges, and the bank is considering closure of the west-end branch to reduce overhead. The budget and profit plan will be reviewed off-site. Additionally, given past call report errors regarding income and expense items, Call Report Schedule RI will be reconciled off-site. On-site follow-up of specific accounts will be performed if necessary.

CAPITAL
Capital levels have been declining, although they currently comply with the provisions of the MOU; the decline has been the result of the slight increase in assets and losses in 20x5. President Lincoln indicated that since issuance of the MOU, the Bank has focused on reducing loan levels and was taking a more conservative approach to growth. A thorough assessment of capital will be conducted to determine whether capital is sufficient to support the level of asset quality issues at the Bank. Policies regarding capital maintenance and strategies for capital augmentation will be reviewed along with the Board's monitoring of capital. Examination procedures related to capital will primarily be conducted off-site.

LIQUIDITY
On-balance sheet levels of liquidity total approximately 15 percent of total assets. A review of how management calculates and reports on-balance sheet liquidity will be completed along with a review of sources and uses of funds. While the bulk of the funding comes from local commercial and retail depositors, the bank also relies on borrowings from the Federal Home Loan Bank of Anyregion and draws on a commitment from Other Bank, Otherstate. Usage of these borrowings will be reviewed, along with policies, procedures, and risk management around liquidity and funds management, including contingency funding plans. Most of the review of this area can be conducted off-site.

SENSITIVITY TO MARKET RISK
The bank's balance sheet is fairly well matched. Examination procedures will focus on a review of the minutes of the Asset Liability Management Committee minutes, a review of the economic value of equity model used by the bank, as well as the reasonableness of the assumptions used in the model. This review will be conducted off-site.

BANK SECRECY ACT (INCLUDING COMPLEXITY LEVEL)
The BCAT completed on June 15, 20x6 indicated a score of 60 or Low Complexity. As such, the lack of complexity in bank operations, coupled with satisfactory BSA/AML program performance noted at the prior examination and lack of new initiatives or products, indicate a lower risk profile for BSA/AML. Examiners will work off-site and focus on determining the adequacy of the five pillars of the program. Examiners will utilize the FFIEC BSA/AML Examination Manual and the related electronic workprograms to document the review.

INFORMATION TECHNOLOGY (INCLUDING COMPLEXITY LEVEL)
The IT Profile completed on June 3, 20x6, resulted in a Technology Profile Score of 60, indicating a "Level C – Low Complexity". The Bank is serviced and primarily relies on third parties for its IT infrastructure and oversight. As discussed with FS Roberts, the IT examination will be allotted 60 hours and commence on-site on the same date as the Safety and Soundness examination. The IT examiner is expected to be at the Bank for the first week and then finish off-site.

In the prior examinations, the overall IT program was rated satisfactory. The review will review actions to address prior recommendations and assess the overall IT posture, based on the Information Technology Risk Examination (InTREx) program. Conformance with Appendix B of Part 364, Interagency Guidelines Establishing Information Security Standards, will also be evaluated, as well as cybersecurity preparedness. Findings of the IT examination will be embedded in the Safety and Soundness ROE.

TRUST (IF APPLICABLE) (INCLUDING COMPLEXITY LEVEL)
The Bank has a small trust department and scored a 40 on the Trust Profile Scoring Matrix. Trust Department assets total $3.3 million, held in 8 personal trust accounts, 44 burial trust accounts, and 1 farm management agency account. The review will include a review of policies, practices, and procedures, trust-related comments in Board minutes, and the last external audit to be performed off-site, and selected accounts, compliance with applicable laws, follow-up on matters criticized at previous examinations, and management discussions to be conducted on-site. The Trust examination will be allotted 50 hours.

OTHER (IF APPLICABLE, INCLUDING ANY SPECIALIZED BUSINESS LINES OR CHARACTERISTICS)
Not applicable.

SUPERVISORY ACTIONS OR OUTSTANDING MRBAs (including dates, requirements, and progress in addressing those items)

January 21, 20X5 MOU – The institution has 6 ongoing provisions in its MOU:

1. The Bank shall maintain an allowance for Loan and Lease Losses at an appropriate level.
2. The Bank shall maintain a Leverage Capital ratio equal to or greater than 7 percent.
3. The Bank shall maintain a Total Capital ratio equal to or greater than 10 percent.
4. The Bank shall file accurate Call Reports
5. The Bank shall not extend or renew, directly or indirectly, credit to, or for the benefit of, any borrower who has a loan or other extension of credit with the Bank that has been charged off or classified, in whole or in part, Loss, Doubtful, or Substandard, unless rationale for the extension is noted in the official Board minutes and the appropriate credit file.
6. The Bank shall not declare or pay any dividends without the written consent of the FDIC.

A review of each of the provisions will be completed within each of the respective component reviews.

STAFFING AND ASSIGNMENTS

Examiner	Assignment	Location (On-site/Off-site)
1. Sandra Smart	**EIC, Capital, Management**	Will be on-site for two weeks beginning on August 1. One week off-site prior and after.
2. Melissa Johnson	**OM, (all operations items not assigned to others)**	Review policies off-site. On-site beginning on August 3.
3. Bill Wilson	**AM, Loan Policy, Concentrations**	Will be on-site for two weeks beginning on August 1.
4. Bob Franks	**IT**	On-site the week of August 1st and off-site 2nd week.
5. Todd Marks	**BSA**	On-site for kick-off meeting on August 1, then off-site. Will return for transaction testing and exit meeting second week.
6. George Woods	**Loan Review/ALLL**	On-site beginning August 1 until loan review is finished, will review ALLL off-site.
7. Pauline Justice	**Loan Review/ALLL**	On-site beginning August 1 until loan review is finished, will review ALLL off-site.
8. Mark Jacobs	**Trust Review**	Week of August 1 off-site. On-site August 8 and 9.

Other Staffing Notes: All Request List items have been provided electronically and placed in appropriate electronic workpaper files.

TRAINING

Pre-Commissioned Examiners	Trainer	Benchmarks
George Woods	**Pauline Justice**	Review ALLL and complete loan review

LOGISTICAL INFORMATION

	Information
Institution Address & Parking Info	557 Madison Parkway, Anytown, Anystate There are ample parking spaces around the Bank's building and some parking in front of the Bank. Closest spots should be left for customers.
Working Hours	7:30 A.M. to 5:30 P.M.
Dress Code	Business Casual Attire
Connectivity Plan	FS Roberts ordered a high-speed digital circuit for examiner use.
Key Institution Management Absences	President Lincoln will be out of the office on Thursday, August 4.
Other	

EIC Sandra Smart	
FS/Designee Approval: Paul Roberts, Jr.	**Date** July 31, 20x6

Examination Documentation Modules

The Examination Documentation (ED) Modules are an examination tool used by FDIC examiners since 1997 to carry out the forward-looking, risk-focused examination program. The program includes a set of Primary and Supplemental Examination Documentation Modules (ED Modules) that address the major functional areas of a financial institution. Primary ED Module procedures, and most Supplemental ED Module Procedures, are separated into three distinct tiers: Core Analysis, Expanded Analysis and Impact Analysis.

The Core Analysis includes procedures to be considered, but not necessarily performed at a given examination, based on the applicability of the ED Module to the institution's business model, risk profile, and complexity of operations. The Expanded Analysis includes procedures to be considered for the areas that present the greatest degree of risk to the institution when the Core Analysis review identifies significant deficiencies or weaknesses. If the Expanded Analysis shows that risks are material or the activity is not adequately managed, then examiners consider the Impact Analysis to assess the financial impact of the deficiencies or weaknesses and to determine whether any enforcement action may be necessary.

Reference Modules are also available for examiners use in evaluating significant business lines or conducting technical reviews. Reference Modules contain only one tier: Core Analysis.

Examination Procedures in ED Modules may not address every risk consideration. Examiners have the discretion to perform and document additional examination procedures to assess risk.

CAPITAL ADEQUACY

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine if an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?

C.1. **Is the capital level sufficient in relation to the risk profile of the bank?** ***Refer to Core Analysis Procedure #19.***

C.2. **Is earnings retention sufficient to provide for future growth, capital maintenance, and potential losses?** ***Refer to Core Analysis Procedure #18.***

C.3. **Are the bank's operating policies, procedures, and risk limits regarding capital preservation adequate?** ***Refer to Core Analysis Procedure #6.***

C.4. **Are information, communication, and regulatory reporting systems adequate and accurate?** ***Refer to Core Analysis Procedures #13-15.***

C.5. **Are the audit or independent review functions adequate?** ***Refer to Core Analysis Procedures #11-12.***

C.6. **Are internal controls adequate?** ***Refer to Core Analysis Procedures #8-10.***

C.7. **Do the Board and senior management effectively supervise this area?** ***Refer to Core Analysis Procedures #20-23.***

CAPITAL ADEQUACY

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Note: **Revised regulatory capital rules* for most insured depository institutions, other than large institutions that are subject to *advanced approaches*, generally became effective on January 1, 2015. The new requirements mandate significant changes to regulatory capital components, risk-weight calculations, minimum regulatory capital ratios, and Prompt Corrective Action thresholds. The revised rules also require institutions to hold a capital-conservation buffer in order to avoid limitations on capital distributions and discretionary bonus payments.**

As the revised rules are phased in (and through full implementation in 2022), financial institutions should be meeting or preparing to meet the new capital requirements. Such steps may include:

- **Evaluating the permissibility of Tier 1 and Tier 2 capital instruments,**
- **Modifying information systems and related procedures to ensure the accurate risk-weighting of assets and other exposures, and**
- **Assessing prospective capital positions and dividend plans relative to minimum regulatory capital ratios and the capital-conservation buffer.**

Examiners should work with bankers to ensure they are appropriately prepared for full implementation of the revised regulatory capital rules. Accordingly, examiners should assess the bank's compliance with applicable (phased-in) capital requirements and the bank's plans and efforts to comply with revised (fully phased-in) regulatory capital requirements. Such assessments may include reviewing the institution's:

- **Understanding of the revised regulatory capital rules and definitions,**
- **Regulatory capital calculations,**
- **Risk-weighted assets calculations,**
- **Capital ratios in relation to the revised Prompt Corrective Action (PCA) standards, and**
- **Capital levels, capital distributions, and discretionary bonus payments in relation to any capital conservation buffer requirements.**

Note: This module is to be used at institutions that do not use the advanced approach.

**** The rules are codified at Title 12 of the Code of Federal Regulations (CFR) for the FRB in Part 217 and codified at Title 12 of the CFR for the FDIC in Part 324.***

Preliminary Review

1. **Review prior examination reports, prior examination work papers, pre-examination memorandum, and file correspondence for an overview of any previously identified capital deficiencies and identification of any government-sponsored capital programs, such as Troubled Asset Relief Program (TARP) and Small Business Lending Fund (SBLF).**

2. **Assess management's preparation for phased-in requirements of the capital rules.**

3. **Review internal and external audits for capital concerns. Review remedial action taken by management to correct prior audit and examination findings.**

4. **Analyze capital levels and trends in the Uniform Bank Performance Report. Consider loan losses, provisions to the allowance for loan and lease losses (ALLL), problem asset levels, loan growth, material concentration levels, and any operating losses.**

5. **Determine whether there have been any changes to the corporate or capital structure since the previous examination, such as Sub Chapter S reorganization or new capital offerings.**

Policies and Procedures

6. **Determine whether policies and practices promote capital preservation and address future capital needs. Consider the following:**
    - **The strategic plan and its underlying assumptions, projected asset growth, dividend plans, asset quality, income, liquidity, funds management, deposit structure, parent-company relationship, contingent liabilities, expansion plans, competition, economic conditions, etc.;**
    - **Findings from interviews with management regarding the strategic planning process (including any potential issues due to a change in PCA designation);**
    - **Internal risk-monitoring policies and procedures;**
    - **The availability of additional capital sources (such as funding provided by insiders, external sources, or additional debt at the parent level); and**
    - **The permissibility of current or planned components of capital to qualify as Common Equity Tier 1 Capital or Additional Tier 1 Capital.**

(Note: Coordinate with examiners completing the Management and Internal Control Evaluation Modules)

7. **Review historical and planned dividend payout ratios and other planned capital reductions. For planned capital stock retirements, ensure management requested prior regulatory approval.[1] Also, determine whether management evaluated the impact of the capital conservation buffer.**

[1] An FDIC-supervised institution must obtain prior FDIC approval for any dividend payment involving a reduction or retirement of capital stock in accordance with Section 324.20 (FDIC); FRB, 12 CFR 303.241.

Internal Controls

8. Determine whether entries to capital accounts are appropriate and properly authorized.

9. Assess controls over off-balance sheet items (Schedule RC-L) and their overall impact to sufficiency of capital levels and needs.

10. Review board and management's procedures to prevent, detect, and respond to policy exceptions that may affect capital.

Audit or Independent Review

11. Determine whether the audit function verifies the accuracy of the capital accounts and regulatory reports; assesses the appropriateness, accuracy, and timeliness of reports produced for the board and executive management; and evaluates the reasonableness of capital planning.

12. Determine whether audits or independent reviews include an assessment of compliance with policies, procedures, and regulatory requirements related to capital issues.

Information and Communication Systems

13. Determine whether board and management reports provide sufficient, timely, and accurate information.

14. Review the accuracy of the bank's calculation of Common Equity Tier 1 Capital, Additional Tier 1, and Tier 2 Capital. Reviewing the bank's calculations may involve some of the following procedures:

- **Review Call Report Schedule RC-R and supporting documentation.**
- **Determine whether the bank has chosen to opt-out of the inclusion of accumulated other comprehensive income (AOCI).**
- **Review applicable deductions and adjustments for each tier of capital, including phase-in and phase-out provisions (refer to 324.22 (FDIC) and 217.22 (FRB) for capital adjustments and deduction rules and 324.300 (FDIC) and 217.300 (FRB) for transition provisions).**

- **Consider whether the bank has non-qualifying capital instruments or non-qualifying minority interests subject to phase-out (refer to 324.20 (FDIC) and 217.20 (FRB) for criteria for capital instruments for each tier of capital, 324.21 (FDIC) and 217.21 (FRB) for minority interest rules, and 324.300 (FDIC) and 217.300 (FRB) for transition provisions).**

15. Review the accuracy of the bank's calculation of risk-weighted assets reported on Schedule RC-R, Part II. Review the bank's supporting documentation as appropriate. Reviewing the bank's calculations may involve some of the following procedures:

- **Determine whether risk weights for most assets conform with applicable requirements (FDIC: Part 324.32, FRB: Part 217.32).**
- **As applicable, review risk weights for other categories of exposures, such as:**
  - **Off-balance sheet exposures (FDIC: Part 324.33 and FRB: part 217.33),**
  - **Over-the-counter derivative contracts (FDIC: Part 324.34 and FRB: Part 217.34),**
  - **Cleared transactions (FDIC: Part 324.35 and FRB: Part 217.35),**
  - **Guarantees and credit derivatives (FDIC: Part 324.35 and FRB: Part 217.35),**
  - **Collateralized transactions (FDIC: Part 324.37 and FRB: Part 217.37)**
  - **Securitizations (FDIC: Part 324.41-45 and FRB: Part 217.41-45),**
  - **Equity exposures (FDIC: Part 324.51-52 and FRB: Part 217.51-52),**
  - **Equity exposures to investment funds (FDIC: Part 324.53 and FRB Part 217.53), and**
  - **Other aspects of the revised capital rules.**

16. Review the bank's capital ratios under the revised PCA standards. If the bank is less than well capitalized under the revised standards (or appears that it could become less than well capitalized due to the phase-in of deductions or other aspects of the new capital rules) consider whether the bank has a reasonable strategy to meet the fully phased-in requirements over the transition period.

17. Review the bank's capital conservation buffer and the appropriateness of any distributions and discretionary bonus payments.

Earnings Considerations

18. Determine whether earnings performance enables the bank to fund growth, compete in the marketplace, and support the overall risk profile. Consider the level and trend of equity capital in relation to asset levels, quality, and growth rates.

- **Assess the impact of current and projected provisions to the ALLL on capital retention and growth.**
- **Review whether the bank is relying on core earnings or non-recurring income.**
- **Determine whether dividends are excessive compared to current earnings. (Consider applicable state and federal laws and regulations.)**

Risk Profile Considerations

19. Determine whether the existing capital level is adequate for the bank's risk profile when considering the following items:

- **The adequacy of capital-management policies and controls;**
- **The level, type, and trend of adversely classified assets;**
- **The adequacy of the ALLL;**
- **The volume and trends of charged-off loans and recoveries;**
- **The balance sheet structure and liquidity needs;**
- **The level, type, and trend of concentrations;**
- **The vulnerability of assets and liabilities to adverse events;** ***(Note: While not required for most institutions, stress testing or sensitivity analysis is considered a prudent practice to assist in the identification, measurement, and mitigation of risks.)***
- **The volume of unrealized gains or losses on available-for-sale securities;** ***(Note: Examiners should closely review this area if an institution has not opted-out of the AOCI treatment for certain securities gains and losses.)***
- **The degree of interest rate risk exposure assumed by the bank;**
- **The reasonableness of booked, future tax benefits;**
- **The accounting treatment and valuation of intangible assets;**
- **The extent of contingent liabilities associated with trusts or other activities;**
- **Dividend/repayment requirements for government capital programs (e.g. TARP or SBLF);**
- **The extent of any other liabilities not shown on the bank's books, including contingent liabilities;**
- **The existence of pending litigation against the bank (and its subsidiaries) and the potential and estimated loss exposure;** ***(Note: This information should be disclosed on the responses to the Officer's Questionnaire or First Day Letter.)***
- **The volume and risk characteristics of new business initiatives and higher risk investment or lending strategies (e.g., subprime lending or mobile banking), or involvement in nontraditional activities such as non-deposit products, insurance sales, or discount brokerage services;**
- **The extent to which higher-risk loans or investments may require additional capital under the revised regulatory capital rules' risk-weights (for example, high-volatility commercial real estate loans, equity exposures, or certain structured or securitized investments);**
- **Compliance with state and federal laws and regulations regarding capital levels; and**
- **The level of operational and reputational risk.**

Managerial Effectiveness

20. Assess the adequacy of management's actions to correct criticisms related to capital in previous examination reports and recent internal or external audits.

21. Evaluate management's effectiveness at preparing for and reacting to changes in economic, industry, and regulatory environments.

22. Determine whether management effectively identifies and manages: • **The institution's overall risk profile,** • **Factors that may change the institution's risk profile, and** • **How a change in the risk profile will affect the sufficiency of capital levels.**
23. Determine whether management adequately prepared for full implementation of the revised regulatory capital rules by: • **Evaluating its prospective capital position pursuant to the new rule;** • **Adopting ways to measure capital (including capital components and deductions, risk-weighted assets, and minimum capital ratios); and** • **Ensuring that the board is aware of these changes.**
End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

EARNINGS

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine whether an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1. Are profit planning and budgeting practices adequate? *Refer to Core Analysis Procedures #8-13.*

C.2. Are internal controls adequate? *Refer to Core Analysis Procedures #14-18.*

C.3. Are the audit or independent review functions adequate? *Refer to Core Analysis Procedure #19.*

C.4. Are information and communication systems adequate and accurate? *Refer to Core Analysis Procedures #20-22.*

C.5. Are earnings sufficient to support operations, provide for funding of the allowance for loan and lease losses (ALLL) (or allowance for credit losses (ACL)[1], when applicable) and augment capital? *Refer to Core Analysis Procedures #23-33.*

C.6. Are earnings sustainable? *Refer to Core Analysis Procedures #34.*

C.7. Do the board and senior management effectively supervise this area? *Refer to Core Analysis Procedures #35-36.*

[1] ACL replaces the term ALLL for those banks that adopted ASU 2016-13.

EARNINGS
Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review
1. Review previous reports of examination, prior examination work papers, and file correspondence for an overview of any previously identified earnings concerns, strengths, or other considerations.
2. Review recent audits and independent reviews to identify deficiencies concerning the reliability of management information systems (MIS) that may affect the quality and reliability of reported earnings.
3. Review management's remedial actions to correct examination and audit deficiencies.
4. Discuss with management any recent or planned changes in strategic objectives and their implications for profit plans.
5. Review board and committee minutes along with management reports to determine the adequacy/quality of MIS systems and reports.
6. Review recent Uniform Bank Performance Reports (UBPR) to develop an initial assessment of overall earnings performance. Consider the impact of Subchapter S tax filing status when selecting performance ratios to review.
7. Compare financial statements, UBPRs, and Consolidated Reports of Condition and Income (Call Reports) to determine whether there have been any significant changes that could materially affect earnings performance.

Profit Planning and Budgeting Practices

8. Review the strategic plan to determine the board's goals and objectives over the near- and moderate-term, including consideration of local and national economic conditions, new products or services, and growth.

9. Assess the potential impact of new strategic initiatives on future earnings performance. Consider the following:

- **Branching activities;**
- **Acquisition/merger activity;**
- **New products and services; and**
- **Anticipated outlays (e.g., technological upgrades).**

10. Determine whether profit plans and budgeting practices are realistic, consistent with the strategic plan, and address the following areas with detail appropriate for the business model, size, complexity, and risk profile:

- **Local and national economic conditions,**
- **Competitive environment,**
- **Strategic plans,**
- **New or changing products and business lines,**
- **Growth objectives,**
- **Capital requirements,**
- **Managerial resources,**
- **Asset and liability mix and pricing,**
- **Funding strategies,**
- **Anticipated level and volatility of interest rates,**
- **Interest rate and maturity mismatches, and**
- **Anticipated funding of the ALLL (or ACL, when applicable).**

11. Determine whether profit plans realistically assess the costs associated with the risk management processes needed for new initiatives, changes in risk appetite, and potential deterioration in asset quality or market conditions.

12. Assess the timeliness of preparing and approving the profit plans and budgets.

13. Compare earnings performance to budget forecasts. Determine whether management compares

budgeted performance to actual performance on a periodic basis, modifies projections when interim circumstances change significantly, and evaluates budget forecasts under multiple stress scenarios.

Internal Controls

14. Review management's procedures to prevent, detect, and correct errors with respect to MIS.

15. Determine whether the income and expense posting, reconcilement, and review functions are independent.

16. Consider testing selected income, expense, and balance sheet items to observe the flow of transactions and to identify internal control weaknesses. Areas commonly selected for review are:

- **High levels of other income in miscellaneous-income, service-fee, or unusual accounts;**
- **Proper amortization of loan origination fees;**
- **Insider expense accounts;**
- **Management fees or other payments to affiliates or insiders;**
- **Significant legal or consulting fees;**
- **Prepaid accounts;**
- **Stale items; and**
- **Expenses accrued and unpaid.**

17. Determine whether significant or non-recurring income, expenses, and capital charges are reviewed and authorized by senior management and the board.

18. Determine whether insider or affiliate-related income and expense items are routinely reviewed for authorization, appropriateness, and compliance with laws and regulations.

Audit or Independent Review

19. Determine whether the audit or independent review program provides sufficient coverage of earnings activities relative to the bank's business model, size, complexity, and risk profile. Determine whether these programs:

- **Assess compliance with profit planning objectives, accounting standards, and Call Report Instructions;**
- **Include sufficient transaction testing to assure income and expenses are accurately recorded;**

- **Assess separation of duties and internal controls;**
- **Assess the adequacy, accuracy, and timeliness of reports to senior management and the board;**
- **Recommend corrective action when warranted; and**
- **Verify implementation and effectiveness of corrective action.**

Information and Communication Systems

20. Determine whether managerial reports provide sufficient information relative to the business model, size, complexity, and risk profile of the bank.

21. Evaluate the accuracy and timeliness of reports produced for the board and executive management. Reports may include:

- **Periodic earnings results,**
- **Budget variance analyses,**
- **Income and expense projections,**
- **Nonrecurring or cyclical items,**
- **Exposure to interest rate/market risk,**
- **Large item reviews,**
- **Insider related transaction disclosures, and**
- **Tax planning analyses.**

22. Validate the accuracy of Call Reports as appropriate. Review bank work papers, the general ledger, and downloaded exception reports; and interview bank personnel to verify the accuracy of Call Report schedules RI, RI-A, RI-B, RI-C, RI-D, RI-E, and RC-K.

Ratio and Trend Analysis

23. Assess the level and trend of the return on average assets (ROAA) relative to historical performance, peer comparisons, the organization's business model, risk profile, balance sheet structure/composition, and local and national economic conditions. Consider the amount and volatility of income from high-risk assets, asset concentrations, non-recurring items, and accounting practices subject to management discretion (which could manipulate earnings). Identify and assess areas needing further investigation.

24. Evaluate the level, trend, and stability of the net interest margin (NIM). Discuss with credit, market, and liquidity risk examiners the impact to present and future earnings performance from potential changes in asset quality, market fluctuations, and interest rates.

25. Evaluate the level and trend of overhead in relation to operational activities. Consider the effect of strategic initiatives (such as, new products/services, branch openings/closings, and staffing increases/decreases).

26. Evaluate the level, trend, and sources of non-interest income. Discuss with management any projections for changes in fee structures. Consider the impact of changes in interest rates and market conditions on mortgage banking income, securities gains, or other non-interest revenue sources.

27. Review the level and trend of provisions to the ALLL (or ACL, when applicable) and the relationship to actual loan losses to determine the impact of asset quality on earnings. Discuss with the examiner(s) responsible for loan review the potential need for additional provision expenses resulting from examination findings.

28. Review the level, trend, and expected frequency of non-operating gains and losses and their impact on earnings.

29. Consider the impact to earnings from purchased-impaired accounting practices, and if applicable, discuss with an accounting specialist.

30. Determine whether there have been or are expected to be any non-recurring events and consider their impact to earnings performance. If necessary for comparison purposes, evaluate this impact on a tax-equivalent basis.

31. Evaluate the level and trend of income tax payments recognizing the bank's basis for filing taxes. (e.g., Subchapter S, tax allocation agreement)

32. Determine whether transactions between affiliated organizations and subsidiaries have an impact on the bank's earnings.

33. Assess the ability of earnings to support capital growth under current, projected, and stressed conditions. Review the earnings retention rate in comparison to past and forecasted growth rates.
Sustainability
34. Determine whether the current level of earnings is sustainable. Consider the following: • **Level and trend of the ROAA, NIM, overhead, fee income, and ALLL (or ACL, when applicable) provisions;** • **Asset quality trends;** • **Management's ability to forecast or control funding and operating expenses;** • **Strategic plans, including new initiatives;** • **Competitive and economic conditions; and** • **Vulnerability to adverse events.**
Board and Senior Management Supervision
35. Review relevant documentation to determine whether the board assesses bank earnings and responds to significant budget deviations.
36. Assess compliance with bank policies, applicable regulations, and governing accounting standards. If applicable, determine compliance with outstanding formal or informal enforcement actions.
End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

INTERNAL AND EXTERNAL AUDIT EVALUATION

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine whether an Expanded Analysis is necessary. This module should incorporate and summarize audit findings from all of the completed ED Modules for a given examination. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

Note: If, after completing this module, examiners answer this question no, continue to the Management and Internal Control Evaluation (MICE) Expanded Analysis module.

C.1. **Has the board of directors established an audit committee that monitors and provides effective oversight of audit activities?** ***Refer to Core Analysis Procedures #1-8 & Procedure #12.***

C.2. **Has management established audit policies and procedures that are adequate for the size, complexity, activities, and risk profile?** ***Refer to Core Analysis Procedure #11.***

C.3. **Is the internal audit function independent from all functional areas?** ***Refer to Core Analysis Procedure #10.***

C.4. **Is the internal audit program sufficient for the risk profile?** ***Refer to Core Analysis Procedures #11-13.***

C.5. **Are internal audit record keeping and reporting processes sufficient?** ***Refer to Core Analysis Procedures #14-15.***

C.6. **Is the internal audit function adequately staffed with auditors who possess an appropriate level of experience and expertise?** ***Refer to Core Analysis Procedure #12.***

C.7. **Do the internal auditors adequately identify, document, and report key risks in the organization?** ***Refer to Core Analysis Procedures #15-16.***

C.8. **If the internal audit function is outsourced, do the board and senior management provide sufficient oversight of the relationship?** ***Refer to Core Analysis Procedure #9.***

C.9. **Is the organization's external audit program effective and in compliance with applicable laws and regulations?** ***Refer to Core Analysis Procedure #17.***

INTERNAL AND EXTERNAL AUDIT EVALUATION

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every institution. Examiners should complete only the procedures relevant for the institution's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Resources: FDIC: 12 CFR Parts 363 and 364, and the Interagency Policy Statement on Internal Audit Function and its Outsourcing FIL 21-2003; FRB: 12 CFR Part 208 - Appendix D, SR 03-5 Amended Interagency Guidance on the Internal Audit Function and its Outsourcing, SR 13-1 Supplemental Policy Statement on the Internal Audit Function and its Outsourcing, and AD 13-2 Examiner Guidance Relating to the Internal Audit Function at Supervised Institutions.

Preliminary Review

1. Identify previous concerns by reviewing prior examination reports, file correspondence, audits and audit or board committee minutes.

2. Determine the general structure and primary responsibilities of the board of directors, board committees, and executive management relating to audit activities.

3. Determine whether any material changes occurred or are expected that may affect this area. Discuss the changes and implications with management.

Audit and Other Independent Reviews

4. Determine whether an audit committee has been established, and evaluate the composition of the committee. Consider the following:

- **Number of members,**
- **Number of outside directors,**
- **Independence from management, and**
- **Presence of financial experts, if required.**

5. Determine whether the audit committee operates under an appropriate charter. Satisfactory charters generally address topics such as:

- **Requirements for audit committee membership;**
- **Frequency of committee meetings;**

- **Responsibility for engaging independent accountants and appointing the internal auditor;**
- **Responsibility for reviewing internal audits, the annual external audit, and the quarterly and annual financial statements;**
- **Requirements and responsibilities for supervision of the internal audit program;**
- **Guidelines for establishing open communication among the audit committee, the internal auditor, the independent accountant and the board of directors; and**
- **Authorization for the audit committee to obtain outside legal counsel and conduct investigations.**

6. Determine whether the board or audit committee reviews the effectiveness of the institution's internal audit systems. Appropriate reviews[1] generally consider items such as:

- **The internal audit charter, budget and staffing levels, and overall risk-assessment methodology;**
- **The audit organizational structure, including the selection, termination, and compensation of external auditors and outsourced internal auditors, and placement of the internal audit function and the internal audit manager within the institution's organizational and management structure, as applicable;**
- **Annual audit plans and updates;**
- **The internal auditor's progress in completing the audit schedule;**
- **Internal audit reports and management's response;**
- **Status reports on management's actions to correct control weaknesses and violations of laws and regulations identified in internal and external audit reports as well as examination reports;**
- **The integrity of internal and external financial-reporting processes (reviews may involve discussions with independent accountants and internal auditors);**
- **The organization's annual financial statements and reports or other financial information submitted to any governmental body, or made public (including certifications, reports, opinions, or reviews rendered by the independent accountants); and**
- **Significant disagreements between management and the independent accountants or the internal auditing department in the preparation of the financial statements.**

7. Determine whether audit committee responsibilities are commensurate with the size, complexity, activities, and risk profile. Responsibilities generally include:

- **Establishing an internal audit function that operates adequately, independently, and has sufficient resources to effectively oversee the audit function;**
- **Evaluating all significant vendor arrangements, including the independence of internal and external auditors, and the effectiveness of the internal audit program;**
- **Retaining auditors who are qualified to audit the organization's activities. (Note: The committee typically hires the senior auditor, sets his or her compensation, and evaluates his or her performance.);**
- **Establishing schedules and agendas for regular meetings with internal and external auditors;**
- **Interacting with the auditor, separate from formally scheduled meetings, to remain current on**

[1] Generally, institutions perform reviews at least annually, with reviews correlated to the risks in activities reviewed.

internal audit department, organizational, or industry concerns;

- **Considering the independent accountants' judgments about the quality and appropriateness of the organization's accounting policies as applied in its financial reporting; and**
- **Considering and approving, if appropriate, all major changes to the institution's auditing and accounting principles and practices as suggested by the independent accountants, management, or the internal auditing department; and**
- **Fostering forthright communication and maintaining processes in which employees or other stakeholders can submit confidential and anonymous concerns to the committee about questionable accounting, internal accounting controls, and other auditing matters.**

8. Determine whether committee minutes note significant actions, such as:

- **Reviewing and approving the code of ethics and audit charter;**
- **Recommending selection and approval of the certified public accountant (CPA) firm to serve as external auditor;**
- **Discussing and validating the CPA firm's independence;**
- **Approving the internal auditor's salary and the audit department's budget;**
- **Reviewing the annual internal audit plan and conformity with the plan;**
- **Discussing internal audit staffing levels and training needs;**
- **Discussing with the CPA firm the quality of the application of accounting principles;**
- **Reviewing and approving the annual and quarterly financial statements prior to issuance; and**
- **Reviewing and approving, if applicable, attestation letters for internal control reports and compliance with Section 36 of the FDI Act, 12 U.S.C. 1831m, and 12 CFR Part 363.**

9. If portions of the internal audit function are conducted by outside vendors, consider whether:

- **An internal audit conducted by the same vendor that conducts the financial statement audit meets independence considerations;**
- **Due diligence is adequate, performed prior to entering the outsourcing arrangement, and considers vendor competence, independence, and objectivity;**
- **The outsourcing contract and engagement letter between the organization and the vendor appropriately detail each party's responsibilities;**
- **The scope of outsourced audit work[2] is adequate, documented, and revised when the institution's environment, activities, risk exposures, or systems change significantly;**
- **Findings are appropriately and effectively communicated; and**
- **Contingency planning is adequate to mitigate audit coverage discontinuity if the outsourcing arrangement is terminated.**

[2] For institutions with formal internal audit departments, refer to the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing for additional information.

10. **Determine whether the internal audit function is sufficiently segregated from operations. Appropriate segregation is generally evidenced by the following items:**
    - **The audit department does not report to an operational function in the organizational structure.**
    - **The audit staff is prohibited from performing operational duties such as preparing general ledger tickets and daily reconcilements, or performing a procedure under dual control.**
    - **Reporting procedures are independent of the influence of operating personnel.**
    - **The auditor reports directly to the board of directors or the audit committee and meets with them to review reports.**

Policies

11. **Determine whether internal audit policies and procedures are adequate for the institution's size, complexity, activities, and risk profile. Items to consider include, but are not limited to:**
    - **Risk analysis and assessments,**
    - **Internal control questionnaires or narratives,**
    - **Audit frequency commensurate with risk,**
    - **Audit schedule,**
    - **Audit work programs,**
    - **Account confirmations,**
    - **Workpapers,**
    - **Reporting standards,**
    - **Corrective-action tracking standards, and**
    - **A comprehensive quality assurance program that:**
        - **Includes both internal and external quality assessments,**
        - **Ensures internal audit activities consider The Institute of Internal Auditors (IIA) professional standards, and**
        - **Ensures audit practices conform with internal audit policies and procedures.**

12. **Determine whether the size and qualifications of the audit staff are appropriate based on the institution's activities, assets, and complexity. Consider the audit staff's academic backgrounds, experience, competency, and ongoing training initiatives.**

13. **Consider whether the internal audit schedule is based on a risk assessment. General considerations include the following items:**
    - **All institution functions and services are reflected.**
    - **The audit schedule is reviewed and approved by the audit committee at least annually.**
    - **The auditor periodically reports progress in completing the schedule to the audit committee.**
    - **The audit committee approves changes to the schedule.**
    - **Audit plans and frequencies are reasonable and completed as scheduled.**
    - **Audit schedules use varied starting dates and time intervals between audits to avoid anticipation by**

those subject to audit.

14. Assess the adequacy of audit workprograms and the maintenance of corresponding audit workpapers. Items to consider include:

- **A reasonable record retention schedule is maintained for audit records.**
- **Audit workprograms are sufficiently detailed to allow for effective audits.**
- **Workprograms are updated to keep pace with changes (such as new products, accounting guidelines, and regulations).**
- **Workpapers document approval of all deviations from established audit procedures.**
- **Workpapers contain evidence that audit managers reviewed the workpapers for conclusions and recommendations.**
- **All significant and unresolved exceptions are noted in workpapers and included in audit reports.**
- **Workpapers are well organized and support conclusions and recommendations.**
- **Workpapers are cross-referenced to procedures and institution reports.**

15. Determine whether the internal audit department's reporting procedures are adequate. Consider if:

- **The auditor submits formal reports directly to the board of directors or audit committee.**
- **Audit reports include an overall opinion and an assessment of the effectiveness of internal controls and compliance with established procedures.**
- **The board or audit committee supports the audit staff in resolving audit matters.**
- **Audit reports record departmental managers' commitment to resolve reported matters.**
- **Audit reports include a summary of the effectiveness of all controls reviewed.**
- **The auditor maintains a formal record of all unresolved audit or regulatory exceptions and recommendations.**
- **Changes to the audit schedule are approved.**

16. Assess the adequacy of work performed by the internal auditors. Items to consider include:

- **Examination findings,**
- **Time elapsed since the previous audit,**
- **Scope and relevance of internal auditors' work, and**
- **Testing performed by internal auditors.**

17. Review the institution's external audit program. Refer to the *Review of External Auditor Workpapers* ED Module as needed.

- **If the institution is covered by Part 363 of the FDIC Rules and Regulations, or Part 208, Appendix D-1 of FRB Regulation H and has $1 billion or more in total assets, determine whether management, at least annually, assesses the effectiveness of its internal control structure and**

procedures for financial reporting and compliance with designated laws. Review the documentation maintained to determine whether management adequately assesses the institution's internal control structure and compliance with laws.

- **Determine whether publicly-owned institutions or those covered by Part 363 that have $1 billion or more in total assets have an external auditor attest to management's assessment of its internal control structure and procedures for financial reporting.**
- **If the institution chose not to obtain an external audit, review the board of director's documentation of its reasons, including whether the auditing program provides sufficient coverage of areas of potential concern or unique risk. Review the minutes describing the board's consideration of this audit issue at each examination.**
- **Determine whether the audit program conforms with FR Appendix D of Regulation H or FDIC Part 363.**
- **Determine whether the external audit engagement letter contains any limitation of liability provisions. Refer to the Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, February 9, 2006. (FDIC: FIL 13-2006, FRB: SR 06-4.)**
- **Determine whether issues presented in the CPA management letter have been addressed.**
- **Review any additional CPA reports and follow up on issues presented.**

End of Core Analysis. If needed, Continue to the MICE Expanded and Impact Analyses.

LIQUIDITY

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine whether an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1. **Are policies, procedures, and risk limits adequate?** ***Refer to Core Analysis Procedures #5-7.***

C.2. **Are internal controls adequate?** ***Refer to Core Analysis Procedures #8-10.***

C.3. **Are the audit or independent review functions adequate?** ***Refer to Core Analysis Procedures #11-13.***

C.4. **Are information and communications systems adequate and accurate?** ***Refer to Core Analysis Procedures #14-17.***

C.5. **Are the management and use of alternative and rate sensitive funding sources reasonable?** ***Refer to Core Analysis Procedures #18-25.***

C.6. **Does the overall assessment of liquidity, including cash flow analysis and contingency funding plans, indicate liquidity needs can be met without adversely affecting operations or financial condition?** ***Refer to Core Analysis Procedures #26-40.***

C.7. **Do the board and senior management effectively supervise this area?** ***Refer to Core Analysis Procedure #7; Procedures #9-10; Procedure #14-17; & Procedures #41-48.***

LIQUIDITY

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review

1. **Identify previous liquidity and funds management concerns by reviewing prior examination reports, file correspondence, and audits.**

2. **Review Uniform Bank Performance Reports (UBPRs), financial statements, and other applicable data to develop a preliminary assessment of liquidity trends and risk.[1] Identify significant trends or changes in source and use of funds that may require further analysis. For banks with moderate to significant asset or loan growth, identify specific funding sources that may require further analysis.**

3. **Review board or committee minutes and information packets presented to the directorate for evidence of oversight, responsibility, routine management reports, and any identified liquidity concerns.**

4. **Determine whether there are recent or planned changes in operations, management, oversight, or strategic direction relating to liquidity and funds management (such as growth, new products, mergers, or acquisitions). Discuss these items with management as necessary and consider the potential liquidity risks and benefits.**

Policies, Procedures, and Risk Limits

5. **Review liquidity and funds management policies to ensure the guidelines include sufficient management guidance and reflect the board's risk tolerances and oversight responsibilities. Prudent liquidity guidelines, which may also be found in investment, loan, or other policies, typically:**
   - **Authorize an individual(s) or committee to conduct activities and delineate planning, management, and reporting responsibilities;**
   - **Describe diversification targets for funding sources and address acceptable terms for each funding source. Such targets may be segmented to address short-, medium-, and long-term funding needs and limit exposures to, or concentrations in, single providers, market segments, wholesale funding types, investment securities, marketable loans, other assets, etc.;**

[1] Average balances may provide useful indicators of operating liquidity levels.

- **Emphasize the importance of cash flow forecasting as a primary measurement and monitoring tool;**
- **Define and place limits on funding sources and uses, such as:**
  - **Maximum loan-to-deposit ratio or loan-to-asset ratio,**
  - **Reliance on less stable funding of longer-term assets,**
  - **Individual and aggregate limits on wholesale and rate sensitive funds by type and source,**
  - **Target amounts of unpledged liquid assets,**
  - **Maximum level of illiquid asset concentrations such as complex financial instruments or bank owned life insurance (BOLI)[2], and**
  - **Off-balance sheet positions;**
- **Require monitoring of bank policy compliance and policy-exception handling and reporting;**
- **Set targets for unencumbered, liquid asset reserves;**
- **Provide contingent liquidity plans for unexpected cash flow mismatches, including periods when unsecured borrowing lines, brokered and high-rate deposits, and other similar funding sources may be unavailable or cost prohibitive;**
- **Include risk limits and funding strategies for material activities (such as securitizations, derivatives, trading, international activities, or backstop-lending for commercial paper) that are subject to adverse financial market events;**
- **Emphasize the importance of comprehensive and timely reports to management and the directorate that address current conditions and stressed scenarios; and**
- **Include a framework for stress testing liquidity risk commensurate with the risk profile and activities of the bank.**

6. Determine whether funds management policies, procedures, and risk limits are reasonable in relation to management abilities, risk appetite, strategic plans, current economic conditions, and the complexity, and overall financial condition of the bank.

7. Evaluate the frequency and timeliness of policy reviews and updates by the board.

Internal Controls

8. Determine whether sufficient separation of duties (or comparable controls) exists over the preparation of reports used in managing the liquidity function.

9. Determine whether reports concerning liquidity sources and uses are prepared and reviewed with appropriate frequency.

[2] Refer to the BOLI ED Module for more information.

10. Determine whether policy exceptions are appropriately identified, reported, tracked, and approved.
Audit or Independent Review
11. Determine whether the scope of audits or independent reviews is sufficient to identify policy, reporting, internal control, and compliance deficiencies.
12. Determine whether audits or independent reviews are properly reported to the board and appropriate operating committee.
13. If recent reviews disclosed deficiencies, determine whether management responses and corrective actions are reasonable and promptly implemented.
Information and Communication Systems
14. Determine whether internal management reports provide accurate and timely information (regarding funding sources and uses) to support ongoing liquidity-management decisions and for monitoring the results of those decisions.
15. Determine whether board and senior management reports provide sufficient and appropriately tailored information to monitor compliance with board policies.
16. Determine whether management performs adequate analysis of funding sources and uses to assure ample funding capacity.
17. Determine whether liquidity needs and risks are effectively communicated to all affected areas.
Analysis of Funding Sources and Uses
18. Compare current liquidity levels and prospective sources of liquidity to present and future funding needs. Consider:

- **Adequacy of funds management reporting and planning;**
- **Stability and diversification of funding sources; and**
- **Financial condition and performance.**

19. Assess the composition and stability[3] of the deposit funding structure, considering:

- **Out of area deposits, including national CDs, internet deposits, money desk operation, and deposit listing services;**
- **Brokered deposits;**
- **Reciprocal deposits;[4]**
- **Public deposits, uninsured deposits, or other large deposit relationships;**
- **Deposits obtained from deposit management programs, such as CD specials, deposit account rate incentives, and internet banking initiatives;**
- **Potential surge deposits;**
- **Maturity distribution; and**
- **Potential deposit rate sensitivity in various market environments.**

20. Assess the composition of the non-deposit funding structure. Identify sources of all significant borrowings or market instruments (e.g., FHLB advances, repos, Fed funds, FRB Discount Window, asset securitization, and complex wholesale borrowings). Review agreements; consider the terms, structure, and collateral requirements of borrowing arrangements; and determine the extent and use of those funds, considering the following factors:

- **Trends in use of such funds, either seasonally or as a more permanent funding vehicle;**
- **Stability and diversification of those sources;**
- **Use of those funds relative to strategic plans, controls, and alternate funding sources;**
- **Remaining borrowing capacity under both secured and unsecured borrowing lines; and**
- **Compliance with collateral eligibility guidelines of each agreement, particularly concerning electronic notes and signatures.**

21. Compare the rates paid for deposits and other funding sources with published indices and local market rates. Determine the cause of any significant variances.

22. Review UBPR aggregate cost data and determine reason(s) for any significant variances or adverse trends in cost of funds, relative to peer data.

[3] Refer to the Brokered and High-Rate Deposits ED Module for further analysis of material exposure to brokered deposits and less stable or rate-sensitive funding sources.
[4] Refer to 12 CFR 337.6(e) for details regarding the limited exception for treating certain reciprocal deposits as brokered deposits.

23. Determine whether management practices or strategies resulted in a funding concentration. If so, determine the use of the funding and whether funding concentrations present elevated risks.

24. Assess the extent of liquidity provided by the securities portfolio and other investments considering:

- **The availability of highly liquid assets that could be sold or pledged to obtain funds under a stress scenario (highly liquid assets include unpledged US Treasury and agency securities);**
- **The volume of assets with limited marketability (e.g., municipals from small issuers, complex financial instruments, BOLI);**
- **The maturity structure, marketability, and vulnerability to market stress (i.e., price risk);**
- **Portfolio depreciation (ensure valuations conform to relevant reporting standards);**
- **Pledging requirements and the availability of unpledged securities;**
- **Significant changes or trends in composition and maturity; and**
- **Legal, regulatory, or operational impediments.**

25. Assess the extent of liquidity provided by the loan portfolio, including pledged assets and cash flows from loan payments or sales.

26. Assess the impact of any other asset pledging and off-balance sheet arrangements (e.g., FHLB standby letters of credit used to collateralize public deposits) on liquidity and contingency funding. Determine whether off-balance sheet liabilities are reported appropriately on Call Report Schedule RC-L, if applicable.

27. Assess the potential impact on liquidity of asset sales that include recourse provisions.

28. Review the use of asset sales or secondary funding sources that were prompted by unplanned liquidity needs and determine whether there were any adverse effects on operations or financial performance.

29. Evaluate management provisions for anticipated but unusual liquidity needs, such as large unfunded loan commitments, maturity of significant volumes of time deposits or borrowed funds, branch closings, new products, mergers, litigation, or growth initiatives.

30. Assess the effect of any other identified trends or material changes in sources and uses of funds.

31. Review historical and projected off-balance sheet funding requirements, and assess the bank's ability to respond to potential funding needs.

Cash Flow Analysis

32. Determine whether the bank has effective methods for projecting cash flows arising from assets, liabilities, and off-balance sheet items over an appropriate set of time horizons (e.g., weekly, monthly, quarterly, and annually).

33. Determine whether internal liquidity and funds management analyses identify primary sources of funding for meeting daily cash outflows, as well as seasonal and cyclical cash flow fluctuations.

34. Assess management's process for establishing and maintaining a level of liquid assets that supports day-to-day operations and includes an additional buffer to address unforeseen circumstances.

35. For banks engaged in significant payment and settlement activities, determine whether internal liquidity monitoring captures intraday liquidity risks associated with derivative activities.

36. Determine whether liquidity stress scenarios are conducted across multiple time horizons, use reasonable modeling assumptions under various stress scenarios, and are commensurate with the bank's complexity and level of risk exposure. Typical liquidity stress scenarios consider the realistic availability of liquidity, given potential haircuts on borrowings, FHLB restrictions, deposit runoff, and likely market conditions during stress events. Possible stress scenarios include:

- **Unexpected loan growth;**
- **Loan losses or reduction in loan repayments:**
- **Changes in economic conditions, market perception, or disruptions in financial systems;**
- **Price fluctuation in the securities portfolio;**
- **Inability to renew or replace maturing funding liabilities;**
- **Unexpected deposit withdrawals or draws on off-balance sheet credit commitments;**
- **Disruptions in payment and settlement systems due to operational failures or local disasters;**
- **Increased FHLB collateral requirements;**

- **Restrictions imposed by correspondents on borrowing availability or terms;**
- **Prompt Corrective Action downgrades, and statutory and regulatory restrictions on brokered deposits and interest rates paid on deposits;**
- **Downgrades of the bank's investment rating by a Nationally Recognized Statistical Rating Organization (for larger organizations) or other rating agency (for smaller organizations); and**
- **Reaching early amortization triggers on pools of assets securitized by the bank.**

Contingency Funding Plan (CFP)

37. Review the CFP to determine whether it provides adequate funding under stressed operating environments, including situations that, while relatively infrequent, could significantly affect the bank. Appropriate plans address shortfalls in emergency situations, including systemic adverse financial market events and reflect the complexity, risk profile, activities, and scope of the bank's operations. Consider whether the CFP:

- **Identifies stress events that could harm the liquidity position;**
- **Addresses levels of severity and timing during a contingent liquidity event by identifying temporary, intermediate, or longer-term disruptions;**
- **Establishes a monitoring framework, such as triggering mechanisms and early warning indicators;**
- **Addresses funding sources and needs during a stress event through a quantitative projection of funding needs and funding capacity;**
- **Identifies potential sources of contingency funding and considers the time needed to establish them;**
- **Assesses the reliability of contingency funding (e.g., irrevocable, as available, revocable);**
- **Identifies terms and conditions of alternative or contingency funding arrangements; and**
- **Establishes a crisis management team, realistic action plans, and provisions for more frequent and detailed liquidity reporting if stress situations intensify.**

38. Confirm whether the CFP is regularly tested, updated, and operationally sound. Consider the following:

- **Maintaining and updating the liquidity event management process, including roles and responsibilities;**
- **Frequency of testing the operational components of the contingency funding plan;**
- **Assessing the mobility of cash and collateral when needed;**
- **Stress testing for collateral devaluations;**
- **Identifying the availability of contingent funding lines of credit when needed;**
- **Maintaining and updating the monitoring framework for contingent events; and**
- **Testing various elements of the contingency funding plan, including standby liquidity sources that are rarely used, such as:**
    - **The sale or securitization of loans,**
    - **Repurchase agreements (repos), and**
    - **FRB Discount Window borrowings.**

39. Determine whether the board and senior management have contingency plans to assist management in taking appropriate and prompt action if the bank becomes less than well capitalized.[5] Consider: • **Statutory and regulatory restrictions on rates paid for deposits;** • **The need to seek approval from the FDIC to accept and renew brokered deposits for adequately capitalized banks; and** • **The inability to accept brokered deposits for less than adequately capitalized banks.**
40. If the bank originates or purchases loans for asset securitizations, determine whether the liquidity risk monitoring system includes contingency plans for possible liquidity strains because of early amortizations.
Board and Senior Management Oversight
41. Determine whether the board and senior management adequately plan and articulate the future direction of the organization, noting projected growth levels, the source of funding for the growth, and associated changes in the overall asset and liability mix.
42. Determine whether the board and senior management have a defined funds management strategy or programs for gathering deposits, and assess the process for developing the strategy or programs. Assess the purpose of the funding strategies or programs and determine how those funds are being used, such as funding normal operations or targeted asset growth.
43. Evaluate the effectiveness of the oversight and control structure for the organization's liquidity practices.
44. Determine whether the board has allocated sufficient resources to liquidity management.
45. Evaluate the technical and managerial expertise of individuals involved in liquidity management.
46. Determine whether the board and senior management established clear lines of authority and

[5] Refer to Prompt Corrective Action Guidelines (Section 38 of the FDI Act, 12 USC 1831) and the Brokered and High Rate Deposits ED Module as needed.

responsibility for monitoring adherence to policies, procedures, and limits.
47. **Determine whether senior management effectively monitors liquidity risk for subsidiaries and other affiliates on an ongoing basis.**
48. **Determine whether organizational practices are consistent with established bank policy.**
End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

LOAN OPERATIONS REVIEW

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine whether an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1.	**Are loan policies, approval procedures, and asset concentration limits adequate? *Refer to Core Analysis Procedure #4, Procedures #8-17, & Procedure #32.***
C.2.	**Are loan documentation, review procedures, and internal controls adequate? *Refer to Core Analysis Procedure #9, Procedures #18-23, Procedures #26-27, Procedure #30, Procedure #33, & Procedure #35.***
C.3.	**Are the audit and independent review functions adequate? *Refer to Core Analysis Procedures #40-41.***
C.4.	**Are collateral controls adequate? *Refer to Core Analysis Procedure #28.***
C.5.	**Are management reporting and communication systems adequate and accurate? *Refer to Core Analysis Procedure #7 & Procedure #42.***
C.6.	**Does management accurately identify and monitor policy exceptions? *Refer to Core Analysis Procedure #3, Procedure #20, Procedure #32, & Procedures #43-44.***
C.7.	**Is the process for loan disbursement, booking, and reconcilement adequate? *Refer to Core Analysis Procedure #20, Procedures #24-25, & Procedure #29.***
C.8.	**Does senior management effectively supervise this area? *Refer to Core Analysis Procedure #36-39 & Procedure #45-46.***

LOAN OPERATIONS REVIEW

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review

1. **Review prior examination reports, prior examination work papers, pre-examination memorandum, and file correspondence to identify any previous deficiencies.**

2. **Review internal and external audit reports to identify areas of concern and significant loan operation deficiencies. Review current loan review reports and assess any documentation deficiencies or unsatisfactory practices.**

3. **Review remedial actions taken by management to correct audit and examination deficiencies.**

4. **Review all loan operation policies and procedures. Consider board approvals and last-reviewed date. Appropriate policies generally address items such as roles, responsibilities, lending authorities, underwriting processes, application and document flows, approval processes, and loan funding methodologies.**

5. **Discuss with management any significant changes in loan operations personnel, service providers, software, operating procedures, or new loan products planned within the next 18 months.**

6. **Review board and loan committee minutes for relevant discussions on loan operations.**

Policy Considerations

7. **Determine whether lending policies are appropriate for the lending activities of the bank. Evaluate the frequency and timeliness of reviews and updates by the board of directors. Appropriate policies generally address items such as:**

- **General fields of lending that the bank engages in and the types of loans within each general field;**
- **Limitations on the maximum volume of loans in relation to total assets;**
- **Description of the bank's normal trade area and circumstances under which the bank may extend credit outside the area;**
- **Guidelines that address the goals for portfolio mix and risk diversification and cover the bank's plans for monitoring and taking appropriate corrective action on any existing concentrations to individual borrowers and their related interests and industries;**
- **Guidelines regarding loans to insiders;**
- **Guidelines for purchased and sold loans, including loan participations;**
- **Lending authority of each loan officer;**
- **Lending authority of a loan committee or executive committee;**
- **Responsibility of the board of directors in reviewing, ratifying, and approving loans;**
- **Guidelines under which unsecured loans will be granted;**
- **Limitations on the extension of credit through overdrafts;**
- **Guidelines for collateral requirements, pricing, and the terms of repayment for various types of loans offered;**
- **Limitations on the amount advanced in relation to the value of the collateral for various loan types, considering the Interagency Real Estate Lending Guidelines and the related documentation for valuing the collateral by loan type. (FDIC: Rules and Regulations, Part 365, Appendix A; FRB: 12 CFR 208, Appendix C);**
- **Documentation required by the bank for each type of secured loan;**
- **Guidelines on the use of interest reserves;**
- **Guidelines for obtaining and reviewing appraisals and evaluations of real estate or other collateral as well as for ordering new appraisals and evaluations;**
- **Guidelines for adequate safeguards to minimize potential environmental liability;**
- **Limits and guidelines on off-balance sheet credit exposures;**
- **Standards for loan presentation sheets and credit memoranda;**
- **Standards for proper underwriting and credit file documentation by loan type;**
- **Guidelines for ongoing documentation review and maintenance of complete and current credit files on each borrower;**
- **Guidelines addressing the bank's loan review and grading system (watch list);**
- **Guidelines addressing the bank's determination, assessment, and review of the appropriate level for the Allowance for Loan and Lease Losses (ALLL) (or allowance for credit losses (ACL),[1] when applicable);**
- **Guidelines addressing loan modifications and the resultant accounting consequences including whether the modification meets the definition of a troubled debt restructuring (TDR);**
- **Guidelines addressing collection and workout procedures;**
- **Guidelines addressing charge-off practices and appropriate follow up for potential recovery;**
- **A process for approving, tracking, and reporting exceptions to policies; and**
- **The time interval for the board’s periodic review of the loan policy for its adequacy.**

8. Determine whether the loan policy establishes appropriate underwriting standards for each loan type made by the bank. Appropriate underwriting standards generally address items such as:

[1] **ACL replaces the term ALLL for those banks that adopted ASU 2016-13.**

- **Loan-to-value limits;**
- **The borrower's business or occupation;**
- **The borrower's past and current financial condition, income, and cash flow;**
- **The purpose of all loans granted to the borrower, the source of repayment, loan terms, and repayment period; and**
- **The collateral, its value, and the source of valuation.**

9. Determine whether incentive compensation programs promote behaviors that are inconsistent with the bank's strategic portfolio objectives and risk tolerances or with safe and sound banking practices.

10. Determine whether repossessed asset and ORE policies are sufficient for the needs of the bank.

11. Review the bank's charge-off policy. Consider the consistency with regulatory and accounting definitions, adherence to policy, timeliness, and senior management and board review.

12. Review the bank's appraisal policies to determine whether they conform with outstanding regulatory requirements.

13. Determine whether the appraisal policy describes the conditions under which the bank will obtain a new or updated appraisal or evaluation of the real estate collateral on an existing commercial real estate (CRE) loan (e.g., movement into workout or material deterioration in real estate market conditions.)

Internal Controls

14. Determine whether appropriate separations of duty are in place. Consider items such as:
- **Preparation of loan documents,**
- **Posting of subsidiary loan records to the core loan application, and**
- **Disbursement of loan proceeds.**

15. Evaluate the adequacy of the loan documentation process. Satisfactory loan documentation systems generally address items such as:

• Assignment of responsibility for assembling loan documents, • Reviews of loan documentation to ensure that all required documents and signatures on applications are present prior to loan approval, • Documentation is reviewed by an independent party after closing to verify that proper procedures are followed, and all required information is on file and properly executed, and • Loan documents are secured during business hours and locked in a fireproof vault overnight.
16. Determine how new and renewed loans are approved and booked and whether loan officers are able to renew and extend loans without an independent review.
17. Determine whether controls are in place to ensure loans are booked with the same terms as those approved.
18. Determine whether the code of ethics governs loan officers lending to relatives or other related parties.
19. Review management's procedures to prevent, detect, and respond to lending policy exceptions. In addition, determine whether deviations from the loan policy are properly approved and documented in accordance with internal loan policy guidelines.
20. Determine the adequacy of reconciliations between subsidiary loan records and the general ledger. Consider the frequency of reconciliations, the disposition of reconciling amounts, and the separation of duties for personnel involved.
21. Evaluate the adequacy of controls over loan closings and disbursements. Consider the following: • Documentation is complete and appropriate waivers are obtained before loans are funded, • Use of documentation waivers is not excessive, • Funds are disbursed in accordance with loan terms, and • Loan proceed disbursements and general ledger entries are properly controlled.
22. Ascertain whether items held in suspense accounts clear in a timely manner.

23. Evaluate the adequacy of controls over off-balance sheet lending activities.

24. Verify if commitments are limited in amount, cover a specific period, and indicate the conditions that must be satisfied before draws will be honored.

25. Evaluate the adequacy of controls over loan participation activities, such as independent credit analysis (prior to purchase and ongoing).

26. Evaluate the adequacy of loan participation agreements. Appropriate agreements generally:

- **Meet the definition of a participating interest* as defined by ASC Topic 860,**
- **Address the timely exchange of information,**
- **Establish expectations involving participants' consultation with each other prior to taking action on defaulted loans, and**
- **Specify the rights and remedies of the lead bank and participant(s).**

**** Refer to the definition of Transfers of Financial Assets in the Call Report Glossary for additional information.***

27. Evaluate the adequacy of controls over loan renewals and extensions. Consider the following:

- **An independent credit analysis is performed prior to renewal or extension;**
- **The number of loan renewals or extensions is compliant with internal loan policy limits; and**
- **The use of interest-only terms is limited.**

28. Evaluate controls regarding collateral held at the bank. Consider the following:

- **Collateral held at the bank is documented with pre-numbered forms that provide a customer's receipt, ledger record, and loan file copy;**
- **Physical or negotiable collateral held at the bank is under joint custody; and**
- **Controls to ensure holds on deposit accounts are maintained.**

29. Evaluate the process for reconciling loan accounts to the general ledger. Consider the following:

- **The frequency that subsidiary loan accounts are reconciled to the general ledger;**
- **Persons involved in approving loans, disbursing proceeds, accepting payments, or posting transactions do not have reconciliation authority;**
- **Reconcilements are reviewed and signed by senior officers; and**
- **The bank has adequate procedures and timeframes for disposing of stale items.**

30. Evaluate controls regarding capitalization of interest.

- **Determine whether there are loans on which interest is not being collected in accordance with the terms of the note, such as loans that have been renewed without full collection of interest, with interest being rolled into principal, or interest paid from the proceeds of a separate note.**
- **Determine whether there are any loans in which the terms have been modified by reducing the interest rate or principal payment, by deferring interest or principal, or by restructuring of repayment terms. Consider any formally restructured loans that were returned to accrual status after a partial chargeoff or before collection of interest in arrears.**

31. Determine whether management appropriately identifies, measures, monitors, controls, and reports concentration risks of credit by industry, type, person, product type, and related borrowers, etc.

32. Determine whether loan approvals are properly documented, and verify that loan terms are consistent with officer, committee, and board approvals.

33. Determine whether credit-scoring models are regularly tested and evaluated to ensure that actual performance approximates initial projections.

34. Determine whether the appraiser selection and appraisal review processes are independent from the lending function.

35. Determine how appraisers are added to the approved appraiser list and how appraisers are selected for assignments.

Credit Administration

36. Determine whether appropriate lending authorities exist at the loan officer and committee levels.

37. Determine whether the lending and credit administration staff is appropriate given the size and nature of current and planned lending activities.

38. Evaluate the effectiveness of the organization's collection and workout procedures.

39. Determine the extent and adequacy of training and continuing education provided to lending personnel.

Audit or Independent Review

40. Determine whether the audit program is sufficient to obtain reasonable assurance that:

- **Loans exist and are owned by the institution as of the balance-sheet date;**
- **The level of the ALLL (or ACL, when applicable) is appropriate and is determined in accordance with generally accepted accounting principles (i.e., the ALLL (or ACL, when applicable) covers estimated credit losses on individually evaluated impaired loans and estimated credit losses inherent in the remainder of the loan portfolio);**
- **Loans are properly classified, described, and disclosed in the financial statements, including fair values and concentrations of risk;**
- **Recorded loans include all such assets of the institution and the financial statements include all related transactions during the period;**
- **Loan transactions are recorded in the proper period;**
- **Loans held for sale are properly classified and are stated at the lower of cost or fair value;**
- **Interest income, fees, and costs and the related balance-sheet accounts (accrued interest receivable, unearned discount, unamortized purchase premiums and discounts, and unamortized net deferred loan fees and costs) have been properly measured and recorded;**
- **Gains and losses on the sale of loans have been properly measured and properly recorded; and**
- **Credit commitments, letters of credit, guarantees, recourse provisions, and loans that collateralize borrowings are properly disclosed in the financial statements.**

(Note: Coordinate with the examiners reviewing the internal audit function.)

41. Determine whether the audit or independent review program provides sufficient coverage relative to the institution's size, scope of lending activities, and risk profile. Appropriate programs often:

- **Recommend corrective action when warranted;**

- **Verify that corrective action commitments have been implemented;**
- **Assess separation of duties, internal controls, and supervision of lending activities;**
- **Determine compliance with internal policies and procedures, and applicable laws and regulations; and**
- **Assess the adequacy, accuracy, and timeliness of reports to senior management and the board.**

(Note: Coordinate with the examiners reviewing the internal audit function.)

Information and Communication Systems

42. Determine whether managerial reports provide sufficient information relative to the size and risk profile of the organization and evaluate the accuracy and timeliness of reports produced for the board and executive management. Reports may include the following types of information:

- **Analysis of the appropriateness of ALLL (or ACL, when applicable);**
- **Chargeoffs and recoveries;**
- **Concentrations;**
- **Insider borrowings;**
- **Kiting suspects;**
- **Legal lending limits;**
- **Loan extensions and modifications;**
- **Loan renewals and new loan approvals/denials (above certain dollar amounts);**
- **Non-conforming loans;**
- **Non-sufficient funds;**
- **Out-of-territory lending;**
- **Overdrafts;**
- **Participations;**
- **Policy exceptions;**
- **Results of internal/external audits;**
- **Results of loan review;**
- **Suspense accounts (contents and reconcilements);**
- **Technical exceptions; and**
- **Unfunded commitments.**

Managerial Effectiveness

PROCEDURES AND PRACTICES

43. Determine how management monitors for compliance with internal policy and limits.

44. Review audits and examinations performed to determine the effectiveness of internal audit in identifying and reporting internal control weaknesses.

45. Determine whether management has addressed and corrected deficiencies cited by internal/external auditors, loan review, and regulatory agencies.
46. Review board, loan, and audit committee minutes to determine whether relevant issues and audit findings are being addressed.
End of Core Analysis.

LOAN PORTFOLIO REVIEW
Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine whether an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Note: This module should be used for reviewing the asset quality of the loan portfolio. Refer to the Loan Operations Review module for evaluating loan operations and credit administration.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1. Are the audit or independent review functions adequate? ***Refer to Core Analysis Procedures #2-3, Procedures #10-11, & Procedure #61.***

C.2. Are information and communication systems adequate and accurate? ***Refer to Core Analysis Procedure #6 & Procedures #12-18.***

C.3. Does management accurately identify, monitor, and reserve for credit risk? ***Refer to Core Analysis Procedures #19-34.***

C.4. Is portfolio quality satisfactory, considering trends in adverse classifications and the overall risk profile? ***Refer to Core Analysis Procedure #7 & Procedures #35-42.***

C.5. Is the volume of ORE and repossessed assets manageable and the ORE portfolio adequately administered and controlled? ***Refer to Core Analysis Procedures #8-9, Procedures #56-59, & Procedure #62.***

C.6. Do the board and senior management effectively supervise this area? ***Refer to Core Analysis Procedure #1, Procedures #3-6, & Procedures #43-55.***

LOAN PORTFOLIO REVIEW

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review
1. Review prior examination reports, prior examination work papers, pre-examination memorandum, audit reports, and file correspondence for an overview of any previously identified lending deficiencies. In addition, determine whether there were any prior concerns related to the Allowance for Loan and Lease Losses (ALLL) (or allowance for credit losses (ACL),[1] when applicable), repossessed assets, or ORE.
2. Review internal and external audit reports, and assess the adequacy of the audit scope.
3. Review internal and/or external loan review reports as well as other reports provided by third parties.
4. Discuss with management any planned changes in lending philosophy, portfolio composition, new products, pricing strategies, etc. Determine whether current and planned lending strategies are consistent with the bank's overall strategic plan.
5. Review and assess the adequacy of loan committee and board minutes.
6. Obtain and analyze data used by management to supervise the loan portfolio. This data may include: • **Organizational charts;** • **Written policy and procedures manual;** • **Problem loans and watch list reports;** • **Delinquency and nonperforming asset reports;** • **Concentration reports;** • **Allowance for Loan and Lease Losses (ALLL) (or ACL, when applicable) analysis;** • **Significant and/or concentrations of charge-offs (by industry or types of borrowers) since the prior**

[1] **ACL replaces the term ALLL for those banks that adopted ASU 2016-13.**

examination; and
- Portfolio stress test reports and documentation, if applicable.

7. Review the composition of the loan portfolio by type, dollar volume, and percentage of capital. Determine whether specialty-lending areas exist and assign responsibility for completing appropriate reviews. Refer to individual Loan Reference modules for additional procedures.

8. Determine the volume of other real estate and the change in volume since the prior examination.

9. Determine the volume of repossessed assets and the change in volume since the prior examination.

Audit or Independent Review

10. Determine whether the audit program is sufficient to obtain reasonable assurance that:

- **Loans exist and are owned by the institution as of the balance-sheet date;**
- **The level of the ALLL (or ACL, when applicable) is appropriate and is determined in accordance with generally accepted accounting principles (i.e., the ALLL (or ACL, when applicable) covers estimated credit losses on individually evaluated impaired loans and estimated credit losses inherent in the remainder of the loan portfolio);**
- **Loans are properly classified, described, and disclosed in the financial statements, including fair values of loans and concentrations of risk;**
- **Recorded loans include all such assets of the institution and the financial statements include all related transactions during the period;**
- **Loan transactions are recorded in the proper period;**
- **Loans held for sale are properly classified and are stated at the lower of cost or fair value;**
- **Interest income, fees, and costs and the related balance-sheet accounts (accrued interest receivable, unearned discount, unamortized purchase premiums and discounts, and unamortized net deferred loan fees and costs) have been properly measured and recorded;**
- **Gains and losses on the sale of loans have been properly measured and properly recorded; and**
- **Credit commitments, letters of credit, guarantees, recourse provisions, and loans that collateralize borrowings are properly disclosed in the financial statements.**

(Note: Coordinate with the examiners reviewing the internal audit function.)

11. Determine whether the audit or independent review program provides sufficient coverage relative to the institution's size, scope of lending activities, and risk profile. Appropriate programs generally include:

- **Recommend corrective action when warranted;**
- **Verify that corrective action commitments have been implemented;**
- **Assess separation of duties, internal controls, and supervision of lending activities;**
- **Determine compliance with policies, procedures, and regulatory requirements; and**
- **Assess the adequacy, accuracy, and timeliness of reports to senior management and the board.**

(Note: Coordinate with the examiners reviewing the internal audit function.)

Information and Communication Systems

12. Determine whether managerial reports provide sufficient information relative to the size and risk profile of the organization and evaluate the accuracy and timeliness of reports produced for the board and executive management. Reports may include the following types of information:

- **Analysis of the appropriateness of ALLL (or ACL, when applicable);**
- **Chargeoffs and recoveries;**
- **Concentrations;**
- **Insider borrowings;**
- **Kiting suspects;**
- **Legal lending limits;**
- **Loan extensions and modifications;**
- **Loan renewals and new loan approvals/denials (above certain dollar amounts);**
- **Non-conforming loans;**
- **Non-sufficient funds;**
- **Out-of-territory lending;**
- **Overdrafts;**
- **Participations;**
- **Policy exceptions;**
- **Results of internal/external audits;**
- **Results of loan review;**
- **Suspense accounts (contents and reconcilements);**
- **Technical exceptions; and**
- **Unfunded commitments.**

13. Review the effectiveness and accuracy of management's system for aggregating related credit exposures.

14. Analyze growth trends by total and loan type, and determine whether actual data satisfactorily mirrors budgeted growth or strategic plans.

15. **Review the accuracy of accounting for loans sold and participations. Consider partial sales and recourse arrangements.**

16. **Determine whether the bank's procedures and practices for placing loans on nonaccrual status are in agreement with Call Report Instructions.**

17. **Determine whether the bank's procedures and practices regarding troubled debt restructurings (TDR) are in agreement with Call Report Instructions.**

18. **Validate the accuracy of Consolidated Reports of Condition and Income where necessary.**

Identifying, Monitoring, and Reserving for Credit Risk

LOAN REVIEW

19. **Consider whether loan review practices are appropriate for the size and complexity of the bank and whether loan reviews are conducted by individuals independent from loan origination and approval processes. Appropriate loan review practices generally meet the following objectives:**
    - **To promptly identify loans having potential credit weaknesses, and appropriately classify loans with well-defined credit weaknesses that jeopardize repayment so that timely actions can be taken and credit losses minimized;**
    - **To project relevant trends which affect the collectability of the portfolio and isolate potential problem areas;**
    - **To provide essential information to determine the appropriateness of the ALLL (or ACL, when applicable);**
    - **To assess the adequacy of and adherence to internal credit policies and loan administration procedures, and to monitor compliance with relevant laws and regulations;**
    - **To evaluate the activities of lending personnel; and**
    - **To provide senior management and the board with an objective and timely assessment of the overall quality of the loan portfolio.**

20. **Determine whether the watch list is regularly updated by management and reviewed by the board.**

21. **Assess the accuracy of the loan review system and internal risk ratings. Also, review any**

documentation exception reports and written classification summaries, and evaluate the scope, frequency, and timeliness of reviews and updates to the board of directors.

Allowance for Loan and Lease Losses

METHODOLOGY ***(When appropriate, refer to the Subprime Lending, Credit Card Activities, and TDR Reference Modules for additional information on assessing whether the level of the ALLL (or ACL, when applicable) is appropriate.)***

22. **Assess the methodology for determining the appropriate ALLL (or ACL, when applicable) level and consider whether it includes portfolio segmentation and impairment analysis for individually evaluated loans.** ***(Refer to ASC Topic 450 and ASC Topic 310.)*** **Determine whether the complexity and scope of the ALLL (or ACL, when applicable) evaluation process and loan review system are appropriate given the risk profile of the bank and the complexity of lending activities. Consider the following:**
    - **The effectiveness of the bank's loan review system and controls.**
    - **The ability of internal data-capture and loan-reporting systems to provide robust and meaningful information regarding portfolio risks.**
    - **Management's ability to evaluate loss-estimation models before they are implemented (when applicable) and to modify model assumptions as needed.**
    - **The bank's methodology is based on a comprehensive, adequately documented, and consistently applied analysis of the bank's loan and lease portfolio.**
    - **Management promptly charges off loans, or portions of loans, that are uncollectible.**
    - **An independent third party periodically reviews and validates the ALLL (or ACL, when applicable) methodology.**

23. **Evaluate the criteria management uses to select loans for individual evaluation under ASC Topic 310. For example, assess:**
    - **Loans or relationships that are above dollar thresholds. If management uses a dollar threshold, assess the threshold in relation to average loan balance, concentrations, or other factors that would cause the loans to be more significant to the institution;**
    - **Loans or relationships that are on the bank's Watch List or that are adversely classified Substandard or Doubtful. If selection criteria do not include loans rated Substandard or Doubtful, explain the rationale for the decision; and**
    - **Loans or relationships that are past due or on nonaccrual status.**

24. **Determine the methodology used by the institution to measure impairment on loans (within the scope of ASC Topic 310) that are individually evaluated and determined to be impaired, and consider whether the institution maintains supporting documentation for the assumptions and estimates used. Consider whether the methodology used is based on:**
    - **The present value of expected future cash flows for individually evaluated impaired loans that are not collateral dependent;**
    - **Observable market price for individually evaluated impaired loans that are not collateral**

dependent; or

- **The fair value of collateral method.** ***(Note: For purposes of the Consolidated Reports of Condition and Income, the impairment of an impaired collateral dependent loan must be measured using the fair value of collateral method.)***

25. Evaluate the reasonableness of and support for management's assumptions, valuations, and judgments used in the analysis of those loans individually evaluated for impairment under ASC Topic 310 and determined to be impaired.

26. Determine how the institution treats:

- **Loans that are individually evaluated for impairment under ASC Topic 310 and are determined not to be impaired; and** ***(Note: These individual loans should be regrouped with loans having similar risk characteristics and assessed collectively for impairment under ASC Topic 450.)***
- **Individually evaluated loans that are determined to be impaired, but there is zero impairment and no allowance is established when measured for impairment under ASC Topic 310. (*****Note: Examiners should determine that the bank is appropriately defining impaired loans (i.e. where collection of the full principal and interest is not expected per original contractual terms). If a loan is being evaluated under ASC Topic 310 but is not impaired by definition, it should instead be included in the ASC Topic 450 evaluation. Once a loan is determined to be impaired and is measured for impairment under ASC Topic 310, it cannot be included in a group of loans collectively assessed for impairment under ASC Topic 450, even if no ASC Topic 310 allowance is established.*****)**

27. Determine the basis for evaluating groups of loans under ASC Topic 450.

- **Ensure that assets are adequately stratified into groups based on one or more predominant risk characteristic.**
- **Evaluate the calculation of historical loss rates for each segment.**
  - **Review the time period and the method of calculation (e.g., simple average, weighted average) for reasonableness and consistency.**
  - **Consider the effect of new loan products or newly expanded markets.** ***(Note: Historical loss rates for a general segment may not be accurate for new products, or loans in a new market, that are included within the general segment.)***
- **Consider how segmentation methods and historical loss-rate calculations reflect qualitative or environmental factors necessary to reflect current conditions and expectations.**

(Note: Adjustments for qualitative or environmental factors, which may be positive or negative, should be made to reflect current conditions and expectations if not otherwise captured in historical loss analysis. The granularity of segmentation and the method used to calculate loss rates would affect the amount of adjustment, if any, necessary to appropriately estimate credit losses in a segment as of the evaluation date. For example, a loss rate calculated using a simple five-year average may require a larger adjustment in response to changes in the credit cycle than would a loss rate calculated using a recently weighted quarterly average.)

28. Determine whether management considers all relevant qualitative and environmental factors and maintains documentation sufficient to support all material adjustments. Appropriate documentation generally addresses all material factors that are likely to cause estimated losses to differ from historical losses. Qualitative or environmental factors include, but are not limited to:

- **Changes in lending policies and procedures, such as underwriting standards and collection, charge-off, and recovery practices;**
- **Changes in national and local economic business conditions and developments, including the condition of various market segments; (*Note: Credit-loss and recovery experience may vary significantly depending upon the business cycle.)***
- **Changes in the nature and volume of the portfolio and in the terms of loans;**
- **Changes in the experience, ability, and depth of lending management and staff;**
- **Changes in the volume and severity of past due and adversely classified loans and in the volume of nonaccrual loans;**
- **Changes in the quality of the loan review system;**
- **Changes in the value of underlying collateral for collateral-dependent loans;**
- **The existence, level, and effect of any concentrations of credit; and**
- **The effect of external factors such as competition or legal and regulatory requirements.**

29. Determine how the institution estimates credit losses on a group of loans with similar risk characteristics when the institution does not have any loss experience of its own for such a loan group.

(Note: An institution may not have a loss history if the product is new or the institution is a de novo organization).

30. Confirm that the bank does not include loans that were determined to be impaired and measured for impairment under ASC 310 in the estimated credit losses under ASC 450, even if the ASC 310 impairment measurement was zero.

31. Determine whether the bank has an *unallocated* allowance for loan and lease losses. If so, determine whether it was calculated in accordance with GAAP and is properly documented and supported.

32. Where appropriate, ensure that the assessment of an appropriate level for the ALLL (or ACL, when applicable) includes an estimate of losses from transfer risk associated with the institution's cross-border lending activities.

33. Determine whether the ALLL (or ACL, when applicable) evaluation process is completed at least quarterly and ensure that appropriate documentation is maintained to support management's assumptions, valuations, and judgments. (Refer to the 2001 Final Interagency Policy Statement on ALLL Methodologies and Documentation for Banks and Savings Institutions; and the 2006 Interagency Policy Statement on ALLL.)

LEVEL OF THE ALLL (or ACL, when applicable)

34. Evaluate the overall level of the ALLL (or ACL, when applicable) for appropriateness and reasonableness.

- **Determine whether the ALLL (or ACL, when applicable) is at an appropriate level based on a review of the bank's methodology coupled with examination findings as they relate to:**
  - **Loan classifications;**
  - **Effectiveness and reliability of the bank's loan review system including differences in level and severity of examiner classifications and that of Watch List Loans (internally classified loans);**
  - **Level and trend of past due and nonaccrual loans (reserve levels should normally be proportionately and directionally consistent with the level and trend of problem loans as reflected in examination classifications), internal watch list ratings;**
  - **Historical recovery of loan charge-offs; and**
  - **Changes in the business cycle that necessitate qualitative or environmental factor adjustments to the institution's historical loss rates.**
- **Consider reviewing applicable ratios as a preliminary check on the reasonableness of the ALLL (or ACL, when applicable).** ***(Note: Ratio analysis, when used prudently, can be a supplemental check on the reasonableness of management's assumptions and analysis. It is not a sufficient basis for determining an appropriate level for the ALLL (or ACL, when applicable).)***
  - **Evaluate trends as compared to an institution's peer group and its own historical experience. For example, the relationship of the ALLL (or ACL, when applicable) to adversely classified or graded loans, past due and nonaccrual loans, as well as historical gross and net charge-offs.**
  - **Analyze changes in key ratios from prior periods, assess the directional consistency of the ALLL (or ACL, when applicable) in relation to these changes, and assess the appropriateness and reasonableness of the ALLL (or ACL, when applicable) based on the collectability of the institution's loan portfolio in the current environment.**
- **If the bank's loan review system is effective and its method for determining an appropriate ALLL (or ACL, when applicable) level is acceptable, compare the result of the bank's methodology to the actual ALLL (or ACL, when applicable) balance. Ensure that the ALLL (or ACL, when applicable) amount reported in the institution's regulatory reports and financial statements reconciles to the ALLL (or ACL, when applicable) analysis. Assess the reasons for any material differences.**
- **Assess management's estimated credit losses, and if necessary, consider the need for additional provision expenses based on examination findings. Consider the following:**
  - **The bank's loan review system is substantially inaccurate, or**
  - **The bank is lending in stressed market conditions,**
  - **Credit administration weaknesses have not been timely identified or addressed, or**
  - **Examination results reflect significant loan quality deterioration.**

Portfolio Quality
35. Evaluate loan commitments, letters of credit, and other contingent liabilities for creditworthiness.
36. Review overdraft protection, large items, uncollected funds, and check kiting reports for irregular activity. Pay particular attention to overdrafts of bank insiders and insiders of other banks.
37. Evaluate the current level and trend of past due ratios for each type of credit and determine which loan categories pose elevated risk.
38. Review and analyze purchased loan participations for appropriate accounting* treatment, due diligence, creditworthiness, underwriting quality, and recourse provisions. Consider: • **Whether these credits are <u>internally</u> classified at the originating bank or other participation holders (when the information is available); and** • **Whether these credits are adversely classified in regulatory examination reports at the originating bank and other participation holders. *(Note: This information <u>cannot</u> be shared with management.)*** **** Refer to the definition of Transfers of Financial Assets in the Call Report Glossary for additional information.***
39. If the bank has acquired other institutions or loan portfolios, analyze the effect these purchases have had on the bank's portfolio composition and risk profile.
40. Determine whether it appears any loans were sold prior to the examination to another bank or to the holding company to avoid criticism by examiners.
41. Determine whether the bank has any borrowing relationships that qualify as Shared National Credits and assign classifications accordingly.
42. Evaluate the level and trend of classified loans and its effect on the bank's credit risk profile.

Managerial Effectiveness

PROCEDURES AND PRACTICES

43. Determine whether loan and executive officers consistently follow the bank's lending policies and practices.

44. Review the bank's loan approval process and determine whether loan presentations include an adequate analysis of the following items:

- **Loan purpose;**
- **Repayment sources and cash flows;**
- **Collateral;**
- **Background of borrower;**
- **Principals and management;**
- **Financial information including balance sheet and income statement;**
- **Financial projections;**
- **Industry and economic outlooks, including real estate trends;**
- **Borrowing and deposit histories;**
- **Loan structure, terms, and covenants; and**
- **Justification for policy exceptions.**

45. Determine whether the bank's financial analysis of borrowers is adequate in relation to the size and complexity of the debt.

- **Review financial analysis for appropriate financial ratios, trends, cash flow history, and projections sufficient to determine the financing needs and repayment capacity of the borrower.**
- **Assess whether the bank's credit assessment includes a review of a credit reports to identify other outstanding debts or contingent liabilities.**
- **Assess whether the bank's review evaluates important items such as salaries, fees, dividends, notes and accounts receivable, and notes and accounts payable, including those to insiders.**
- **Determine whether significant balance sheet and income statement changes are properly explained and whether the bank identifies and reviews contingent liabilities.**
- **Evaluate the bank's comparison of actual results to projected performance.**
- **Consider the prospects for support from any financially responsible guarantors, with emphasis on excess liquidity, cash flow, and demonstrated willingness to honor guaranty agreements.**

46. Determine whether management utilizes financial and reporting covenants. If so, evaluate how covenants are tracked and enforced.

APPLICABLE LAWS AND REGULATIONS
47. Determine the bank's regulatory and internal lending limits, and ascertain the bank's compliance with the limits.
48. Review transactions with affiliates for compliance with Section 23A of the Federal Reserve Act. (Note: 12 U.S.C. 371 (c) defines covered transactions; sets quality, terms, and collateral requirements; and places aggregate limits on such activities.)
49. Review extensions of credit to insiders for compliance with FRB Regulation O.
50. Review the bank's compliance with the anti-tying provisions of Section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C.1972),which prohibits extensions of credit that are conditioned upon the borrower obtaining or providing any additional credit, property or service to or from the bank or its holding company.
51. Determine whether the bank complies with applicable laws and regulations for loans secured by stock. Items to consider include: • **Loans secured by the bank's own stock;** ***(Note: 12 U.S.C.83, Section 5201 of the Revised Statutes and Section 9 of the Federal Reserve Act prohibit a bank from making a loan secured by its own stock.)*** • **Loans for the purpose of purchasing or carrying margin stock; and** ***(Note: If secured directly or indirectly by margin stock, Federal Reserve Board's Regulation U is applicable.)*** • **Determine that the institution is familiar with the Lost and Stolen Securities program (SEC Rule 240.17f1) and has taken the appropriate measures to minimize exposure on loans secured by stock. Refer to the securities information center webpage for further guidance.**
52. Review and assess the bank's compliance with applicable real estate lending and appraisal regulations.
CREDIT ADMINISTRATION
53. Assess the adequacy of management's actions to correct criticisms noted in the previous examination report, most recent loan review reports, as well as in recent internal and external audits.

54. Evaluate management's effectiveness at reacting to changing economic, industry, and regulatory environments.

55. Evaluate the membership composition of the loan committee. Determine whether members are independent and qualified to function effectively.

Other Loan Related Items

OTHER REAL ESTATE (ORE)

56. Determine whether ORE files are adequately documented. Consider the following:

- **Evidence of ownership;**
- **Book value (current and at the time of acquisition);**
- **Appropriateness of capitalized costs, if any;**
- **Current outside appraisal or internal valuation;**
- **Analysis of cost to carry (break-even analysis);**
- **Formal purchase offers (if applicable);**
- **Sales efforts or listing agreements;**
- **Current hazard and liability insurance;**
- **Receipt evidencing payment of RE taxes; and**
- **Disposal of the parcel (who, when, how), if applicable.**

57. Determine the appropriateness of ORE accounting procedures, carrying values, and dispositions. Consider the following:

- **Appropriateness of initial recording of ORE at fair value less cost to sell, which becomes the cost basis of the ORE;**
- **Prior liens, including recording such liens as liabilities;**
- **Appropriateness of accounting for ORE after acquisition at lower of cost or fair value less cost to sell, including the use of a property-specific valuation allowance for any decline in fair value less cost to sell below cost;**
- **Appropriateness of rental income and expense entries;**
- **Appropriate review of expenses;**
- **Adequacy of appraisal or evaluation;**
- **Environmental concerns; and**
- **Holding period in compliance with state laws.**

58. Evaluate the quality of the portfolio and classify parcels accordingly.
REPOSSESSED ASSETS
59. Determine the appropriateness of repossessed asset accounting policies, carrying values, holding periods, and dispositions. Classify as necessary.
NON-LEDGER ASSETS
60. Determine whether appropriate approval authorities and levels of review are in place given the volume and magnitude of chargeoffs.
61. Ascertain whether the audit practices are sufficient given the volume and magnitude of charge-offs. • **The audit program should determine the validity/existence of charged-off assets by physical inspection of items held at the bank or by direct confirmation with persons who have possession of them outside of the bank (e.g., attorneys or collection agents).** • **The validity of charged-off items should also be tested, with particular attention given to possibly fictitious loans that were charged-off. Methods of authenticating the validity of charged-off items include:** o **Direct confirmation with borrowers,** o **Evidence of personal contact with the borrower by persons other than the loan officer regarding borrowing relationship,** o **Verification through bank records that the borrower received the loan proceeds, and** o **Verification through non-bank records such as telephone and city directories that the borrower may exist.** • **The auditor may choose to confirm all charge-offs of more than a certain size or may prefer to confirm a statistical sample of all charges over a certain amount.** ***(Note: Coordinate with the examiners reviewing the internal audit function.)***
62. Determine that appropriate efforts are being made to collect charged off assets.
End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

MANAGEMENT AND INTERNAL CONTROL EVALUATION

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine whether an Expanded Analysis is necessary. This module is intended to incorporate and summarize the findings from all of the completed ED Modules for a given examination. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1. Does the board adequately supervise the affairs of the bank and provide for management depth and succession? ***Refer to Core Analysis Procedures #1-19, Procedure #22, Procedures #27-29, Procedure #43.***

C.2. Has management established an adequate control environment throughout the organization? ***Refer to Core Analysis Procedures #23-25, Procedure #29, Procedures #40-42, Procedures #44-47.***

C.3. Is management responsive to recommendations from auditors and supervisory authorities? ***Refer to Core Analysis Procedure #26.***

C.4. Are insider activities appropriate? ***Refer to Core Analysis Procedures #30-31.***

C.5. Are management capabilities sufficient for the size, activities, and condition of the bank? ***Refer to Core Analysis Procedures #20-21*****.**

C.6. Does management identify and assess the major risks confronting the bank? ***Refer to Core Analysis Procedures #33-42.***

C.7. Are policies and procedures generally adequate given the size and complexity of the bank? ***Refer to Core Analysis Procedure #24*** **&** ***Procedure #27-28.***

C.8. Do management information systems provide effective internal communication of the bank's risks? ***Refer to Core Analysis Procedures #48-49.***

C.9. Are appropriate governance systems in place to monitor the activities of the bank? ***Refer to Core Analysis Procedure #32*** **&** ***Procedure #50.***

MANAGEMENT AND INTERNAL CONTROL EVALUATION
Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review

1. Review board, committee, and shareholder meeting minutes since the last examination and the most recent and year-end board packages to assess the extent and adequacy of board supervision. Document important details and consider the following items:

- **Director attendance;**
- **Changes in control since the prior examination;**
- **Board independence from executive management;**
- **Dominant control by a board member, shareholder, or executive management;**
- **Significant changes in the direction or activities of the bank;**
- **Adequacy of management information systems;**
- **Implementation and maintenance of adequate policies; and**
- **The bank's strategic plan.**

2. Review changes in management or the directorate since the last examination. Assess compliance with rules concerning notification of changes in executive management. (FRB: Section 914 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. FDIC: Section 32 of the Federal Deposit Insurance Act (FDI Act).)

- **Consider why changes were made or are planned.**
- **Assess the effect of any changes on bank operations or risk profile.**
- **Review biographical information for new executive officers and directors.**

3. Review prior examination reports, workpapers, and correspondence for comments regarding board supervision, management, and internal controls.

Board and Management Supervision

4. Review the bank's charter, by-laws, and other related documents to understand the governance framework for the board of directors. Consider the following:

- **The number of directors;**
- **Qualifications or restrictions for directors, including the chairman of the board;**

- **Mandatory retirement age, if any, for board members;**
- **Advisory Directors or Advisory Board**
- **Directorate nomination and election process;**
- **Required committee structure; and**
- **Required frequency of board and committee meetings.**

5. **Assess the composition of the organization's board of directors. Consider the following:**
   - **The number of independent directors,**
   - **Involvement of the chairman in day-to-day operations,**
   - **The number of years each member has served on the board, and**
   - **The presence of any financial and other experts on the board.**

6. **Determine whether the board has an effective process to identify, nominate, and select qualified individuals.** ***(Note: Effective processes generally include recruiting board members whose relevant business, industry, or financial expertise corresponds with the institution's risk profile and strategic plans.)***

7. **Determine whether the organization provides new board members with an overview of their fiduciary responsibilities and opportunities for ongoing training.**

8. **Determine whether the board has adopted a code of ethics that applies to all board members, officers, and employees, and assess adherence to that code.**

9. **Determine whether the board adopted and management has implemented a strategic plan for the organization's operation over the next three to five years.**

10. **Determine whether the board is actively involved in the selection and retention of the chief executive officer (CEO) and other executive officers, and consider whether the board regularly assesses executive officers' performance.**

11. **Determine whether the board and management have talent development and succession plans for all key personnel and periodically reviews and updates such plans.** ***(Note: Succession plans may be formal***

or informal.)
12. Determine whether the board, either directly or through a compensation committee: • **Approves the compensation of senior executives;** • **Ensures that incentive compensation arrangements for covered employees are appropriately balanced and do not jeopardize the safety and soundness of the institution; and** • **Established a process for re-evaluating compensation in the event that employee decisions lead to adverse financial outcomes.**
13. Determine the extent and appropriateness of board and management reliance on external advisors or consultants.
14. Assess the appropriateness and effectiveness of board and management committee structures. Consider the following: • **Charters delineating a committee's size, responsibilities, and membership qualifications;** • **Selection process for committee members;** • **Rotation requirements;** • **Selection of committee chair;** • **Meeting frequency and attendance;** • **Meeting agendas and minutes;** • **Quality and timing of information flows from committees to the full board; and** • **Need for additional committees.**
15. Determine whether committee charters adequately address financial and non-financial risk governance. Consider if charter elements: • **Define the responsibilities for oversight of risk management policies and practices;** • **Outline board responsibilities to sanction, review, and amend committee practices;** • **Articulate the board's role and responsibility in establishing and reviewing risk levels;** • **Identify metrics for assessing and reporting risk levels relative to defined risk thresholds and limits; and** • **Provide for ongoing dialogue between board and management regarding risk management practices.**
16. Assess the process for setting board and committee meeting agendas, and evaluate the appropriateness,

accuracy, completeness, and timing of information received prior to meetings.

17. Determine whether the board established and communicated a whistleblower process that allows employees, vendors, and customers to anonymously report their concerns. (FDIC: consider FIL 80-2005, *Guidance on Implementing a Fraud Hotline.*)

18. Determine whether the board of directors, its committees, and executive management periodically conduct self-assessments of their performance.

19. Evaluate the reasonableness and appropriateness of compensation paid to the directorate. Consider the following:

- **Compensation or fees paid on a per meeting attended, annual, or other basis;**
- **Additional compensation for committee meetings;**
- **Compensation basis (cash, stock, stock option, or other basis);**
- **Deferred or other benefits; and**
- **Existence of performance-based compensation.**

20. Determine whether key executives have the appropriate knowledge, skills, and experience relative to the nature and scope of their responsibilities.

21. Identify and assess the influence exerted by any dominant official or policymaker.

Note: The presence of a dominant official should not be viewed negatively or as a supervisory concern in and of itself. Rather, the presence of a dominant official coupled with other risk factors such as ineffective internal controls, lack of board independence or oversight, or engaging in risky business strategies may create regulatory concerns or require enhanced supervision.

22. Determine whether the organizational structure is appropriate given:

- **The size, complexity, and overall risk profile of the bank; and**
- **The organization's strategic plan.**

Control Environment

23. Determine whether the board implemented an effective internal control system and ensures all personnel understand the importance of internal controls. Control systems should be designed to provide reasonable assurance that internal controls will prevent or detect:

- **Materially inaccurate, incomplete, or unauthorized transactions;**
- **Deficiencies in the safeguarding of assets;**
- **Unreliable financial or regulatory reporting; and**
- **Deviations from laws, regulations, and internal policies.**

24. Determine whether the bank has a policy that requires all officers and employees to be absent from their duties for an uninterrupted period of not less than two consecutive weeks. Assess its adequacy.

Note: Absence may involve vacations, rotations of duty, or a combination of both activities. Such policies are highly effective in preventing embezzlements, which usually require a perpetrator's ongoing presence to manipulate records, respond to inquiries, and otherwise prevent detection. The benefits of such policies are substantially, if not totally, eroded if the duties normally performed by an individual are not assumed by someone else.

25. Determine whether management addresses integrity in its code of conduct, ethics policy, and actions. (FDIC: refer to FIL 105-2005, *Corporate Codes of Conduct: Guidance on Implementing an Effective Ethics Program*, and Statement of Policy: *Guidelines for Compliance with Federal Bank Bribery Law*). Consider the following:

- **Internal guidelines regarding conflicts of interest, periodic training, and acceptable/unacceptable practices;**
- **Remedial action concerning policy exceptions; and**
- **Documentation concerning deviations from policy and associated remedial action.**

26. Determine whether management takes appropriate and timely action to address recommendations by auditors and regulatory authorities. *(Refer to the Internal and External Audit Evaluation module.)*

27. Determine whether the board, through effective monitoring and enforcement, restricts management's ability to override established policies and procedures.

28. Determine whether the organization has written policies governing compensation programs. Policies should address base pay and/or performance-based compensation arrangements. Areas of consideration include:

- **Cash and noncash payments;**
- **Equity compensation (stock options, stock appreciation rights, restricted stock/stock units, etc.);**
- **Deferred compensation and supplemental retirement plans;**
- **Severance (golden parachutes/change-in-control payments); and**
- **Forfeitures and clawbacks.**

29. Assess overall compensation practices.

- **Evaluate the appropriateness of incentive compensation arrangements for executive management and other employees (individually or as a group) that initiate material risk positions for the bank. When reviewing incentive compensation arrangements, consider:**
    - **The type, level, and significance of incentive compensation as part of the overall compensation model and its influence on the institution's risk profile;**
    - **Board approval of executive compensation incentives;**
    - **The use of golden parachute agreements (FRB: SR-96-21; FDIC: FIL-8-96, FIL-66-2010, and Part 359); and**
    - **Any incentive compensation issues identified during compliance examinations (e.g., mortgage loan origination compensation).**
- **Determine whether any compensation arrangements could be considered unsafe and unsound. When assessing compensation arrangements, review the combined value of all cash and noncash benefits provided to the individual and consider the following:**
    - **The compensation history of the individual and others with comparable expertise and responsibilities;**
    - **The financial condition of the institution;**
    - **Documentation of the board's review of compensation practices at comparable institutions *(Note: Such reviews typically consider factors such as asset size, geographical location, and complexity of activities)*;**
    - **For post-employment benefits, the projected total cost and benefit to the institution;**
    - **Connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse;**
    - **Bank purchases of life insurance for compensation purposes; and**
    - **Any other relevant factors.**

    Note: Appropriate incentive compensation arrangements generally balance risks and rewards; reflect effective controls and risk management practices; and are supported by strong corporate governance. Examiners should refer to the Interagency Guidance on Sound Incentive Compensation Policies, issued June 21, 2010, for further discussion.

30. Determine whether adequate systems are in place to identify and mitigate self-serving practices or conflicts of interest. Consider compliance with applicable laws, and determine whether:

- **Insiders have undue influence over customer activities;**
- **Insiders are lending personal funds to customers or borrowers;**
- **Privileges or benefits given to insiders are commensurate with the services rendered;**
- **Insiders are conducting excessive non-bank related business at the bank or are spending inordinate**

amounts of time away from the bank; and

- **Transactions related to insiders' purchase or use of bank assets (such as other real estate, repossessed vehicles, equipment, or bank facilities) are appropriate.**

31. Determine whether the board appropriately monitors and manages potential conflicts of interest between the institution and its directors, management, principal shareholders, and affiliates (collectively, *affiliated parties*). The board should ensure the institution has policies and standards designed to ensure that:

- **All transactions between the institution and an affiliated party are sound, in the best interest of the institution, and appropriately documented; and**
- **Any exceptions to established policies and standards governing transactions with affiliated parties are legally permissible and appropriately approved and documented.**

32. Determine whether (and if so, why) the external auditor or legal counsel changed since the last examination.

Risk Assessment

33. Review the adequacy of internal risk assessments for all significant business activities. Determine whether the assessments identify all material risks and consider the adequacy of compensating controls. Consider whether the results of assessments are appropriately reported and that internal controls and risk-assessment methodologies are updated as needed to reflect changes in business activities and work processes.

34. Determine whether management's risk-taking practices are conservative, moderate, or aggressive by assessing practices relating to loans; investments; asset/liability management; growth; nontraditional banking services; deposit structures, rates, and products; and other pertinent areas.

- **Determine whether internal controls sufficiently mitigate higher-risk activities.**
- **Determine whether there are any material changes in management's risk-taking practices. For example, changes in deposit products or funding sources; loan products, underwriting, or portfolio mix; security investments, due diligence, or maturity distributions; or asset growth.**

35. Assess the effectiveness of the board and management's planning processes. Consider the following:

- **Strategic plans, budget processes, profit plans, and growth projections;**
- **Experience of individuals involved with the planning process;**
- **Reasonableness of assumptions;**

- **Method of comparing actual performance against objectives;**
- **Frequency of revisions;**
- **The use of stress tests in the strategic planning process to identify potential vulnerabilities *(Note: Stress testing is considered a prudent practice to assist in the identification, measurement, and mitigation of risks whether on a whole bank or portfolio basis.)*;**
- **The adequacy of research regarding new strategic initiatives such as new products and investments, branch expansions, acquisitions, or mergers; and**
- **The adequacy of business continuity planning that incorporates enterprise-wide considerations.**

36. Determine whether management adequately considers risks that influence the success or failure of established objectives. Generally, risk assessments should address:

- **External sources of risk, such as:**
  - **Technology changes,**
  - **Cyber-security risks,**
  - **Competition,**
  - **Economic conditions,**
  - **Legislative and regulatory environment, and**
  - **Accounting pronouncements.**
- **Internal sources of risk, such as:**
  - **Retention of key management and staff,**
  - **Availability of funds,**
  - **Information systems and related conversions,**
  - **Adequacy of capital funds,**
  - **Corporate restructuring,**
  - **Concentrations of credit and funding sources,**
  - **Rapid growth, and**
  - **New products or business lines.**
- **The significance and likely impact of identified risks, compensating controls, and any mitigating factors.**

37. Determine whether management monitors reputational risk arising from sources such as:

- **Media, internet, and social networks;**
- **Press releases and annual reports;**
- **Participation in or sponsorship of community events; and**
- **Public perception.**

38. Consider whether the bank has an appropriate marketing and public relations strategy to manage its reputational risk.

39. Consider whether risks identified by examiners and external auditors often differ from those identified by management.

Control Activities

40. Assess the appropriateness of blanket bond insurance levels. Consider:

- **Financial condition of bank, including capital levels and asset quality;**
- **Asset/deposit size and trends;**
- **Size of transactions, such as loans (in relation to legal lending limit) and wire transfers;**
- **Single-loss and aggregate liability levels;**
- **Effectiveness of internal controls;**
- **Whether areas of operations are rapidly expanding;**
- **Amount of cash, securities, and negotiable items normally held;**
- **Number, experience, and turn-over rate of personnel;**
- **Extent of trust and merchant-credit-card activities;**
- **Data processing activities and internet presence;**
- **Presence of a dominant official or policymaker; and**
- **Previous fraudulent activities or claims and suspicious activity reports.**

41. Consider the adequacy of other insurance policies including Director and Officer and any excess employee fidelity policy.

42. Determine the reasons for any significant fidelity insurance claims.

43. Determine whether employment practices for prospective directors, officers, employees, and significant third-party contractors address potential employment impediments. For example, criminal convictions subject to Section 19 of the FDI Act (crimes related to dishonesty, fraud, and money laundering) and banking prohibition orders. (*Note: all FDIC-insured depositories are subject to Section 19 of the FDI Act.*)

44. Determine whether policies, procedures, and practices are adequate for the size, complexity, and risk profile of the bank by reviewing findings from other modules completed during the examination.

45. **Determine whether existing controls help ensure adherence to established internal policies and appear reasonable in relation to risk exposures. Review the results of other reviews completed during the examination to determine the overall adequacy of internal controls.**

46. **Determine whether management maintains an effective system of controls and safeguards for activities that expose the bank to risk. Consider the following:**
    - **Authorization and reporting requirements;**
    - **Data access controls; and**
    - **Joint custody, dual control, and separation-of-duty arrangements.**

47. **Determine whether management takes appropriate steps to comply with laws and regulations.**

Information and Communication

48. **Determine the adequacy of information systems to identify, capture, and report relevant internal and external information.**
    - **Determine whether the systems are commensurate with risks.**
    - **Determine whether the board or management periodically evaluates the adequacy and accuracy of management information systems.**
    - **Consider the accuracy of the Consolidated Reports of Condition and Income.**

49. **Evaluate whether communication of information is sufficient for personnel to carry out their responsibilities.**

Monitoring

50. **Determine whether systems are in place to monitor material risks arising from all major activities in which the institution is engaged. Assess risk monitoring with respect to the following:**
    - **Credit risk,**
    - **Market risk,**
    - **Liquidity risk,**
    - **Operational risk,**
    - **Legal risk,**
    - **Reputation, and**

• **Compliance risk. (FRB: See SR 16-11)**
End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

OTHER ASSETS AND LIABILITIES

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine whether an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1.	**Are operating policies, procedures, and risk limits adequate? *Refer to Core Analysis Procedures #9-10, Procedure #14, Procedure #18, Procedure #20, Procedure #22, Procedure #27, & Procedures #34.***
C.2.	**Are internal controls adequate? *Refer to Core Analysis Procedure #11, Procedure #15, Procedure #23, Procedure #28, & Procedure #35.***
C.3.	**Are audit or independent review functions adequate? *Refer to Core Analysis Procedures #5-8.***
C.4.	**Are information and communication systems adequate and accurate? *Refer to Core Analysis Procedure #12, Procedure #16, Procedure #21, Procedure #25, Procedure #29, Procedure #33, & Procedure #36.***
C.5.	**Is there adequate information to justify carrying values, and are adjustments made on a timely basis? *Refer to Core Analysis Procedure #13, Procedures #17, Procedure #24, & Procedures #37-38.***
C.6.	**Do the board and senior management provide effective supervision? *Refer to Core Analysis Procedure #6, Procedure #19, Procedure #26, & Procedures #30-32.***

OTHER ASSETS AND LIABILITIES

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review

1. **Identify previous concerns by reviewing prior examination reports, file correspondence, and audits.**

2. **Develop a preliminary view of financial trends. Review Uniform Bank Performance Reports (UBPRs), financial statements, and other applicable data to identify material factors (levels, changes, or trends) that may require analysis or help in scoping this review.**

3. **Determine the primary responsibilities of the board of directors, board committees,[1] and executive management relating to other assets and other liabilities.**

4. **Determine whether any material changes (e.g., strategic, operational, economic) occurred or are expected that may affect this area. Discuss the changes and implications with management.**

Audit or Independent Review

5. **Evaluate the scope of audits and independent reviews. Consider whether audits and reviews are sufficient to identify internal control, reporting, and policy-compliance deficiencies.**

6. **Determine whether findings from audits and independent reviews are reported to the board or an appropriate board committee.**

7. **Determine whether audits and independent reviews assess policy-exception practices. Issues to consider include, but are not limited to exception approval, documentation, reporting, and tracking practices.**

[1] **Through discussions with management or by reviewing applicable policies.**

8. **Determine whether responses to audit and independent review findings are reasonable, timely, and tracked to completion.**

Cash Accounts

9. **Evaluate policies and procedures for controlling cash. Satisfactory guidelines generally address items such as:**
   - **Separation of duties and joint-custody controls for items such as vault access, night depository, and ATMs;**
   - **Separate cash drawers for each teller, dollar limits for cash drawers, and surprise cash counts;**
   - **Depth of review of overages and shortages;**
   - **Compliance with applicable laws and regulations; and**
   - **Compliance with limits stated on bonding applications.**

10. **Evaluate written policies for controlling cash items by reviewing whether policies address items such as:**
    - **Maximum holding periods (i.e., items cleared or charged-off timely),**
    - **Acceptable reasons why items can be held, and**
    - **Frequency of management reviews and level of oversight.**

11. **Assess the accuracy and timeliness of cash and cash-item reconciliations by:**
    - **Reviewing reconciling items for reasonableness,**
    - **Evaluating the use of suspense accounts,**
    - **Determining whether items in suspense accounts are stale, and**
    - **Determining whether employees who prepare reconcilements are independent from control of cash and preparation of entries to the accounting system.**

12. **Determine whether management receives and appropriately reviews cash item reports.**

13. **Evaluate the documentation maintained to support the carrying values of cash items.**
    - **Consider the reason(s) an item is held, the date originated, and collectability. Classify accordingly.**
    - **Determine whether items not in process of collection are reported appropriately in the Call Report.**

Correspondent Bank Accounts and Interest Bearing Balances

14. Evaluate policies and procedures for monitoring correspondent bank accounts and interest-bearing balances. Satisfactory guidelines generally address items such as:

- **Individuals responsible for reconcilements and for maintaining records;** ***(Note: If the institution's size precludes full separation of duties, mitigating procedures often ensure one individual does not have exclusive control over reconcilements while also preparing or entering data to the general ledger or subsidiary ledger.)***
- **Supervisors responsible for reviewing reconciliations and reconciling items;**
- **Arrangements regarding compensating balances for loans to the parent, an affiliate, or insiders; (*FRB 12 CFR Part 223 Regulation W)***
- **Approval procedures for entries to the accounts;**
- **Timeframes for charge-off of stale items; and**
- **Procedures to prevent excessive exposure, including all credit exposure, to individual correspondents.** ***(Note: Refer to Section 308 of the FDIC Improvement Act of 1991 and FRB 12 CFR Part 206 Regulation F, Limitations on Interbank Liabilities.)***

15. Examine a sample of reconcilements to evaluate internal controls. Consider whether:

- **Statements for each account are reconciled promptly upon receipt;**
- **Starting balances agree with general ledger accounts and correspondent bank statements;**
- **Individuals who prepare reconcilements are different than those who prepare or approve general ledger entries, effect funds transfers, issue drafts or official checks, or prepare or approve entries to due from bank accounts;**
- **Reconcilements include the preparer's name, preparation date, and document a review by an officer or supervisor;**
- **Records of open-item investigations are maintained even after an item cleared; and**
- **Credit and debit items clear timely. Generally, clearing time frames are as follows:**
  - **Cash letters - the next day;**
  - **ACH transactions - the same or next day;**
  - **ACH returns - generally within two days;** ***(Note: ACH rules allow for three returns rather than the paper-presentation rule of two times. However, only two of the returns can be by the same method, i.e., 1 physical and 2 ACH, or 2 physical and 1 ACH.)***
  - **Non-ACH returns - generally within one week;**
  - **E bonds - depends on how transmitted, but generally within two to three days;**
  - **Cash shipments - the next day;**
  - **Bond transactions - the same or next day; and**
  - **Interest payment or charges - the next day.**

16. Determine whether management reviews suspense account and aging (stale item) reports. Satisfactory aging reports generally reflect the number and amount of open items for each due-from account and

the status of large items and long-term open items. Consider whether the frequency of reviews coincides with the volume of accounts and stale items (i.e., level of risk).

17. Determine whether documentation supports general ledger carrying values.

- **Investigate unusual items or items outstanding for an undue period.**
- **Determine whether a charge-off or other classification is necessary.**

Permissible Activities and Equity Investments

NOTE: A listing of permissible national bank activities and equity investments is available on the FDIC website on the Bank Application Resources - Part 362 Activities and Investments web page or on the OCC website in the Activities Permissible for National Banks and Federal Savings Associations, Cumulative document.

18. Determine whether the bank obtained appropriate approvals for activities or equity investments that are not permissible for national banks. Consider the following:

- **Banks that engage, directly or indirectly, in activities or equity investments that are not permissible for national banks must meet applicable capital standards. *(FDIC: Part 362 of the FDIC Rules and Regulations, FRB: 12 CFR Part 208.)***
- **Banks must meet applicable capital standards when subsidiaries engage, directly or indirectly, in activities that are not permissible for national banks.**
- **Ensure management monitors compliance with regulatory conditions and restrictions imposed by approval orders.**
- **Make certain the investments and activities adhere to the strategies and business plans presented with the bank's application.**

19. Determine whether the board has approved all equity investments and activities.

20. Evaluate business plans and strategies regarding permissible and approved activities and equity investments.

21. Determine whether management and the board receive appropriate financial and operating information regarding each activity and equity investment.

Premises and Fixed Assets
22. Evaluate policies and procedures regarding premises and fixed assets. Satisfactory guidance generally discusses items such as: • **Specifying that the directorate approve all major purchases;** • **Discouraging conflicts of interest or self-dealing with vendors, servicers, and insurers; and** • **Maintaining the level and nature of premises and fixed asset investments in compliance with applicable laws and regulations (e.g., state laws and Section 24A of the Federal Reserve Act).**
23. Evaluate internal controls. Consider whether: • **Individuals who post purchase and sale records are responsible for the property custody or inventory;** • **Subsidiary ledgers of depreciation are balanced to the general ledger by persons who have sole custody;** • **Periodic physical inventories confirm asset values;** • **Adequate fire and extended insurance coverage is in force for bank premises, furniture, and equipment;** • **Asset sales, including the recognition of gains and losses, are appropriately recognized; and** • **Disclosures, including the existence of liens, are appropriate.**
24. Determine whether investment in premises and equipment is reasonable and complies with state laws.
25. Determine whether information and reporting regarding fixed assets to senior management and the board is adequate.
26. Determine whether real estate held for future expansion still qualifies as bank premises.
Deposit Activities
27. Evaluate policies and procedures for deposit account activity. Satisfactory policies generally include guidelines for the following: • **Opening and closing accounts,** • **Dormant and inactive accounts,** • **Held and returned mail,** • **Overdrafts,** • **Uncollected funds,**

- **Deposit sweep activities,**
- **Account maintenance, and**
- **Escrow accounts.**

28. Evaluate internal controls. Consider the following:

- **Reconciliation frequency;**
- **Segregation of duties exist so individuals who reconcile deposit accounts do not post items or handle cash or official checks;**
- **Suspense account items clear timely;**
- **New account opening (ensure appropriate segregation of duties);**
- **Transactions that affect customer accounts and other internal entries are properly and promptly processed with appropriate approval;**
- **Dormant and inactive account controls; and**
- **Overdrafts, large uncollected funds, and kiting suspect reports are reviewed regularly.**

29. Determine whether management receives appropriate periodic reports on open items in suspense, in process, and other deposit accounts and whether the reports include the aging and status of significant items.

30. Review and evaluate overdraft, large item, uncollected funds, and check kiting reports, periodically throughout the examination for irregular activity. Pay particular attention to activities of bank insiders.

31. Evaluate how management handles outstanding adjustments or differences (i.e., un-reconciled or stale items).

32. Determine whether the bank uses retail repurchase agreements (a.k.a. sweep accounts.) If so, confirm the following:

- **Advertising discloses that the instrument into which deposit funds are swept is not insured by the FDIC and is not an obligation of or guaranteed by the bank;**
- **Proceeds of deposit sweep arrangements are invested only in short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable investment grade assets that can be disposed with minimal loss of principal; and**
- **Confirmations comply with the requirements of the Government Securities Act.**

33. Determine whether management information systems are sufficient to track performance metrics (e.g., volumes, rates paid, maturities, originators, and concentrations) of brokered funds and other alternative deposits, and whether these funds are reported correctly in the Call Report.

Official Checks

34. Evaluate policies and procedures regarding official checks (e.g., expense checks, cashier's checks, loan disbursement checks, certified checks). Effective guidelines generally address items such as:

- **Accounts maintained for each type of official check.**
- **Board-approved individuals with signing authorities.**
- **Procedures and authorities for issuing and approving official checks, including enhanced procedures for handling certified checks.**

35. Evaluate internal controls. Consider whether management:

- **Maintains records that track official checks by serial number;**
- **Maintains reserve supplies of unissued checks under dual control;**
- **Periodically and independently reconciles reserve check supplies using the vendor's invoice;**
- **Periodically traces certified checks for appropriate charges to customers' accounts to determine whether the accounts had sufficient balances when certified; and**
- **Ensures that outstanding checks are regularly reconciled by an individual who does not have signing authority.**

36. Ascertain whether management maintains an appropriate reporting mechanism for reconcilements, inventories, and check signing.

Other Items

NOTE: Examiners are responsible for evaluating all significant risks relating to assets and liabilities. Consider whether the bank has comprehensive policies and procedures, strong internal controls, appropriate audit programs, and effective management information systems. Overstatements in asset accounts result in losses that, if material, should be detailed in the examination report.

37. Evaluate other asset categories on the general ledger. Common problem areas include the following:

- **Book values exceed cash surrender values for life insurance policies insuring the lives of key officers. *(Note: Substantial cash values in excess of carrying values may be shown in the report as Sound Banking Values Not Shown on Books. Overstatements should be classified loss. Refer to ASC 835-30, ASC 325-30, and Section 24 of the FDI Act for additional information.)***

- **The bank does not control non-booked assets (e.g., software and fine art).** ***(Note: Insurance riders might show assets insured but no longer in the bank.)***
- **Capitalized bonding company claims, which are rarely justified unless realization is assured beyond any reasonable doubt.**
- **Unrealizable deferred tax assets - deferred tax assets can be recognized for operating loss and tax credit carry-forwards just as they are for deductible temporary differences. A bank can recognize the benefit of a net operating loss for tax purposes or a tax credit carry-forward to the extent management determines that a valuation allowance is not necessary (i.e., if the realization of the benefit is more likely than not).**
- **Prepaid services costs (surety bonds, insurance policies, advance rental payments) are not charged to current expenses over the life of the purchased goods or services.**

38. Evaluate other liability categories on the general ledger. Determine whether:

- **Any liabilities are not reflected on the bank's books.** ***(Note: This information may be obtained through discussions with bank personnel, auditors, or through findings resulting from examiner review of other functional areas.)***
- **Reports that provide an aging of applicable liability accounts are prepared and reviewed by management periodically.**
- **Detailed records or calculations are maintained to support recorded liabilities.**

End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

RATE SENSITIVITY

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine if an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1. **Do the bank's assets, investments, deposits, other funding sources, and financial derivatives present a low or well-controlled level of interest rate risk?** ***Refer to Core Analysis <u>Procedures #1-5</u>.***

C.2. **Have adequate corporate governance processes (policies, procedures, risk limits, and strategies) been established?** ***Refer to Core Analysis <u>Procedures #6-12</u>.***

C.3. **Are internal measurement processes and systems adequate? Refer to Core Analysis *<u>Procedures #13-16</u>*.**

C.4. **Are model inputs and management's assumption development process adequate?** ***Refer to Core Analysis <u>Procedures #17-19</u>.***

C.5. **Are the audit and internal control functions adequate?** ***Refer to Core Analysis <u>Procedures #20-22</u>.***

C.6. **Has an effective Independent Review function been established?** ***Refer to Core Analysis <u>Procedures #23-26</u>.***

C.7. **Are management information systems and reporting adequate?** ***Refer to Core Analysis <u>Procedures #27-29</u>.***

C.8. **Is the level of risk reasonable relative to capital and earnings levels?** ***Refer to Core Analysis <u>Procedure #30-33</u>.***

C.9. **Do the Board and senior management effectively supervise this area?** ***Refer to Core Analysis <u>Procedure #34-38</u>.***

RATE SENSITIVITY
Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review
1. Review prior examination reports, supervisory reviews, and file correspondence to identify prior rate-sensitivity concerns. Also, review internal, or third party, audits and reviews to identify any concerns or recommendations.
2. Review board or committee minutes and information packets for evidence of oversight, responsibility, routine management reports, and any identified rate sensitivity concerns.
3. Determine whether there are any recent or planned changes in strategic direction and discuss with management the implications for rate sensitivity risks.
4. Review offsite analytical reports (FDIC: IRRSA) to develop a preliminary assessment of rate sensitivity trends and risks.
5. Review UBPR, Call Report, balance sheet, and income statement data to develop an initial rate sensitivity profile. Note common risk areas such as: • **Shifts in long term assets and long term liabilities;** • **Mortgage-loan exposure (direct or indirect through mortgage backed investments);** • **Mortgage servicing assets;** • **Significant securities depreciation;** • **Structured notes;** • **Fluctuations in non-maturity deposits; and** • **Hedging activities, such as rate swaps, forwards, futures, options, or other derivative products.**
Policies, Procedures, and Risk Limits

6. Review rate sensitivity policies. Policy guidance may be incorporated in liquidity, loan, investment, interest rate risk (IRR), or other policies, but taken as a whole, should provide sufficient guidance to management relative to the board's risk tolerances and oversight responsibilities. Policy formality and sophistication will vary, depending upon the level of the bank's risk and the complexity of its holdings and activities. In general, satisfactory policies:

- **Assign authority and responsibility to an individual(s) or committee for establishing and maintaining an effective IRR management program that identifies, measures, monitors, and controls IRR within board-approved risk limits;**
- **Identify the types of instruments and activities that may be used to manage IRR exposure;**
- **Provide for comprehensive measurement systems that are commensurate with the size and complexity of the institution for valuing positions and assessing performance, including procedures for updating model scenarios and underlying key assumptions;**
- **Require regular, detailed reporting that informs management and the board of IRR exposures;**
- **Outline the process and responsibility for sensitivity testing of critical model assumptions;**
- **Require periodic back testing of IRR projections and analysis of significant variances;**
- **Establish earnings and capital exposure limits commensurate with the risk tolerance of the board;**
- **Require management to factor IRR into broader risk management considerations and strategic decisions to ensure interrelationships between IRR and other risks are considered and addressed;**
- **Require the board or a designated committee to periodically review and approve the policy, risk limits, and strategies;**
- **Assign responsibility for authorizing policy exceptions, and require documentation of the rationale for authorizing such exceptions; and**
- **Provide that the asset/liability committee (ALCO), or a similar committee, has sufficient representation across major functions that influence IRR exposure.**

7. Determine whether the board or a delegated committee oversees the establishment, approval, implementation, and annual review of IRR management strategies, policies, procedures, and limits (or risk tolerances).

8. Discuss IRR management processes and practices with management. Review ALCO meeting minutes and packages to evaluate the process. Potential topics for discussion include:

- **Lines of responsibility and authority for IRR exposure management;**
- **Development of IRR policies and practices;**
- **Adequacy of IRR measurement system used (e.g., gap, income simulation, economic value of equity);**
- **Assumptions used in the IRR measurement system (e.g., asset prepayments, deposit price sensitivity, decay rates, growth rates) and any adjustments to key assumptions;**
- **Management's understanding of the underlying analytics and methodologies of IRR models;**
- **Board/management understanding of model assumptions, particularly if developed by third parties;**
- **Strategies to manage IRR (e.g., cash flow or duration matching, altering balance sheet composition, hedging with derivatives);**
- **Technical expertise of staff relative to the complexity of products used and the complexity of the**

IRR measurement system; and,

- **Board and management understanding of the specific embedded risk characteristics of the institution, (e.g., basis risk, option risk).**

9. If IRR management processes include hedging with derivatives, determine whether policies outlining hedging strategies include:

- **Requirements for analysis of market, liquidity, credit, and operating risks;**
- **Requirements regarding the expertise/experience of personnel involved in implementing and monitoring derivative hedging strategies;**
- **Permissible strategies and types of derivative contracts;**
- **Risk limits for hedging activity such as position limits (gross and net), maturity parameters, and counterparty credit guidelines;**
- **Names of individuals authorized to initiate hedging transactions and their limits of authority;**
- **Requirements for monitoring hedging activity and ensuring activities fall within approved limits and lines of authority; and**
- **Descriptions of how management will ensure compliance with technical accounting guidance that governs hedging activity, most notably ASC Topic 815.**

10. Determine whether management uses static balance sheet modeling to assess baseline IRR exposure. Refer to the 1996 Joint Agency Policy Statement on IRR and the 2010 FFIEC Advisory on IRR Management for further discussion of balance sheet modeling.

11. Determine whether management uses IRR modeling to evaluate large-scale shifts in strategies, product offerings, or significant concentrations.

12. Determine whether procedures and risk limits are reasonable relative to current economic conditions and the overall condition of the bank. Determine whether management:

- **Evaluates the potential effect on income and capital levels when establishing risk limits;**
- **Reviews limits at least annually (and more frequently if the bank's financial condition, strategic direction, or products and services are changing); and**
- **Considers the risks and potential rewards of adverse/favorable rate movements when establishing an IRR position or strategy.**

Measurement System Capabilities

13. Determine whether the measurement system contains the functionality (and is updated as needed) to adequately assess risk exposures.

14. **Determine whether the IRR measurement system captures and reports all material on- and off-balance sheet positions. Consider the level of detail in charts of account, data input, and output reports.**

15. **Determine whether the system measures the potential effect of changes in market rates on both earnings and capital.**

16. **Determine whether the IRR measurement system has capabilities to provide meaningful stress-test simulations applicable to the institution. Consider the following:**
    - **Instantaneous and significant rate shocks (considering the current rate environment);**
    - **Substantial changes in rates over time (prolonged rate shocks exceeding periods of 1 year);**
    - **Changes in the relationships between key market rates (i.e., basis risk);**
    - **Various scenarios (e.g., base case, worst case, static, dynamic); and**
    - **Nonparallel yield curve shifts (e.g. steepened, flattened, and inverted yield curves).**

Assumptions and Data Inputs

17. **Assess management's process for developing and reviewing key scenarios and assumptions. Consider the institution's documentation, monitoring, and update procedures. Typical key assumptions include:**
    - **Asset prepayment speeds,**
    - **Non-maturity deposit price sensitivities,**
    - **Non-maturity deposit decay rates or average life, and**
    - **Key/driver rates.**

18. **Review the reasonableness and support for management's key assumptions.**

19. **Review the institution's sensitivity analysis on key assumptions.**

Internal Controls

20. **Determine whether management established sufficient lines of authority and separation of duties, or comparable controls, over the development and use of measurement systems and monitoring tools.**

21. Determine whether IRR reports are reviewed by senior management and the board at least quarterly.

22. Determine whether management complies with policy parameters and documents the reasons for variances, and any actions plans initiated. If applicable, discuss the board's oversight and approval of variances and any related mitigating actions.

Audit or Independent Review

23. Determine whether management provides for an adequate audit of the IRR measurement process.

24. Determine whether the independent review includes an adequate scope (certain aspects of which may have been completed by internal audit or an external model validation). Adequate scoping generally includes an assessment of items such as the:

- **Adequacy of, and compliance with, policies and procedures;**
- **Suitability of the bank's measurement system given the size and complexity of activities;**
- **Appropriateness of rate scenarios used;**
- **Validity of risk measurement calculations; and**
- **Reasonableness and accuracy of assumptions and data inputs including back testing.**

25. Ensure that the results of annual independent reviews are promptly reported to the board, or committee thereof. Determine whether management reviewed and reported the results of any validation performed on the IRR model used.

26. If recent reviews disclosed any deficiencies, or if back testing has shown past estimates deviated significantly from actual performance, determine whether management responses are reasonable and timely.

Reporting and Communication Systems

27. Determine whether internal reports provide sufficient information for ongoing IRR management decisions and for monitoring the results of those decisions. Reports should contain sufficient detail for the board and senior management to:

- **Analyze IRR levels and trends and estimate the potential effect on earnings and capital;**
- **Identify material risk exposures and sources;**
- **Evaluate key assumptions, including interest rate forecasts, deposit behaviors, and loan prepayments;**
- **Make pricing decisions;**
- **Verify compliance with risk limits/policy guidelines and to monitor policy exceptions;**
- **Assess the institution's IRR sensitivity in base-case and changing-rate scenario, and**
- **Assess important assumptions underlying the measurement systems.**

28. Determine whether interest rate risks are communicated to all relevant operational and oversight personnel.

29. Consider testing reports for accuracy by comparing results with regulatory reports and internal records.

Risk Exposure Considerations

30. Determine the level of IRR and assess the potential effect on the institution's risk profile. Consider IRR trends that, while still within established risk tolerances, may indicate an increasing risk profile.

31. Compare the earnings projections used in the IRR measurement systems to management's budget. Determine the magnitude of any differences and the reason for the differences. Determine the extent to which management relies on IRR projections and uses them in strategic and capital planning.

32. Determine whether recent or anticipated changes or trends in the balance sheet composition alter the IRR profile relative to historical data. When significant structural changes have or are expected to occur, de-emphasize historical analysis and focus on current and forecasted balance sheet composition. Significant structural changes may include:

- **Major shift in the maturity (repricing) characteristics of the investment portfolio, loans, borrowings, or deposit accounts;**
- **Increased holdings of financial instruments such as mortgage securities, callable securities, fixed-rate residential loans, and structured notes;**
- **Fundamental changes in liability mix between core deposits and other funding sources;**
- **Unexpected changes in level or trend of securities appreciation and depreciation; and**
- **Adoption of, or an increase in, the volume of derivative or hedging instruments.**

33. Analyze changes in the net interest margin and net operating income relative to:

- **Market interest rate fluctuations,**
- **Reliance on rate sensitive noninterest income activities (such as mortgage banking activities),**
- **Earnings and capital levels, and**
- **Strategies to manage the effect of the changes on earnings and capital.**

Oversight & Risk Mitigation

34. Determine whether the board understands and is regularly informed about the level and trend of IRR exposure. Consider the following board responsibilities:

- **Setting the bank's tolerance level for interest rate risk,**
- **Identifying lines of authority and responsibility for managing risk,**
- **Ensuring adequate resources are devoted to IRR management,**
- **Monitoring the overall IRR profile, and**
- **Ensuring that IRR is maintained at prudent levels.**

35. Determine whether senior management ensures that board-approved strategies, policies, and procedures for managing IRR are appropriately executed within the designated lines of authority and responsibility. Consider the following management responsibilities:

- **Implementing detailed reporting processes to inform senior management and the board of the level of IRR exposure;**
- **Maintaining comprehensive systems and standards for measuring IRR, valuing positions, and assessing performance, including procedures for updating IRR measurement scenarios and key underlying assumptions driving the institution's IRR analysis;**
- **Developing and implementing procedures that translate the board's goals, objectives, and risk limits into operating standards that are understood and followed by bank personnel;**
- **Providing sufficient staff to operate measurement systems, including back-up personnel who possess requisite technical expertise;**
- **Establishing adequate training and development programs;**
- **Implementing internal controls over the IRR process; and**
- **Ensuring independent reviews and validations of the IRR program are regularly completed.**

36. Determine whether historical performance indicates weakness in board and senior management oversight.

37. Determine whether the board effectively oversees and management effectively implements planned

initiatives and strategies.
38. If risk limits were breached, determine what steps management took, or plans to take, to remedy, or mitigate exposures. If management decides against corrective action, determine whether such decisions are reasonable and appropriately reported and documented.
End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

RISK SCOPING ACTIVITIES

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should exclude unnecessary items from the request letter. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive. This module is intended to help the examiner-in-charge (EIC) determine the examination scope, allocate staff resources, and prepare a pre-examination memorandum. When specialty examinations are to be integrated with safety and soundness examinations and reports, procedures for these specialties should be added.

Activity Identification

Note: Completing the procedures below should require a discussion with bank management in advance of sending out the First Day information request letter (to assist in scoping the request) and after receipt of the information (to clarify understanding of information received). Also, discussions with the agency's case manager (or equivalent) and the results off-site monitoring will likely provide additional information for consideration in planning the scope of the examination.

1. **Determine whether concerns or higher-risk activities are present, such as :**
   - **Internal control/audit issues were cited in previous examination or audit reports, including:**
     - **Excessive internal control deficiencies,**
     - **Inadequate documentation,**
     - **Out-of-balance accounts,**
     - **Inadequate account reconciliations,**
     - **Significant policy exceptions or inadequate reporting of exceptions,**
     - **Inability or unwillingness to downgrade loans or recognize impairment/loss promptly, or**
     - **Inaccurate reporting of troubled debt restructures (TDRs) in the Consolidated Reports of Condition and Income (Call Reports).**
   - **Asset quality issues, such as:**
     - **Unusual loan types or particularly complex loans considering the profile of the institution and the expertise of lending staff;**
     - **A material volume of loans with high-risk characteristics (e.g., low quality, poor underwriting, nonperformance, watch-list or classified status);**
     - **Inadequate policies and procedures for obtaining appraisals/evaluations during renewals or extensions;**
     - **Significant concentrations in high-risk loans (based on loan type, borrower, geography, market segment, etc.);**
     - **Concentrations of assets for which valuation methods are complex or uncertain;**
     - **Significant volumes of loan modifications or TDRs;**
     - **Use of brokered, correspondent, or third-party arrangements to originate or service loans;**
     - **Use of volume incentives for loan originators; or**
     - **Over reliance on interest reserves.**
   - **Management/strategic planning issues, such as:**
     - **Excessive growth or over reliance on nontraditional funding sources;**
     - **High-risk strategies, reliance on non-core income sources, or significant business-line changes;**
     - **Significant personnel turnover, the departure of key staff, or inadequate succession plans; and**
     - **Over emphasis on earnings without proper risk management practices or internal controls.**
   - **Regulatory issues, such as:**

- **Several quarters of significant provision expenses;**
- **Marginal capacity to raise equity capital;**
- **High volume of consumer complaints;**
- **High volume of intercompany transactions (FRB Regulation W);**
- **Significant insider transactions that are not properly approved or documented (FRB Regulation O); or**
- **Parent company issues that limit its ability to serve as a source of strength to the bank (such as having low liquidity, high debt, or an overreliance on bank dividends for cash flow).**

2. Review available information to determine the significance of bank activities and associated risks.

- **Obtain from the bank:**
  - **Strategic plans and budgets;**
  - **Internal management reports;**
  - **Watch lists**
  - **Board packages;**
  - **Annual reports; and**
  - **Auditor reports, management letters, quality control reports, and other reviews (such as loan, interest rate risk, mortgage banking, and Small Business Association (SBA) loan reviews).**
- **Obtain from other sources:**
  - **Call Reports, Uniform Bank Performance Reports (UBPR), and Bank Holding Company Performance Reports;**
  - **Offsite surveillance monitoring reports;**
  - **Real Estate Stress Tests (FDIC: REST);**
  - **Problem Bank Review Summaries;**
  - **Interest Rate Risk Reports (FDIC: IRRSA);**
  - **Press releases, published news stories, and on-line information/databases;**
  - **Large Insured Depository Institution (LIDI) Reports (FDIC);**
  - **Reports of examination issued by the institution's primary regulator;**
  - **Regulatory reports of examinations relating to security- or insurance-activities conducted by bank subsidiaries or other entities;**
  - **FDIC-Assisted Transactions, loan pool purchases, mergers/acquisitions; and**
  - **Regional economic conditions.**

3. Discuss with management potential concerns identified through interim offsite reviews, financial analysis, or correspondence.

- **Identify economic conditions that may affect the bank's overall financial condition and discuss issues such as:**
  - **The bank's primary trade area and its principal business activities within the area. Consider issues such as the size of the bank's trade area, boundary descriptions, population levels and trends, per capita income, employment growth, and unemployment rates;**
  - **Management's views regarding local economic trends and other factors that may affect the bank (for example, new businesses, expansion plans, business closings, or planned layoffs);**

- **Deposit levels and trends and any plans for new or special-rate deposit products;**
  - **Types of loans currently emphasized and any material changes in loan types or volumes;**
  - **Competition and how it affects loan and deposit pricing; and**
  - **The bank's dependence on any particular industry or economic sector (for example, oil and gas, government, or agriculture).**
- **Identify managerial, operational, and functional changes. Determine if there have been any changes, or anticipated changes, in areas such as:**
  - **Overall bank objectives, risk appetites, or management philosophies;**
  - **Ownership, key personnel, or audit firms;**
  - **Board composition;**
  - **Investment strategies or brokers;**
  - **Operations, including information systems;**
  - **Policies and procedures;**
  - **Committee structures, reporting relationships, and recordkeeping systems;**
  - **The level and trend of regulated security or insurance activities conducted by bank subsidiaries or other entities on bank premises or on behalf of the bank; and**
  - **The scale or trend of other business lines (new or expanding) such as, mortgage banking, SBA lending, and commercial and industrial (C&I) lending.**
- **Determine what senior management considers the most significant factors affecting the bank, including high or emerging risks.**

Note: The EIC should schedule a pre-examination visit to the bank or conduct a telephone conversation with management if a visit is not feasible. The meeting or discussion should focus on emerging risks, changes to bank policies, strategic direction, new products or delivery channels, and significant activities that have occurred since the previous examination. The meeting provides the EIC the opportunity to solicit management's perspective about economic conditions, local and regional competition, internal and external audit programs, loan review activities, and overall risk management practices.

4. Review the findings of internal and external audits regarding the adequacy of internal control programs. Consider the degree to which examiners can rely on internal audits, and whether certain examination activities can be reduced or omitted due to the strength of internal controls, internal audit programs, and the absence of adverse audit findings. As part of this evaluation, review the:

- **Independence and experience of personnel conducting internal control reviews;**
- **Appropriateness of the audit universe, schedule, and scope;**
- **Adequacy of the size of the internal audit staff given the complexity and risk profile of the bank;**
- **Effectiveness of internal control reviews and reporting;**
- **Completeness of audit reports and the adequacy of management's written response to audit findings; and**
- **Accuracy and completeness of workpapers, if necessary.**

5. Review the findings of external auditors. Determine whether findings exist relating to:

- **Internal controls,**
- **Accounting practices,**

- **Regulatory reporting, and**
- **Exposure to high-risk activities.**

6. Assess any control weaknesses identified by internal or external audits, the previous examination, or other control procedures.

7. Review information regarding consumer complaints or problems noted in other specialty areas (Bank Secrecy Act, compliance, trust, information technology, mortgage banking, or other specialty activities), and assess any potential safety and soundness concerns. Consider the materiality of activities in terms of sales volume, revenues, and expenses, as well as the significance of risks posed to the bank.

8. Determine the significance of any activities conducted by a functionally regulated subsidiary of the bank or holding company and whether such activities pose a material risk to the insured depository institution. Contact the functional regulator to obtain available information about the functionally regulated subsidiary that warrants further review. Consider whether the subsidiary's functional regulator identified any significant supervisory concerns.

- **If supervisory information on a functionally regulated subsidiary of the insured depository institution is not available from the bank or the functional regulator of the subsidiary, information may be requested of a functionally regulated subsidiary itself only in limited circumstances. (FDIC: Consult with the regional office; FRB: Consult with Board staff.)**
- **An examination of a functionally regulated subsidiary should be undertaken only after consultation with and direction from the FDIC regional office or the FRB Board staff, except for subsidiaries that sell insurance products on bank premises or on behalf of the bank, which may be examined for compliance with the Rules and Regulations on Consumer Protections for Depository Institution Sales of Insurance [FDIC: 12 C.F.R. § 343; FRB: 12 C.F.R. § 208 (Regulation H)].**

Resource Allocation

9. Review relevant examination documentation modules and identify areas warranting greater emphasis or areas that may be suitable for limited reviews due to low risk profiles. Determine the feasibility of performing offsite loan review.

10. Allocate examination resources based on the bank's activities and risk profile, preliminary assessments of the control environment, and areas targeted in examination documentation modules. Also, consider the relative skills and experience of the available examination staff.

Scope Memorandum

11. Prepare a scope memorandum per applicable agency policy. The memorandum should be tailored to the risk, size, and complexity of the bank and define the objectives of the examination. The memorandum should address growth expectations, management or ownership changes, and the status of prior examination findings and criticisms. Include the following information:

- **Summary of pre-examination meetings or discussions;**
- **Summary of audit and internal control environment and a general statement regarding the level of reliance examiners can place on internal controls and the audit function;**
- **Preliminary risk assessments addressing CAMELS components, and comments regarding the ability to assess certain CAMELS components offsite (assess credit, market, liquidity, operational, legal/compliance, and reputational risk associated with the institution);**
- **Summary of examination procedures, including a discussion of the examination procedures to be completed and the depth of coverage in different areas;**
- **Summary of anticipated loan reviews (FRB: See SR 16-8, *Off-site Review of Loan Files* for more information on conducting all or portions of the loan review offsite);**
- **Summary of specialty areas to be targeted for examination (for example, mortgage banking, specialty lending, or other business lines); and**
- **Examination staffing requirements and identification of any training opportunities or specialized skills needed.**

End of Core Analysis.

SECURITIES AND DERIVATIVES

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine whether an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?

C.1.	**Are policies, procedures, and risk limits adequate? *Refer to Core Analysis Procedures #8-11.***
C.2.	**Are internal controls adequate? *Refer to Core Analysis Procedures #12-19.***
C.3.	**Are the audit or independent review functions adequate? *Refer to Core Analysis Procedures #20-22.***
C.4.	**Are information and communication systems adequate and accurate? *Refer to Core Analysis Procedures #45-46; Procedures #49-50; & Procedure #61.***
C.5.	**Does management appropriately identify and measure portfolio risks? *Refer to Core Analysis Procedures #23-26; Procedures #27-31* (ACL only); *Procedures #32-35* (non-ACL only); *Procedures #36-53; & Procedure #57.***
C.6.	**Do the board and management effectively oversee securities and derivatives activities? *Refer to Core Analysis Procedures #19-20; Procedure #24; & Procedures #55-66.***

SECURITIES AND DERIVATIVES EXAMINATION PROCEDURES

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review

1. Review prior examination reports, pre-examination memorandum, and file correspondence for an overview of any previously identified investment deficiencies.

2. Review internal and external audit reports and other independent reviews.[1]

3. Review remedial actions taken by management to address audit and examination recommendations.

4. Analyze the level and trend of securities and derivatives activities in the Uniform Bank Performance Report or Interest Rate Risk Standard Analysis (IRRSA - FDIC), and assess any risks in the portfolio(s).

5. Review the securities portfolio, certificates of deposit held for investment purposes, and end-use derivative contracts.

- **Review transactions entered into or amended since the last examination.**
- **Identify securities that may require further analysis, such as instruments that have unusual, leveraged, or highly variable cash flows, including mortgage-backed securities (MBS), collateralized debt obligations, and asset-backed securities. The process may involve reviewing institution-prepared reports, investment prospectuses, trade confirmations, and accounting methods.**

6. Discuss with management the institution's investment philosophy, portfolio composition, and underlying business purpose(s) for investment activities.

[1] If the institution is subject to the Sarbanes-Oxley Act (SOX), review the SOX information pertaining to the investment portfolio, such as SOX narratives, flow charts, and internal control matrices.

7. Review investment committee minutes and other relevant committee minutes (such as asset-liability committee minutes) that discuss investment activities. Determine whether substantive investment activities are sufficiently discussed including any changes in strategy, philosophy, or responsibilities.

Policies, Procedures, and Risk Limits

8. Evaluate whether policies are appropriate for securities and derivatives activities. Effective policies are generally tailored to the institution's unique risk profile and address items such as:

- **The board's investment goals and objectives;**
- **Delegations of investment authority;**
- **Duties and responsibilities of individuals involved in the investment process;**
- **Transaction authorizations and trade limits for individuals responsible for initiating trades;**
- **Authorized activities and instruments;**
- **Unacceptable investment activities;**
- **Credit quality and ongoing monitoring guidelines;**
- **Investment guidelines or limits (e.g., portfolio composition, maturities);**
- **Required pre- and post-purchase analysis, including due diligence for more complex securities;**
- **Off-balance-sheet investments;**
- **Portfolio valuations and frequency requirements;**
- **Pledging requirements;**
- **Safekeeping procedures;**
- **Internal controls;**
- **Audit and independent reviews;**
- **Reporting requirements;**
- **Broker-dealer selection and ongoing monitoring;**
- **Accounting and taxation considerations, including whether debt securities are properly measured under ASC Topic 320, Investments – Debt Securities, or ASC Topic 326, Financial Instruments – Credit Losses, as appropriate;**
- **Conflicts of interest;**
- **Exception reporting; and**
- **Frequency of policy reviews by the board.**

9. Determine whether management established risk limits appropriate for the institution. Appropriate risk limits consider, as appropriate:

- **Credit risk,**
- **Concentration risk,**
- **Market risk,**
- **Liquidity risk,**
- **Price risk,**

- **Investment types, and**
- **Maturity and call features.**

10. When applicable, assess management's strategies to modify market risk (e.g., hedging). Effective policies generally address items such as:

- **Approved strategies and instruments,**
- **Activity limits,**
- **Analysis and documentation standards,**
- **Exposures needing modification,**
- **Accounting treatment,**
- **Monitoring requirements, and**
- **Counterparty credit risk requirements.**

11. Evaluate the frequency and timeliness of policy reviews and updates by the board.

Internal Controls

12. Assess the internal control program. Appropriate control programs generally:

- **Ensure transactions are conducted by authorized personnel;**
- **Assess the appropriateness of delineation of responsibilities for joint custody and dual control; and**
- **Maintain appropriate separation of duties (executing, posting, and reconciling).**

13. Determine whether internal control procedures are commensurate with the volume and complexity of investment activities. Adequate procedures generally address items such as:

- **Portfolio valuation(s),**
- **Personnel,**
- **Settlement procedures,**
- **Physical controls and documentation,**
- **Conflicts of interest,**
- **Appropriate accounting for debt and equity securities,[2]**
- **Reporting,**
- **Independent review, and**
- **Validation of risk measurement techniques.**

[2] In accordance with ASU 2016-01, equity securities may no longer be designated as available-for-sale.

14. **Determine whether management performs activities that may result in elevated risks or inadequate controls. Consider reviewing activities or file sampling for:**
    - **Gains trading, when-issued trading, pair-offs, extended settlements, repositioning repurchase agreements, short sales, or adjusted trading;**
    - **Incomplete transaction documentation;**
    - **Contravention of internal policy limits for transaction amounts or types with individual dealers;**
    - **Inaccurate reporting or accounting;**
    - **Failure to monitor personal investment activities of staff with securities activities responsibilities;**
    - **Transactions completed by unauthorized personnel;**
    - **Inappropriate delegation of investment authorities;**
    - **Inappropriate assignment of due diligence responsibilities to third parties; and**
    - **Exclusive reliance on credit rating agencies to assess credit risk.**

15. **Assess management's procedures for payment, reconciliation, exceptions, and control of securities and derivatives positions.**

16. **Determine whether investment activities are accurately reported in the Call Report and appropriately supported by work papers prepared by management.**

17. **Determine whether transfers of debt securities occur between the available-for-sale, held-to-maturity (HTM), or trading accounts.**

18. **Determine whether debt security sales from the HTM account have occurred, and if so, whether they are consistent with the safe harbor provisions in U.S. Generally Accepted Accounting Principles (GAAP).**

19. **Determine, by sampling transactions, whether management uses one dealer or representative for substantially all securities and derivatives activities. If so, determine whether management has safeguards to ensure the institution receives the best execution, including price and likelihood and speed of execution.**

Audit or Independent Review

20. Determine whether audits or independent reviews provide sufficient coverage relative to the institution's size, scope of investment activities, and risk profile. The independent review should:

- **Assess separation of duties, internal controls, and supervision of investment activities;**
- **Compare actual risk levels to board-approved limits;**
- **Determine whether policies and procedures are adequate and appropriately comprehensive;**
- **Determine compliance with internal policies and procedures, as well as regulatory requirements;**
- **Assess the adequacy and accuracy of risk measurement systems, including critical assumptions;**
- **Assess the adequacy, accuracy, and timeliness of reports to senior management and the board;**
- **Assess the accuracy and timeliness of price information, including underlying assumptions;**
- **Validate the accuracy of accounting and inventory reports:**
  - **Assess management's procedures for identifying and measuring impairment for debt securities under ASC Topic 320 or properly measuring debt securities for the proper credit loss allowance under ASC Topic 326, as appropriate;**
  - **Assess management's procedures for establishing the fair value for equity securities and measuring changes in fair value through earnings, as appropriate (refer to procedure 36);**
  - **Verify correct accounting for debt securities and derivatives positions, including accrued interest; principal amortization, premium amortization, discount accretion, and valuation;**
- **Verify securities trial balance reconciliations to the general ledger and safekeeping reports (considering the frequency of reconciliations, disposition of reconciling amounts, and separation of duties when evaluating the adequacy of reconciliations);**
- **Ensure appropriate pre-purchase analysis and on-going due diligence is performed;**
- **Verify that appropriate on-going due diligence is conducted on brokers or brokerage firms used;**
- **Assess the documentation related to off-balance-sheet derivative transactions;**
- **Recommend corrective action, when warranted;**
- **Verify that corrective action commitments have been implemented; and**
- **Review third party assessments of the securities portfolio for reasonableness.**

21. Confirm that audit or independent review results and management's responses are reported to the board or designated committee, as appropriate, on a timely basis.

22. Determine whether management's responses to recent audits or independent reviews are timely and reasonable.

Risk Identification, Measurement, and Reporting Systems

DOCUMENTATION REVIEW

23. Review a sample of files that contain analysis of securities and derivatives positions entered into or amended since the last examination.[3] Determine whether management:

- **Adequately identified the risks associated with each security prior to acquisition and periodically thereafter, consistent with the institution's policies;**
- **Established an appropriate risk and performance measurement system, including pre-purchase analysis documentation requirements and periodic monitoring;**
- **Verified that securities are investment grade without relying exclusively on external credit ratings;**
- **Adequately assessed whether the instrument's cash flows, risks, and potential returns continue to fit within its investment strategy; and**
- **Obtained sufficient documentation to make an informed investment decision.**

24. Determine whether management's method of evaluating and selecting authorized securities dealers, investment bankers, and brokers is appropriate. When selecting a dealer, investment banker, or broker, prudent management generally reviews:

- **The firm's current financial information, such as annual reports and credit reports, and evaluate its ability to honor commitments;**
- **The firm's general reputation by contacting previous or current customers; and**
- **Information from state or federal securities regulators and industry self-regulatory organizations, such as FINRA, concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel.**

CREDIT RISK

Procedures 27-31 apply to institutions that adopted ASU 2016-13. Procedures 32-35 apply to institutions that did not adopt ASU 2016-13. Procedures 25-26 and 36-41 apply to all institutions.

25. Determine whether management's pre-purchase and ongoing credit analysis is commensurate with the risk of the instrument.[4]

[3] The same level of pre-purchase analysis may not be appropriate for all investment instruments. It may be appropriate to conduct less analysis for noncomplex and standardized instruments, the risks of which are well known to the institution, than for complex, nonstandard, or volatile instruments. Detailed pre-purchase analysis and documentation may be appropriate for investments in relatively complex instruments, nonstandard instruments, and potentially volatile instruments.

[4] The depth of the due diligence reflects the security's credit quality, complexity, and size. For example, for structured instruments, pre-purchase and ongoing credit risk analysis typically enables management to understand the characteristics of the underlying collateral, the securitization structure (such as its cash waterfall and performance triggers), and how the instrument may perform under stressed scenarios. If credit analysis is outsourced to third parties, management should verify the third party's independence, understand its credit analysis methodology, and confirm the adequacy of that methodology.

26. Determine whether management's credit analysis and risk limits for repurchase agreements and counterparties are appropriate.[5]
27. For HTM debt securities, review and assess procedures, practices, and policies regarding the allowance for credit losses (ACL). • **Determine whether the ACL evaluation process is completed at least quarterly and verify that appropriate documentation is maintained to support management's assumptions, valuations, and judgements.[6]** • **Evaluate the institution's ACL policies and procedures. Assess the loss estimation method(s) used to arrive at overall estimates of ACLs, including the documentation supporting the reasonableness of management's assumptions, valuations, and judgements.** • **Evaluate whether management has appropriately considered historical loss information, current conditions, and reasonable and supportable forecasts, including significant qualitative factors that affect the collectability of the HTM debt securities portfolio.** • **Determine whether management evaluates expected losses on a collective basis when HTM debt securities share similar risk characteristics. If an HTM debt security does not share similar risk characteristics with other assets, expected credit losses for that security should be evaluated individually.** • **Evaluate the institution's policies and procedures for determining when HTM debt securities have zero expected credit losses. Examples of HTM debt securities that may result in expectations of zero credit loss include U.S. Treasury securities, as well as mortgage-backed securities issued and guaranteed by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association.**
28. Determine the method(s) used by management to measure the expected collectibility of HTM debt securities, and consider whether management maintains appropriate supporting documentation for the assumptions and estimates used.
29. For available-for-sale (AFS) debt securities, review and assess the institution's procedures, practices, and policies regarding the identification of impairment in the investment portfolio and the ACL. Impairment is assessed at the individual security level. • **Verify whether management determines at least each reporting period whether an individual AFS debt security's decline in fair value below amortized cost has resulted from a credit loss or other factors.**

[5] For more information, refer to the FFIEC Policy Statement on Repurchase Agreements of Depository Institutions with Securities Dealers and Others.

[6] Refer to the 2020 Interagency Policy Statement on Allowances for Credit Losses.

- **Determine how management estimated the portion of the decline in fair value that was attributable to the credit loss (i.e., did management compare the present value of cash flows expected from the security with its amortized cost).**
- **Determine whether the present value calculation included management's best estimate based on past events, current conditions, and a reasonable and supportable forecast. Verify the following:**
  - **The interest rate used to discount the cash flow is the effective interest rate on the AFS debt security when it was acquired (at inception) or the current accretable yield; and**
  - **Forecasts of future cash flows, such as:**
    - **The financial and operating condition of the issuer,**
    - **Reasonableness of estimates of expected default and recovery rates,**
    - **The value and characteristics of any underlying collateral securing the AFS debt security, and**
    - **Remaining payment terms of the debt security.**
- **Determine whether the institution's credit loss estimate is limited to the amount that the fair value is less than the amortized cost on the security (i.e., the fair value floor).**

30. Determine whether management intends to sell an AFS debt security, or whether it is more likely than not management will be required to sell a security before the recovery of its amortized cost.[7]

- **If management does not intend to sell the AFS debt security, or if it is more likely than not management will not be required to sell the AFS debt security before recovery of its amortized cost basis, determine whether the estimate of credit loss is recorded through an ACL with a charge to the provision for credit losses for the credit loss component in the decline in fair value. Determine whether any non-credit component in the decline in fair value is properly recorded as a fair value adjustment in other comprehensive income net of tax.**
- **If management intends to sell the AFS debt security or if it is more likely than not that management will be required to sell the AFS debt security before recovery of its amortized cost basis, determine whether management charged off any amount that was recorded as an ACL. Determine whether any additional decline in fair value that was not charged off through the ACL was charged down to fair value through earnings.**

31. Determine whether the overall level of the ACL for HTM and AFS debt securities is appropriate and reasonable. Assess management's implementation of policies, procedures, processes, and controls to maintain an appropriate ACL on HTM and AFS debt securities.

32. Review and assess the institution's procedures, practices, and policies regarding the identification of OTTI (other than temporary impairment) in the investment portfolio.

- **Determine whether management ascertains, at least quarterly, whether a decline in an individual debt security's fair value below its amortized cost is temporary or other-than-temporary.**

[7] Refer to ASC paragraphs 326-30-55-1- through 55-2 for more information pertaining to this assessment.

- **If the current fair value of the security is lower than its amortized cost basis, verify consistency with accounting rules under ASC 320-10-35.**
- **Determine whether management's OTTI analysis addresses the following:**
  - **The length of time and the extent to which the fair value has been less than the amortized cost;**
  - **Adverse conditions specifically related to the security, industry, or geographic area;**
  - **The historical and implied volatility of the fair value of the security;**
  - **The payment structure of the debt security and the likelihood of the issuer being able to make payments that may increase in the future;**
  - **Failure of the issuer of the security to make scheduled interest or principal payments;**
  - **A significant deterioration in the earnings performance, risk profile, asset quality, or business prospects of the investee;**
  - **Significant adverse change(s) in the regulatory, economic, or technological environment of the investee;**
  - **Factors that raise material concern about the investee's financial capacity, such as negative cash flow from operations, and working capital deficiencies, non-compliance with debt covenants.**

33. Determine whether OTTI exists by considering whether the institution expects to recover the entire amortized cost basis of the security.

- **If an institution is unable to assert that it will recover its amortized cost basis, an OTTI is considered to have occurred.**
- **In assessing whether the entire amortized cost basis of the security will be recovered, an institution may compare the present value of cash flows expected to be collected from the security with the amortized cost.**
- **If the present value of cash flows expected to be collected is less than the amortized cost basis of the security, a credit loss exists and an OTTI is considered to have occurred.**

34. Determine whether management intends to sell any OTTI security or if it is more likely than not that management will be required to sell any OTTI security before recovery of its amortized costs basis. Ensure any impact to earnings is appropriately reflected.

- **If a credit loss exists, and management intends to sell the OTTI debt security, or it is more likely than not that management will be required to sell the OTTI debt security before recovery of its amortized cost basis, the difference between the security's amortized cost basis and its fair value at the balance sheet date must be recognized in earnings.**
- **If a credit loss exists, and management does not intend to sell the OTTI security and it is *not* more likely than not that management will be required to sell the OTTI debt security before recovery of its amortized cost basis less any current-period credit loss that exists, the amount of the total OTTI related to the credit loss must be recognized in earnings, but the amount of the total impairment related to other factors must be recognized in other comprehensive income, net of applicable taxes.**

35. Determine whether management uses discounted cash flow analysis to identify credit impairment.[8] Verify the following:

- **The interest rate used to discount the cash flows is the effective interest rate on the security when it was acquired (at inception) or current accretable yield; and**
- **Assumptions affecting forecasts of future cash flows, such as:**
  - **The financial and operating condition of the issuer,**
  - **Reasonableness of estimates of expected default and recovery rates,**
  - **The value and characteristics of any underlying collateral securing the debt security, and**
  - **Remaining payment terms of the security.**

36. Determine whether all equity securities are measured at fair value through net income.[9] Determine whether:

- **All equity securities are properly measured at fair value at least quarterly, unless the practical expedient for non-marketable equity securities was elected.**
- **Management elected the practical expedient approach for any non-marketable equity securities, such as bankers' bank stock. If so, determine whether management appropriately adjusts these non-marketable equity securities for impairment, if any, and for subsequent movements in an observable price change. Any price adjustment is required to be made on the date of the observable price change.**

37. Determine whether management's counterparty credit analysis is adequate for off-balance-sheet derivatives. The analysis generally includes:

- **Identification of counterparties with material credit risk,**
- **Review of counterparty compliance with collateral agreements, and**
- **Review of netting agreements for capital calculations for institutions that report risk-based capital ratios.**

38. Determine whether the process for setting credit limits for issuers and counterparties is appropriate.

39. Determine whether the process for monitoring ongoing credit risk exposure is appropriate.

[8] A credit loss exists when the present value of the cash flows expected to be collected on a debt security is less than its amortized cost.

[9] Federal Home Loan Bank and Federal Reserve Bank stock are carried at cost and not subject to this accounting treatment.

40. Determine whether concentrations of credit exist in the institution's portfolio(s).
41. Determine whether credit risk exposure is significant relative to earnings, capital, and risk limits.
Note: Market, liquidity, and legal risk in the securities and derivatives portfolios also may be addressed by other examination team members with those findings documented in other ED Modules. If that is the case, coordinate the completion of the Market, Liquidity, and Legal Risk sections below with the appropriate examination team members.
MARKET RISK
42. Assess current appreciation or depreciation relative to earnings, capital, and risk limits.
43. Determine whether market risks are significant relative to earnings, capital, and risk limits. Consult with the examiner in charge of market risk.
44. Determine whether the market risk measurement system properly identifies and measures material risks. Appropriate systems generally: • **Identify and measure the price sensitivity of high duration, structured, or otherwise complex securities, including those with embedded options;** • **Incorporate stress testing with interest rate shocks large enough to measure realistic potential market movements and risk;** • **Adjust changes in instruments' prices when interest rate movements exceed 100 basis points, to account for the effect of convexity; and** • **Subject instruments that may be exposed to risk from changes in the shape of the yield curve (e.g., dual index bonds) to nonparallel interest rate shocks.**
45. Determine whether management has assessed the effectiveness of any risk reduction strategies implemented by management (e.g. hedging).
LIQUIDITY RISK
46. Determine whether the cash flows from periodic payments and maturing securities are consistent with liquidity objectives and projections.

47. Determine whether liquidity risk from investment activities is significant relative to earnings, capital, and risk limits.

48. Determine whether the pricing process provides timely, accurate, and objective data by:

- **Confirming that management periodically obtains pricing information from an independent source,**
- **Assessing whether management consistently applies an approach to pricing illiquid or complex instruments, and**
- **Verifying whether management obtains valuation estimates for illiquid or complex securities from more than one source.**

49. Determine whether management periodically reviews the assumptions used to calculate fair values for instruments that do not have readily observable market prices.

50. For off-balance-sheet derivatives, determine whether management assesses market factors, such as the number of market makers, transaction volumes, and contract liquidity before engaging in such derivative transactions.

51. Determine whether the volume of pledged securities, depreciated securities, or securities with limited marketability affect the institution's overall financial condition.

52. Determine the adequacy of the process for valuing derivatives positions.

LEGAL RISK

53. For off-balance-sheet derivatives, determine whether management properly documents the transactions through contracts and appropriate legal staff assesses the enforceability of those contracts.

Securities and Derivatives Classifications

54. Determine whether the investment portfolio contains any non-investment grade assets. Classify these assets as appropriate. Refer to the Uniform Agreement on the Classification and Appraisal of Securities Held by Financial Institutions (Financial Institution Letter 51-2013, and SR Letter 13-18).
55. Determine whether management has invested in any instrument that is highly sensitive to changing interest rates or is subject to high prepayment risk and may not return the institution's initial principal investment (e.g., interest only stripped MBS and principal-linked structured notes). Classify these instruments as appropriate.
56. Determine whether there are any material accounting errors in the financial statements that warrant adverse classification.
57. Estimate the potential loss for all derivative contracts for which counterparty performance is not sufficiently assured.
Board and Senior Management Oversight
GENERAL
58. Assess management's compliance with policies and risk limits established by the board.
59. Determine whether board reports appropriately identify and measure risk exposure and performance resulting from the securities and derivatives portfolio(s). Generally, effective board reports: • **Summarize all investment activity,** • **Describe investment portfolio risks and returns,** • **Indicate management's compliance with the investment policy and all risk limits,** • **List exceptions to internal policy,** • **Identify and describe instances of noncompliance with regulatory requirements, and** • **Discuss the effectiveness of derivatives used by management as part of a strategy to modify market risk.**
60. Determine whether board meeting minutes and relevant committee meeting minutes indicate appropriate oversight of securities and derivatives activities.

61. Through discussions with management, determine whether management has sufficient experience and expertise to understand, measure, monitor, and control risks in the investment portfolio and how those risks fit within the overall business strategy. When applicable, assess management's

- **Understanding of tranche structures and performance triggers related to any structured securities in the institution's portfolio,**
- **Monitoring of the performance of the underlying collateral, and**
- **Understanding of the impact that collateral deterioration may have on the security's performance.**

62. Determine whether current and planned investment strategies are consistent with the institution's strategic plan.

63. Determine whether the board or senior management has established an agreement delegating some aspects of the investment process to a third party.[10] Prior to establishing such an agreement, management should conduct appropriate due diligence and evaluate the third party's reputation, performance, creditworthiness, and compliance record. If such an agreement exists, determine whether it addresses the following items:

- **Compensation,**
- **Approved broker-dealers,**
- **Investment goals,**
- **Approved activities and investments,**
- **Risk limits,**
- **Risk and performance measurements,**
- **Reporting requirements,**
- **Settlement practices, and**
- **Independent reviews.**

COMPLIANCE WITH LAWS AND ACCOUNTING STANDARDS

64. Determine whether management adheres to U.S. GAAP. Some issues that may merit particular attention include interest accruals, principal amortization, premium amortization, and discount accretion.

- **Consider sampling trade tickets to validate purchase and sale price accuracy.**
- **Consider sampling interest accrual calculations or audits to validate accuracy of those calculations.**
- **Consider sampling premium amortization and discount accretion transactions.**
- **Review any procedures for making periodic adjustments for amortizing investments to assess appropriateness.**

[10] Management should not delegate complete investment authority to a third party and is expected to provide adequate oversight over aspects it does delegate.

65. Determine whether management complies with applicable laws and regulations, which may include the following: • **Various parts of title 12 of the Code of Federal Regulations (e.g., 12 CFR 1, 160, 351);** • **Government Securities Act of 1986 (in the Miscellaneous Statutes and Regulations), and related regulations issued by the U.S. Department of Treasury, which address requirements related to financial responsibility, protection of customer securities and balances, and recordkeeping and reporting of brokers and dealers in government securities; and** • **State laws and regulations.**
66. Determine whether management has implemented accounting principles regarding securities appropriately. Consider the following: • **Uniform Agreement on the Classification and Appraisal of Securities Held by Financial Institutions (Financial Institution Letter 51-2013 and SR Letter 13-18); and** • **FFIEC Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (Financial Institutions Letter 45-98 and SR Letter 98-12).**
End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

CAPITAL ADEQUACY

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?

E.1. **Has management taken sufficient action to address capital deficiencies?** ***Refer to Expanded Analysis Procedures #1-18.***

E.2. **Are capital deficiencies immaterial to the bank's condition?** ***Refer to Expanded Analysis Procedures #1-18.*** **If capital ratios are below regulatory minimums, proceed to *Impact Analysis*.**

CAPITAL ADEQUACY
Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible procedures specified for the Core Analysis also apply to the Expanded Analysis.

Policies and Procedures

1. Determine why exceptions to internal policies or regulatory capital requirements exist. Consider whether management:

- **Overlooked issues,**
- **Is unfamiliar with or disregarded regulatory requirements, or**
- **Is unfamiliar with or disregarded established internal policies.**

2. Determine whether management commits to and supports the adoption of appropriate controls and monitoring practices that will ensure that internal policy and procedure guidelines will be followed in the future. Determine whether proposed controls, if any, are reasonable.

3. Evaluate management's response to examiner and auditor recommendations.

Internal Controls

4. Review general ledger transactions since the prior examination. Obtain or prepare a detailed capital reconciliation and scrutinize entries for appropriateness.

5. Review procedures regarding stock certificates to assess the following controls:

- **Unissued stock certificates are under dual control, and**
- **Redeemed stock certificates are properly controlled and canceled.**

Audit or Independent Review

6. Research all inadequacies cited in audit or independent reviews to determine the underlying cause(s).

7. Evaluate the materiality of any deficiencies disclosed in the audit or independent reviews.

Information and Communication Systems

8. Research the inaccuracies or inadequacies in reporting systems to determine underlying cause.

9. Evaluate the appropriateness of reports distributed to management and the board.

10. Determine whether any of the inaccuracies cited above compromise management's planning efforts or negatively affect the overall effectiveness of implementing strategic initiatives.

11. Consider the implications of employee stock ownership plans (ESOPs) and associated accounting procedures. Refer to the Consolidated Reports of Condition Instructions. (FDIC: Refer to Advisory Opinions 81-15, 84-22, 90-18, 91-33, and 93-75.)

Earnings Considerations

12. If there is significant uncertainty whether the bank's future performance will be satisfactory, estimate future capital levels under applicable and to-be-phased-in regulatory capital rules using information collected during the examination and discussions with management (such as, additional provision expenses, estimated impairment losses related to goodwill or core deposit intangibles, fees paid to the parent company, and non-recurring items).

13. Determine whether there is undue pressure to pay dividends. Items to consider include:

- **The holding company's financial condition and contractual obligations,**
- **The financial condition of affiliates,**
- **Stockholder or market pressure, and**
- **Capital distribution and bonus limitations under the capital conservation buffer (effective phase-in starting January 1, 2016).**

Risk Profile Considerations

14. Validate the following calculations if reported compliance with risk-based capital minimums is marginal: • **Risk-weighted assets, and** • **Capital ratios.**
15. If high levels of off-balance sheet activities exist, review supporting documentation and determine whether management properly monitors these exposures. (Note: Monitoring of concentrations should include contingent liabilities.)
16. Assess the adequacy of blanket bond insurance.
17. Review lawsuits (legal opinions or other documentation) that involve the bank or management (focus primarily on cases involving insiders or significant dollar amounts).
18. If capital exposure is significant, assess the board and management's capacity to mitigate or remediate the exposure in the near term (such as raising additional capital, selling assets, restructuring the balance sheet, etc.). Prospective capital raises should conform to the criteria mandated in the capital rules. ***Note: The rules are codified at Title 12 of the Code of Federal Regulations (CFR) for the FRB in Part 217 and codified at Title 12 of the CFR for the FDIC in Part 324.***
End of Expanded Analysis. If needed, Continue to Impact Analysis.

CAPITAL ADEQUACY

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Assess the impact current capital levels may have on the future viability of the bank. • **Assess management's ability to reverse deteriorating trends and augment capital through earnings.** • **Assess the bank's ability to raise capital from existing shareholders, by issuing new capital instruments, or accessing alternative sources of capital.** • **If the capital level and trend raise going-concern issues, estimate time to reach insolvency as well as time to reach the 2 percent of Tangible Equity to Total Assets.**
2. Determine the need for administrative or enforcement actions, formulate specific recommendations, and discuss concerns with appropriate regulatory supervisors.
3. After discussing concerns with appropriate regulatory supervisors, discuss potential regulatory responses with management and the board. Topics of discussion may include: • **Formal or informal enforcement actions or capital directives;** • **The submission of a capital restoration plan (for banks with less than the minimum leverage capital requirement);** • **Written agreements to increase capital to acceptable levels (for banks with less than a 2 percent of Tier 1 Tangible Equity to Total Assets ratio as of January 1, 2015; and** • **Other requirements or restrictions under PCA guidelines (for banks that are undercapitalized, significantly undercapitalized, or critically undercapitalized).**
End of Impact Analysis.

EARNINGS

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

E.1.	**Are management and control of earnings functions satisfactory?** ***Refer to Expanded Analysis Procedures #1-28.***
E.2.	**Are earnings deficiencies or fluctuations immaterial?** ***Refer to Expanded Analysis Procedures #1-28.***

EARNINGS

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible guidelines specified for the Core Analysis also apply to the Expanded Analysis.

Profit Planning and Budgeting Practices

1. **Assess the significance and determine causes of budgeting deficiencies. Address areas that do not appear realistic in the examination report.**

2. **When appropriate, consider requesting that management revise budget projections using modified assumptions. Revisions to the budget should be presented to the board for approval.**

Internal Controls

3. **Determine the causes of inadequate accounting or reporting practices and evaluate the implications to earnings performance and as appropriate, stock price, and pending or needed capital raises.**

4. **Verify source documents against general ledger entries to determine whether errors on Consolidated Reports of Condition and Income (Call Reports) influence performance ratio levels and trends.**

5. **Consider transaction testing to verify the authorization, propriety, and accuracy of reviewed activity if internal controls are deemed insufficient.**

Audit or Independent Review

6. **Review audit or independent review workpapers and consider expanding examination activities in the areas of concern.**

7. **Research deficiencies cited in audit or independent review reports to determine the underlying causes and assess management's corrective efforts.**

Information and Communication Systems

8. Assess the significance of internal management reporting deficiencies and determine underlying causes.

9. Determine needed changes in report distribution throughout the organization.

10. Consider performing a detailed review of the Call Report where significant errors are indicated. Request that filings be amended where identified errors are material, and revise Report of Examination data where necessary.

Ratio and Trend Analysis

11. Determine the underlying reasons for a low or erratic return on average assets and discuss management's plans to improve or stabilize earnings performance.

12. Determine the extent a low or inconsistent net interest margin results from composition and yields of the loan and investment portfolios versus composition and costs of funding sources.

13. Where earnings concerns derive from interest income levels, identify the underlying cause(s). Potential reasons for low interest income levels may be:

- **The level and trend of nonaccrual loans and other nonearning assets,**
- **Ineffective asset pricing strategies,**
- **Investment decisions,**
- **Asset repricing structure and excessive interest rate risk exposure,**
- **Asset distribution,**
- **Changes in asset mix, and**
- **Competition.**

14. If interest income levels are fluctuating significantly, review IRRSA (FDIC), FOCUS (FRB), or other interest rate reports for possible interest rate risk exposure. Coordinate with examiners reviewing sensitivity to market risk.

15. Where earnings concerns derive from interest expense levels, determine the underlying causes, such as:

- **Use of high-cost borrowings;**
- **Concentration of high-cost deposits;**
- **Liability repricing structure and excessive interest rate risk exposure;**
- **Migration of core deposits to higher rate products;**
- **Ineffective funding strategies;**
- **Competition; and**
- **Low levels of core deposits.**

16. When earnings concerns derive from non-interest expenses, determine the underlying causes. Examples include:

- **Excessive personnel expenses, including unreasonable incentive compensation plans relative to the bank's business model, risk profile, complexity, and earnings performance;**
- **Unusually high personnel benefits;**
- **Inaccurate reporting of employee benefits;**
- **Inadequate authorization by the board of directors of all material employee benefits;**
- **Inefficient staffing levels relative to the organization's business lines and risk profile;**
- **Over-reduction of personnel (downsizing) and occupancy expense that negatively affect management's ability to prudently conduct and supervise banking activities;**
- **Unusually high expenses for premises and fixed assets (depreciation/amortization, property insurance, real estate taxes, etc.); and**
- **Abnormal impact of write-downs of intangible assets.**

17. Assess fixed asset investments and lease payments, paying particular attention to any insider or intercompany transactions (e.g., purchase of bank vehicles from a director's auto dealership, leasing office space to or from the parent company).

18. Review service fees paid to affiliated parties and others to ensure compliance with applicable laws or regulations. Review and assess service agreements or intercompany transaction agreements and compliance therewith.

19. Review legal expenses and identify underlying causes of increased legal charges. Discuss with the responsible examiner the bank's inherent level of litigation risk, adequacy of litigation risk management practices, and composite risk level and trend. Consider the following situations, which can elevate legal expenses:

- **Administration and disposal of problem assets;**

- **Involvement in significant litigation; and**
- **Significant changes in the bank's strategic objectives (purchases or mergers).**

20. Review the sources or activities generating significant volumes of non-interest income and determine whether the current volume is sustainable (e.g., insurance activities or mortgage banking programs).

21. Determine management's rationale or motivation for increased reliance on non-interest income. Consider the strategic decisions that support an increased level of non-interest income (such as new service or business ventures) and whether management prudently researched the risks and rewards of such initiative(s).

22. If there are asset quality concerns, analyze (or discuss with examiners reviewing asset quality) the potential impact to operating profitability from:

- **Increasing levels of nonperforming assets;**
- **Escalating administrative, legal, and collection expenses; and**
- **Increasing provisions for loan losses or inadequate reserves.**

23. Determine whether gains from asset sales result from strategic asset restructurings or a short-term response to improve earnings. If the latter, assess the sustainability of this income source and evaluate the potential, long-term affects to core earnings.

24. Review erratic or unusually large tax levels to determine the underlying reason. High or fluctuating tax liabilities may be indicative of:

- **Inaccurate financial reporting;**
- **Inaccurate accounting for applicable taxes;**
- **Poor tax planning; and/or**
- **A change in tax basis.**

25. Verify internal tax calculations, assess the timing of required interim payments, and review compliance with intercompany tax-sharing agreements and applicable laws or regulations.

Board and Senior Management Supervision
26. Where applicable, determine why previously identified deficiencies remain uncorrected.
27. Determine the reasons for poor compliance with internal policy guidelines, governing accounting standards, applicable regulations, or formal/informal enforcement actions.
28. Identify needed corrective actions and assess the adequacy and viability of management's commitments.
End of Expanded Analysis. If needed, Continue to Impact Analysis.

EARNINGS

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Analyze the impact of earnings deficiencies on the bank's overall condition. Estimate future earnings levels and calculate the impact on capital levels and access to liquidity sources if these performance issues continue.
2. Determine the need for administrative or enforcement actions, formulate specific recommendations, and advise the appropriate supervisory officials on the nature of the concerns.
3. Discuss the possibility of administrative or enforcement actions with senior management and the board of directors.
End of Impact Analysis.

LIQUIDITY

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

E.1. Are deficiencies immaterial to management's supervision of liquidity? ***Refer to Expanded Analysis Procedures #1-16.***

E.2. Are liquidity deficiencies immaterial to the bank's financial condition? ***Refer to Expanded Analysis Procedures #1-16.***

LIQUIDITY
Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible guidelines specified for the Core Analysis also apply to the Expanded Analysis.

Policies, Procedures, and Risk Limits

1. **Investigate why the bank's policies and procedures are deficient based on the Core Analysis. Discuss the deficiencies with management. Consider whether management:**
   - **Overlooked issues;**
   - **Is unfamiliar with prudent liquidity guidelines and procedures; or**
   - **Has not been responsive to prior recommendations to create or enhance policies and procedures.**

2. **If management is deficient in following the bank's policies and procedures, determine the reasons. Possible reasons include:**
   - **Lack of awareness of policies;**
   - **Disregard for established policies;**
   - **Misunderstanding of policy guidelines; and**
   - **Poor internal communication of revisions to policies and procedures.**

3. **Determine whether management commits to and supports proper controls and monitoring to ensure the bank's policy guidelines are followed in the future. Determine whether proposed controls and implementation periods are reasonable.**

Information and Communication Systems

4. **Determine the validity of internal liquidity reports and ratios by verifying the amounts to the bank's general or subsidiary ledgers, budgets, projections, or other records.**

5. **Assess the scope and frequency of internal reports for measuring and monitoring liquidity. Reportable items may include, but are not limited to:**
   - **Cash flow gaps,**
   - **Asset and funding concentrations,**
   - **Critical assumptions used in cash flow projections,**
   - **Key early warning or risk indicators,**
   - **Funding availability,**

- **Status of contingent funding sources,**
- **Available collateral, and**
- **Management of collateral usage.**

6. If management is not properly monitoring the bank's liquidity position, identify weaknesses and formulate recommendations to correct deficiencies. Prudent liquidity management techniques may include:

- **Monitoring and managing seasonal and cyclical factors that may cause loan and deposit levels to move in opposite directions. Failure to monitor these factors may cause insufficient liquidity to meet loan demand or deposit withdrawals;**
- **Monitoring intraday liquidity and applicable collateral requirements especially for institutions with material settlement and clearing activities;**
- **Monitoring daily cash letters and long-term liquidity needs through appropriate forecasting;**
- **Monitoring changes in economic conditions;**
- **Planning for contingencies including identifying minimum and maximum liquidity needs and weighing alternative courses of action;**
- **Monitoring the price and availability of credit and the level of liquid assets available to meet funding requirements; and**
- **Monitoring the incremental cost of liquidity, whether gained through asset management, liability management, or a combination of both.**

Analysis of Funding Sources and Uses

7. Consider completing a cash flow projection if liquidity requirements are significant.

- **Determine whether cash needs are likely to exceed available funding sources, and**
- **Determine how management plans to meet significant liquidity demands.**

8. If specific deposit rates are significantly above market rates, determine whether the bank is soliciting brokered deposits or experiencing pricing pressures from competitors.

- **Review internally prepared rate sheets, reflecting the bank's and competitors' rates, if available.**
- **Review interest rates for area banks.**
- **Verify compliance with interest rate restrictions that apply to less than well capitalized banks.**

9. If the Core Analysis indicates the bank relies on concentrations in unstable funding sources for growing a program and leveraging capital, perform an in-depth analysis of the sources to determine the extent of reliance; if excessive, assess management's plan to stabilize or reduce risk exposure. As needed:

- **Determine whether management understands its strategy;**

- **Perform migration analysis using internally prepared deposit schedules, the Uniform Bank Performance Reports, or Interest Rate Risk Standard Analysis (IRRSA) (FDIC). Determine whether certain deposit accounts are experiencing declines, the reasons for the declines, and the potential liquidity risk;** - **Compare deposit volumes with rate histories to see whether a significant correlation exists and how future events may impact these rates and volumes;** - **Review deposit accounts for any significant out-of-area deposits. Determine whether these deposits are stable funding sources or the customers are chasing attractive rates; and** - **Review insider deposit relationships.**
10. Determine whether the bank has securities that may be used for sale under agreements to repurchase and whether repurchase arrangements exist.
11. Determine whether the bank has adequate documentation to support lines of credit from other financial institutions.
12. Determine whether contingency funding plans, including funding commitments from other financial institutions, are periodically tested.
13. Determine whether credit lines contain material adverse change clauses that would preclude their use in problem situations.
14. Assess management's process for identifying, monitoring, and controlling risks associated with wholesale and rate-sensitive funding. When appropriate, assess management's plan to stabilize or reduce liquidity risks associated with complex or rate-sensitive funding.
15. For less than well-capitalized banks, assess management's plan to comply with Brokered Deposit and Interest Rate Restrictions in Section 29 of the Federal Deposit Insurance Act as implemented by Section 337.6 of the FDIC Rules and Regulations. **FDIC: Refer to FIL-42-2016 FAQ on Identifying, Accepting, and Reporting Brokered Deposits; and the Brokered and High-Rate Deposits ED Module.**

16. Determine whether appropriate stress testing was completed either internally or by a third party. Appropriate stress testing generally: • **Is completed prior to obtaining wholesale or rate sensitive funding;** • **Covers a reasonable range of contractual triggers and external events;** • **Includes the potential impact of these events on individual wholesale funding sources, the assets funded, and on the overall liquidity of the institution; and,** • **Provides for full disclosure to management regarding the risks associated with the wholesale funding.**
End of Expanded Analysis. If needed, Continue to Impact Analysis.

LIQUIDITY

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. For deficiencies identified in the Core and Expanded Analysis, measure the effect on the bank's financial condition.
2. Determine how management plans to meet daily cash needs if liquidity is severely strained.
3. Assess whether the bank can continue to operate profitably. Assess whether severe liquidity problems will impair growth objectives, profits, and the bank's reputation to a point where the bank's future viability is questionable.
4. Determine the need for administrative and enforcement actions, formulate specific recommendations, and advise appropriate supervisors on the nature of the concerns.
5. Discuss the possibility of administrative and enforcement actions with appropriate supervisory officials, executive management, and the board of directors.
End of Impact Analysis.

LOAN OPERATIONS REVIEW

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?

E.1. Are deficiencies immaterial to the supervision of the lending function? ***Refer to Expanded Analysis Procedures #1-47.***

E.2. Are deficiencies immaterial to the bank's condition? ***Refer to Expanded Analysis Procedures #1-47.***

LOAN OPERATIONS REVIEW

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible procedures specified for the Core Analysis also apply to the Expanded Analysis.

Policy Considerations

1. **Investigate why the lending and loan review policy or procedure deficiencies identified in the Core Analysis exist. Discuss with management its response to examiner recommendations. Possible reasons for policy deficiencies may include the following:**
   - **Management overlooked these issues,**
   - **Management is unfamiliar with prudent loan and loan-review guidelines and procedures, or**
   - **Management is unwilling to create or enhance policies and procedures.**

2. **If poor compliance with policies and procedures exist, determine the reasons. Possible reasons are detailed below:**
   - **Poor internal communication of policy and procedures or subsequent revisions,**
   - **Lack of awareness of policy existence,**
   - **Disregard for established policies, and**
   - **Misunderstanding of policy or procedures.**

3. **Determine whether management commits to and supports proper controls and monitoring to ensure policy and procedures are followed in the future. Determine whether proposed controls, if any, are reasonable.**

Internal Controls

4. **Determine the underlying cause of internal control deficiencies identified within the Core Analysis section.**

5. **If internal loan reconcilements are inadequate, perform loan account reconcilements.**

6. **Determine whether management gives proper attention to out-of-balance conditions regardless of the amount.**

7. Evaluate the ability of loan records to provide satisfactory audit trails that allow for the tracing of transactions from initiation to disposition.

8. Consider tracing loan proceeds for a sample of loans including large and unusual credits and ascertain the adequacy of the disbursement controls.

9. Determine whether loan terms and other information on new loans are checked for accuracy and verified against loan trial reports.

10. Determine that two employees are required to effect a status change in a customer account record.

11. Determine whether source documents supporting loan modifications are supported by proper authorizations.

12. Determine whether supervisory overrides or approvals are required to perform the following, or similar, functions:

- **Processing payments on loans and leases in the process of foreclosure or other legal action, and**
- **Waiving late charges or other penalties.**

13. Determine whether loan officers are prohibited from processing loan payments.

14. Determine whether the employees who receive or release collateral to borrowers are different from those who post related entries to the collateral register and general ledger. In addition, determine whether appropriate records are maintained.

15. Determine whether collateral receipts exist and identify each item retained by the bank.

16. **Determine whether negotiable collateral is under dual control.**

17. **Determine whether discount, interest, commission, and fee computations are compared or tested to initial records by employees who cannot originate entries.**

18. **Determine the extent of collateral attachment problems.**

19. **Determine whether the financial institution is identified as a loss payee on the collateral insurance coverages.**

20. **Determine whether tickler systems for insurance, taxes, and collateral filings are adequate.**

21. **Determine whether officers and employees are strictly prohibited from holding blank signed notes in anticipation of future borrowings.**

22. **Determine whether paid notes are canceled and promptly returned to customers.**

23. **Determine whether charged-off notes are adequately segregated, controlled, and verified.**

24. **Determine whether loan charge-offs are approved and reported to the board or appropriate committee.**

25. **Determine whether the record of charged-off loans is maintained by a person other than the one who has custody of the notes or receives payments.**

26. Determine whether subsidiary payment records and files for serviced loans are adequately segregated and identifiable.

27. Review situations where loans are purchased and sold between institutions and evaluate the appropriateness of reciprocal arrangements.

Audit or Independent Review

28. Research the inaccuracies or inadequacies cited in audit or independent review findings to determine the underlying cause.

Information and Communication Systems

29. Research the inaccuracies or inadequacies in the loan reporting systems to determine the underlying cause.

30. Determine the appropriate distribution of reports to operating management.

31. Determine whether any of the inaccuracies cited above compromise executive management's planning efforts and negatively impact the overall effectiveness of implementing strategic initiatives.

Credit Administration

32. If credits are funded that exceed established lending limits, determine why approval procedures were not followed.

33. Assess management’s plan for addressing staffing weaknesses.

34. Determine why collection and workout procedures are ineffective. Reasons for ineffective workout strategies and resolution of problem loans may include the following:

- **Inadequate or slow recognition of problem loans,**
- **Insufficient or inexperienced workout staff, and**
- **Management's reluctance to address problem loans and implement corrective action.**

Managerial Effectiveness

35. Determine the cause of any violations or non-compliance with internal policies and identify the responsible party or parties. Consider the following items:

- **Lack of familiarity with laws or regulations,**
- **Negligence,**
- **Misinterpretation, and**
- **Willful disregard or noncompliance.**

36. Determine why management has not addressed and corrected deficiencies cited by internal/external auditors, loan reviewers, and regulatory agencies.

End of Expanded Analysis.

LOAN OPERATIONS REVIEW

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Determine the impact of noted deficiencies on the institution's capital, earnings, and liquidity, and assess the future impact on the institution if these deficiencies continue.
2. Determine the impact of identified weaknesses in risk management practices on the institution's overall condition.
3. Determine the need for direct confirmation of loan accounts.
4. Determine the need for administrative and enforcement actions, formulate specific recommendations, and advise appropriate supervisors on the nature of the concerns. (FDIC: field office supervisor, regional office.)
5. Discuss the possibility of administrative and enforcement actions with executive management and the board of directors–after consultation with appropriate field and/or regional office personnel.
6. Evaluate the circumstances and facts surrounding risk management deficiencies and apparent violations. Consider potential recommendations for administrative actions, Civil Monetary Penalties, Suspicious Activity Reports, and law enforcement referrals as needed. (FDIC: Section 8 removal action; FRB: administrative hearing.)
End of Impact Analysis.

LOAN PORTFOLIO REVIEW

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?

E.1. Are deficiencies immaterial to the supervision of the lending function? ***Refer to Expanded Analysis Procedures #1-20.***

E.2. Are deficiencies immaterial to the bank's condition? ***Refer to Expanded Analysis Procedures #1-20.***

LOAN PORTFOLIO REVIEW

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible procedures specified for the Core Analysis also apply to the Expanded Analysis.

Identifying, Monitoring, and Reserving for Credit Risk

LOAN REVIEW

1. Evaluate the inadequacies in the loan review process to determine the underlying cause.

2. Expand loan sampling in order to gain a better understanding of the credit risk within the loan portfolio.

ALLOWANCE FOR LOAN AND LEASE LOSSES (ALLL) (or allowance for credit losses (ACL),[1] when applicable

When the overall ALLL (or ACL, when applicable) appears deficient, bank management should be directed to address the appropriateness of its ALLL (or ACL, when applicable) estimate and to provide additional allowances as necessary for estimated credit losses identified in the examination process that have not been included, or have not been fully included, in management's original ALLL (or ACL, when applicable) estimate.

Examiners should determine whether the bank's methodology could be utilized with adjustments to arrive at a reasonable and reliable estimate for additional needed provisions. If the bank's methodology can be utilized, examiners should direct bank management to make appropriate adjustments and use the most relevant information sources available to develop a reasonable estimate of the deficiency in the bank's ALLL (or ACL, when applicable). The information sources used should include examination loan review findings and publicly available data on real estate or other collateral values in the bank's lending area.

In the rare event, that the bank's methodology cannot be utilized even with adjustments (substantially inadequate loan review, material weakness in credit administration etc.) examiners should estimate the ALLL (or ACL, when applicable) deficiency in the absence of more relevant data. The selection and use of financial ratios or statistical models (utilizing bank-specific historical loss data) should be supported by sufficient analysis to demonstrate objective support for a short-term range of proxy estimates. However, such estimates based on industry or peer group information should only be used as a short-term proxy and cannot be accepted as a substitute for an effective ALLL (or ACL, when applicable) methodology. Bank management should be directed to correct deficiencies in their methodology as soon as possible.

Consider the following items in this section to determine an appropriate ALLL (or ACL, when applicable) level.

[1] **ACL replaces the term ALLL for those banks that adopted ASU 2016-13.**

3. **Determine if the ALLL (or ACL, when applicable) is sufficient to cover estimated credit losses on:**
   - **Loans classified Loss (in whole or in part) that have not yet been charged-off;**
   - **Loans classified Doubtful (without partial Loss classification);**
   - **All remaining adversely classified loans (without partial Loss or Doubtful classifications, either individually, if impaired under ASC Topic 310, or in groups);**
   - **Other problem loans (either individually, if impaired under ASC Topic 310, or in groups); and**
   - **Remaining categories of loans segmented into groups with similar risk characteristics.**

4. **Consider the bank's loan loss history in aggregate and by loan type.**
   - **Calculate the average loan loss history, generally for the past five years, using net loan chargeoffs to average total loans. Such data should available in year-end UBPRs.**
   - **Evaluate any aberrations in a specific year, and make adjustments as needed for current conditions to arrive at a realistic average that reflects loss expectations similar to current conditions.**
   - **Consider migration analysis.**

5. **Consider the most recent, average reserve coverage of nonperforming loans by state, rating, and charter.**

   Note: Care should be exercised when considering reserve coverage because these ratios compare banks' ALLLs (or ACL, when applicable) to the amount of these loans, but the ALLL (or ACL, when applicable) should cover the estimated credit losses on the nonperforming loans, which is an estimate of the net chargeoffs likely to be realized on the loans. Particularly for nonperforming loans that are collateralized, net chargeoffs are not likely to equal the entire amount of these loans.

6. **Consider the historical average of loan loss reserves to nonperforming loans for all banks within the region and the nation. (Reminder: Reserve coverage of nonperforming loans is typically higher at banks with sound loan portfolios. FDIC: Refer to the FDIC Quarterly Banking Profile.)**

7. **Consider the following factors to determine appropriate adjustments to the bank's average loss experience by loan type for nonclassified loans:**
   - **Degree of board or committee involvement, oversight, and control;**
   - **Expertise, training, and adequacy of loan staff;**
   - **Adequacy of and adherence to the bank's loan policy;**
   - **Effectiveness of collection procedures;**
   - **Adequacy of renewal and extension policies;**
   - **Adequacy of charge-off policies;**
   - **Effectiveness of internal loan review function;**
   - **Adequacy of appraisal procedures;**

- **Maintenance and analysis of financial information;**
- **Adequacy of documentation (other than financial information);**
- **Capitalization of interest;**
- **Over reliance on collateral values;**
- **Composition of the loan portfolio;** ***(Note: It may be appropriate to use different percentages for consumer, residential and commercial real estate, and commercial loans.)***
- **Existence of self-dealing and insider transactions;**
- **Level of classified loans and trend over past few examinations;**
- **Level and trend of internally identified loan problems;**
- **Level and trend of overdue and nonaccrual loans;**
- **General economic considerations (local, state, regional, national);**
- **Growth trends;**
- **Entry into new areas of lending;**
- **Extent of out-of-territory lending; and**
- **Adequacy of follow-up systems.**

(Note: If the bank uses a formula approach that includes both historical loss experience and adjustments for qualitative or environmental factors to determine an appropriate level for the ALLL (or ACL, when applicable), it may be feasible to use the internal formula in arriving at the estimated credit losses for these loans even though the overall system may be considered inadequate.)

Portfolio Quality

8. Determine the reasons for the current level of asset quality problems.

- **Evaluate the impact of local economic conditions on the loan portfolio.**
- **Determine if there are sectors of risk within the portfolio by either type of or concentrations of risk.**
- **Evaluate the impact of ineffective underwriting in new product areas on the level and severity of classifications or delinquencies.**
- **Determine that individual account officers as well as lending committees have appropriate lending authorities.**
- **Evaluate delinquency levels by individual account officers.**
- **Evaluate individual loan officers' experience levels and expertise.**

9. Based on the results of the above analysis, consider expanding the sample of loans (including off-balance sheet activities).

Managerial Effectiveness

APPLICABLE LAWS AND REGULATIONS

10. Determine the cause of any violations and identify responsible parties. Consider the following items:

- **Lack of familiarity with laws or regulations,**
- **Negligence,**
- **Misinterpretation, and**
- **Willful disregard or noncompliance.**

CREDIT ADMINISTRATION

11. Determine why collateral appraisals are not sufficient to support current loan advances.

12. Determine why management did not correct identified deficiencies. Consider whether:

- **Management overlooked issues,**
- **Management is unfamiliar with prudent loan portfolio practices and procedures, and**
- **Management is unwilling or unable to react to changing conditions.**

13. Determine why loan losses are not recognized in a timely manner. Reasons for not recognizing losses in a timely manner may include the following:

- **Inadequate identification or reporting of problem loans,**
- **Loss deferral motivated by earnings performance and bonus compensation, and**
- **Loss deferral motivated by poor financial condition.**

Other Loan Related Topics

OTHER REAL ESTATE (ORE)

14. Determine if management's non-compliance with regulations or accounting pronouncements are due to oversight, lack of requisite knowledge or experience, or a general disregard.

15. Compare expenses and income information contained in appraisals with the actual income and expenses of related income producing properties. Recalculate appraisal results using realistic assumptions, if necessary.

16. Investigate the deficiencies identified in managing foreclosed real estate.

17. Expand file sampling as necessary to accurately determine the quality of ORE. Where appropriate, consider conducting on-site inspections to assist in valuation and classification.
REPOSSESSION
18. Investigate the deficiencies identified in managing repossessed assets.
19. Expand file sampling as necessary to accurately determine the quality of repossessed assets. Where appropriate, consider physical inspections of the repossessed assets to assist in valuation and classification.
NON-LEDGER ASSETS
20. Determine the underlying reasons for asset write-offs.
End of Expanded Analysis. If needed, Continue to Impact Analysis.

LOAN PORTFOLIO MANAGEMENT AND REVIEW: GENERAL

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Determine the impact of noted deficiencies on the institution's capital, earnings, and liquidity, and assess the future impact on the institution if these deficiencies continue.
2. Assess the overall effectiveness of risk management practices in light of the identified deficiencies.
3. Determine the impact of an inadequate ALLL (or ACL, when applicable) on the bank's earnings and capital.
4. Determine the need for direct confirmation of loan accounts.
5. If administrative or enforcement actions appear necessary, form specific recommendations and discuss concerns with appropriate supervisors. (FDIC: field office supervisor, regional office.)
6. If approved by appropriate supervisors, discuss the possibility of administrative and enforcement actions with executive management and the board of directors.
7. Investigate the circumstances and facts surrounding apparent violations. When necessary, prepare recommendations for appropriate actions
End of Impact Analysis.

MANAGEMENT AND INTERNAL CONTROL EVALUATION

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?

E.1. **Are management deficiencies or concerns immaterial?** ***Refer to Expanded Analysis Procedures #1-5.***

E.2. **Does management have the ability and commitment to implement corrective measures to effectively address deficiencies or concerns?** ***Refer to Expanded Analysis Procedures #1-5.***

MANAGEMENT AND INTERNAL CONTROL EVALUATION

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible procedures specified for the Core Analysis also apply to the Expanded Analysis.

Expanded Analysis Procedures
1. Based on the volume and severity of weaknesses, consider citing, apparent violations or contraventions, as appropriate, listed under the Interagency Guidelines Establishing Standards for Safety and Soundness, FDIC: Part 364 Appendix A, or FRB: Appendix D, of Regulation H.
2. Determine the significance of insider abuses identified in other modules.
3. Determine the root cause of examination concerns with management or board oversight. Consider issues such as: • **Compliance with internal policies and applicable laws and regulations;** • **Inconsistencies with general safety and soundness tenets;** • **Adequacy of risk management practices, overall monitoring, management information systems, reporting processes, and audit programs;** • **Responsiveness to recommendations from auditors and supervisory authorities;** • **Rapid growth, and stressed or changing business conditions;** • **Effectiveness of mitigants in place to manage current business risks;** • **Management depth and succession;** • **Training and development of internal audit staff; and** • **Compensation practices.**
4. Assess management and the board's willingness and ability to correct deficiencies.
5. Determine if the viability of the organization is threatened by management's inability to correct problems and implement appropriate risk management practices.
End of Expanded Analysis. If needed, Continue to Impact Analysis.

MANAGEMENT AND INTERNAL CONTROL EVALUATION

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures

1. **Determine whether management deficiencies or suspicious activities have resulted in or could result in increased asset quality problems, earnings deterioration, reduced capital protection, or undue risk to the bank.**

2. **Consider whether an informal or formal enforcement action is warranted. Advise the appropriate supervisory officials. (FDIC: field office supervisor or regional office.)**

Civil Money Penalties (FDIC)

3. **Prepare recommendations for Civil Money Penalties (CMPs), if appropriate. (FDIC: The Manual of Examination Policies details specific instances in which CMPs may be assessed.) Complete the CMP matrix for fineable violations, unsafe and unsound practices, or breach of fiduciary duties. The matrix should be prepared whenever an examiner believes that a penalty may be warranted. The Interagency Policy Regarding the Assessment of Civil Money Penalties sets forth thirteen factors to consider when determining whether civil money penalties should be imposed:**
   - **Evidence that the violation or pattern of violations was intentional or committed with a disregard of the law or the consequences to the institution.**
   - **The frequency or recurrence of violations and the length of time the violation has been outstanding.**
   - **Continuation of violation after the respondent becomes aware of it, or its immediate cessation and correction.**
   - **Failure to cooperate with the agency in effecting early resolution of the problem.**
   - **Evidence of concealment of the violation, or its voluntary disclosure.**
   - **Any threat of or actual loss or other harm to the institution, including harm to public confidence in the institution, and the degree of any such harm.**
   - **Evidence that participants or their associates received financial or other gain, benefit, or preferential treatment as a result of or from the violation.**
   - **Evidence of any restitution by the participants in the violation.**
   - **History of prior violations, particularly where similarities exist between those and the violations under consideration.**
   - **Previous criticism of the institution for similar violations.**
   - **Presence or absence of a compliance program and its effectiveness.**
   - **Tendency to create unsafe or unsound banking practices or breach of fiduciary duty.**
   - **The existence of agreements, commitments, or orders intended to prevent the subject violation.**

4. **A CMP recommendation should only be considered if it meets the test of gravity after considering the above 13 points and when any one of the following criteria is present:**
   - **The bank suffers a substantial financial loss as a result of the violation;**
   - **The violation is willful, flagrant, or otherwise evidences bad faith on the part of the bank or individual involved in the violation;**
   - **An insider (or associate) directly or indirectly involved in the violation materially benefited from the transaction; or**
   - **Previous supervisory actions have not been effective in eliminating or deterring violations.**

5. **If the examiner recommends CMPs, follow these procedures:**
   - **Consult with the regional office to determine the documentation necessary to support the violation and the CMP recommendation.**
   - **Prepare a memorandum to the appropriate regional director addressing the 13 points and specifying the recommendation.**
   - **Include the home mailing addresses for all directors and any other individuals involved in a fineable violation in the confidential pages.**
   - **Discuss the violations with management, but do not refer to potential CMPs or to the possible amount of CMPs except in the most serious circumstances and <u>after obtaining regional office approval</u>.**
   - **If CMPs are approved for discussion, limit discussions to the criteria used to determine whether to assess a penalty.**
   - **Examiners should not discuss penalties regarding Section 8 matters. If questioned, discussions should be limited to stating that CMPs can be assessed for noncompliance with an order. (Note: For FDIC, only a regional director can determine compliance with a Section 8 Order.)**
   - **If the violation involves financial gain to an insider or financial loss to the bank, examiners should attempt to quantify the amount of loss. The violation write-up should include the monetary amount and method of calculation. If the amount cannot be determined, the examiner should include the reason why.**
   - **Copy evidence supporting the violations and retain in field office files in a separate labeled folder apart from the regular exam workpapers.**

Suspicious Activity Reports

6. **Notify the appropriate bank regulatory officials of suspected activities and actions taken.**

7. **Discuss the possibility of administrative and enforcement actions with executive management and the board of directors. If suspicious activity is discovered, and the Reserve Bank or regional office concurs, examiners should report the discovery of the suspicious activity and any related apparent violations to the bank's board of directors.**
   - **Examiners should present the facts giving rise to the apparent violation, but avoid any conclusions**

as to guilt or innocence of any particular individuals.

- **Remind the board of the regulatory requirements[1] to report apparent violations promptly to law enforcement agencies and the appropriate supervisory officials.**

8. Determine if management has or will file Suspicious Activity Reports (SARs). (Note: Examiners should generally bring apparent criminal activities to management's attention for reporting by the bank. Under certain situations, it may not be appropriate to notify bank officials.)

9. Prepare a SAR if the report submitted by the bank is deemed inadequate or the suspected criminal conduct has not been reported by the bank and the examiner believes it is in the best interest of the agency. (A SAR prepared and entered into the SAR system by the bank does not prevent examiners from making a more detailed report. SARs should be completed when the examiner first obtains evidence to support a belief that a crime has been committed. Do not wait until the examination concludes.)

10. If the examiner is preparing the SAR:

- **Use the appropriate software;**
- **Attach copies of documents that prove or support the suspected criminal violations; and**
- **Segregate and store additional supporting documents.**

End of Impact Analysis.

[1] References: FRB 12 CFR, 208.62, 211.5(k), 211.24(f), and 225.4(f); FDIC: 12 CFR, 353.

OTHER ASSETS AND LIABILITIES

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?

E.1. Does management provide proper supervision and take appropriate action to address other asset and liability deficiencies? *Refer to Expanded Analysis Procedures #1-93.*

E.2. Are deficiencies immaterial to the bank's financial condition? *Refer to Expanded Analysis Procedures #1-93.*

OTHER ASSETS AND LIABILITIES

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible procedures specified for the Core Analysis also apply to the Expanded Analysis.

Cash Accounts

Note: The primary objectives of cash and due from audits are to ensure account balances are properly recorded, cash items clear within a reasonable period, and due-from accounts are substantiated and tested. When appropriate, examiners should verify items (e.g., cash on hand, cash items, overdrafts, and other assets or liabilities held in suspense) to ensure items are properly controlled, recorded, and disposed.

CASH ON HAND

1. **Determine whether tellers, including relief tellers, have sole access to their cash supply and cash drawer.**

2. **Determine whether duplicate keys and combinations are under dual control.**

3. **Determine whether the total cash supply for tellers that are on vacation or absent for an extended period is counted under dual control.**

4. **Determine whether cash drawers or teller cages have locking devices to protect cash during periods when the teller is absent from his/her window.**

5. **Determine whether each office and teller maintains currency within pre-established cash limits. Cash items should not be kept as part of teller's cash.**

6. **Determine whether bait money is maintained appropriately and counted each day.**

7. **Determine whether daily procedures compare each teller's cash, in aggregate, to an independent control from the proof or accounting control department.**

8. Determine whether teller differences are cleared daily or appropriately documented.

9. Determine whether cumulative over-and-short records are maintained for all persons who handle cash.

10. Determine whether each teller prepares and signs a daily proof sheet detailing currency, coin, consignment items, and cash items.

11. Determine whether tellers report large differences to a responsible official for clearance.

12. Determine whether the bank has a policy that prohibits tellers from maintaining "kitties" of pooled funds that are not reconcilable to one individual.

13. Determine whether teller transactions identify the responsible teller.

14. Determine whether both tellers verify and initial teller transfer entries.

15. Determine whether tellers possess operational guidelines that establish dollar limits for check cashing or withdrawals not requiring officer approval.

16. Determine whether controls prevent tellers from processing transactions to their own accounts.

17. Determine whether tellers clear all checks from their funds daily.

18. Determine whether teller duties are restricted to teller operations, unless a well-defined business reason

exists.
19. Determine whether vault opening and closing procedures are adequate and require dual control.
20. Determine whether the vault cash is appropriately controlled and that all currency is counted on a surprise basis including verification of all strapped cash packets.
21. Determine whether the bank maintains records showing amounts and denominations of vault cash.
22. Determine whether currency shipments are prepared and sent, received, and counted under dual control.
23. Determine whether someone independent of the teller function controls the master teller-machine key.
24. Determine whether tellers remove their keys when they leave their window.
NIGHT DEPOSITORY
25. Determine whether the bank provides lockable night deposit bags to customers.
26. Determine whether written contracts authorize the institution to open night deposit bags.
27. Determine whether two employees open night deposit bags; initial recording of bag numbers, envelope numbers, and depositors' names in the register; and count and verify contents.

AUTOMATED TELLER MACHINES (ATM)
28. Determine whether the bank's ATMs limit the amount of cash and the number of dispense transactions during a specified period for each account.
29. Determine whether ATMs capture the card if the wrong personal identification number (PIN) is consecutively used or an invalid card is used.
30. Determine whether the ATM automatically shuts down after it experiences recurring errors.
31. Determine whether a bank representative is present during ATM maintenance.
32. Determine whether the ATM has adequate lighting.
33. Inquire about negative-file capabilities. (If the ATM is operated off-line, determine whether it has the capacity to recognize and capture lost, stolen, or other undesirable cards.)
34. Determine whether activity reports identify ATM use by a customer in excess of that customer's history (e.g., three uses during the past three days compared with a history of one use per month).
35. Ascertain whether safeguards prevent the observation of a customer's PIN by others who observe the PIN pad.
36. Determine whether a communication interruption between an ATM and the central processing unit triggers the alarm system.
37. Determine whether all ATMs contain alarm devices.

38. Determine whether the bank mails PINs separately from cards.

39. Determine whether personnel who have custody of cards are prevented from accessing PINs at any stage (issuance, verification, or reissuance).

CASH ITEMS

40. Determine whether someone other than the teller who originated the transaction handles returned items.

41. Determine whether an officer, or other designated individual, reviews all cash items over a specified dollar limit with respect to collection and credit.

42. Determine whether an officer, or other designated authority, reviews and initials a daily report of all cash items.

43. Determine whether the bank's procedures forbid holding overdraft checks in the cash item account.

44. Determine whether the directorate, a designated committee thereof, or an officer with no conflicting responsibilities reviews and approves cash items recommended for charge-off.

PROOF AND TRANSIT

45. Ensure appropriate internal controls, such as dual controls and separation of duties, govern proof and transit operations.

46. Determine whether the bank handles cash letters appropriately. Consider whether:

- **Cash letters are prepared, sent, and reconciled daily;**
- **Cash letters are imaged before they leave the bank;**
- **Copies of the proof or hand-run tapes are identified and retained;**
- **Records of cash letters sent to correspondent banks are maintained that identify the subject bank, date, and amount; and**
- **Remittances for cash letters are received by employees independent of those who send out the cash letters.**

47. Determine whether all entries to the general ledger have been proofed.

48. Determine whether all entries prepared by the general ledger or customer account department are reviewed by a supervisor other than the person preparing the entry.

49. Determine whether errors detected by the proof operator are corrected by another employee or designated officer.

50. Determine whether appropriate source documents support all general ledger entries.

51. Determine whether the bank appropriately handles returned items. Consider whether returned items:

- **Are handled by an independent section of the proof and transit department or delivered unopened to personnel not responsible for preparing cash letters or handling cash;**
- **Are periodically reviewed by supervisory personnel to determine that items are handled correctly by the proof and transit section and clear timely; and**
- **Are scrutinized for employee, large, or repeat items.**

52. Determine whether items reported missing from the cash letter are promptly traced with a copy sent for credit.

53. Evaluate the rotation of duties in the proof and transit area.

54. Ascertain whether the bank prohibits proof machine operators from filing checks or deposit slips, or preparing deposit account statements.

Correspondent Bank Accounts and Interest Bearing Balances

55. Consider contacting the correspondent bank to obtain an interim account statement. ***(Note: The statement should be sent to the examiner-in-charge's attention. If the bank receives a statement daily, obtain it before bank personnel open it.)***

56. Prepare correspondent account reconcilements and trace exception and open items. ***(Note: Examiners are instructed to review the bank's internal reconcilements in the Core Analysis. If reconcilements do not exist or are incomplete, then examiners should perform this function.)***

Permissible Activities and Equity Investments

57. Determine whether the bank complies with all conditions imposed by regulations and orders, including investment limitations or divestiture plans.

58. Determine whether accounting records accurately record income and expenses generated by the investments and ventures.

59. Determine whether contingent liabilities exist and the extent of any potential exposure.

Premises and Fixed Assets

60. Reconcile premises and equipment subsidiary ledgers to the general ledger.

61. Assess the reasonableness of investment in premises and equipment.

- **Review the current and prospective use of fixed assets in serving banking needs.**
- **Review Uniform Bank Performance Report schedules to determine whether investments in premises and fixed assets are reasonable in relation to total assets and consider the percentage of operating income absorbed by occupancy expense.**

Deposit Activities

62. Determine whether deposit records provide satisfactory audit trails (i.e., the transaction can be traced from initiation to final disposition).

63. Determine whether changes to customer account records require separation of duties between origination, input, and review.

64. Determine whether source documents for customer deposit account modifications are supported by proper authorizations (e.g., address change or name change).

65. Review a sample of internal control overrides for appropriateness and approval.

66. Verify that management does not pay fees until funds are verified and physically transferred (i.e., the bank does not give a broker an advance fee for his or her services prior to settling the transaction).

67. Determine whether the institution maintains documentation supporting a current reconcilement of each deposit account category recorded on the general ledger.

68. Verify that reconciliations are performed by an individual who is not directly involved in accepting or preparing transactions or entries to customer accounts.

69. Determine whether the preparation of input and posting of subsidiary deposit records are performed and adequately reviewed by persons who do not accept or generate transactions or handle cash.

70. Determine whether in-process, suspense, and interoffice accounts related to deposit accounts are closely monitored by individual(s) who do not have posting or reconciling duties.

71. **Determine whether the bank flags deposit account files of employees, officers, directors, and any of their related business interests.**

72. **Ascertain whether posting and check filing procedures are separated from statement preparation.**

73. **Determine whether customer account statements are appropriately controlled.**

74. **Determine whether individuals who open new accounts or who have access to unused new account records are different than individuals who make entries to customer accounts or the general ledger.**

75. **Determine whether a periodic review of inactive accounts is performed to ascertain whether to place them on dormant status.**

76. **Determine whether the closed account lists are prepared and circulated to appropriate management for review.**

77. **Determine whether accounts that do not reflect recent activity, and for which customer contact cannot be reestablished, are removed from active files, clearly classified as dormant, and in compliance with state escheat laws.**

78. **Determine whether signature cards for closed accounts are promptly pulled from the active account file and placed in a closed-account file.**

Official Checks

79. **Determine whether reconcilements are a part of the overall deposit function. Consider whether:**
    - **Outstanding checks are listed and reconciled to the general ledger.**

- **Permanent evidence of reconcilements is maintained.**
- **Clear separation of duties exist, or reconcilement duties are rotated.**
- **Reconcilements are reviewed by an officer.**
- **Authorized signatures and endorsements are verified.**

80. Investigate the types of checks issued. Appropriate safeguards or procedures generally address issues such as:

- **If multi-copy checks and certified check forms are not used, detailed registers of disbursed checks are maintained;**
- **All checks are pre-numbered and issued in numerical sequence;**
- **Check preparation and issuance are separate from recordkeeping;**
- **Signing checks in advance is prohibited;**
- **Procedures prohibit issuance of a check before the credit is processed;**
- **Customer accounts are debited when certified checks are issued; and**
- **Certified checks are stamped or marked across the face of the check and signed by an appropriate bank official. *(Note: Holes are often punched at the bottom of certified checks to prevent double posting.)***

81. Test for appropriate controls over check signing machines, if used. Verify whether:

- **Procedures preclude certification of checks drawn on uncollected funds.**
- **Voided checks and certified check forms are promptly defaced and filed with paid checks.**

Other Items

82. Test the accuracy of the accrual system. Determine whether any of the income earned but not collected is contingent upon items in default or of otherwise doubtful collectability.

83. Determine whether the preparation of entries and posting of subsidiary other liability records is performed or tested by persons who do not also have direct control of the related liabilities.

84. Determine whether subsidiary other liability records are approved and balanced to the general ledger monthly by persons who do not also have direct control of the related liabilities.

85. Ensure contingent liabilities for future expenditures or losses are booked at the time they become

probable and can be reasonably estimated. Ascertain if such accounts are closely monitored, with periodic status reports to management.

86. Ensure sufficient documentation (i.e. board resolutions) is available to support amounts due to officers, directors, or their related interests.

87. Determine whether payroll tax liabilities reconcile to appropriate payroll records.

88. Ascertain if liabilities for undistributed customer receipts (i.e., deposits, funds transfers, dividend/interest payments, securities fails) are controlled in separate accounts.

89. Determine whether customer receipts are treated as deposits for reporting and reserve requirements.

90. Determine whether amounts that cannot be credited or otherwise paid to the rightful owner are classified as dormant and placed under dual control.

91. Determine whether formal approval procedures are in place and independent from recordkeeping for all other liabilities that are charged off or revalued.

92. Determine whether obligations are booked immediately upon receipt of invoices or bills for services received.

93. Verify that procedures exist to ensure invoices and bills are:

- **Verified for accuracy prior to payment,**
- **Approved by designated employees prior to payment, and**
- **Paid within the discount period.**

End of Expanded Analysis. If needed, Continue to Impact Analysis.

OTHER ASSETS AND LIABILITIES

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Determine the impact of identified deficiencies on the bank's capital, earnings, and asset quality.
2. Determine the need for administrative and enforcement actions, formulate specific recommendations, and advise the appropriate supervisory officials.
3. Discuss the possibility of administrative and enforcement actions with the examiner-in-charge and applicable regulatory supervisors, and when appropriate, executive management and the board of directors.
4. Determine the circumstances and facts regarding Civil Money Penalties, Suspicious Activity Reports, and removal action under Section 8 of the FDI Act, if necessary.
End of Impact Analysis.

RATE SENSITIVITY

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

E.1.	**Are management deficiencies immaterial to the oversight of the bank's interest rate risk (IRR) posture? *Refer to Expanded Analysis Procedures #1-12*.**
E.2.	**Is the level of IRR immaterial to the overall condition of the bank? *Refer to Expanded Analysis Procedures #1-12*.**

RATE SENSITIVITY
Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible procedures specified for the Core Analysis also apply to the Expanded Analysis. The procedures in the Expanded Analysis section focus on identifying risk exposures, verifying significant risks, and determining the capabilities and reliabilities of the internal measurement systems.

IRR Profile and Exposure Considerations

1. **Identify significant factors that contribute to IRR exposures and the institution's risk profile. Consider information from:**
   - **Supervisory IRR monitoring reports (FDIC: IRRSA),**
   - **Balance sheet and account data,**
   - **Internal IRR reports,**
   - **Strategic and business plans,**
   - **Product pricing guidelines,**
   - **Hedging or derivative activity, and**
   - **Other examination findings.**

2. **Identify factors that contribute to elevated risk exposures. Consider the following:**
   - **Long-term, fixed-rate assets;**
   - **Variable rate loans or securities with extended repricing intervals (more than two years);**
   - **Investment securities and associated unrealized gains and losses;**
   - **Trading portfolio activities;**
   - **Other funding sources;**
   - **Non-maturity deposits;**
   - **Option risk (stemming from callable bonds, mortgage-backed securities, structured notes, mortgage loans, non-maturity deposits, complex wholesale borrowings, or derivatives);**
   - **Off-balance sheet derivatives (interest rate swaps, futures, forwards, or options);**
   - **Other basis and yield curve risks in on- and off-balance sheet products;**
   - **Mortgage banking activities (including mortgage servicing assets);**
   - **Fee income levels; and**
   - **Product pricing strategies.**

3. **Assess price risks that could arise from changing market interest rates. Consider the following:**
   - **Security valuations and potential changes to accumulated other comprehensive income,**
   - **Gains and losses on the sale of mortgage loans and the possible effect on other income, and**
   - **Mortgage servicing asset valuations and the potential effect on earnings and capital.**

Internal Measurement System Capabilities

4. Assess the adequacy of the IRR measurement system.

- **Review a summary description of system capabilities, procedures manual for system, vendor updates on purchased systems, and other applicable documentation;**
- **Verify that the system contains the components and updates needed to generate applicable and accurate measurements commensurate with the types of IRR assumed; and**
- **Discuss the system's capabilities, limitations, and assumptions with management.**

5. Discuss whether the IRR measurement system sufficiently captures all material interest rate risk positions and enable management to identify risks arising from existing activities and new business initiatives. Consider the following attributes:

- **Static and dynamic rate scenarios,**
- **Severity of modeled stress scenarios, and**
- **Details of the measurement system input and output.**

Internal Measurement System Data and Assumptions

6. Review the bank's internal control system relative to data and assumptions used by the IRR measurement system.

7. Evaluate data inputs for the IRR measurement system to determine the accuracy of baseline instrument characteristics and data aggregation practices.

- **Review account data for larger, more complex account categories such as:**
  - **Contractual coupon rates and formulas,**
  - **Current balances,**
  - **Coupon reset dates,**
  - **Scheduled principal payments,**
  - **Scheduled interest payments,**
  - **Caps and floors, and**
  - **Maturities.**
- **Review the data aggregation process and ensure that it reasonably portrays the bank's cash flow characteristics.**
- **Determine whether base case interest rates and market values are accurate.**

8. Review information regarding all key assumptions including supporting documentation, IRR

management committee and board minutes, vendor's or consultant's reports, and independent reviews of the IRR program. Determine whether:

- **Interest rate forecasts are consistent with other forecasts used throughout the bank's planning processes and include increasing and decreasing rate environments,** ***(Note: Satisfactory forecasts generally provide useful results that consider potential interest rate shocks, yield curve risks, as well as basis risk.)***
- **Driver rates are supported and accurately applied,**
- **Reinvestment rates are reasonable and consistent with other bank forecasts,**
- **Non-maturity deposit-sensitivity factors (betas) are adequately supported with documented analysis,** ***(Note: IRRSA provides historical non-maturity deposit-analysis measures for examiner review.)***
- **Prepayment forecasts reasonably estimate unscheduled principal cash flows from amortizing instruments, and**
- **Growth estimates reflect the strategic goals and forecasts used in the strategic planning process.**

9. Review the sensitivity analysis of assumptions, which helps management identify the assumptions that have the most influence on model output. Institutions should have robust support for assumptions that significantly affect model results.

Internal Measurement System Results and Validation

10. Determine whether system reports are timely and identify:

- **Material risk exposures and sources,**
- **IRR levels expressed in measures that correspond to the board's risk limits,**
- **Trends in IRR exposure, and**
- **Deviations from policy risk limits.**

11. Review the results of the IRR measurement system for the current period and a sample of prior periods. Pay particular attention to results that:

- **Indicate risk exposures exceed board established risk limits;**
- **Demonstrate increasing risk trends, or rapid growth in risk exposure;**
- **Illustrate risks different from those identified by historical financial analysis; and**
- **Suggest that the system contains obvious flaws or deficiencies.**

12. Review internal control procedures to determine whether the system's prior forecasts reasonably estimated actual performance by comparing:

- **Past system results to actual results (i.e., back-testing);**
- **Market value assumptions to observable market prices; and**

• **The bank's measurement system and results to the independent reviewers'/internal or external auditors' measurement systems and results (i.e., challenger-model or parallel-model runs).**
End of Expanded Analysis. If needed, Continue to Impact Analysis.

RATE SENSITIVITY
Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Determine the effect of IRR levels and management deficiencies on the bank's earnings, liquidity, capital, and sensitivity to market risk. Assess the potential impact on the bank if the IRR exposure or management deficiencies continue.
2. Document deficiencies of the internal measurement system, such as design flaws, quantitative errors, data inaccuracies, unreasonable or unsupported assumptions, and reporting weaknesses. Attempt to resolve deficiencies with management during the examination.
3. Discuss IRR deficiencies with management and seek commitment to remedy corporate governance, IRR exposure, risk management, internal control, and independent review deficiencies.
4. Determine whether the severity of weaknesses warrant citing non-conformance with the *Interagency Guidelines Establishing Standards for Safety and Soundness*[1] in the ROE.
5. Consider recommending an accelerated IRR examination schedule if management's efforts to rectify deficiencies should be verified before the next regular safety and soundness examination.
6. Determine the need for administrative and enforcement actions, formulate specific recommendations, and advise the appropriate supervisors on the nature of the concerns. (FDIC: field supervisor and the regional office). Identify specific recommended provisions for potential actions.
7. After obtaining appropriate supervisory approval, discuss the possibility of administrative and enforcement actions with executive management and the board of directors.

[1] References: FDIC, Appendix A of Part 364 of the FDIC's Rules and Regulations. FRB: 12 C.F.R. Part 208, Appendix D-1.

8. Investigate potential recommendations for civil money penalties.
End of Impact Analysis.

SECURITIES AND DERIVATIVES

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

E.1.	**Are deficiencies immaterial to management's supervision of the securities and derivatives activities?** ***Refer to Expanded Analysis Procedures #1-19.***
E.2.	**Are deficiencies immaterial to the institution's condition?** ***Refer to Expanded Analysis Procedures #1-19.***

SECURITIES AND DERIVATIVES EXAMINATION PROCEDURES

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible procedures specified for the Core Analysis also apply to the Expanded Analysis.

Policies, Procedures, and Risk Limits

1. Investigate the reason(s) policy deficiencies identified in the Core Analysis exist. Discuss recommendations with management. Possible reasons for policy deficiencies may include:

- **Management overlooked these issues,**
- **Management is unfamiliar with prudent guidelines and procedures, or**
- **Management is unwilling to create or enhance policies and procedures.**

2. If poor compliance with internal policies or procedures exists, determine the reasons. Possible reasons may include:

- **Poor internal communication of policies and procedures or subsequent revisions to either,**
- **Lack of awareness of policies or procedures,**
- **Disregard for established policies or procedures,**
- **Misunderstanding of policies or procedures, and**
- **Change in the institution's investment strategy.**

3. Determine whether management recognizes and supports proper controls and monitoring consistent with the institution's policy guidelines. Determine whether proposed controls, if any, are reasonable.

Internal Controls

4. Determine whether the institution's operations staff is knowledgeable with respect to existing policies, procedures, and controls.

5. When concerns with internal controls are identified in the core analysis, independently evaluate whether those internal control weaknesses may expose the bank to material risks.

6. Review a sample of trade tickets to assess whether purchase and sale prices are accurate.

7. Confirm clearing account reconciliations.

8. Verify that confirmations are reconciled against trade tickets in a timely fashion.

9. Review a sample of general ledger tickets to assess the accuracy of entries.

Audit or Independent Review

10. Assess any concerns regarding audit or independent review functions identified in the Core Analysis.

Risk Identification, Measurement, and Reporting Systems

MARKET RISK

11. Assess management's methods for measuring and forecasting market risk in the securities and derivatives portfolio(s). Consider whether:

- **The measurement methods are appropriate considering each instrument's or portfolio's cash flow characteristics.**
- **Management's assumptions concerning factors such as interest rate shocks, prepayment forecasts, and current prices are reasonable and supported.**

12. If appropriate, request enhanced management analysis during the examination, and use this enhanced analysis to assess the institution's market risk relative to earnings, capital, and board-established risk limits.

CREDIT RISK

13. Determine whether management's credit analysis demonstrates that the obligor has adequate capacity to meet its financial commitments with respect to the security for the projected life of the asset or exposure. Adequate capacity is evident when the probability of default is low and full and timely repayment of principal and interest is expected.

14. Assess credit risk from off-balance-sheet derivatives and perform credit analysis of all counterparties with whom management maintains material positions. Management typically maintains relevant financial information (e.g., annual reports, other SEC filings) on these counterparties.

LIQUIDITY RISK

15. Verify management's price information.

- **Obtain independent prices on a sample of the portfolio. If in the Core Analysis, prices were obtained, expand the sample as appropriate.**
- **For instruments valued using a model, determine whether assumptions are supported appropriately by management. If management cannot provide support for the assumptions, or the assumptions appear unrealistic, request a revised valuation using appropriate assumptions.**

16. Assess management's intentions and the institution's ability to hold instruments with significant depreciation.

17. To the extent the portfolio(s) includes material volumes of potentially illiquid instruments, verify that management's valuation methods appropriately consider liquidity risk under stressed scenarios.

18. Determine whether the portfolio(s) includes a significant volume of investments that potentially could not be sold at a price reflecting their expected economic value due to limited market depth or other unfavorable market conditions.

Board and Senior Management Oversight

COMPLIANCE

19. Identify the cause(s) of any compliance violations and identify the responsible party or parties. Consider the following factors:

- **Lack of familiarity with laws or regulations,**
- **Negligence,**
- **Misinterpretation of laws or regulations, and**
- **Willful disregard.**

End of Expanded Analysis. If needed, Continue to Impact Analysis.

SECURITIES AND DERIVATIVES EXAMINATION PROCEDURES

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Assess the potential effect of any concerns regarding management on the institution’s safety and soundness.
2. Assess the effect that market, credit, liquidity, operational, and legal risks from the institution’s securities and derivatives activities may have on the institution’s financial condition.
3. Evaluate the effect that management’s current and planned securities and derivatives activities may have on the institution’s capital, asset quality, earnings, liquidity, and sensitivity to market risk.
4. Gauge management’s willingness and ability to correct any identified weaknesses.
5. Determine whether formal or informal administrative actions are recommended, formulate specific recommendations, and discuss concerns with the appropriate supervisors.
6. Investigate potential recommendations with respect to civil money penalties.
End of Impact Analysis.

CREDIT CARD RELATED MERCHANT ACTIVITIES

Core Analysis Decision Factors

Examiners should evaluate Core Analysis factors to determine whether Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1. **Are policies, procedures, and risk limits adequate?** ***Refer to Core Analysis Procedures #2-3.***

C.2. **Are internal controls adequate?** ***Refer to Core Analysis Procedures #4-7.***

C.3. **Are the audit or independent review functions adequate?** ***Refer to Core Analysis Procedures #8-10.***

C.4. **Are controls over merchants, agent banks, and Independent Sales Organizations (ISOs) adequate?** ***Refer to Core Analysis Procedures #11-47.***

C.5. **Does management properly monitor and control chargebacks?** ***Refer to Core Analysis Procedures #29-32.***

C.6. **Are reserves for chargebacks adequate?** ***Refer to Core Analysis Procedure #31.***

C.7. **Are information and communication systems adequate and accurate?** ***Refer to Core Analysis Procedures #48-50.***

C.8. **Do the board and management effectively supervise this area?** ***Refer to Core Analysis Procedures #51-54.***

CREDIT CARD RELATED MERCHANT ACTIVITIES

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review

1. Consider the following factors when determining the scope of the review of Credit Card Related Merchant Activities:

- **The significance that merchant activities play in an institution's overall strategic plans and budgeting process;**
- **The total-dollar sales volume of credit card related merchant activities processed and the number of merchants;**
- **Whether merchants are concentrated in one industry or geographic area that may pose increased risk to the financial institution;**
- **The bank's capital structure;**
- **Whether activities are conducted primarily to accommodate existing customers or if they represent a significant activity for the bank;**
- **Management expertise as reflected in previous examination reports, audit reports, and other correspondence; and, any remedial action taken by management to correct any deficiencies noted;**
- **Use of third party service providers that provide merchant processing activities; and, the adequacy of management's oversight of third parties (as reflected in prior audits and examinations);**
- **Use of Independent Sales Organizations (ISOs);**
- **Risk profiles of the merchants (examples of higher risk profiles include mail order businesses, telemarketing, retailers selling goods or services for future delivery, and merchants selling low-quality products or services);**
- **Prior losses from, and trends in the volume of, merchant chargebacks and unreconciled items in the settlement account; and**
- **Any contingent liabilities arising from the bank's processing activities.**

Policies, Procedures, and Risk Limits

2. Determine whether merchant processing policies adequately establish:

- **Lines of authority and responsibility;**
- **Risk-assessment and fraud-detection procedures;**
- **Cardholder information security standards;**
- **Risk identification practices and limits on the amount of risk the bank is willing to accept;**
- **Limits on individual and aggregate volumes and/or concentrations of merchant activity (*management should set limits on the amount of sales volume processed that correlates with merchants' risk profiles and the bank's management expertise and capital structure);***
- **Requirements for written contracts between all third parties;**

- **Due-diligence criteria for initially accepting merchants and periodically reviewing merchants' creditworthiness;**
- **Due-diligence criteria for initially ensuring, and periodically reviewing, third party compliance with Association (Visa and MasterCard) requirements regarding issues such as registration, contract provisions, audit accessibility, etc.;**
- **Guidelines for monitoring merchant activities and assessing their information-security practices;**
- **Criteria for determining the appropriateness of merchant reserve accounts;**
- **Criteria for contracting with any ISO to act as agent for the bank;**
- **Guidelines for acquiring or issuing rent-a-bins (see Procedure 34.);**
- **Guidelines for handling policy exceptions;**
- **Guidelines for accepting agent banks;**
- **Pricing policies; and**
- **Requirements for legal reviews of all contracts and applications (by legal counsel familiar with merchant processing).**

Note: Formal policies may not be necessary for banks with minimal merchant activity. Institutions are expected to assess the risks posed by individual merchants on a case-by-case basis and to implement controls to manage relationships commensurate with identified risks.

3. Determine whether the merchant-processing procedures manual appropriately provides for:

- **Establishing new business relationships;**
- **Monitoring existing relationships for credit and financial exposures;**
- **Monitoring potential or existing concentrations (for example, by merchant type/industry, geographic location, or processing volumes by one merchant);**
- **Dealing with ISOs;**
- **Handling complaints from merchants;**
- **Performing settlement procedures that include clearing items in a timely fashion;**
- **Processing merchant charge-backs; and**
- **Training new and existing personnel.**

Note: Banks with minimal activity may not need a formal procedures manual.

Internal Controls

4. Review recent risk assessments relating to merchant activities and determine whether internal and external threats are identified and appropriate controls are in place. Consider whether the bank uses:

- **Appropriate risk rating processes (using internal metrics or industry codes); and**
- **Reports that clearly display the types of merchants they serve and the risks involved, (including information on whether the merchants are generally swipe, keyed, or chip merchants).**

5. Determine whether the board and senior management regularly review pertinent merchant activity (using reports, dashboards, or other mechanisms that provide information commensurate with the

level of merchant risks).

6. Determine whether adequate separation of duties (or compensating controls) exists in sensitive areas such as:

- **Preparation of input and reconciliation of output, and**
- **Merchant acquisitions/approvals.**

7. Determine whether appropriate procedures are in place to prevent, detect, and respond to policy and procedural exceptions.

Audit or Independent Review

8. Review internal and external audit reports to identify any concerns relating to merchant processing.

9. Determine whether the board and management regularly review audit reports and Association correspondence and appropriately respond to audit findings and Association concerns.

10. Review the scope, frequency, and adequacy of the audit function and determine whether all merchant processing areas are addressed.

Note: Effective audit programs will identify contraventions of internal policy, Association regulations, and written contracts; and ensure timely settlement balancing.

Merchant Underwriting Standards and Monitoring Procedures

11. Evaluate practices designed to ensure compliance with the merchant-approval policy.

- **To assess compliance with policy guidelines, review a sample of files for recently approved merchants. The sample should include, when applicable, merchants solicited directly by the bank, through ISOs, and through agent banks. The merchant-approval policy should provide clear and measurable underwriting standards for merchants. Verify that standards are maintained and files contain, at a minimum, the following items:**
  - **Merchant applications listing the type of business, location, principal(s), and other relevant structure information;**
  - **Merchant processing agreements that detail all pertinent activities;**
  - **Corporate resolutions, if applicable;**

- **Onsite inspection reports;**
- **A credit bureau report on the principal(s) of the business;**
- **Documentation of the bank checking prospective merchants against the Member Alert to Control High Risk Merchants (MATCH) system;**
- **Financial information on the business (typically received annually);**
- **Sales tax number for the business (tax ID number);**
- **Evidence of review of previous merchant activity (recent monthly statements from the previous processor); and**
- **Estimate of the merchant's projected sales activity.**

- **Verify that management determines why a merchant has or is switching banks (could indicate excessive charge-backs with previous processor).**

12. Select a sample of merchant reserve accounts and review for compliance with merchant contracts and Association requirements.

13. Determine whether exceptions to merchant approval policies are approved, reasonable, and documented.

14. Determine whether merchant applications are reviewed by a person who has adequate credit experience.

15. Determine whether the acquiring bank maintains a list of restricted merchants. Characteristics that banks consider when determining restrictions may include:

- **Business plans, types of merchandise or services offered, and marketing practices; and**
- **Order, shipping, and return policies.**

16. Determine whether underwriting activities, monitoring procedures, and management information systems (MIS) adequately consider or include:

- **Sale volumes and product delivery periods;**
- **Projected and actual ticket sizes;**
- **Card-not-present transactions;**
- **Telemarketing, mail-order, or internet merchants metrics;**
- **Products sold for future delivery, e.g. travel agents and health clubs;**
- **Volume of disputes; and**
- **Chargeback volumes.**

17. **Determine whether merchant reserve accounts are separately maintained (not commingled with related operating accounts or other merchant reserve accounts).**

    Note: Commingling accounts can disguise insufficient reserve levels as it makes it difficult to ensure management is not using the cash flow generated from one merchant to cover the remittance requirement of another merchant.

18. **Review the composition of merchant customers for concentrations of industries, geographic areas, or other factors.**

    Note: Segmenting merchants according to location or activity can help identify concentration risks.

19. **Ensure procedures are in place to appropriately monitor the financial condition of merchants that present higher risks.**

20. **Evaluate the bank's pricing system. Pricing policies and practices should ensure that merchants are priced appropriately throughout the life of the contract. Consider the following:**

    - **Minimum discount rates should reflect:**
        - **The merchant's volume of sales activity,**
        - **Inherent risk in operations, and**
        - **Overall financial conditions.**
    - **Management's evaluation of:**
        - **Employee and equipment costs,**
        - **Cost of float in the clearing process,**
        - **Insurance and bonding needs,**
        - **Loss histories and the risk of future loss,**
        - **Annual budget and strategic plans, and**
        - **Competition.**

21. **Determine whether management verifies actual sales volumes and ticket sizes to ensure consistency with projected volumes and sizes, at least annually.**

22. **Evaluate management's compliance with internal risk limits related to capital held to support merchant processing and determine whether the level is appropriate.**

23. Determine whether additional capital is needed to support the level of merchant processing. ***(Note: No specific capital requirements exist for merchant processing activities; however, examiners should determine whether management periodically assesses the adequacy of capital support relating to credit card related risks. FDIC: Refer to the Credit Card Activities Manual, Chapter XIX, Merchant Processing.)***

Settlement Process

24. Review the vendor management program to ensure management periodically evaluates third-party contingency plans. Assess a sample of contingency plans for parties involved in the settlement process and agents involved in merchant servicing tasks.

Note: When practical, coordinate the vendor management review with Information Technology examiners.

25. Review the settlement process to determine the flow of funds, the parties involved, and who controls funding and settlement.

26. Review a sample of contracts and assess the financial liability of all parties.

27. Determine whether MIS reports provide accurate, timely, and sufficient information for management to assess the function's activities and results.

28. Determine whether outstanding items in the settlement account clear in a timely fashion.

Chargeback Processing and Reserves

29. Assess the adequacy of chargeback monitoring procedures:

- **Determine whether the bank generates chargeback reports.**
- **Evaluate the adequacy of the chargeback system. Determine whether the system can perform the following tasks:**
  - **Quantify outstanding chargebacks,**
  - **Identify the age of the chargebacks,**
  - **Prioritize the chargeback research process, and**
  - **Measure the efficiency of the chargeback process.**

- **Review significant trends in volume (dollar and number of accounts) and aging of chargebacks.**
- **Determine whether the bank's risk management systems sufficiently track excessive chargebacks.**

Note: The acquiring bank should not place undue reliance on the Association to identify merchants with excessive chargebacks.

30. Assess the institution's chargeoff policy for stale chargebacks. Classify stale chargebacks according to the FFIEC *Uniform Retail Credit Classification and Account Management Policy*.

31. Determine whether the bank establishes and periodically reviews the adequacy of its chargeback systems and reserves. Consider whether:

- **Management adequately plans for contingencies, such as a large merchant bankruptcy where a material volume of chargebacks occurred;**
- **Any significant losses incurred by the bank related to merchant chargebacks;**
- **The methodology for establishing required chargeback reserves is adequate;**
- **The bank establishes specific merchant reserves or holdback reserves for higher-risk merchants.**
- **Reserve deficiency reports identify all significant exposures; and**
- **The bank confirmed that merchants implemented chip technology, and (when applicable) assessed risks that could affect a merchant's financial condition if a merchant did not implement chip technology. (*Note: Chip cards contain an embedded microchip for enhanced security that creates an individual transaction code when used for in-store payments.)***

32. Assess how management reflects merchant chargeback losses on internal reports.

Note: Management should produce reports that identify, on an individual and aggregate basis, chargebacks attributed to individual merchants. For example: Chargeback 1234 of $50.00 from Merchant ABC. Merchant ABC: Chargebacks YTD total $9,000.00.

Independent Service Organizations (ISOs) / Merchant Service Providers (MSP)

ISOs solicit merchants' credit card transactions for an acquiring (clearing) bank. Examiners should only complete this section if the bank uses ISOs.

ISOs have assumed an increased role in retail merchant processing activities and rely heavily on sales commissions to generate business; therefore, examiners should assess the bank's processes controlling risks at ISOs. For example, ISOs should perform appropriate due diligence and monitoring of the retail merchants that they engage. FDIC: Refer to FIL 44-2008, Guidance for Managing Third-Party Risk.

33. Review a sample of ISO contracts and assess compliance with the contracts. In general, the contracts should appropriately address items such as:

- **Financial compensation and payment arrangements;**

- **Fee structures (fees should generally be tied to performance indicators such as sale volumes, number of merchants, and chargeback activity);**
- **Required security deposits by the ISO to offset potential merchant losses (security deposits should correlate to the ISO's financial condition, the quality of the merchants it solicits, and the level of sales volume it generates);**
- **Remedies to protect the bank if the ISO fails to perform as expected;**
- **Requirements for monetary transactions to be handled directly between the bank and the merchant;**
- **Prohibitions concerning the ISO's ability to assign the agreement or delegate responsibilities to a third party;**
- **Criteria for acceptability of merchants;**
- **Control of future use and solicitation of merchants;**
- **Allowable use of the name, trade name, and logo of the bank and the ISOs;**
- **Frequency and means of communication and monitoring of each party;**
- **Records each party must maintain (contracts should allow institutions access to ISO records);**
- **Frequency and type of financial statements to be required of the ISO;**
- **Warranties that all consumer laws are followed;**
- **Handling and other responsibilities for merchant chargebacks; and**
- **Onsite inspections by bank employees.**

34. Determine whether the acquiring bank permits ISO/MSPs to use the bank's VISA Bank Identification Number (BIN) or MasterCard Interbank Card Association number (ICA) to acquire merchants and/or settle credit card transactions. ***Note: This arrangement is often referred to as rent-a-bin (RAB). The BIN-owner retains the risk of loss as well as responsibility for settlement with the Associations consistent with the contract between the bank and the Association.***

- **Assess management's oversight and control of acquiring RAB arrangements to ensure the ISO/MSP is appropriately managing risks.**
- **Review any lending relationships the bank has with ISO/MSPs to ensure management analyzes total risk exposures.**

35. Review a sample of ISO credit files and assess compliance with policies and guidelines. The files should contain the following items:

- **A current financial statement on the principal(s) and the ISO, which should correlate to the size and complexity of the company;**
- **Initial onsite inspections of ISOs (and periodically thereafter based on performance) performed by a bank employee;**
- **Evidence of bank and trade references;**
- **A credit report on the principal(s) of the ISO; and**
- **A criminal check on the principal(s) of the ISO.**

36. Review management's analysis of the financial stability of ISOs, and determine whether ISO reserve accounts are consistent with the condition of the company and the volume of business generated.
37. Review and assess the procedures for monitoring the activities of the ISOs and determine whether adequate due diligence is performed. Consider management's reviews of the ISO's: • **Operational audits;** • **Past performance for evidence of misleading advertisements or inappropriate activities; and** • **Sales methods, customer service practices, and overall operations.**
38. Determine whether the bank has registered all ISOs with VISA or MasterCard.
39. Determine whether management reviews promotional material used by ISOs and attends sales training sessions for ISO salespersons.
40. Determine whether management appropriately performs initial and periodic due diligence, risk assessments, and vendor reviews of all ISO's with access to the bank's data systems. ***Note: Coordinate assessments with Information Technology examiners.***
41. If the ISO is performing servicing tasks, determine whether management requires an audit of the ISO's technology system.
42. Determine whether contingency plans exist to cover the accounting and servicing functions performed by ISOs to ensure data continuity.
Fraud Detection
43. Review the bank's fraud detection system and determine whether the scope and frequency of the fraud review is adequate. The primary tool of a bank's fraud detection system is the exception report, which is generated from parameters based on expected merchant activities. Fraud identification should not rely exclusively on unusual chargeback activity. A good fraud report should tailor exception parameters for each merchant (beginning with dollar volume of sales and customer chargebacks) and identify the following items:

- **Variances in average ticket size,**
- **Variances in daily volume,**
- **Multiple same-dollar amounts on tickets,**
- **Chipped, keyed, and swiped transactions,**
- **Multiple use of same cardholder number, and**
- **Inactive merchant accounts.**

Note: Exception reports listing merchant's out-of-parameter items should be generated and reviewed daily. Associations and sponsoring banks may also provide educational materials and provide fraudulent activity reports. Fraud monitoring or reports provided by Associations or sponsoring banks should supplement - not replace - the bank's own fraud system.

44. Assess the adequacy of actions taken if suspicious activity is detected. Consider:

- **Suspicious Activity Report guidelines,**
- **Placement of the merchant on MATCH,**
- **Termination of fraudulent merchant accounts, and**
- **Other actions taken to suspend or block settlement and/or authorization processing.**

Agent Banks

Note: Acquiring (clearing) banks often process credit card transactions for other banks, which are known as agent banks. Depending on the contractual arrangement, the agent bank may or may not be liable to the acquiring bank for chargeback or fraud losses. Only review this section if agent bank relationships exist.

***45.* Determine whether the bank has an agent bank policy that addresses the following items:**

- **Agent bank agreements, which should outline the agent bank's financial liability for merchant losses;**
- **Agent bank merchant underwriting standards, which should be similar to subject bank;**
- **Approval of policy exceptions;**
- **Agent bank liabilities and responsibilities regarding merchant fraud;**
- **Early termination of the agent bank relationship; and**
- **Approval authorities for each agent bank.**

Note: If the agent bank relationship involves only one or two agent banks with minimal activities, formal written policies may not be necessary as long as sound controls exist.

46. Review reports that show agent bank merchant volume by agent bank. Review the activities of agent banks that have significant merchant volume in comparison to the size of the agent bank. (Small banks with large merchant volume may have difficulty fulfilling their responsibilities regarding chargebacks.)

47. Review a sample of agent bank files, if necessary. Evaluate information and check for compliance with internal policy requirements (such as obtaining and reviewing periodic financial information).

Information and Communication Systems

48. Determine whether internal management reports provide sufficient information for risk management decisions and for monitoring the results of those decisions. Reports should provide sufficient detail for the board and senior management to:

- **Identify and monitor risks and their effect on earnings and capital;**
- **Evaluate profitability; and**
- **Verify compliance with risk limits and policy guidelines, including policy exception reporting.**

49. Determine whether merchant risks are effectively communicated to all areas affected.

50. Consider testing reports for accuracy by comparing them to regulatory reports and/or subsidiary records.

Board and Senior Management Oversight

51. Determine whether the board provides adequate management resources by (as appropriate):

- **Conducting interviews to determine whether the staff's technical expertise is commensurate with the scope of operations,**
- **Assessing whether current staffing levels are appropriate for present and future growth plans, and**
- **Determining whether training and development programs are adequate.**

52. Determine whether management's plans for the department are clear and communicated to the staff.

53. Review the blanket bond to ensure merchant processing activities have sufficient coverage.

Note: Servicers are typically not covered under a bank's fidelity coverage.

54. Review the department's operating statements. Compare the statement to the budget and investigate

significant variances.
End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

ELECTRONIC FUNDS TRANSFER RISK ASSESSMENT

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine whether an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Examiners are reminded that wire activity can have an impact on other exam assignments such as BSA, Asset Quality, Liquidity, and Sensitivity. Examiners reviewing Electronic Funds Transfer (EFT) have an opportunity to observe such things as suspicious activity, loan participation activity, borrowing activity, brokered deposits and other non-core inflows and outflows, among other important things. When observed, appropriate information should be shared with examiners reviewing those respective areas.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1. **Are policies, procedures, and risk limits adequate?** ***Refer to Core Analysis Procedure #8.***

C.2. **Are internal controls adequate?** ***Refer to Core Analysis Procedures #9-34.***

C.3. **Are the audit or independent review functions adequate?** ***Refer to Core Analysis Procedure #35.***

C.4. **Are information and communication systems adequate and accurate?** ***Refer to Core Analysis Procedures #36-37.***

C.5. **Do the board and senior management effectively supervise the electronic funds transfer area?** ***Refer to Core Analysis Procedures #38-43.***

ELECTRONIC FUNDS TRANSFER RISK ASSESSMENT

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review
1. Review previous examination reports, earlier work papers, and file correspondence for an overview of previously identified electronic funds transfer (EFT) concerns.
2. Obtain an organizational chart and flowchart for the EFT area and determine key job responsibilities and workflows. *Note: If the institution is subject to Sarbanes-Oxley (SOX), review the SOX information pertaining to the wire transfer function (e.g. SOX narratives, flow charts, and internal controls).*
3. Review the most recent audits and internal reviews of EFT activities to identify scope and noted deficiencies.
4. Review management's actions to correct examination and audit deficiencies.
5. Discuss with management recent or planned changes in EFT activities.
6. Review reports to determine the type and volume of wire activity. Ascertain if any alternative systems were implemented to supplement/replace wire transfer systems (e.g., ACH remittance programs).
7. Review the minutes of management committees that oversee EFT activity. Review for content and follow-up of material matters.

Policies and Procedures

8. Determine whether policies and procedures are adequate for the type and volume of funds transfer activities. At a minimum, guidance should addresses the following broad areas of concern:

- **Acceptable methods of wire requests (in-person, phone, fax, e-mail, E-Banking)**
- **Customer versus non-customer wire requests.**
- **Use of wire transfer request forms.**
- **Use of wire transfer agreements for recurring wire customers.**
- **Collected funds versus uncollected funds.**
- **Credit standards and overnight and daylight overdrafts limits.**
- **Callback requirements.**
- **Use of customer confirmations and advices.**
- **Maintenance of wire log.**
- **OFAC compliance.**
- **Separation of duties for funds transfer personnel including originating, receiving, testing, and approving functions; authorizing dollar limits; and preparing data entry.**
- **Clearly defined security procedures over payment orders and controls over source documents.**
- **Record retention.**
- **Exception reporting.**
- **Organizational reporting controls.**
- **Maintenance of adequate blanket bond coverage.**
- **Internal Audit coverage.**
- **Board reporting requirements.**
- **System testing.**
- **Network security.**
- **Incident response.**
- **Personnel hiring and dismissing.**
- **User security reviews.**
- **Implementation of a comprehensive business continuity, contingency planning, and disaster recovery program.**

Internal Controls

9. Evaluate management's procedures to prevent, detect, and respond to policy exceptions.

FUNDS TRANSFER REQUESTS

10. Review the bank's standard form of agreement or other written agreements with its customers, correspondent banks, and vendors. Determine whether those agreements are current and clearly define the liabilities and responsibilities to all parties.

11. Review the bank's procedures for validating transfer requests, including those received via on-line terminals, telephone, fax, E-Banking systems, or written instructions. Determine procedures provide for adequate security. For bank's that allow customers to submit requests via E-Banking products, determine whether appropriate authentication measures are in-place (refer to the FFIEC Supplement to *Authentication in an Internet Banking Environment*: FDIC: FIL-50-2011; FRB: SR 11-09).
12. Determine whether more than signature verification (tests, callbacks) are required on written requests. Verify that any callback procedures utilized by the institution comply with actual callback requirements (if any) stated in the blanket bond coverage.
13. Determine whether management maintains a current record of authorized signers for customers who use the bank's funds transfer services. The following items reflect prudent controls: • **Recurring wire transfer customers should be required to have current signed wire transfer agreements on file that outline duties and responsibilities of both the customer and the institution.** • **The record includes authorized sources of funds transfer requests (telephone, memo, and fax).** • **The bank advises its customers to limit the number of authorized signers.** • **Customer authorization lists limit the amount one individual is authorized to transfer.**
14. Ascertain if customer signature records are maintained under dual control or are otherwise protected.
15. Determine that procedures are in place to prohibit transfers of funds against accounts that do not have collected balances or preauthorized credit availability.
16. In situations where payments are to be made against uncollected funds and intraday overdrafts in excess of established limits, ensure that they are referred to appropriate authority for approval.
17. In situations where payments are made against uncollected funds and in excess of established limits, ensure that timely and appropriate steps are taken to obtain covering funds.
18. Evaluate management's compliance with Office of Foreign Assets Control (OFAC) procedures.

19. Determine if the Outgoing Wire Log is appropriately completed and documented. At a minimum, the log should include the following: ***Note: Ensure logs include customer-initiated and bank-purpose wires.***

- **Originator name.**
- **Originator account number.**
- **Dollar amount of transaction.**
- **Beneficiary Name.**
- **Beneficiary Account Number.**
- **Counterparty Institution.**
- **Counterparty Location.**
- **Domestic or Foreign.**

PAYMENT PROCESSING AND ACCOUNTING

20. Review the daily reconcilements of incoming and outgoing funds transfer activities, including both the dollar amount and number of messages. Determine whether appropriate controls are in place, such as:

- **Independent end-of-day reconcilements for messages sent to and received from intermediaries (Federal Reserve Bank, servicers, correspondents, and clearing facilities).**
- **System activity reconcilements to transfer request source documents.**
- **Daily supervisory review of funds transfer and message reconcilements.**
- **Daily activity balancing is performed separate from the receiving, processing, and sending functions.**
- **Federal Reserve Bank, correspondent bank, and clearing house statements used for funds transfers are reconciled and reviewed daily in another area of the bank (accounting or correspondent banking) to ensure they agree with the funds transfer records.**

21. Determine that the person reviewing rejects and exceptions is not involved in receiving, preparing, or transmitting funds.

22. Ensure that suspense items or adjustment accounts are appropriately accounted for, reviewed for abnormal fluctuations, and do not contain unusual or stale items.

CREDIT EVALUATION AND APPROVAL

23. Determine if there are well-documented, periodic credit reviews of funds-transfer customers and ensure that they are completed by credit personnel who are independent of account officer and operations staff.

24. Ensure that limits on intraday and overnight overdrafts are reasonable in view of the organization's capital position and the creditworthiness of the respective customers.

INCOMING FUNDS TRANSFERS

25. Determine whether incoming payments not received over a secure system (FedLine) are authenticated prior to processing.

26. Determine whether the bank maintains separation of duties over receiving instructions, posting to a customer's account, and mailing customer credit advices.

27. Determine whether management maintains audit trails from receipt through posting to a customer's account.

28. Determine whether management issues customer advices in a timely manner. (Best practices would indicate advices sent for incoming as well as outgoing wires)

29. Determine if the Incoming Wire Log is appropriately completed and documented. At a minimum, the log should include:

- **Beneficiary name.**
- **Beneficiary account number.**
- **Dollar amount of transaction.**
- **Sender Name.**
- **Sender Account Number.**
- **Counterparty Institution.**
- **Counterparty Location.**
- **Domestic or Foreign.**

Note: Ensure logs include customer-initiated and bank-purpose wires.

BUSINESS CONTINUITY AND DISASTER RECOVERY

(To the extent possible, leverage off the work of Information Technology examiners.)

30. Determine whether management has properly planned for contingencies and evaluate the reasonableness of the plan in relation to the volume of activity. Determine whether the contingency

plan incorporates appropriate safeguards, including:

- **A back-up system in the event of equipment failures and line malfunctions.**
- **A method for sending and receiving transfers if forced to operate at a different site.**
- **Procedures to ensure that data is recovered by the opening of the next day's processing.**
- **A requirement for supervisory approval for using back-up equipment.**
- **A requirement that the plan be distributed to all funds transfer personnel.**
- **Periodic testing of the back-up systems.**
- **Procedures and controls to prevent the inadvertent release of test data into the production environment.**

31. Determine whether procedures for backup and off-site storage of critical information and inventory control on hardware and software are in force.

FEDLINE ELECTRONIC FUNDS TRANSFER

Note: This type of transfer activity will be the most common type of funds transfer in community banks. Refer to the FFIEC IT Examination Handbook on Retail Payment Systems and the FedLine Advantage workprogram.

WHOLESALE ELECTRONIC FUNDS TRANSFER SYSTEMS (FTS)

Note: These procedures generally apply to larger banks that initiate large dollar transfers. Refer to the FFIEC IT Examination Handbook - Wholesale Payment Systems.

32. Review flowcharts or narratives of the bank's overall FTS to determine the degree of automated interface, linkage to functions not supported by the FTS, and separation of duties or functions. Review this information as it relates to any of the following systems used by the bank:

- **FedLine.**
- **CHIPS or other local payments system.**
- **SWIFT (Society for Worldwide Interbank Financial Telecommunications).**
- **Internal transfers (book entry).**
- **Customer networks.**
- **Internal networks.**

33. Review the adequacy of security procedures in place for both outgoing and incoming payment orders for each step of the FTS process.

- **Payment order origination such as message testing for fax, telephone, letters, or memos.**
- **Data entry.**
- **Payment order execution or release.**
- **Telecommunication lines.**
- **Physical security.**

34. Review a sample of contracts authorizing the bank to make payments from a customer's account and determine whether the contracts and disclosures adequately set forth responsibilities of the bank and the customer, primarily regarding the provisions of UCC Article 4A relating to authenticity and timing of transfer requests.

Audit or Independent Review

35. Determine that the audit or independent review program provides sufficient coverage relative to volume and nature of EFT activities. Independent review efforts should address all areas of EFT business, including:

- **Adequacy of and compliance with policies and procedures.**
- **Payment order origination (funds transfer requests).**
- **Message testing.**
- **Customer agreements.**
- **Payment processing and accounting.**
- **Personnel policies.**
- **Physical and data security.**
- **Contingency plans.**
- **Credit evaluation and approval.**
- **Incoming funds transfers.**
- **Outgoing funds transfers.**
- **Accuracy and completeness of wire logs.**
- **Bank Secrecy and Office of Foreign Assets Control (OFAC) issues, if applicable.**
- **Federal Reserve's Payment System Risk Program issues.**
- **Adequacy of blanket bond coverage, as well as compliance with any requirements of this insurance coverage for things such as callbacks.**
- **Evaluation of metrics utilized by management to measure the transactional risk inherent in the wire transfer function.**
- **Appropriateness of board reporting of wire activity that is commensurate with level of risk.**

Information Systems and Communication

36. Determine whether management reports provide sufficient information in relation to the nature and volume of EFT activities and that it is sufficient for the directorate to assess the organization’s inherent risk in EFT activities. Consider the following:

- **Identification of customers with large intraday and overnight overdrafts.**
- **Drawings against uncollected funds or in excess of established credit limits.**
- **Credit evaluation and approval.**
- **Total and average number of wires.**

- **Total and average dollar amount of wires.**
- **Volume of incoming vs. outgoing wire activity.**
- **Volume of domestic vs. international wire activity.**
- **Location of international activity.**
- **Volume of customer-initiated vs. bank-purpose wire activity.**
- **Trend of wire activity (number, dollar, average, etc.)**

37. Evaluate the accuracy and timeliness of information provided to the board and senior management.

Managerial Effectiveness

38. Assess compliance with board policies and guidelines.

39. Determine the adequacy of bank documentation of EFT activities, including the sufficiency of record retention practices.

40. Analyze compliance with laws and regulations, including requirements of the Bank Secrecy Act and Financial Recordkeeping.

41. Assess the adequacy of management's response to audit exceptions and recommendations.

42. Determine whether management has properly planned for contingencies and has developed reasonable contingency plans and safeguards that are commensurate with the volume of EFT activities.

43. Determine the adequacy of insurance coverage for each EFT operation and the overall EFT environment. (Note: Standard blanket bonds do not cover funds transfer operations. Banks typically obtain a special rider for funds transfers. However, the special rider does not normally provide coverage if telephonic requests for funds are honored.) Assess compliance with any requirements of the blanket bond coverage such as callback requirements.

End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

MORTGAGE BANKING - CORE

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine if an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1. **Are policies, procedures, and risk limits for the mortgage banking operations adequate?** ***Refer to Core Analysis Procedures #3-4, Procedures #37-38, Procedure #48, Procedure #53, Procedure #58, & Procedure #63.***

C.2. **Are internal controls adequate?** ***Refer to Core Analysis Procedures #5-8, Procedures #23-25, Procedure #43, Procedure #49, Procedure #52, Procedure #55, Procedure #68, & Procedure #77.***

C.3. **Are the audit or independent review functions adequate?** ***Refer to Core Analysis Procedure #6, Procedures #9-12, & Procedure #56.***

C.4. **Are information and communication systems adequate and accurate?** ***Refer to Core Analysis Procedures #13-15 & Procedure #43.***

C.5. **Does management use appropriate strategies to manage liquidity and limit interest rate risk exposure?** ***Refer to Core Analysis Procedures #34-40 & Procedures #73-74.***

C.6. **Are warehouse loans sold in a timely manner?** ***Refer to Core Analysis Procedures #31-33.***

C.7. **Is the mortgage banking department's financial performance acceptable?** ***Refer to Core Analysis Procedure #50, Procedure #54, & Procedure #72.***

C.8. **Are foreclosures handled properly to limit reputation and legal risk?** ***Refer to Core Analysis Procedures #63-69.***

C.9. **Do the board and senior management effectively supervise the mortgage banking area?** ***Refer to Core Analysis Procedure #4, Procedure #7, Procedure #15, & Procedures #76-80.***

MORTGAGE BANKING - CORE

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

This core module is intended for use in banks with more complex mortgage banking operations, including programs that service sold loans and retain mortgage servicing assets. Examiner judgment will ultimately determine whether to use the Abbreviated or Core Mortgage Banking module. Examiners should consider using the core module in more complex situations when the bank:

- ***Has a formal mortgage banking department or a mortgage banking subsidiary;***
- ***Has purchased and integrated a mortgage banking operation or company;***
- ***Engages in wholesale activities, including loans originated through third-parties;***
- ***Has warehouse line(s) of credit to fund the mortgage banking pipeline;***
- ***Is experiencing delinquencies, foreclosures, or extended agings within the warehouse;***
- ***Speculates on interest rate movements through unhedged positions;***
- ***Originates and sells nontraditional or subprime mortgage products; or***
- ***Services sold loans or retains mortgage servicing assets.***

References

- ***Interagency Advisory on Mortgage Banking (FDIC FIL-15-2003, FRB SR 03-4)***
- ***Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans (FDIC FIL-39-2005, FRB SR 05-10)***
- ***Interagency Guidance on Nontraditional Mortgage Product Risks (FDIC FIL-89-2006, FRB SR 06-15)***
- ***Statement on Subprime Mortgage Lending (FDIC FIL-62-2007, FRB SR 07-12)***
- ***Statement on Working with Mortgage Borrowers (FDIC FIL-35-2007, FRB SR 07-6)***
- ***Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages (FDIC FIL-76-2007, FRB SR 07-16)***
- ***Servicing for Mortgage Loans: Supplemental Information for Loss Mitigation Strategies (FDIC FIL-77-2007)***
- ***Discontinuation of Foreclosure Proceedings (FDIC FIL-14-2016)***

Preliminary Review

1. **Review the following documents:**
   - **Previous examination reports and workpapers on mortgage banking;**
   - **Recent internal and external audit reports, management letters, and management's response to any criticisms or recommendations;**
   - **Reports, if available, from government-sponsored enterprises (GSE), Federal Housing Administration (FHA), and significant private investors;**
   - **Internal memoranda, board minutes, and management reports on mortgage banking operations;**
   - **Financial performance reports to gain a basic understanding of assets, liabilities, and profitability;**
   - **If the bank is a loan servicer, review GSE or rating agency reports on servicing performance; and**

- **Organizational charts pertinent to mortgage banking activities.**

Note: References to GSEs include the Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC).

2. Review the types of products offered, sales volumes, originator channels, and target markets.

Policies and Procedures

3. Review policies and procedures regarding mortgage banking activities. Consider the following:

- **Permissible mortgage banking activities, including hedging;**
- **Loan production, origination, and underwriting activities;**
- **Individual officer and employee responsibilities;**
- **Lending limits and segregations of duty;**
- **Position and earnings-at-risk limits; and**
- **Accounting procedures for loan sales, loans held for sale, and derivatives.**

4. Evaluate the process for granting exceptions to policies and procedures. Consider whether prompt exception reporting is made to senior management and the board of directors and whether compensating factors that support exceptions are documented.

Internal Controls

5. Determine whether management established an effective quality control program that is independent from the loan production process and ensures that loans, whether originated or purchased, are processed, underwritten, closed, and serviced according to lender and investor standards.

6. Determine whether the quality control program meets GSE, FHA, and/or private investor guidelines and addresses the following:

- **Pre- and post-closing reviews;**
- **Retail and wholesale loan production;**
- **Re-verification of pertinent underwriting criteria;**
- **On-site branch audits if the lender is FHA or GSE approved; and**
- **Compliance with applicable laws and regulations related to mortgage foreclosures, including the Servicemembers Civil Relief Act.**

7. Determine whether quality control findings (and management's response) are clearly documented and presented to the board and senior management at least quarterly.

8. Determine whether procedures exist to detect fraudulent activity, investigate suspected fraud, issue appropriate management reports, and, when warranted, file Suspicious Activity Reports.

Audit or Independent Review

9. Determine whether the scope of audits and independent reviews is sufficient to identify policy, reporting, and internal control deficiencies and whether results are fully and promptly reported to the board.

10. If recent reviews or audits disclosed deficiencies, determine whether management responses are reasonable.

11. Determine whether the internal audit program covers compliance with state and federal laws, auditing standards, and investor requirements.

12. If applicable, verify that there is an independent review or audit of monthly servicer reports.

Information and Communication Systems

13. Determine whether management information systems (MIS) have the capacity to handle existing volumes and activities, as well as projected levels, strategies, and objectives.

14. Determine whether MIS reports generate sufficient information for management to identify and monitor:

- **Closed held-for-investment and held-for-sale loans;**
- **Loans segregated by product type and investor;**
- **The dollar amount and percentage of total loans for each type and investor;**
- **Loan application volumes, throughout the origination process, including:**

- **Applications received, including locked applications,**
    - **Commitments outstanding and related delivery status, and**
    - **Historical fall-out rates for specific loan categories;**
- **The status of delivery commitments to investors and the effectiveness of hedges;**
- **Daily positions, including pipeline commitments, fallout estimates, warehouse inventories, and forward sales contracts;**
- **The status of warehouse lines of credit; and**
- **The status of loans serviced for investors, including payments, delinquencies, foreclosures, modifications, and servicer advances.**

15. Assess the quality of board reports and determine whether the following information is conveyed in sufficient detail given the size and complexity of the mortgage banking program. Consider:

- **Operating results, including profitability, efficiency, and cost information;**
- **Asset quality trends, including delinquencies, chargeoffs, foreclosures, and collection accounts;**
- **Production volumes and processing backlogs;**
- **Warehouse inventory agings and turnover rates;**
- **Servicer advances, including recoverable and non-recoverable advances;**
- **Valuations of servicing rights, held-for-sale loans, and derivatives, including significant valuation assumptions and adjustments; and**
- **Hedging activities, including products, results, and strategies.**

Internal Loan Production (Origination, Underwriting, and Closing)

16. Review organization charts to assess the structure and independence of the production function.

17. Review loan production guidelines, which generally may address:

- **Types of loans to be originated or purchased;**
- **Sources from which the loans will be acquired, such as retail, wholesale, and the Internet; and**
- **Underwriting and appraisal standards (typically set by the investors).**

18. Review the qualifications, experience, and compensation levels of originators, processors, and underwriters.

19. Evaluate how management plans for funding during peak origination periods. If funding from an external warehouse line, consider how many times the line turns on a monthly basis.

20. Determine how management monitors adherence to underwriting guidelines.

21. Determine whether management established an underwriting authority matrix and whether underwriting functions are outsourced. Determine how management tracks loan quality for each underwriter. Most notably, ensure underwriting standards address investor requirements regarding the assessment and documentation of borrowers' ability to repay.

22. Evaluate procedures for closing and funding loans. Determine whether management requires that necessary documents are obtained before funds are released.

Wholesale Activities

Wholesale loan sources include third-party originators (TPO), such as brokers and correspondents.

23. Determine the types and dollar volume of loans submitted from each approved TPO. Determine whether controls exist to prevent loans closing from non-approved sources. Investigate any closings or purchases from sources not on the approved TPO list.

24. Review management's process for evaluating and monitoring the quality of loans submitted by TPOs. The quality control process should consider:

- **Historical default and foreclosure levels,**
- **Non-delivery history (pull-through rates),**
- **Documentation deficiencies, and**
- **Repurchase demands and other investor concerns.**

25. Determine how frequently the bank is required to repurchase loans (putbacks) that originated from TPOs. Assess the reasons for putbacks, and determine whether the bank tracks putbacks by source in order to identify TPOs that should be considered for removal from the approved TPO list.

Pipeline Management

The pipeline represents applications approved, but not funded.

26. Review the appropriateness and timeliness of pipeline reconciliation reports. Satisfactory reporting is

generally performed at least monthly.

27. Review the timeliness and accuracy of pipeline commitment reporting.

- **Determine whether unfunded commitments are specifically identified by product type and interest rate.**
- **Determine whether fixed-, floating-, and adjustable-rate derivative loan commitments are separately identified and tracked.**
- **Review management's process for handling expired rate-lock commitments.**

28. Determine whether management reports all rate-lock commitments (on loans designated as held for sale) as derivatives (written options). ***(Refer to the May 2005 Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans.)***

29. Determine whether pipeline commitments are accurately reported in financial and regulatory reports.

30. Review procedures for monitoring and projecting fallout rates (withdrawn from the pipeline or unapproved commitments), which can depend on historical behavior, loan type, current and anticipated interest rates, or other factors. Assess how fallout rates correlate to hedging practices.

Warehouse Management

Warehouse loans are closed, funded, and waiting to be delivered to the secondary market.

31. Review internal warehouse reconciliation reports and determine whether warehouse loans are accurately reported as held-for-sale at the lower of cost or fair value within financial and regulatory reports. Satisfactory processes generally include at least monthly reconciliations.

32. Review warehouse turnover and aging reports.

- **Research any unusual characteristics that may indicate impaired marketability, such as delinquent loans or loans in the warehouse beyond normal periods.**
- **Consider the level of, and reasons for, nonconforming or unsaleable loans.**
- **Review management's methods for handling warehouse loans that are ineligible for sale. Advise examiners conducting the loan review if a significant volume of ineligible loans are being placed in, or transferred to, the bank's held-for-investment loan portfolio.**
- **Determine whether part of the warehouse line is designated for loan repurchases and the number**

of loans within that category of the warehouse line.

33. **Determine whether the bank’s estimates of fair value of mortgages held for sale appropriately include the framework and fair value inputs described in ASC Topic 820, Fair Value Measurements.**

Hedging Practices

Mortgage banking programs often use derivative instruments, such as forward commitments, to hedge the rate-lock pipeline and warehouse loans against changing market interest rates.

34. **Assess the effectiveness of hedging strategies used to offset risks in unfunded (rate-locked) commitments and funded but unsold (warehouse) loans. Review assumptions used in simulation models, if applicable.**

35. **Ensure management reports forward commitments and options (if they meet the ASC Topic 815 definition of a derivative) as derivatives in financial and regulatory reports.**

36. **Determine whether management failed to fill any forward commitments or paid any pair-off fees. Determine the exposures and causes, if applicable.**

    (Note: If management is unable to meet commitments, refer to the hedging activities section in the Expanded Analysis.)

37. **Determine whether hedging policies are interest rate neutral or speculative. Review the effectiveness of such hedging strategies.**

38. **Determine whether management adequately assesses counterparty risks and establishes appropriate limits.**

39. **Review recent profit or loss reports for the mortgage banking operation to evaluate the effectiveness of hedging strategies.**

40. Discuss with management the degree of interest rate risk the bank is willing to accept and strategies for achieving and maintaining desired goals.

Secondary Marketing

Note: Secondary marketing encompasses the process of selling and delivering mortgage loans to investors, which includes the risk of repurchase.

41. Review a sample of loan purchase and sale agreements (correspondent agreements) with investors and determine the amount, maturity, terms of the commitment, representations and warranties, and other recourse provisions (e.g., credit default provisions).

42. Determine the number of pools sold that lack final pool certification, the reasons why, and whether the mortgage banking group is required to post a letter of credit.

43. Determine whether appropriate controls exist over recourse provisions, which may include the following:

- **MIS reports adequately track all recourse obligations;**
- **Recourse liability reserves are at an appropriate level for loans sold with recourse; and**
- **Management properly accounts for all loans sold with recourse in the regulatory reports, including the accurate risk weighting of recourse associated with credit default and premium recapture.** ***Note: Low-level recourse rules apply to premium recapture provisions.***

44. Determine the number of loan repurchase demands the bank received from external investors over the past 12 months and the status of each (outstanding, repurchased, indemnification agreement, withdrawn by investor) as well as any associated losses.

45. Determine whether correspondent agreements contain pass-through recourse provisions, which require the bank to be responsible for recourse that is contained in subsequent sales agreements between the investor and other third parties.

46. **In regards to the Credit Risk Retention Rule, determine whether the bank sells, or intends to sell, mortgages (that it originates) that represent 20 percent or more of a securitization that is sponsored by another entity (FDIC: Refer to Part 373 of FDIC Rules and Regulations, FRB: Refer to Part 244). If so, determine whether:**

- **Management is aware of the allocation-to-originator option and has factored the potential effects into the secondary marketing program;**
- **Requests have been made to, or granted by, the bank to acquire an eligible interest of the risk retention obligation from the securitization sponsor;**
- **The allocation-to-originator option is addressed in the sales agreements;**
- **Management considered the impact of any risk retained under this option on the bank's financial condition; and,**
- **The bank complies with the hedging, transferring, and pledging restrictions of the Credit Risk Retention Rule for any interests retained for purposes of accepting an allocation to originator option.**

(Note: The option to allocate risk to the originator permits the sponsor (i.e., the securitizer) to allocate its risk retention obligation to the originator (i.e., the bank) of securitized assets if the originator contributed at least 20 percent of the total assets in the securitization and the originator agrees to retain the risk. The originator's allocation cannot exceed the originator's share of the securitized assets.)

Mortgage Servicing

PORTFOLIO SUPERVISION

47. **Review servicing agreements with investors and ascertain the bank's main responsibilities as servicer.**

48. **Determine whether written policies and procedures for mortgage loan servicing adequately cover all facets of the servicing operations (e.g., loan set-up, adjustable rate mortgage adjustments, investor accounting, escrow administration, insurance, collections, foreclosure, bankruptcy, other real estate owned, customer service).**

49. **Review a sample of investor account reconcilements and consider the following controls:**

- **Each investor account is reconciled at least monthly,**
- **A supervisor reviews and approves reconcilements,**
- **Outstanding items are resolved in a timely manner, and**
- **Stale and un-reconciled items are promptly charged off.**

50. **Assess current and projected operating results for servicing functions. Determine whether:**

- **Cost estimates are completed on an average or incremental basis,**
- **Management analyzes profitability for each product type, and**
- **Cost analyses include all direct and indirect servicing expenses.**

51. Review the list of external vendors and sub-servicers engaged by the bank, and determine how management assesses the quality of work performed by these third parties.

52. Review significant consumer complaints and any pending litigation to identify possible internal control deficiencies and ensure appropriate resolution practices.

53. Determine whether the bank has purchased any loans from the servicing portfolio.

- **Determine the reasons for purchases.**
- **Analyze the volume and trend of purchases.**
- **Assess the appropriateness of policies and procedures that govern purchases.**

54. Evaluate the asset quality of the servicing portfolio, review delinquency reports, and assess the potential impact on the bank's financial performance, profitability, and reputation.

55. Determine whether the bank, as servicer, is required to make servicer advances on delinquent principal or interest payments, escrow costs, or foreclosure expenses. If so, consider the:

- **Book balance and credit quality of the advances,**
- **Controls surrounding the advances,**
- **Designation between recoverable and non-recoverable advances,**
- **Potential recourse if the bank is not in first position, and**
- **Ability to collect advances.**

MORTGAGE SERVICING ASSETS (MSAs)

56. Determine the extent to which MSAs are reviewed by internal and external auditors.

57. Review management's procedures for initially recording, subsequently recording, and periodically re-

evaluating MSAs. Procedures should address the:

- **Valuation method and assumptions used for initially measuring each MSA, and**
- **Subsequent method (either fair value or amortization) for measuring and recording each MSA.**

58. For MSAs accounted for under the amortization method, determine whether impairment policies and procedures are sufficient and reasonable, and consider whether:

- **The bank's stratum (basis point range) used for analyzing and tracking impairment is acceptable;**
- **The bank's analysis for impairment includes assessments based on product type, terms, rates, and other risk-layering characteristics;**
- **The bank is assessing MSAs for impairment or increased obligation based on fair value at least quarterly; and**
- **The bank's procedures to ensure market price or valuation assumptions used for the impairment analysis are current and reflect expected levels of mortgage prepayments and discount rates.**

59. Evaluate the bank's fair value measurements for mortgage servicing rights. Ensure that:

- **Sources of value are reliable;**
- **Prices used for valuations are appropriate for the bank's MSAs;**
- **Servicing assets (pertaining to all loan types and securitizations) are consistently valued;**
- **Valuation processes include adjustments for impairment;**
- **Modeling assumptions for MSAs are appropriate; and**
- **Assumption factors, such as interest rate scenarios and prepayments, made in modeling MSAs are consistent with other assumptions used by the bank.**

60. Evaluate the due diligence process for bulk acquisitions of MSAs, if applicable.

- **Determine whether the bank performs a comprehensive due diligence review prior to purchasing a servicing portfolio.**
- **Determine whether management applies reasonable valuation assumptions, which may include data on underlying mortgages, servicing revenues and costs, prepayment speeds, and discount rates.**

61. Verify that management is properly reporting MSAs in financial and regulatory reports. Determine whether management is treating MSAs properly for regulatory capital purposes (FDIC: Part 324 of FDIC Rules and Regulations, FRB: 12 CFR - Part 217).

62. Ensure that the bank adheres to FASB ASC Topic 860, which requires the disclosure of accounting

policies, volumes, cash flows, and key assumptions made in determining fair values of servicing assets and liabilities. Items to consider include the:

- **Amount of MSAs capitalized (or purchased) during the reporting period,**
- **Method and amount of amortization for the reporting period,**
- **Fair value of MSAs, including valuations methods and sensitivity of those fair values to changes in key assumptions,**
- **Reasons for not estimating fair value of MSAs and mortgage loans without MSAs (for banks that do not to capitalize MSAs),**
- **Risk characteristics of underlying loans for the purpose of measuring MSAs, and**
- **Activity in valuation allowances.**

Collections and Foreclosures

63. Review policies and procedures associated with collecting delinquent loans.

- **Determine whether collection efforts follow serviced loan investor guidelines. If governing documents allow loss mitigation strategies, determine whether servicers:**
  - o **Proactively identify borrowers at heightened risk of delinquency or default, such as those with impending interest rate resets;**
  - o **Contact borrowers to assess their ability to repay;**
  - o **Assess whether there is a reasonable basis to conclude that default is “reasonably foreseeable” and,**
  - o **Explore, when appropriate, a loss mitigation strategy that avoids foreclosure or other actions that result in a loss of homeownership.**
- **Determine whether the bank documents all attempts to collect past due payments.**
- **Determine whether uncollectible balances are promptly charged off.**

64. Determine whether management avoids unnecessary foreclosures and considers mortgage loan modifications or other workout strategies that are affordable and sustainable.

65. Determine whether the institution thoroughly assesses the abilities of sub-servicers to fulfill their contractual obligations for collections and foreclosures.

66. Ensure that foreclosures are conducted properly and consistent with all applicable laws, and that:

- **Foreclosures are in the name of the holder of the note or the party entitled to enforce the note,**
- **The foreclosing entity has possession of the original note and either a recorded mortgage or a recorded valid assignment of the mortgage before initiating the foreclosure, and**
- **Lost note affidavits are only used after a good faith effort to locate the original note.**

67. Determine whether management has appropriate policies and practices relating to decisions to discontinue the foreclosure process that address:

- **Obtaining and assessing current valuation and other relevant information,**
- **Releasing liens,**
- **Notifying local authorities, and**
- **Notifying and contacting the borrower(s).**

68. Determine whether attestations in a foreclosure affidavit comply with local laws and contain:

- **Facts explaining the basis for the personal knowledge of the affiant (e.g., job title, job position, job duties, etc.); and**
- **Assurances that the affiant reviewed supporting records to ensure the inclusion of all necessary documents for foreclosure in the particular jurisdiction.**

69. Ensure that the complaint document and foreclosure affidavit address the:

- **Specific amount due under the note,**
- **Payment history (to sufficiently demonstrate servicing of the loan),**
- **Description of the quality control procedures governing the foreclosure process, and**
- **Authorization under which the mortgage is validly assigned to the foreclosing note holder.**

70. Review the compensation program and determine whether the institution pays bonuses to law firms, servicers, and/or employees for processing high volumes of foreclosures.

Financial Analysis

GENERAL

71. Review the mortgage banking department's balance sheet and income statement and research items that are large relative to operations or that pose undue financial risk for other reasons.

72. Evaluate officer compensation arrangements and determine whether any compensation or incentive programs encourage unsafe or unsound practices.

EARNINGS PERFORMANCE

73. Assess the profitability of mortgage banking activities in terms of the level, composition, and trend of net income. Consider growth plans, interest rates, economic environment, and industry comparisons when evaluating earnings.

LIQUIDITY AND FUNDING

74. Evaluate management's process for meeting the mortgage banking department's liquidity needs, considering loans in the pipeline and warehouse.

75. Determine whether liquidity sources are adequate for current conditions and projected funding needs.

- **Evaluate the methods used to fund mortgage operations. The methods may include repurchase agreements, commercial paper, revolving warehouse lines of credit, and long-term debt.**
- **Review asset/liability management practices to determine whether funding maturities approximate maturities of underlying assets.**

CAPITAL ADEQUACY

76. Assess the effect of mortgage banking activities on risk-based and total capital.

Board and Senior Management Oversight

77. Determine whether a separate board committee for mortgage banking activities exists, and review committee minutes, if applicable, for significant information.

78. Determine what management committees have oversight and control over mortgage banking operations and evaluate the effectiveness of the committee structures. Further, determine whether there are deficiencies or conflicts resulting from the structures.

79. Determine whether the experience, technical knowledge, and administrative capabilities of management are sufficient for mortgage banking operations.

80. Review the mortgage banking strategic planning process and determine whether goals are reasonable,

attainable, complement the bank's overall business plan, and reflect the board’s risk appetite.
81. Determine whether management depth and succession plans are adequate.
End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

MORTGAGE BANKING – ABBREVIATED

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine if an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1.	**Are policies, procedures, and risk limits for the mortgage banking operations adequate?** ***Refer to Core Analysis Procedures #3-4 & Procedure #19.***
C.2.	**Are internal controls adequate?** ***Refer to Core Analysis Procedures #5-6 & Procedure #24.***
C.3.	**Are the audit or independent review functions adequate?** ***Refer to Core Analysis Procedure #1 & Procedures #7-8.***
C.4.	**Are information and communication systems adequate and accurate?** ***Refer to Core Analysis Procedure #4, Procedure #9, Procedure #12, Procedure #14, & Procedure #24.***
C.5.	**Does management use appropriate strategies to manage liquidity and limit interest rate risk exposure?** ***Refer to Core Analysis Procedures #9, Procedures #22, & Procedures #25-26.***
C.6.	**Are warehouse loans sold in a timely manner?** ***Refer to Core Analysis Procedures #15-18 & Procedure #23.***
C.7.	**Is the mortgage banking financial performance acceptable?** ***Refer to Core Analysis Procedure #25.***
C.8.	**Do the board and senior management effectively supervise the mortgage banking area?** ***Refer to Core Analysis Procedures #4-6, Procedure #11, Procedure #19, & Procedure #27-28.***

MORTGAGE BANKING - ABBREVIATED

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

This Abbreviated module is for use in banks with non-complex mortgage banking operations that sell loans with servicing released. Mortgage banking activities vary greatly among banks and it may not be necessary to perform all of these procedures. When useful, examiners can complete this Abbreviated module, or portions of it and portions of the Mortgage Banking - Core module. Examiner judgment should be used to determine whether to use abbreviated or core procedures. Generally, examiners should use the Mortgage Banking – Core module in more complex situations such as when the bank:

- ***Has a formal mortgage banking department or a mortgage banking subsidiary;***
- ***Has purchased and integrated a mortgage banking operation or company;***
- ***Engages in wholesale activities, including loans originated through third-parties;***
- ***Has warehouse line(s) of credit to fund the mortgage banking pipeline;***
- ***Is experiencing delinquencies, foreclosures, or extended agings within the warehouse;***
- ***Speculates on interest rate movements through unhedged positions;***
- ***Originates and sells nontraditional or subprime mortgage products; or***
- ***Engages in the servicing of sold loans and/or retains mortgage servicing assets.***

References

- ***Interagency Advisory on Mortgage Banking (FDIC FIL-15-2003, FRB SR 03-4)***
- ***Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans (FDIC FIL-39-2005, FRB SR 05-10)***
- ***Interagency Guidance on Nontraditional Mortgage Product Risks (FDIC FIL-89-2006, FRB SR 06-15)***
- ***Statement on Subprime Mortgage Lending (FDIC FIL-62-2007, FRB SR 07-12)***
- ***Statement on Working with Mortgage Borrowers (FDIC FIL-35-2007, FRB SR 07-6)***
- ***Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages (FDIC FIL-76-2007, FRB SR 07-16)***
- ***Servicing for Mortgage Loans: Supplemental Information for Loss Mitigation Strategies (FDIC FIL-77-2007)***

Preliminary Review

1. **Review the following documents.**
   - **Previous examination reports and workpapers, including consumer compliance examinations;**
   - **Internal audit reports;**
   - **The most recent external audit report, management letter, and management's response to criticisms and recommendations;**
   - **Government-sponsored enterprise (GSE), Federal Housing Administration (FHA), and significant private investor reports, if available; (*Note: References to GSEs include the Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC).)***
   - **Internal memoranda, board minutes, and management reports on the mortgage banking activities;**

- **Asset, liability, and profitability reports; and**
- **Organizational charts pertinent to the mortgage banking activities.**

2. Review the types of products offered and sold, originator channels, and target markets.

Policies and Procedures

3. Review bank policies and procedures regarding mortgage banking activities. Consider the following:

- **Permissible mortgage banking activities, including hedging;**
- **Loan production, origination, and underwriting guidelines;**
- **Individual officer and employee responsibilities;**
- **Lending limits and segregation of duties;**
- **Position and earnings-at-risk limits; and**
- **Accounting procedures for loan sales, loans held for sale, and derivatives.**

4. Evaluate the process for monitoring exceptions to policies and procedures. Satisfactory processes generally include monthly exception reporting to senior management and the board (including "no-exception" reports) and reports that detail compensating factors for each exception.

Internal Controls

5. Determine whether management established an effective quality control program that is independent from the loan production process and ensures that loans, whether originated or purchased, are processed, underwritten, closed, and serviced according to lender and investor standards.

6. Determine whether quality control findings are clearly documented and presented periodically to the board and senior management and include documentation of management's response.

Audit or Independent Review

7. Determine whether the scope of recent audits or independent reviews is sufficient to identify policy, reporting, and internal control deficiencies. Ensure detailed results are promptly reported to the board.

8. If internal audits or independent reviews disclosed any deficiencies, determine whether management responses are appropriate and timely.

Information and Communication Systems

9. Determine whether the management information systems (MIS) generate all necessary reports, such as:

- **Held-for-sale loans and inventory agings;**
- **Loans segregated by product type and investor;**
- **Application volumes (through origination), and any processing backlogs;**
- **The status of delivery commitments to investors;**
- **Daily positions, including pipeline, warehouse, and hedged loans;**
- **Operating results, including profitability, efficiency, and cost information; and**
- **Liquidity and capital needs.**

Loan Production (Origination, Underwriting, and Closing)

10. Assess the qualifications, experience, and compensation levels of originators and underwriters.

11. Evaluate procedures for underwriting and closing loans. Determine whether management ensures all necessary documents are obtained before funds are released.

Pipeline Management

Pipelines include loan applications that are approved, but unfunded.

12. Review the timeliness, accuracy, and composition of pipeline reporting.

- **Determine whether unfunded commitments are identified by product type, and adequately stratified, such as between fixed-, floating-, and adjustable-rate commitments and rate-locked or non-rate-locked commitments.**
- **Review management's process for monitoring and reporting expired rate-locked commitments.**

13. Ensure that management reports all rate-locked commitments (on loans designated as held for sale) as derivatives (written options) in financial and regulatory reports, as described in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 815.

14. Review management's procedures and assumptions for monitoring and projecting fallout rates, and consider how these rates correspond to hedging practices.

Warehouse Management

Warehouse loans are funded and closed loans waiting to be delivered to the secondary market.

15. Review the appropriateness and timeliness of internal warehouse-reconciliation reports.

16. Review warehouse turnover and aging reports, and determine whether there are any unusual characteristics that suggest impaired marketability, such as delinquencies, underwriting defects, or loans in the warehouse for extended periods. Determine the level of, and reasons for, any unsaleable loans.

17. Review the number and volume of loan-repurchase demands from investors since the prior examination. Consider the status (outstanding, repurchased, indemnified, or withdrawn by investor) and any associated losses.

18. Determine whether warehouse loans are accurately reported at the lower of cost or fair value. Determine whether estimates of fair value for held-for-sale loans use reasonable approaches, assumptions, and are valued in accordance with ASC Topic 820, Fair Value Measurements.

Hedging Practices

Many mortgage banking programs use derivative instruments, such as forward commitments, to hedge the rate-locked pipeline and warehouse loans against changing market interest rates.

19. Determine whether management established hedging policies that, at a minimum, address objectives, derivative types, authorizations, exposures, and exceptions.

20. Review the effectiveness of hedging strategies, such as forward sales or options, used to hedge risks associated with the pipeline and the warehouse.

21. Determine whether hedging instruments are accurately reported in financial and regulatory reports.

22. If the bank was unable to fulfill any forward commitments, assess the potential implications, such as pair-off fees, interest rate risk, and reputation risk.

Secondary Marketing

Secondary marketing encompasses the process of selling and delivering mortgage loans to investors, which includes repurchase risk.

23. Review a sample of loan purchase and sale agreements with investors (correspondent agreements). Identify volume commitments, expirations, representations, warranties, recourse provisions, repurchase guidelines, and other provisions.

24. Review a sample of correspondent agreements to determine whether the bank has any continuing recourse obligations to the purchaser beyond standard representations and warranties. If the bank is selling loans with recourse, determine whether appropriate controls exist over recourse provisions, which may include the following:

- **MIS reports adequately track all recourse obligations;**
- **Recourse liability reserves are at an appropriate level for loans sold with recourse; and**
- **Management properly accounts for all loans sold with recourse in the regulatory reports, including accurate risk weighting of recourse associated with credit default and premium recapture.**

Financial Analysis

25. Assess the earnings of the mortgage banking activities in terms of the level, trend, volatility, composition, and earnings at risk. Consider historic and projected gains on sales, growth plans, interest rates, economic environment, and industry comparisons when evaluating earnings.

26. Determine whether liquidity and capital levels support the demands and risks of the operation.

Board and Senior Management Oversight

27. Evaluate the effectiveness of management's oversight of the mortgage banking operations. Determine whether the experience, technical knowledge, and administrative capabilities of management are

sufficient.
28. Review the strategic planning process and determine whether mortgage banking goals are reasonable, attainable, and complement the bank's overall business plan and reflect the bank's associated risks.
End of Abbreviated Module. If needed, continue to Core Analysis Module.

RELATED ORGANIZATIONS
Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine if an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1.	**Are bank policies and procedures adequate for the level of transactions among the holding company, affiliates, and subsidiaries?** ***Refer to Core Analysis Procedures #7-8.***
C.2.	**Are internal controls adequate?** ***Refer to Core Analysis Procedures #10-13.***
C.3.	**Are audit and independent review functions adequate?** ***Refer to Core Analysis Procedures #14-16.***
C.4.	**Are information and communication systems adequate and accurate?** ***Refer to Core Analysis Procedure #17.***
C.5.	**Are affiliates appropriately separated from the bank and able to operate without threatening the bank's financial condition?** ***Refer to Core Analysis Procedures #18-28.***
C.6.	**Do transactions comply with applicable federal and state laws and regulations?** ***Refer to Core Analysis Procedures #29-32.***
C.7.	**Are all affiliated organizations adequately capitalized?** ***Refer to Core Analysis Procedure #34.***
C.8.	**Do the board and senior management effectively supervise this area?** ***Refer to Core Analysis Procedure #8-9, Procedure #13, Procedure #16, & Procedures #35-36.***

RELATED ORGANIZATIONS

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Important

The bank's corporate structure is subject to various laws and regulations, such as the Bank Holding Company Act (BHC Act) of 1956, Regulation W (which implements Sections 23A and 23B of the Federal Reserve Act), and Part 362 of the FDIC Rules and Regulations. A thrift's (savings association's) corporate structure is subject to laws and regulations such as the Home Owners' Loan Act (HOLA), FRB Regulation W, and FRB Regulation LL. These regulations define terms such as conclusive presumption, rebuttable presumption, covered transaction, low-quality asset, and affiliate. (This module includes general descriptions of terms and regulations; examiners should review the actual regulations when necessary for specific guidance and definitions.)

Different statutes and regulations have different definitions of affiliate. Affiliate is a broad term and includes the following: (1) Bank holding companies and savings and loan holding companies (SLHCs), (2) insured depository institution (IDI) subsidiaries of the holding company, (3) Nonbank subsidiaries of the holding company, (4) certain subsidiaries of the bank, and (5) Any company that the Federal Reserve determines by regulation or order to be an affiliate. Regulation W also provides that any company that is controlled by 25 percent or more of the shareholders that control 25 percent or more of the BHC/ SLHC or IDI is an affiliate for purposes of Regulation W.

An IDI is a state bank, national bank, trust company, banking association, or any institution that takes deposits insured by the FDIC, including savings associations (thrifts).

Section 312 of the Dodd-Frank Act transferred various powers and duties from the former Office of Thrift Supervision to the FRB, FDIC, and OCC. Under this provision, the FRB has oversight of SLHCs, the FDIC has oversight of state chartered thrifts, and the OCC has oversight of federally chartered thrifts. Examiners should be aware that SLHCs and thrifts are subject to certain restrictions under HOLA if the thrift does not maintain Qualified Thrift Lender status; see procedure #33.

Preliminary Review

1. **Review prior examination reports, pre-examination memorandums, file correspondence, and Federal Reserve holding company inspection reports for an overview of known related organizations and any previously identified criticisms.**

2. **Review recent external and internal audit reports to determine the scope of the review(s) and to identify criticisms and recommendations regarding transactions between the bank and its affiliates.**

3. Review relationships with holding companies or parent organizations, other affiliates and subsidiaries using such reports as the FR Y-6, the FR Y-10, the National Information Center (NIC) organizational hierarchy report (FRB), and the holding company organizational chart. Determine possible ownership ties not identified by the institution.

4. Examine the corporate structure surrounding the IDI and identify affiliate transactions. Carefully consider the following items:

- **Policies and practices regarding services and transactions between the IDI and its affiliates;**
- **Tax sharing arrangements and intercompany tax transactions;(see the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure for further discussion);**
- **Listing of affiliated transactions from the pre-examination information;**
- **Related interests of principal shareholders, directors, and executive officers; and**
- **Fixed-asset subsidiaries or affiliates.**

5. Review the holding company (or other parent organization) and the IDI's corporate structure for the possibility of a chain banking group. Determine whether the members of the chain-banking group control other companies through 25 percent common ownership. ***(Note: A chain banking group exists when a common individual or company, or group of individuals or companies ─ acting alone, through, or in concert with any other individual or company ─ owns, controls or has the power to vote at least 25 percent of the outstanding voting shares of two or more banks or savings associations.)***

6. Review the stockholders listing and most recent proxy statements of the holding company or parent organization. Identify ownership percentages and instances of control that satisfy the definition of control as set forth within the BHC Act (Section 225.2(e)) or HOLA.

7. Review, to the extent possible, other federal and state examination reports of the IDIs within the single holding company organization or within a chain banking organization for mutually shared risks. Consider the following items:

- **Size and complexity of the organizations;**
- **Overall condition of the institutions in the organization;**
- **Extent, type, and quality of transactions among institutions in the organization;**
- **Degree of interdependence among institutions;**
- **Common deficiencies in lending and investment policies;**
- **Possible insider abuse;**
- **Shared employees or management; and**
- **Degree and nature of control being exerted over individual institutions (absentee ownership).**

Policies and Procedures

8. Determine whether policies appropriately address relationships and transactions with related organizations.

9. Determine whether formal and informal employee sharing agreements are appropriate and dual employees' work allocation and compensation conform to the agreement. Satisfactory agreements generally:

- **Define employment relationships between the IDI and affiliate,**
- **Establish procedures and timeframes for payment,**
- **Are independently reviewed by the board of each affiliate, and**
- **Assign authority for managing dual employee relationships.**

Internal Controls

10. Assess the IDI’s methods for identifying transactions subject to Sections 23A and 23B of the Federal Reserve Act are adequate. Consider the following:

- **Internal reports**
- **Documentation of covered transactions,**
- **Loan records,**
- **Deposit accounts,**
- **Accounts payable and receivable, and**
- **Board minutes.**

11. Determine the volume and frequency of covered transactions. Ensure covered transactions are conducted on terms and conditions consistent with safe and sound banking practices and at readily determinable and well-documented market values. Review for noncompliance or abusive activities. Consider the following items:

- **Prohibitions on an IDI’s purchase of low quality assets from an affiliate or use of low quality assets as collateral,**
- **Prohibitions on the transfer of low quality assets to an IDI,**
- **Prohibitions on the acceptance of affiliate shares as collateral for loans to affiliates,**
- **Collectability of receivables,**
- **Collateral requirements,**
- **Restrictions on advertisements and agreements that suggest the IDI is responsible for the obligations of an affiliate, and**
- **Fixed asset arrangements.**

12. Review any formal or informal agreements regarding management or other fees paid by the IDI to affiliates. Satisfactory agreements generally detail and support the following:

- **Fee structures for services provided (e.g., based on asset size, number of employees, hours on-site, comparisons to market rates);**
- **Quality of services;**
- **Qualifications of service providers;**
- **Billings; and**
- **Timing of payments for services.**

13. Determine the IDI's compliance with any regulatory conditions/commitments pertaining to related organizations.

Audit or Independent Revie

14. Determine whether the independent review provides sufficient coverage relative to the institution's size, scope of related organization activities, and risk profile. Satisfactory independent reviews generally:

- **Determine compliance with policies, procedures, and regulatory requirements;**
- **Assess separation of duties, internal controls, and supervision of related organization activities;**
- **Assess the adequacy, accuracy, and timeliness of reports to senior management and the board;**
- **Recommend corrective action, when warranted; and**
- **Verify that corrective action commitments were implemented.**

15. Determine whether the results of audits and independent reviews are promptly reported to the board or a designated committee. If results are presented to a designated committee of the board, ensure the committee includes at least one outside/independent director.

16. Determine whether management's responses to recent audits or independent reviews are reasonable and whether corrective actions, such as reimbursements, are promptly implemented.

Information and Communication Systems

17. Determine whether management reports provide accurate, timely and sufficient information relative to:

- **The size and frequency of affiliate transactions, and**
- **The organization's size and risk profile.**

Evaluation of Affiliate Operations

18. Confirm the holding company's control (ownership, control, or power to vote) of all IDIs, nonbank subsidiaries, and tiered holding companies.

Note: Portions of procedures 19 – 22 may be more applicable to BHC/SLHC inspections than to a bank examination.

19. Identify ownership levels that have increased to more than 10 percent.

- **If any company controls more than 10 percent of the bank holding company stock or thrift holding company stock, determine whether notice was submitted to the responsible Reserve Bank.**
- **For Employee Stock Ownership Plans (ESOPs) or Employee Share Ownership Trusts (ESOTs) controlling or approaching control of more than 10 percent of the bank holding company, determine whether the ESOP/ESOT submitted a notice of agreement to comply with the standard Passive Commitments and whether or not the ESOP/ESOT is in compliance therewith.**
- **Determine who votes or controls the ESOP/ESOT shares (usually a trustee or trustees) and ensure this control is reported on each individual's applicable regulatory reporting forms and disclosure statements.**
- **Determine whether there are any financial transactions between the IDI and the ESOP/ESOT and, if so, that the transactions are consistent with Sections 23A and 23B of the Federal Reserve Act.**

20. Determine whether there were changes among large shareholders and, if necessary, whether a change in control notice was filed with the responsible regulator.

21. Determine who votes/controls the shares of any trusts owning more than 5 percent of the bank or bank holding company's outstanding shares.

- **Determine whether the trust itself is a company as defined within the Bank Holding Company Act (Section 225.2(d)). If so, determine whether the trust submitted notice of ownership to the responsible Reserve Bank, whether any commitments are in place, and if so, compliance with the commitments.**
- **Determine whether the trust, when combined with other shares owned or controlled by the same individual or group of individuals, meets the definition of a bank holding company, and if so, has filed appropriate applications with the Federal Reserve Bank.**

22. Determine whether all required regulatory filings were submitted and are accurate (e.g., FR Y-6, FR Y-10, Notice of Change in Control).

23. Analyze the holding company's balance sheet, income statement, and statement of cash flows; and review the most recent holding company inspection report, rating, and Officer's Questionnaire. Consider, with particular scrutiny when the IDI's condition is dependent on direct financial support from the parent company, the:

- **Origin of long-term debt, short-term debt, unamortizing debt, and the level of pressure exerted on the bank to upstream dividends;**
- **Level of holding company or parent-organization borrowings used to provide equity contributions to the subsidiary bank (double leverage);**
- **Parent company cash flow sources and uses (note any undue reliance on bank dividends or management and service fee income from subsidiary banks);**
- **Ability of the parent company to borrow funds or raise capital, if needed, for the injection of capital into the subsidiary bank(s);**
- **Holding company or parent organization's transactions with subsidiaries;**
- **Timing and amount of quarterly income tax payments and settlement payments by and between the bank, the parent and the IRS (Refer to the 1998 Interagency Statement of Policy - Income Tax Remittance by Banks to Holding Company Affiliates and to the 2014 Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure for additional information.);**
- **Level and trend of affiliate deposit relationships maintained at the bank; and**
- **Merchant banking or other activities at the holding company or parent organization that may affect credit decisions at the bank level.**

24. Review the management structure and programs of the holding company or parent organization and its subsidiaries. Assess the effect(s) on the institution and ensure compliance with applicable regulations and statutes. Consider the following issues:

- **Level of centralized control by the holding company or parent organization over bank and non-bank subsidiaries;**
- **Access to management/audit/loan review expertise or services and the potential benefits from economies of scale;**
- **Training programs and their ability to foster consistency among the management of sister banks and non-bank affiliates;**
- **Movement of officers between the bank, holding company, and non-bank affiliates and the potential benefit to management succession planning (note any unfilled positions within the bank subsidiary);**
- **Management contracts (and supporting documentation) between the holding company or parent organization and the bank or non-bank subsidiaries; and**
- **Allocation of bank management's time devoted to bank, holding company, or other affiliate issues.**

25. Determine whether fees (such as, management, service, lease, or other fees) paid between the bank and its affiliates are proportional to the value of the goods or services provided or received. Appropriate

fee arrangements often include:

- Service contracts in place between the IDI and the affiliates;
- Fees based on the fair market value of services provided or, when there is no market, based on actual costs plus a reasonable profit;
- Service and pricing factors that are thoroughly supported and documented;
- Transactions that comply with applicable laws and regulations; and
- Prompt reimbursement to the bank for all funds due from an affiliate.

26. Determine the extent of deposit gathering activities performed by employees of affiliates, and the potential application and reporting requirements of brokered deposit regulations.

27. Review any mortgage banking activities or servicing contracts with affiliates. When applicable, consider:

- The capacity in which the affiliate is acting (as principal, on behalf of, or as agent for the IDI);
- The nature of the services provided;
- The transfer of low quality assets from an affiliate to an IDI via purchase or sale;
- The adherence to regulatory requirements for mortgage servicing rights;
- The billing arrangement, frequency of billing, method of computation, and basis for fees;
- The method for compensating the bank for balances maintained, and net interest earned on warehouse loans and lines;
- The pricing of loans and sales of servicing rights;
- Risks related to mortgage servicing, delinquent loans, and foreclosed assets; and
- Whether asset purchases, including servicing rights and extensions of credit, satisfy the quantitative, collateral, and safety and soundness requirements of Section 23A of the Federal Reserve Act.

28. Analyze the financial information and operating policies of affiliates and determine whether they may be detrimental to the institution's financial position. Consider the following items:

- Quality of assets,
- Funding needs,
- Fees received from the bank,
- Salary structure of subsidiary's officers and shared officers, and
- Financial condition of the subsidiaries.

Compliance with Other Applicable Regulations

29. Confirm that the bank's loan agreements do not restrict a borrower from obtaining credit, property, or service from a direct competitor of the holding company/parent organization or the holding

company's/bank's subsidiaries as a condition of credit. ***(Note: These anti-tying provisions of the BHC Act are not intended to restrict the bank's ability to impose debt limitations on borrowers.)*** **For a thrift, confirm that the thrift complies with the anti-tying provisions outlined in Section 5(q) of HOLA.** ***(Note: Regulation LL (FRB) Section 238.7 outlines exceptions to thrift-related tying restrictions.)***

30. Determine whether bank customers who purchased financial products of affiliated organizations were notified of the affiliate relationship. If the customer received IDI financing to purchase the assets, determine whether the transaction was subject to and in compliance with Regulation W.

31. Determine whether the subsidiaries' activities are permissible and comply with appropriate federal and state laws and regulations.

32. Assess the adequacy of corporate, management, and physical separations that exist between the bank and affiliated organizations.

Qualified Thrift Lender

33. Determine the potential financial impact on a savings association (or state savings or cooperative bank that has been deemed a savings association under Section 10(*l*) of HOLA) if the savings association fails to maintain qualified thrift lender (QTL) status and the SLHC:

- **Is no longer eligible to engage in activities permissible for certain Unitary SLHCs (Sections 10(c)(3) and 10(c)(9)(C) of HOLA),**
- **Is no longer eligible to continue certain grandfathered activities permissible for certain unitary SLHCs (Section 10(c)(6)(B) of HOLA), and**
- **Is required to convert to a BHC within one year of the association failing to maintain QTL status (Section 10(m)(3)(C)) and is no longer eligible to engage in activities permissible for SLHC's but not BHCs.**

Affiliate Capitalization

34. Determine whether affiliates comply with the capital requirements of their functional regulator.

Board and Senior Management Supervision

35. Determine whether the board of directors reviews all affiliate relationships at least annually and approves all agreements between the institution and any related organizations.

36. Determine whether all affiliate relationships have adequate supervision by bank officers. (Affiliate relationships are subject to the same standards as any unaffiliated vendor relationship.)
End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

RETAIL INSURANCE AND SECURITIES SALES ACTIVITIES

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine whether an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1.	**Are the bank's policies, procedures, and other risk limiting methods adequate?** ***Refer to Core Analysis Procedures #8-10* & *Procedure #27*.**
C.2.	**Are internal controls adequate?** ***Refer to Core Analysis Procedures #11-12, Procedure #25, & Procedures #28-29.***
C.3.	**Are the audit or independent review functions adequate?** ***Refer to Core Analysis Procedures #13-14 & Procedure #30.***
C.4.	**Are information and communication systems adequate and accurate?** ***Refer to Core Analysis Procedures #15-16.***
C.5.	**Are third party agreements and the bank's reviews of compliance with such agreements adequate?** ***Refer to Core Analysis Procedures #17-19* & *Procedure #31*.**
C.6.	**Do the bank's board and senior management effectively oversee and administer sales and incentive programs and activities involving insurance or securities products offered directly by the bank or by third party entities from or on behalf of the bank?** ***Refer to Core Analysis Procedures #20-24 & Procedure #26.***

RETAIL INSURANCE AND SECURITIES SALES ACTIVITIES

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review

1. **Review information such as prior examination reports, prior examination work papers, pre-examination memoranda, other regulator reports, and file correspondence for an overview of the bank's retail insurance or security-sales activities.**

2. **Review internal and external audit reports and independent reviews to determine their scope and to identify any concerns and conclusions relevant to insurance and security-sales programs.**

3. **Review the balance sheet, income statement, and cash flows of any insurance agency or security-sales unit that is a department or subsidiary of the bank.**

4. **Consider contacting the appropriate functional regulator(s) to obtain supervisory information regarding these activities.**

5. **Review board or committee minutes and internal management reports for evidence of managerial oversight, responsibility delegations, or concerns with respect to these activities.**

6. **Discuss insurance products, security-sales programs, and related controls with management.**

7. **Review the budget pertaining to the bank's insurance and security-sales activities.**

Policies, Procedures, and Other Risk Limiting Methods
8. Determine whether policies and procedures are adequate for the retail insurance or security-sales programs, and any networking arrangement the bank may have with a broker-dealer.
9. Determine whether the board approves policies at least annually, or more frequently if substantive changes occur.
10. Assess whether management conducts appropriate due diligence before entering into agreements with third parties to conduct insurance or security activities and before specific insurance or security products are offered to customers on bank premises or on behalf of the bank.
Internal Controls
11. Determine whether the bank's internal control program includes separation of duties between the sales, management, compliance, and accounting functions for retail insurance or security-sales activities.
12. Determine whether the bank has procedures to prevent, detect, and respond to written policy exceptions.
Audit or Independent Review
13. Determine whether the coverage and frequency of the audit or independent review are sufficient to identify deficiencies in policies and procedures, financial and operating risk management, internal controls, information and communication systems, and management relative to the bank's retail insurance agency or security-sales activities. The independent review process should: • **Determine compliance with policies, procedures, and regulatory requirements.** • **Assess the due diligence processes for purchased entities that conduct retail insurance or security-sales activities.** • **Verify compliance of third parties with contractual agreements.** • **Assess separation of duties, internal controls, and supervision of insurance agency or securities brokerage activities.** • **Test for the adequacy, accuracy, and timeliness of information produced by reporting systems.** • **Assess the adequacy, accuracy, and timeliness of reports to senior management and the board.** • **Review operations for potential conflicts of interest, self-serving practices, and insider abuses.** • **Recommend corrective action, where warranted.**

- **Verify that corrective action commitments have been implemented.**

14. Determine whether results of independent reviews are reported to the full board or a designated committee.

Information and Communication Systems

15. Determine whether management reports include the following types of information:

- **Sales volume of each type of product offered.**
- **Fees, product commission rates, expenses, and overall financial results of the retail insurance or security-sales programs.**
- **Status of premium collection and remittance processing by insurance agents, if applicable.**
- **Amount of compensation received by retail insurance and security salespeople.**

16. If the bank conducts insurance sales activities directly or owns an agency, determine whether management accurately reports these activities on its Consolidated Reports of Condition and Income. Verify that the reports are accurately consolidated using Generally Accepted Accounting Principles.

Third Party Agreements and Reviews

17. Determine whether management has entered into a formal written agreement with each third party involved in insurance or security-sales activities for the bank and if the agreement has been approved by the bank's board of directors.

18. Determine whether the bank's legal counsel reviews all contracts and agreements for content and enforceability of terms.

19. Determine how often management evaluates the operating soundness of third parties by reviewing compliance evaluations, independent audits, financial reports, examination reports and/or other information. ***Note: Insurance companies provide the products (insurance and annuities) sold by the bank or agency. These third parties are subject to examination by state insurance regulators (functional regulators). Their report of examination is a public document in most states and can be obtained from the state insurance regulator of the state in which the insurance company is based.***

Board and Senior Management Oversight

20. Determine whether there have been any technology system installations or conversions for insurance agencies or securities brokerage firms acquired and if such changes were successfully completed.

21. Determine whether the officers designated to implement and manage the bank's retail insurance or security-sales activities possess appropriate knowledge and experience.

22. Assess whether management mandates professional qualification training and continuing education opportunities for all officers and employees involved with the insurance or security programs.

23. Determine whether any plans for expansion of insurance or security activities are consistent with overall strategic plans and board approved policies.

24. Determine whether management adequately responds to audit or independent-review concerns.

Compliance with Insurance and NDIP Consumer Protections (Non-FDIC Only)

Note: FDIC: Defer to DCP for all compliance reviews. FRB examiners can review the Regulation R Training Modules on the Board's internal website for additional information.

25. Determine whether the bank's compliance function has processes to ensure the maintenance of appropriate agent licensing for retail insurance and security-sales programs conducted on behalf of the bank.

26. Review any customer complaints in the bank's retail insurance or security-sales program files. Also, review FRB, state insurance department, and FINRA or SEC complaint records for potential concerns over the administration of the activities (e.g., misrepresentations, untimely claims distributions, suitability issues, etc.).

27. Determine whether adequate policies and procedures exist to address consumer protection aspects of retail insurance sales or non-deposit investment products at an office of the bank, or on behalf of the bank. Consider if such policies and procedures sufficiently cover:

- **Training programs for all personnel involved in insurance or security referrals, recommendations, and sales activities conducted on bank premises or on behalf of the bank, including activities conducted through telemarketing contacts;**
- **Product suitability guidelines for customer sales;**
- **Compliance with applicable laws, regulations, and consumer protection rules that address prohibitions on:**
  - **Tying of sales of insurance to credit products,**
  - **Coercive sales practices, and**
  - **Discrimination against victims of domestic violence in sales of insurance products;**
- **Prominent display of required written minimum disclosures;**
- **Compliance with incentive compensation restrictions on unregistered bank employees that refer customers to a broker-dealer (in connection with networking arrangements) pursuant to the FRB and SEC's joint Regulation R and the Gramm-Leach Bliley Act (GLBA) Title II broker-push-out rules that have been incorporated into the Securities Exchange Act of 1934, Section 3(a)(4)(B)(i); and**
- **Restrictions on the activities of bank employees (other than associated persons of a broker-dealer who are qualified under securities self-regulatory organization (SRO) rules) to the performance of only clerical or ministerial functions in connection with brokerage transactions.**

28. Determine whether management has established adequate procedures that address:

- **Timing of minimum required disclosures;**
- **Minimum disclosures for advertising and promotions;**
- **Documenting customers' receipt of all required disclosures:**
  - **Before an account is opened,**
  - **Before an the initial sale of an insurance product is completed,**
  - **During any sales presentation,**
  - **When investment advice is provided, and**
  - **When an account is opened for an NDIP;**
- **Alternative disclosures for telephone and electronic sales;**
- **Compensation for referrals by non-licensed personnel;**
- **Physical segregation of retail insurance and NDIP sale activities from deposit taking areas; and**
- **The conditions in the Securities Exchange Act (Section 3(a)(4)(B)(i)) detailing when a bank may allow a broker-dealer to offer bank customers brokerage services on or off bank premises and not be considered a broker that is required to register with the SEC. These conditions include:**
  - **The broker dealer is clearly identified;**
  - **Brokerage services are provided in a clearly marked, and preferably physically separate area;**
  - **Advertising and promotional materials make clear that brokerage services are provided by the broker dealer, and not the bank;**
  - **Advertising and promotional materials are in compliance with federal securities laws;**
  - **Bank employees (other than broker dealers, or SRO-qualified associated persons) perform only clerical or ministerial functions;**
  - **Bank employees do not receive incentive compensation for brokerage transactions unless they are associated persons of a broker dealer and SRO-qualified, except that bank employees may receive customer referral compensation in the form of a nominal, one-time cash fee of a fixed dollar amount, if payment of the fee is not contingent on whether the referral results in a**

transaction;

- **Customers receiving brokerage services are fully disclosed to the broker dealer;**
- **The bank does not carry customer security accounts except as permitted under other GLBA trust, custody, or safekeeping exceptions; and**
- **The bank or broker dealer informs each customer that brokerage services are provided by the broker dealer and not the bank, and that securities are not deposits or other obligations of the bank, are not guaranteed by the bank, and are not FDIC-insured.**

29. Evaluate controls concerning product suitability. Determine whether procedures:

- **Require security-sales representatives or insurance agents to evaluate sufficient customer information before offering investment recommendations regarding NDIPs, including variable insurance products.**
- **Require representatives to clearly explain all recommendations to customers.**

30. Ascertain whether policies and procedures for internal controls require thorough reviews of sales practices, advertising methods, and customer complaints.

31. Determine whether the compliance program includes oversight of the documentation required of third parties to demonstrate compliance with customer acknowledgement requirements.

End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

SECURITIZATION

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine if an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1.	**Are policies, procedures, and risk limits adequate?** ***Refer to Core Analysis Procedure #7.***
C.2.	**Are internal controls adequate?** ***Refer to Core Analysis Procedures #8-17.***
C.3.	**Are audit and independent review functions adequate?** ***Refer to Core Analysis Procedures #18-20 & Procedure #75.***
C.4.	**Are information and communication systems adequate and accurate?** ***Refer to Core Analysis Procedures #21-28.***
C.5.	**Are risks associated with underlying assets clearly identified and measured?** ***Refer to Core Analysis Procedures #29-52.***
C.6.	**Are beneficial interests properly valued?** ***Refer to Core Analysis Procedure #26, Procedure #55, & Procedure #76.***
C.7.	**Are risks from securitizations that require consolidation adequately identified and managed?** ***Refer to Core Analysis Procedures #58-67.***
C.8.	**Do the board and senior management effectively oversee securitization activities?** ***Refer to Core Analysis Procedure #5-6, Procedure #20, & Procedures #68-77.***

SECURITIZATION

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Important

Refer to the Interagency Guidance on Asset Securitization Activities when completing this module. FDIC examiners should, when necessary, contact regional capital markets and securities specialists, or the Capital Markets Branch, for assistance in completing this module. Refer to the FDIC's Credit Card Securitization Activities Manual for supplemental guidance when examining banks that securitize credit card receivables.

Scope: Examiners should determine whether securitized assets were properly accounted for as transfers of financial assets, secured borrowings, or whether the variable interest entity (VIE) needs to be consolidated. This module primarily applies to examinations of institutions that use securitizations to transfer financial assets off their balance sheets and that meet any of the following criteria: 1) originate or purchase financial assets for securitization, 2) retain beneficial interests in securitized assets, or 3) provide liquidity or credit enhancements.

Procedures 58-67 address securitizations accounted for as secured borrowings where the financial assets remain on the balance sheet. This module does not include procedures for assessing servicing activities.

Preliminary Review

1. Determine whether securitization concerns were identified in:

- **Prior examination reports,**
- **File correspondence,**
- **Internal/external audit reports,**
- **Independent reviews, or**
- **10-K and 10-Q reports.**

2. Review reports, correspondence, and audits to identify activities and trends in:

- **Securitization volumes,**
- **Collateral types,**
- **Deal structures,[1]**
- **Cash flows, and**
- **Performance.[2]**

3. Review performance information (internal and publically available reports) for the institution's pools

[1] Such as, VIE type, concentration limitations, representations, and warranties.
[2] Consider issues such as delinquencies, chargeoffs, prepayments, excess spreads, and put-back volume.

and comparable pools.

4. Review internal and third-party valuation reports regarding beneficial interests.

5. Review board/committee minutes and internal management reports for evidence of oversight, responsibility, and any identified concerns.

6. Discuss with management, its securitization strategy and determine if it is consistent with the board's strategic plans and policies.

Policies, Procedures, and Risk Limits

7. Determine whether securitization policies, procedures, and risk limits adequately address:

- **Permissible (i.e., board authorized) securitization activities;**
- **Authority and responsibility over:**
  - **Transaction approvals and cancellations,**
  - **Deal negotiations and executions,**
  - **Deal summaries,**
  - **Counterparty approvals,**
  - **Transaction monitoring,**
  - **Pricing approvals,**
  - **Personnel supervision,**
  - **Risk management, and**
  - **Processes for reporting and approving policy exceptions;**
- **Underwriting standards for loans originated or purchased for securitization;**
- **Credit ratings;**
- **Servicing standards, including criteria for selecting third-party servicers;**
- **Exposure limits, such as beneficial-interest concentration limits by type, maturity, and volume as a percent of Common Equity Tier 1 and Tier 1 capital;**
- **Limits on the amount of funding derived from securitization;**
- **Standards (consistent with contractual recourse obligations) for repurchasing loans from securitized asset pools;**
- **Hedging activities, including embedded derivatives;**
- **Approval of hedging counterparties;**
- **Legal-counsel reviews of contracts and agreements;**
- **Accounting methodologies;**
- **Regulatory reporting requirements;**
- **Methods for valuing beneficial interests, including procedures for reviewing and approving**

underlying assumptions;

- **Management reporting;**
- **Contingency plans;**
- **Compensation policies; and**
- **Credit-risk-retention requirements and standards to ensure regulatory compliance.**[3]

Internal Controls

8. Determine whether internal control programs address key issues, such as:

- **Individual authority limits,**
- **Separation of duties,**
- **Physical and electronic access controls, and**
- **Independent reviews.**

9. Determine whether separation-of-duty controls effectively restrict interactions between management and operational personnel, so that no one can unduly affect established securitization procedures.

10. Determine whether controls adequately restrict access to, or manipulation of, securitization records.

11. Determine whether loan-servicing statements and trustee reports for each securitization are routinely reconciled.

12. Determine whether controls are in place to verify that transfers of financial assets to VIEs are not required to be consolidated under ASC Topic 810, Consolidation.

13. Determine whether controls are in place to verify that financial assets transferred meet the sales criteria in ASC Topic 860, Transfers and Servicing.

14. Determine whether policy deviations are addressed and reported in accordance with approved policies.

[3] **FDIC: Part 373. FRB: Part 244.**

15. When the bank retains recourse in a securitization, assess controls to ensure recourse payments to the trust do not exceed the bank's contractual obligation.

16. When the bank acts as servicer or retains a beneficial interest in the securitization, determine whether the bank properly identifies and tracks cash flows through lockboxes, trust accounts, and bond payments. Assess procedures for ensuring that collected servicing and finance fees are not comingled with the bank's own collection accounts.

17. If the bank uses models in securitization activities or to value beneficial interests, determine whether controls prevent the individual who establishes model assumptions from being responsible for reviewing model results.

Internal Audit or Independent Review

18. Determine whether the scope of internal audits/independent reviews is sufficient to identify policy, risk management, internal control, and compliance deficiencies. Typical audit/review scopes include assessments of:

- **The valuation process for beneficial interests and the appropriateness of underlying assumptions;**
- **Modeling processes and validation mechanisms;**
- **Verification procedures designed to prove that loans serviced by a third party, including a subsidiary or an affiliate, reconcile to internal records;**
- **Compliance with deal covenants;**
- **Conformance with pooling and servicing agreements;**
- **The adequacy of information systems to process data accurately;**
- **The accuracy of regulatory and public reporting;**
- **Compliance with policy guidelines;**
- **Procedures for monthly reconciliations of loans held-for-sale;**
- **Accounting procedures for loans held-for-sale;**
- **Accounting procedures for loans transferred from the institution's held-for-sale portfolio to the held-for-investment loan portfolio;**
- **Accounting procedures for original bookings, subsequent valuations, and regulatory reporting of beneficial interests;**
- **Policies and procedures to ensure that a sale under ASC Topic 860 occurred; and**
- **Compliance with the credit-risk retention rule.**[2]

19. Determine whether regular and unscheduled reviews are performed.

20. Determine whether internal audit results are promptly reported to the board, and whether responses to recent internal audits or independent reviews are reasonable and timely.

Information and Communication Systems

21. Review the use of modeling for beneficial interests (whether using an external party or using in-house models) and determine whether:

- **Bank personnel have a reasonable understanding of how the model works and what the output means (and if used in-house, the ability to operate the model);**
- **The model and model assumptions have historically produced results in line with past projections (back testing);**
- **Modeling software and systems are:**
  - **Appropriate for performing required tasks and calculations;**
  - **Appropriate for the types of collateral and transactions that create the cash flows being modeled; and**
  - **Independently maintained by individuals authorized to install updates and make changes to the model.**

22. Determine whether financial reports and disclosures are compliant with the SEC's Regulation AB and the enhanced disclosure requirements of Regulation AB II.[4] Assess the adequacy of other regulatory reports and disclosures as applicable.

23. Determine whether institutions using advanced approaches under Basel III capital rules comply with the qualitative and quantitative disclosure requirements related to their securitization activities.

24. Determine whether internal reports provide management with sufficient information to make informed decisions and to monitor the results of those decisions. If the institution maintains a beneficial interest in securitized assets, reports should address:

- **Deal summaries for completed, current, and prospective securitization transactions, that include relevant information, such as:**
  - **Collateral type,**
  - **Facility amount,**
  - **Maturity,**
  - **Class structure,**

[4] **Regulation AB applies to registered securities only.**

- Termination events,
  - Credit enhancement and subordination features,
  - Financial covenants,
  - Rights of repurchase,
  - Servicing responsibilities, and
  - Counterparty exposures;
- **Pool performance factors, such as:**
  - Gross portfolio yields,
  - Probability of default,
  - Loss severities (under default),
  - Payment rates, and
  - Excess spreads;
- **Vintage analysis (using monthly data) for each pool;**
- **Static pool cash-collection analysis;**
- **Monthly statements of covenant compliance;**
- **Quarterly (or more frequent) sensitivity analyses or stress tests;**
- **Exposure by counterparties and functions (e.g., originator, seller, servicer);**
- **Profitability analysis by securitization and function (e.g., originator, seller, servicer);**
- **Liquidity usage and expected funding requirements;**
- **Roll-rate analysis that tracks delinquency trends and the timing and age of chargeoffs; and**
- **Sufficient details on beneficial interests to allow management to assess credit, concentration, valuation, and liquidity risks.**

25. Determine whether management properly determines risk-based capital requirements for all securitization exposures.

26. Determine whether the bank correctly applies the appropriate approach for calculating regulatory capital for beneficial interests (e.g., supervisory formula approach, simplified supervisory formula approach (SSFA), or 1,250% risk weighting).

27. For re-securitization exposures, determine whether management is using the SSFA to measure risk-based capital charges based on the underlying exposures.

28. Determine whether information on securitization activities is effectively communicated to the lending, credit review, funds management, and risk management areas.

Risk Identification and Measurement
29. Review credit quality ratios for portfolio, securitized, and held-for-sale loans to determine whether underwriting standards for securitized and held-for-sale loans are comparable to portfolio loan ratios. Compare ratios such as: • **Noncurrent loans to gross loans,** • **Total past due loans to gross loans, and** • **Net losses to average total loans.**
30. Review performance factors and counterparty profiles to determine whether events triggered, or are close to triggering, over-collateralization or early-amortization protections as defined in the securitization documents.
31. Determine whether curing or re-aging practices mask poor performance in securitized assets.
32. Review internal standards for approving originators and brokers, and assess how management ensures originators and brokers maintain acceptable underwriting standards.
33. Determine whether management monitors portfolio risks by obtaining FICO scores, behavioral patterns or scores, or other credit data on borrowers.
34. Review aging reports for held-for-sale loans. Identify loans with longer-than-average holding periods and determine the cause.
35. Consider whether unmarketable loans are transferred from the held-for-sale loan portfolio to the general (held for investment) portfolio. Assess the level, frequency, and cause of transfers, and the effect on the institution's overall asset quality.
36. If the institution retains a beneficial interest in securitized assets, determine whether management monitors prepayments, delinquencies, defaults, and losses on sold assets.

37. For banks with beneficial interests, ensure documentation demonstrates the bank's clear ownership in the beneficial interests and the right to cash flows.

38. If the bank acts as servicer, determine if servicer advances are made for principal, interest, escrow, and/or foreclosure-related payments. If so:

- **Determine whether management:**
  - **Properly accounts for the advances as receivables,**
  - **Assesses the credit risk of the advances, and**
  - **Establishes contingency reserves as needed;**
- **Determine whether the advances fall under the risk-based capital rules as recourse arrangements, by considering whether:**
  - **The servicer is entitled to full reimbursement or, for any one loan, non-reimbursable advances are limited to an insignificant amount of the outstanding principal on that loan; and**
  - **The servicer's entitlement to reimbursement is not subordinated.**

39. Assess the financial impact on the institution if management takes action to prevent early amortizations or rating downgrades. Such actions may include purchasing pool assets, exchanging assets within the pool, or waiving certain fees.

40. Determine whether management identified any embedded derivatives[5] within securitizations. Consider:

- **The counterparties to the derivatives and their financial strength,**
- **Accounting implications, and**
- **The potential for reportable recourse arrangements (such as clean-up calls over 10% of pool).**

41. Determine whether the bank's beneficial interest is subject to basis risk due to differences between indices on the underlying loans and the bond classes. Assess how the risk is identified and managed.

42. Determine whether assets related to securitization activity (such as, beneficial interests and held-for-sale loans) are properly reflected in the bank's interest rate risk model.

[5] **Derivatives may include interest rate swaps, caps, forward arrangements, or call options.**

43. Review management's statements of covenant compliance and consider whether the institution's marketplace reputation may be damaged.

44. Assess the adequacy of capital and liquidity contingency plans designed to manage trigger events and market disruptions that could render further securitizations unfeasible. When applicable, sound stress-testing practices capture severe-but-plausible scenarios, and appropriate contingency planning addresses:

- **Alternative sources of liquidity; and**
- **Management and operation of cash flows to implement covenants concerning over-collateralization accounts, reserve funds, and other related accounts.**

45. If a third party servicer is used, including a subsidiary or an affiliate, determine whether management reviews audits or other documentation to analyze the operating soundness of this entity.

46. Determine whether the use of credit substitutes (such as standby letters of credit) is subject to the review and approval of the credit department.

47. Determine whether exposures arising from recourse exposures or direct credit substitutes are analyzed during internal credit reviews.

48. Review agreements to provide back-up liquidity and determine the institution's obligations to fund advances and its rights to withhold advances.

49. Determine whether the bank retains an ownership interest in, or acts as a sponsor to, a securitization structure that falls within the Volcker Rule's definition of a covered fund.

50. Determine whether covered funds qualify for exclusion from the Volcker Rule's restrictions.

51. Determine whether any bank plans to divest of beneficial interests that do not meet the Volcker Rule's exclusions comply with the divestiture timelines of the rule.

Prior to completing item 52, determine whether securitizations are, or create, asset-backed securities and whether the bank is a sponsor as defined in the credit risk retention rule. Complete item 52 only if the securitized assets consist of asset-backed securities and the bank is a sponsor.

52. Assess compliance with the requirements of the credit risk retention rule by reviewing items such as:

- **Type, amount, and measurement of risk retention;**
- **Eligibility conditions if a transaction-specific or allocation-to-originator option is used;**
- **Qualification standards and conditions if an exemption, exception, or reduction is used;**
- **Maintenance of, and adherence to, applicable policies and procedures when risk retention is allocated to the originator, originator-seller, or third-party;**
- **Disclosures;**
- **Repurchase, cure, or buy-backs for qualified residential mortgages or qualifying assets;**
- **Hedging and transfer prohibitions and pledging restrictions; and**
- **Record maintenance.**

Valuation of Retained Interests

53. Determine whether management reviews contractual documents to ensure valuation modeling is properly mapping the cash flows legally owed to the beneficial interests. The cash flows may include excess principal and interest payments from the collateral and the release of reserve funds.

54. Determine whether management appropriately stratifies securitized assets by loan characteristics when making valuation assumptions.

55. Assess the reasonableness of prepayment, default, loss, and discount rate assumptions used to value beneficial interests.

- **Review management's documentation supporting the appropriateness of assumptions.**
- **Determine whether management regularly (at least quarterly) reviews and updates (based on current and projected market conditions) the reasonableness of assumptions.**
- **Assess management's procedures for identifying impairment.**

56. Review cash flow documentation to determine whether:

- **The amount of interest paid to bond classes matches the stated coupon rate for each bond class;**
- **Cash flows are distributed to bond classes and beneficial interests according to the terms of the prospectus, offering circular, or pooling and servicing agreement; and**
- **The deal redemption or cleanup provision is accurately reflected in the cash flows to beneficial**

interest holders.

57. If a third party values the beneficial interest(s), review management's documentation, and evaluate the due diligence performed for determining the qualifications of the third party.

Securitizations that Require Consolidation

58. Determine whether the creditors of any of the bank's consolidated VIEs have recourse to the general credit of the institution rather than only to the assets of the VIE (i.e., whether the bank provided a guarantee to the securitization).

59. If creditors have recourse to the general assets of the institution, determine the circumstances under which creditors have recourse, whether management is monitoring the performance of the bank's securitizations (to assess the likelihood of general creditor claims), and actions management is taking to mitigate the risk exposure.

60. Determine whether management's assumptions and judgments are reasonable, adequately supported, and properly documented.[6]

61. Determine whether management considers the bank's exposure to general creditor claims in its assessment of capital adequacy and in capital planning.

62. Review the institution's involvement with consolidated VIEs, including judgments and assumptions made in determining consolidation requirements.[7]

63. Determine whether the institution's involvement with VIEs affects the institution's financial position, financial performance, or cash flows.

[6] **For example, if the bank provides guarantees, the obligation should be periodically fair valued based on the performance of the underlying collateral.**

[7] **Management should validate whether the institution is the primary beneficiary.**

64. Assess the impact of the interest income recognized on VIE financial assets and the interest expense on VIE liabilities on the bank's net interest income (since the financial assets and liabilities of the VIE are consolidated).
65. Determine whether: • **Management evaluates the collectability of VIE loans that are reported as held-for-investment,** • **The bank's methodology for the allowance for loan and lease losses (ALLL) properly incorporates VIE loans within its scope, and** • **The level of the consolidated ALLL is appropriate to cover the estimated credit losses on VIE loans.**
66. Assess the earnings impact resulting from timing differences caused by loan and lease losses that must be taken on VIE loans in the periods when the credit losses are incurred.[8]
67. Determine whether there are restrictions on consolidated VIE assets or the settlement of its liabilities reported on the institution's balance sheet.
Board and Senior Management Oversight
68. Determine whether management properly accounts for the transfer of financial assets in securitized transactions.[9]
69. Determine whether management properly designates SPEs as VIEs under ASC Topic 860.
70. Determine whether the institution is the primary beneficiary of the VIE.[10] If so, determine whether management appropriately consolidates VIEs.[11]

[8] Any expected reductions in the cash flow to investors who hold beneficial interests in the securitization normally will not result in a reduction in the VIE's liabilities to these beneficial interest holders.

[9] Refer to the Call Report Instructions and ASC Topics 810 and 860 for additional information.

[10] A controlling financial interest exists when the institution has the power to direct significant VIE activities and the obligation to absorb significant VIE losses or the right to receive significant VIE benefits.

[11] Sales accounting treatment cannot be achieved when the institution is the primary beneficiary (when the VIE is consolidated).

71. Assess management's analysis of securitization activities to determine whether the activities and associated risks are consistent with the institution's strategic and financial objectives. Appropriate analysis generally includes assessments of:

- **The cost of securitizing assets compared to the cost of alternative funding sources,**
- **Initial/ongoing costs and projected returns of transactions, and**
- **Risks related to a transaction.**

72. Determine whether securitization documents contain any adverse covenants[12] that are tied to supervisory actions or thresholds, (such as downgrades in the institution's composite CAMELS or RFI/(C) D ratings, changes in the institution's Prompt Corrective Action capital category), or if the institution is placed under any type of written enforcement action by a supervisory authority.[13]

73. Determine whether management provides sufficient capital in relation to risks arising from securitization activities.

74. Determine whether the board reviews and approves securitization policies (at least annually), new products, and material changes in securitization activities.

75. Determine whether management reviews financial audits (or other information) to analyze the condition of any third party credit enhancement provider, including a subsidiary or an affiliate,[14] involved in the institution's securitizations.

76. Determine whether management complies with laws, accounting standards, and regulatory requirements.

- **Determine whether management appropriately applies the minimum risk-based capital standards to securitization transactions that involve recourse, including low-level recourse.**
- **If the institution securitizes assets and retains an interest that serves as a credit enhancement supporting transferred assets, determine whether management reflects these transactions as assets**

[12] Adverse covenants include items such as termination triggers, early amortization events, and servicing transfer covenants.

[13] Refer to the Interagency Advisory On The Unsafe And Unsound Use Of Covenants Tied To Supervisory Actions In Securitization Documents. (FDIC: FIL-53-2002. FRB: SR 02-14)

[14] If necessary, refer to the Related Organizations Module to determine compliance with Sections 23A and B of the Federal Reserve Act.

sold with recourse in schedules RC-L, RC-R, RC-S of the Consolidated Reports of Income and Condition.

- **Determine whether the securitization and the beneficial interests are accounted for consistent with ASC Topic 810, ASC Topic 860, and other applicable accounting standards.**
- **Determine whether held-for-sale loans are valued at the lower of cost or fair value**
- **Determine whether management appropriately follows risk retention rules.**

77. Determine whether historical performance indicates adequate board and senior management oversight.

End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

TRUST
Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine if an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1.	**Are policies, procedures, and other methods for limiting risk adequate?** ***Refer to Core Analysis Procedures #12-13.***
C.2.	**Are internal controls adequate?** ***Refer to Core Analysis Procedures #14-28.***
C.3.	**Are the audit or independent review functions adequate?** ***Refer to Core Analysis Procedures #29-34.***
C.4.	**Are information and communication systems adequate and accurate?** ***Refer to Core Analysis Procedures #35-36.***
C.5.	**Are trust department earnings adequately managed and sufficient to support the institution's fiduciary activities?** ***Refer to Core Analysis Procedures #37-43.***
C.6.	**Does the institution comply with internal policies and procedures, governing instruments, applicable laws and regulations, and sound fiduciary principles?** ***Refer to Core Analysis Procedures #44-54.***
C.7.	**Are asset management and investment advisory practices adequate?** ***Refer to Core Analysis Procedures #55-89.***
C.8.	**Do the board and senior management effectively supervise fiduciary activities?** ***Refer to Core Analysis Procedures #90-102.***

TRUST

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review

1. **Review prior examination reports, work papers, and file correspondence for an overview of any previously identified deficiencies or higher risk issues.**

2. **Review internal and external audit reports, engagement letters, and management responses.**

3. **Review remedial actions taken by management to correct audit and examination deficiencies.**

4. **Review other sources to determine the general risk profile of the trust department and identify the types of accounts administered (e.g., personal trust, corporate trust, employee benefit (defined contributions, defined benefit, and investment management). Consider the following:**
   - **Schedule RC-T in the FFIEC Reports of Income and Condition (Call Reports);**
   - **Other regulatory reports, examinations, investigations, and correspondence from state banking authorities, Securities and Exchange Commission, FINRA, or Department of Labor;**
   - **Public information such as stockholders reports, the bank's Internet site, press releases, and published news stories;**
   - **Current trust department Statement of Assets and Liabilities or trust department Statement of Condition;**
   - **Responses to the First Day Letter and the Trust Officer's Questionnaire;**
   - **Customer complaints, including complaints received by the FDIC, FRB, or state; and**
   - **Pending or threatened litigation.**

5. **Determine whether the trust department administers or uses common trust funds, collective investment funds, proprietary mutual funds, or other pooled investment vehicles.**

6. **Determine which of the following activities should be reviewed given the trust department risk profile:**

- **Securities lending,**
- **Fiduciary services delivered via electronic banking channels,**
- **Employee benefit participant record keeping,**
- **Fee sharing arrangements, including receipt of 12b-1 or sub-accounting fees from mutual funds,**
- **Services provided to or received from third parties,**
- **Sweep arrangements/cash management,**
- **Soft dollar arrangements,**
- **Institutional custody,**
- **Use of outside investment advisors,**
- **Open Architecture/Separately Managed Accounts,**
- **Securities transactions (i.e., compliance with the SEC/FRB Regulation R and GLBA broker exception rules.)**

7. Review regulatory information concerning any purchase, acquisition, or merger activity since the last examination.

8. Discuss the following issues with management, focusing on significant changes since the last examination or planned changes:

- **Key personnel and staffing,**
- **Organizational structures,**
- **Operations and automated systems,**
- **Marketing strategies,**
- **New products and services,**
- **Investment strategies, and**
- **SEC/FRB Regulation R and GLBA broker exception rules.**

9. Review the following information regarding management of the trust department:

- **Minutes of meetings of the board of directors and trust related committees;**
- **Organizational charts;**
- **Committee composition and structure; and**
- **Management information reports, such as:**
    - **Net overdrafts and other account liabilities,**
    - **Large cash balance reports,**
    - **Past-due loans (including participant loans in employee benefit accounts), and**
    - **Delinquent fee reports.**

10. Determine the scope of the account review. Consider the following:

- **General account selection criteria:**
  - **Pending or threatened litigation,**
  - **Customer complaints,**
  - **Previous examination criticisms,**
  - **New and closed accounts,**
  - **Successor appointments,**
  - **Co-fiduciary relationships,**
  - **Internal watch lists and accounts risk rated inherently "high" (e.g. ERISA-governed accounts),**
  - **Assets not carried on the department's books,**
  - **Accounts with liabilities,**
  - **Accounts lacking diversification,**
  - **Accounts holding unique assets (such as real estate, mineral, oil and gas interest, and limited partnerships), and**
  - **Administratively complex assets held in discretionary and investment advisory accounts;**
- **Actual or potential conflicts of interest, such as:**
  - **Discretionary investments in own institution or parent securities and deposits,**
  - **Discretionary investments in securities and other obligations of insiders,**
  - **Discretionary investments in proprietary products (such as mutual funds, insurance, and annuities),**
  - **Inter-trust transactions, and**
  - **Accounts where insiders serve as co-fiduciary;**
- **Employee benefit accounts with plans that:**
  - **Cover the institution's employees,**
  - **Are sponsored by directors or their related interests,**
  - **Hold participant loans, or**
  - **Are under investigation by the Department of Labor;**
- **Corporate accounts with issues that are:**
  - **In default or litigation, or**
  - **Subject to the Trust Indenture Act; and**
- **Estates that have been open for an extended time.**

11. Prepare the examination scope memorandum.

Policies, Procedures, and Other Risk Management Methods

12. Determine whether policies, procedures, and other methods for managing risks are adequate in relation to the institution's risk profile. When applicable, such policies and procedures should address the following:

- **Asset management, including investment reviews,**
- **Account liabilities (including overdrafts),**
- **Account administration and reviews,**
- **Conflicts of interest and self-dealing,**

- **Operations and internal controls,**
- **Securities trading,**
- **Broker and investment advisor selection,**
- **New-business development,**
- **Incentive compensation,**
- **Selection and retention of legal counsel,**
- **Ethical standards for trust department personnel,**
- **SEC/FRB Regulation R/GLBA broker exception rules,**
- **Investment selections,**
- **Fee concessions,**
- **Exception reporting and approval, and**
- **BSA/OFAC adherence.**

13. Determine whether the trust department's policies and procedures adequately address:

- **Privacy issues,**
- **Electronic banking,**
- **Electronic funds transfer, and**
- **Business continuity planning and testing.**

Note: Department guidelines may be contained in the institution's general policy framework as well as trust department specific policies.

Internal Controls

CONTROL ENVIRONMENT

14. Determine whether management and the board have provided for:

- **Adequate staffing for efficient operational processing and appropriate separation of duties;**
- **Compensating controls (if limited staffing precludes separation of duties);**
- **Clearly defined responsibilities, duties, and lines of authority; and**
- **Proper reporting and prompt correction of internal control deficiencies.**

PROTECTING AND CONTROLLING ASSETS

15. Assess the effectiveness of internal controls by considering whether:

- **Trust assets are separated from the assets owned by the institution**
- **Controls over the receipt and release of assets require:**
  - **More than one institution employee to be present when assets are received or inventoried in a residence, and**
  - **Account holders or beneficiaries to sign written confirmations for all items distributed to them;**
- **Assets held in the vault are under dual control and subject to periodic verification;**

- **The value of worthless assets are appropriately researched, documented, and periodically reviewed;**
- **Worthless assets are maintained on the department's books at nominal value;**
- **Hold and return mail procedures are appropriate;**
- **Account statements are mailed by trust operations personnel (or an outside data processor) and not the account administrator.**
- **Procedures over the disbursement of trust funds include:**
  - **Controls over unissued checks, such as using sequential or pre-numbered documents, and**
  - **Signature controls and defined authorization limits.**

16. Assess arrangements where a registered broker-dealer serves as custodian for trust assets, by considering:

- **The adequacy of management's analysis and documentation (both prior to entering arrangements and periodically thereafter) of the financial strength of the broker-dealer (including SEC/FINRA capital adequacy and Specific Reserve Account requirements); [See SEC Rule 15c3-3(c)]**
- **The adequacy of the governing written agreement, which should include provisions addressing:**
  - **Unauthorized conversions of trust assets,**
  - **Unauthorized securities lending,**
  - **Rights of offset against unpaid securities, and**
  - **Termination provisions;**
- **Whether the records of the broker-dealer segregate customer trust assets from the financial institution's own securities portfolio (for example, customer trust assets could be recorded in the name of the financial institution "as trustee for");**
- **Whether State law permits broker-dealers to serve as a custodian for trust assets; and**
- **The adequacy of Securities Investor Protection Corporation (SIPC) insurance coverage.** ***(Note: Generally, individual trust accounts must be separately identified on the broker-dealer's records for such accounts to be eligible for SIPC insurance.)***

17. Determine the nature, extent, and adequacy of controls over wire transfer activities. (Refer to Electronic Funds Transfer Risk Assessment ED Module.)

RECORDKEEPING

18. Determine whether internal controls provide for accurate and reliable record keeping and regulatory reporting by considering whether record keeping systems:

- **Maintain records in sufficient detail to properly reflect all trust department activities;**
- **Report the assets of each trust account separately from the assets of every other account;**
- **Account separately for principal and income in accordance with state requirements or governing account agreements;**
- **Facilitate the timely and accurate processing of all transactions, including:**
  - **Securities income,**

- **Distributed cash/assets,**
- **Securities prices and ratings,**
- **Mutual fund and cash sweep transactions (including allocated income and service fees), and**
- **Corporate actions that affect security holdings.**

- **Provide for accurate filing of Consolidated Reports of Condition and Income Schedule RC-T;**
- **Demonstrate compliance with SEC/FRB Regulation R and GLBA broker exception rules, in particular with the "Chiefly Compensated" provision of the Trust & Fiduciary Exception; and**
- **Provide for accurate and timely reporting of cost-basis information on Form 1099, as well as the provision and receipt of transfer statements. (See IRC §6045 and §6045A)**

RECONCILIATIONS

19. Determine whether reconciliation procedures are adequate for security depositories, brokerage accounts, internal accounts, mutual funds, and cash management services. ***Note: The status of all reconciliations should be reported to management on a timely basis.***

INFORMATION SYSTEMS

20. Evaluate the adequacy of internal controls over information systems used by the trust department, including the adequacy of contingency plans for possible failures of critical systems and the frequency with which contingency plans are tested.

OTHER INTERNAL CONTROL MATTERS

21. Assess the effectiveness of the department's internal controls in ensuring compliance with applicable laws and regulations.

22. Determine whether appropriate controls exist over securities transactions, including timely execution and proper segregation between account administration and settlement.

23. Determine whether proper procedures are in place to process securities proxies, corporate actions, and other shareholder communications. (Refer to the Shareholders Communications Act of 1985)

24. Determine whether the institution allows daylight overdrafts (a.k.a., free riding) during the securities settlement process in custody accounts. If allowed, consider whether the institution:

- **Sets guidelines and standards for the acceptance of new custodial accounts, such as customer**

background and credit reviews;

- **Requires identification of broker-dealers that will be sending securities and accepting payments from custodial accounts;**
- **Has systems to monitor trading and track accounts involving broker-dealers;**
- **Ensures that each account has sufficient funds to perform any trade, or:**
  - **That temporary overdrafts incurred for the purchase of exchange-traded or margin stocks are secured by collateral margins required in FRB Regulation U, and**
  - **Form FR U-1 is obtained from customers where credit in excess of $100,000 is extended;**
- **Rejects customer trades that would result in a violation of FRB Regulation U;**
- **Prohibits temporary overdrafts which could aid a broker-dealer in violating FRB Regulations T or X; and**
- **Has training programs for administrators and operations personnel involved in the securities settlement process.**

25. Determine whether the department maintains effective controls over dormant and unclaimed funds to ensure that such funds are adequately documented, monitored, aged, and escheated as required by applicable state law.

26. Evaluate the institution's process for providing customer account statements and other information.

27. Ensure that account administrators are not involved in the account statement generation and distribution process.

28. Determine whether original trust documents are adequately protected and copied/backed up.

Audit or Independent Review

29. Determine whether the board provides for an annual or continuous audit of fiduciary activities.

30. Determine whether the scope of audit coverage is commensurate with the level of risk associated with fiduciary activities. Determine whether audit activities adequately evaluate:

- **The accuracy and validity of transactions;**
- **Fee calculations, collections, and waivers;**

- **Compliance with governing instruments, internal policies, statutory and regulatory requirements, and securities laws and regulations such as SEC/FRB Regulation R and GLBA broker-exception rules;**
- **Internal routines and controls;**
- **Account administration practices such as documentation of:**
  - **Trust agreements and court orders,**
  - **Income receipts and distributions,**
  - **Principal invasions such as appropriate approvals,**
  - **Receipt of assets,**
  - **Co-fiduciary and grantor approvals,**
  - **Beneficiary and third-party approvals,**
  - **Unique assets, and**
  - **Annual administrative and investment reviews;**
- **Management information systems;**
- **Verification of assets;**
- **Trust committee minutes;**
- **Trading activities; and**
- **Assessment of management's corrective actions.**

31. Assess the adequacy of audit reporting procedures and consider whether:

- **Formal reports are provided to the board of directors or appropriate committee;**
- **Audit reports include a summary of the effectiveness of internal controls in the trust department;**
- **Audit findings, including actions taken as a result of the audit, are recorded in the board minutes or appropriate committee minutes; and**
- **Audit program deviations are appropriately reported and approved.**

32. Determine the reason for any change in internal or external auditors.

33. Evaluate auditor independence and consider whether:

- **The in-house audit function is free from the undue influence of senior management, and**
- **External audit providers perform other services for the institution that could adversely affect the independence of audit findings.**

34. Evaluate auditor experience and expertise.

Management Information Systems

35. Determine whether written reports and communication processes provide sufficient information to enable the board, senior management, and staff to make appropriate risk management decisions. Review the information provided to the board, trust committee, and trust-related subcommittees to determine the quality, accuracy, timeliness, and completeness of reporting on items such as:

- **New and closed accounts;**
- **New products, business opportunities, and marketing programs;**
- **Emerging risks;**
- **Accounts involving administrative difficulties;**
- **Accounts involving complaints or threatened/pending litigation;**
- **Conflicts of interest;**
- **Investment strategies and performance, including common and collective investment funds and proprietary investment products;**
- **Exposures to counterparties;**
- **Activities experiencing sustained or significant losses;**
- **Exceptions from established policies, procedures, and risk limits;**
- **Audit and regulatory reports;**
- **Profitability;**
- **Corporate trust issues in default; and**
- **Significant discretionary actions.**

36. Determine whether trust department personnel have sufficient, timely, accurate, and meaningful information to perform their responsibilities.

Earnings

37. Determine whether management's methodology for measuring trust department profitability is reasonable and commensurate with the volume and nature of services.

38. Assess the adequacy of the board or designated committee reviews of trust profitability. Consider the scope and frequency of reviews, including analysis of material business lines and individual accounts.

39. Assess the department's historical, current, and projected earnings by considering:

- **The level and trend of earnings;**
- **Whether revenues are sufficient to support overhead and provide a return commensurate with the risks assumed;**
- **The materiality of surcharges, losses, and litigation costs;**

- **The significance of credit for deposits (if the institution calculates it);**
- **The impact of nonrecurring expenses or revenues;**
- **The department's reliance on large fee-producing accounts; and**
- **Management's opinion of material future events that may impact earnings such as threatened or pending litigation, new business opportunities, and competition.**

40. In institutions where trust services are offered as a benefit to the community, and profit is not the primary motivation, determine whether the board:

- **Periodically evaluates whether trust services provide an essential service to customers or the community, and**
- **Establishes guidelines with respect to the amount of recurring losses that are acceptable if trust services cannot be offered profitably.**

41. Evaluate the adequacy of the budget process by considering:

- **Comparisons of forecasted to actual earnings performance;**
- **The reasonableness of growth and profitability assumptions;**
- **Whether forecasted earnings are sufficient to support fiduciary activities; and**
- **Whether the board or a designated trust committee periodically approves, reviews, and revises the budget.**

42. Review the department's marketing plan, if any, and consider whether the plan:

- **Establishes reasonable goals and strategies for attaining goals,**
- **Clearly defines marketing responsibilities for marketing staff and/or account administrators,**
- **Includes any incentive pay,**
- **Identifies appropriate products and target customer groups, and**
- **Provides for periodic progress reports.**

43. Evaluate any internal or external reports, analyses, or recommendations pertaining to trust profitability, including those contained in audit or consultant reports.

Compliance

ACCOUNT ADMINISTRATION

44. Determine whether account administration is adequate by reviewing a sample of accounts.

45. Assess compliance with governing instruments by considering whether:

- **Account files contain all necessary governing documents;**
- **Account officers are familiar with the terms of governing instruments;**
- **The trust department's actions, such as investments, co-fiduciary approvals, and discretionary distributions, are authorized under governing documents;**
- **The trust department is performing all fiduciary duties prescribed in the governing documents; and**
- **Synoptic records are accurate.**

46. Determine whether account documentation reflects adequate administration of accounts. Review and consider:

- **Synoptic records;**
- **Notes in files and customer call reports;**
- **Administrative and annual investment reviews;**
- **Minutes of committee(s) responsible for review accounts;**
- **Any problem issues with an account including problem grantors and/or beneficiaries; and**
- **Any documentation pertaining to litigation in an account.**

47. Evaluate the trust department's administrative review process.

- **Determine whether administrative reviews are:**
  - **Performed promptly and in accordance with account risks;**
  - **Performed by the trust committee, subcommittee, or disinterested account officer; and**
  - **Appropriately documented.**
- **Determine whether deficiencies are monitored and corrected in a timely manner.**

48. Determine whether customer complaints are appropriately addressed.

OPENING AND CLOSING ACCOUNTS

49. Determine whether account acceptance practices are adequate by considering:

- **Management's assessments of:**
  - **Real or potential conflicts of interest,**
  - **Unusual circumstances or administrative complexities,**
  - **The account's objectives and asset holdings,**
  - **The legal sufficiency of governing instruments,**

- **Environmental risks associated with real property,**
    - **Whether actions require third-party approvals (such as by a co-trustee or court), and**
    - **The expertise of trust department personnel;**
- **Procedures for avoiding potential liability such as obtaining:**
    - **Proof of the prior trustee's resignation or removal,**
    - **Prior accountings, and**
    - **Indemnification from the prior trustee or account beneficiaries for acts of the prior trustee;**
- **Whether all necessary governing instruments and supporting documentation are received and appropriately reviewed prior to accepting the account;**
- **Whether account fees are commensurate with risk levels and administrative duties; and**
- **Account set-up processes and whether there are appropriate secondary reviews.**

50. Assess the adequacy of account closing procedures by considering whether:

- **Necessary releases/receipts and discharges are obtained;**
- **Final accountings and tax returns are filed;**
- **Assets are properly distributed in a timely manner;**
- **Fees and expense reimbursements are received;**
- **Closed accounts are approved by the board or a board committee;**
- **Court releases are obtained when applicable; and**
- **The institution appropriately retained copies of all relevant documents.**

CONFLICTS OF INTEREST

51. Determine whether the trust department identifies and monitors actual and potential conflicts of interest and self-dealing. Consider the following potential conflicts:

- **The use of material inside information, including information arising from commercial bank relationships;**
- **Use of own-bank products and services such as deposit accounts, loans, proprietary mutual funds and brokerage services;**
- **Receipt of fees from other sources, including fees from mutual funds and sweep fees;**
- **Relationships with brokers and other agents, including soft-dollar arrangements;**
- **Investments in own-bank or affiliated securities;**
- **Transactions involving insiders or their interests;**
- **Proxy voting, including own-bank or affiliated securities;**
- **Investment in securities underwritten by the bank or affiliates; and**
- **Inter-account and multi-account transactions.**

52. Assess conflict-of-interest controls by considering whether management:

- **Makes full disclosures;**

- **Obtains appropriate consents;**
- **Obtains court approvals;**
- **Resolves conflicts in favor of account beneficiaries;**
- **Complies with self-dealing restrictions in the Employee Retirement Income Security Act, Internal Revenue Code, and state laws; and**
- **Obtains independent, reasoned legal opinions.**

LAWS AND REGULATIONS

53. Determine whether the institution complies with applicable federal and state statutes and regulations, such as:

- **Employee Retirement Income Security Act (ERISA) and related Department of Labor regulations;**
- **State fiduciary statutes, including the Uniform Trust Code and Prudent Investor Act; and**
- **Federal Deposit Insurance Act Section 11(a) prohibitions on the acceptance of deposits from employee benefit plans if the institution is less than adequately capitalized.**

54. Determine whether common and collective investment funds are operated in accordance with applicable laws and regulations. ***(Note: If the Pooled Investment Vehicles Module is completed, document procedures in that module.)***

Asset Management

55. Determine whether the board of directors, trust committee, or related subcommittee has approved general investment and administrative guidelines.

56. Review internal and external investment research methods and evaluate management's due diligence in selecting assets for purchase.

57. Determine the appropriateness of criteria for including or excluding securities from the approved list of investments.

58. Assess the process for retaining or selling assets that do not meet established investment criteria.

59. Review the methods for developing investment strategies and determine whether such strategies are consistently applied.
60. If the institution uses open architecture or offers separately managed accounts, consider the adequacy of: • **Due diligence governing the selection and retention of outside asset managers,** • **On-going monitoring of the performance of outside managers, and** • **Operational systems supporting open architecture and separately managed accounts.**
61. Determine whether quantitative and qualitative measurement tools are used in the asset management process, and consider whether the tools adequately evaluate and monitor financial risks.
62. Determine whether sales commissions or fee arrangements, such as 12b-1 fees received from mutual funds, do not unduly influence investment decisions. ***(Note: Refer to the Pooled Investment Vehicles Module for additional considerations.)***
63. Determine whether guidelines for using asset allocation models as a basis for making investment management decisions are in place, and consider: • **Which accounts will be invested based on modeling information,** • **How portfolios will be monitored to ensure they remain within model guidelines, and** • **How investment objectives are determined and monitored.**
64. Evaluate the appropriateness of investments in own-bank deposits and documentation that own-bank deposits receive a competitive rate of interest.
65. Review the use and performance of pooled investment vehicles, including proprietary and third-party mutual funds, common trust funds, collective investment funds, and, if applicable, conversions of common and collective funds to mutual funds. ***(Note: If the Pooled Investment Vehicles Module is completed, document procedures in the reference module.)***
66. Evaluate the use of derivatives and other complex securities. ***(Refer to the Personal Trust Module,***

FDIC Capital Markets Handbook, or FRB Trading and Capital Markets Activity Manual for specific considerations.)

67. Determine whether exceptions to investment guidelines are appropriately reported, documented, approved, and monitored.

68. Review any securities lending activity. ***(Refer as needed to the Employee Benefit Reference Module)***

69. Assess practices for establishing discretionary account objectives. Determine whether the institution considers:

- **General economic conditions,**
- **Tax consequences,**
- **Other resources of the grantor or beneficiaries,**
- **Expected total returns,**
- **Liquidity and income needs of beneficiaries,**
- **Beneficiary requests,**
- **Purpose of the trust,**
- **Limitations of the governing instrument,**
- **Requirements for preservation or appreciation of capital,**
- **Diversification standards, and**
- **Risk tolerance levels.**

70. Determine whether all discretionary accounts receive a documented investment review at least once each year. At a minimum, reviews should:

- **Be performed by an independent person or committee;**
- **Evaluate the continued appropriateness of the account objectives;**
- **Assess the suitability of the account's investments, including tax considerations, risk tolerance, and liquidity needs;**
- **Consider any asset allocation imbalances or lack of diversification;**
- **Compare relative portfolio/account investment performance to established benchmarks and investment objectives; and**
- **Ascertain attributes of investment performance.**

71. Determine whether appropriate investment objectives are established when an account is accepted. Also, determine whether investments received in-kind are reviewed within a reasonable time for

suitability and prudent retention.

72. Assess the appropriateness of assets held in discretionary and investment advisory accounts by considering:

- **Requirements of the governing document;**
- **The account's stated objective(s);**
- **Approved investment guidelines; and**
- **Applicable common-law standards, state laws, and federal laws (e.g., prudent person/prudent investor act, ERISA, and Internal Revenue Code).**

73. Assess the adequacy of the practices, including valuation methodologies, that the institution uses to administer unique assets. ***(Note: If the Personal Trust or the Employee Benefit Modules are completed, document procedures in those modules.)***

74. Assess the adequacy of cash management practices by considering whether:

- **Cash balances are promptly invested;**
- **Net-overdraft procedures include authorized approvals and controls to ensure overdrafts do not remain outstanding for an unreasonable period;**
- **Fees imposed under cash sweep arrangements are reasonable, comply with state laws, and are properly disclosed to the customer;**
- **Cash investment vehicles have a competitive interest rate;**
- **Management maintains sufficient cash to meet the liquidity needs of individual accounts; and**
- **Cash management vehicles are highly liquid and ensure the preservation of principal.**

TRADING AND BROKERAGE

75. Determine whether security transactions effected in a fiduciary or custodian capacity satisfy the requirements for exemption from the definition of "broker" in the Securities Exchange Act of 1934. (Refer to Section 3(a)(4)(B)(iii) of the Securities Exchange Act of 1934, and SEC/FRB Regulation R.) Consider the following requirements:

- **Trust & Fiduciary Exceptions:**
  - **Transactions are effected in a department or division of the bank that is regularly examined for compliance with fiduciary standards;**
  - **The percentage of relationship compensation to total trust and fiduciary compensation, averaged over the immediately preceding two years, is at least 70% if computed on a bank-wide basis, or more than 50% for each account if computed on an account-by-account basis (refer to Section 10.F of the FDIC Trust Examination Manual for the definition of relationship compensation and details on Regulation R, chiefly-compensated requirements);**
  - **Securities transactions are effected by a registered broker/dealer;**

- **Securities transactions are effected in a cross-trade or similar transaction that is not in violation of fiduciary standards or in any other way permitted by the SEC; and**
- **The institution does not publicly solicit brokerage business. (Note: A bank may, in conjunction with advertising its other trust activities, state that it effects securities transactions as part of its administration of fiduciary accounts.)**

- **Custody & Safekeeping Exemptions:**
  - **Employee Benefit, IRA, and Similar Accounts**
    - **The institution does not advertise that it accepts orders for employee benefit plan accounts or individual retirement accounts or similar accounts (except as part of advertising its other custody and safekeeping activities), and does not advertise that such accounts are brokerage accounts or that the bank's safekeeping and custody services substitute for brokerage accounts;**
    - **Advertisements and sales literature descriptions of order-taking services should not be more prominent than other aspects of an institution's custody and safekeeping services;**
    - **No employee of the institution is compensated based on whether a securities transaction is executed, or based on the quantity, price, or type of security involved;**
    - **The institution is not a trustee or fiduciary, other than a directed trustee;**
    - **The institution is not acting as a carrying broker; and**
    - **The institution complies with the Exchange Act Section 3(a)(4)(C) trade execution requirements.**
  - **Accommodation Trades (i.e. order taking for accounts that are not Employee Benefit, IRA, or similar accounts.)**
    - **The institution does not advertise that it accepts orders;**
    - **Sales literature does not state that the bank accepts orders, except as part of describing other aspects of its custodial and safekeeping services;**
    - **Sales literature should not describe order-taking services more prominently than other aspects of an institution's custody and safekeeping services;**
    - **No employee of the institution is compensated based on whether a securities transaction is executed, or based on the quantity, price, or type of security involved;**
    - **Any fee charged or received by the institution does not vary based on whether the bank accepted the order or the quantity or price of the securities bought or sold;**
    - **The institution is not a trustee or fiduciary, other than a directed trustee;**
    - **The institution does not provide investment advice or research, make recommendations, or solicit transactions;**
    - **The institution is not acting as a carrying broker; and**
    - **The institution complies with the Exchange Act Section 3(a)(4)(C) trade execution requirements.**
  - **Non-Custodial Third Party Administrators**
    - **The third-party administrator and the custodial institution that contracted with it must comply with the requirements for Employee Benefit, IRA, and similar accounts; and**
    - **The third-party administrator does not execute cross trades (other than crossing or netting open-end mutual funds not traded on an exchange) or crossing or netting orders for accounts of the custodial institution.**
  - **Sub-Custodians**
    - **Both the sub-custodial and the custodial institution comply with the relevant requirements for Employee Benefit, IRA, and similar accounts or accommodation trades, as applicable; and**
    - **The sub-custodian bank does not execute cross trades (other than crossing or netting open-end mutual funds not traded on an exchange) or crossing or netting orders for accounts of the custodial institution.**
  - **Other Exceptions and Exemptions**

- **Sweep Account/Money Market Fund,**
- **Networking/High Net Worth – Institutional Customer Referrals,**
- **SEC Regulation S Securities,**
- **Securities Lending Transactions,**
- **Permissible Securities Transactions,**
- **Stock Purchase Plans,**
- **Private Securities Offerings,**
- **Affiliate Transactions,**
- **Identified Banking Products,**
- **Municipal Securities, and**
- **De Minimis.**

References: FDIC: Section 10.F of the FDIC Trust Examination Manual; FRB: Regulation R.

76. Evaluate management's efforts to obtain best execution on securities trades.

77. Determine whether credit and operational risks with broker/dealers are adequately controlled. Consider whether the institution maintains an approved list of brokers, broker allocation guidelines, and credit or trading limits.

78. Determine whether an appropriate level of due diligence is performed on all counterparties, even when transactions do not expose the institution to credit risk.

79. Determine whether trade transaction reports include all necessary information to validate the transaction and whether the institution can reconstruct an account's trading history.

80. Determine whether transactions are executed and recorded in a timely manner.

81. Determine whether the allocation of securities and the prices paid for securities are fair and equitable. Consider whether:

- **Orders for the same security are received at approximately the same time.**
- **Securities are purchased and sold in block transactions.**
- **Buy and sell orders are matched between accounts (i.e., the crossing of buy and sell orders).**

82. Determine whether transaction discrepancies (such as failed trades, confirmation conflicts, securities not delivered or received, and pricing inconsistencies) are properly investigated and resolved.

- **Review trade investigation logs to determine the number and dollar amount of outstanding disputes.**
- **Determine whether trade metrics (such as trade volumes and the number of failed trades) are reported periodically to management for oversight and risk management purposes.**
- **Determine whether customer complaints are resolved by someone other than the person who executed the trade.**

83. Determine whether the institution prohibits traders from effecting personal securities trades. If traders are allowed to effect personal securities trades, determine whether management has established adequate controls to both prohibit and identify front-running, late trading in mutual funds, market timing in mutual funds, and other inappropriate trading practices.

84. Assess the separation of duties for confirming, reconciling, valuing, clearing, accounting, receiving, and disbursing assets related to trading and brokerage activities.

85. Determine whether access to trading programs is properly controlled. Consider, whether the programs prevent or identify late-trading or market-timing activities in mutual funds and whether only authorized personnel can initiate trades.

86. Determine whether broker statements are sent directly to accounting or operations personnel and not to trading personnel.

87. Determine whether discrepancies on broker statements are directed for resolution to someone outside the trading function.

88. Determine whether trading activities are covered in the audit program and whether the scope of review is appropriate for the level of activity.

89. Review management's compliance with securities record-keeping and confirmation requirements,

including reports of personal securities trading. (FDIC: Part 344/FRB: Reg. H)

Board and Senior Management

90. Determine whether board and trust committee minutes and supporting documentation reflect adequate supervision of fiduciary activities.

91. Determine the purpose and function of each trust sub-committee.

92. Determine whether organizational and committee structures are appropriate and provide for clearly defined lines of authority and responsibility.

93. Determine whether the trust committee meets at least quarterly and maintains comprehensive minutes of meetings held and actions taken.

94. Determine whether attendance by board and committee members is satisfactory.

95. Assess the board, trust committee, and management's ability to plan and respond to changing business conditions and determine whether fiduciary activities are adequately considered in the institution's strategic planning process.

96. Determine whether a dominant official exerts significant influence over department operations. If so, assess the adequacy of the Board’s oversight and mitigating controls.

97. Determine whether management takes adequate and timely corrective action to address recommendations by auditors and regulatory authorities

98. Determine whether the board retains legal counsel when necessary.

99. Determine whether the board provides for adequate insurance of fiduciary activities and periodically reviews blanket bond, errors and omissions, and other applicable insurance coverage.

100. Determine whether fiduciary lines of business are managed and staffed by persons with requisite knowledge, experience, and expertise. Consider the background of key management personnel and the adequacy of training for management and staff.

101. Determine the adequacy of management succession plans.

102. Evaluate management's due diligence process for selecting and monitoring outside service providers (e.g. investment managers, investment advisors, consultants, custodians, broker/dealers, etc.). Determine whether:

- **Delegations of fiduciary responsibility by the institution are authorized under state law.**
- **The board or its designated committee conducts and documents an adequate due diligence review before contracting with a third party. Consider whether the board evaluates the:**
  - **Financial strength of the servicing organization,**
  - **Ability of the servicing organization to handle the volume and nature of trust accounts and assets to be serviced,**
  - **Investment results of the servicing organization,**
  - **Policies/procedures and controls of the servicing organization,**
  - **Audit coverage of the servicing organization (including SSAE 16 reports if available), and**
  - **Fidelity insurance coverage of the servicing organization.**
- **Determine whether written agreements clearly define the scope and terms of any third-party relationships, including:**
  - **Duties and responsibilities of each party,**
  - **Service level agreements,**
  - **Business resumptions plans for critical vendors,**
  - **Compensation and any cost sharing agreements,**
  - **Ownership of files and records,**
  - **Access to trust accounts or activities by auditors and regulators,**
  - **Terms under which an agreement may be terminated,**
  - **Liabilities of each party in the event of surcharges or losses,**
  - **Requirements for bonding or fidelity insurance, and**
  - **Privacy responsibilities.**
- **Determine whether the board or a designated committee periodically reviews and approves written agreements with third parties and monitors performance and compliance with written agreements.**

End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.

TRUST - ABBREVIATED

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine if an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Note: This module is intended for use in non-complex trust departments. The nature and extent of fiduciary activities vary greatly among banks and it is not always necessary to perform all procedures. Some procedures may not be applicable for institutions that engage in limited fiduciary activities or administer a limited number or type of trust accounts.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

C.1. **Are policies, procedures, and other methods for limiting risk effective?** ***Refer to Core Analysis Procedures #5-10* & *Procedures #14-16.***

C.2. **Are internal controls effective?** ***Refer to Core Analysis Procedure #9.***

C.3. **Are the audit or independent review functions effective?** ***Refer to Core Analysis Procedure #5.***

C.4. **Are information and communication systems effective and accurate?** ***Refer to Core Analysis Procedure #10 & Procedure #30.***

C.5. **Are trust department earnings effectively managed and sufficient to support the institution's fiduciary activities?** ***Refer to Core Analysis Procedures #11-13. (Note: Generally, the Earnings component rating is not assessed if the department has < $100 million in discretionary trust assets under management. This item should be answered as "Not Reviewed" if earnings are not assessed.)***

C.6. **Does the institution follow internal bank policies and procedures, governing instruments, and sound fiduciary principles and comply with applicable laws and regulations?** ***Refer to Core Analysis Procedure #14-16 & Procedures #17-22.***

C.7. **Are asset management and investment advisory practices effective?** ***Refer to Core Analysis Procedures #21-23.***

C.8. **Do the board and senior management effectively supervise fiduciary activities?** ***Refer to Core Analysis Procedures #24-30.***

TRUST - ABBREVIATED

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Preliminary Review

1. Review prior examination reports, pre-examination memorandum, and file correspondence for an overview of any previously identified trust concerns and trends. Also, review Consolidated Reports of Condition and Income, Schedule RC-T - Fiduciary and Related Services.

2. Identify the types of accounts and the fiduciary capacity of the accounts, including the following:

- **Accounts:**
  - **Personal,**
  - **Corporate,**
  - **Employee benefit,**
  - **Investment management, and**
  - **Estates.**
- **Capacity:**
  - **Custodian, and**
  - **Trustee.**

3. Review publicly available bank information, including the bank's website, for any trust-related information.

4. Discuss with management, any significant changes that may have taken place such as:

- **Changes in risk profile, such as new business lines, products or personnel;**
- **Changes in governance or committee structures;**
- **Pending or threatened litigation and customer complaints;**
- **Mergers, acquisitions, or significant growth; and**
- **Changes in third party, fee-sharing, or outsourcing agreements.**

Operations, Internal Controls, and Audits

5. Determine whether the board maintains an effective trust audit program and follow-up procedures.

Ensure:

- **Audit scope is commensurate with level of risk (including cyber-security risks),**
- **Audit activities are appropriate, and**
- **Audit reporting functions and procedures are adequate.**

6. Determine whether trust activities are accurately reported in Consolidated Reports of Condition and Income (Schedule RC-T).

7. Determine whether recordkeeping and reconciliation practices are effective and there is appropriate segregation of duties.

- **Ensure that recordkeeping is accurate and reliable.**
- **Review reconciliation policies and procedures.**

8. Review net overdrafts and clearing procedures.

9. Evaluate the effectiveness of the internal control environment and ensure account administrators are not involved in statement generation or distribution. Assess the adequacy of:

- **Staffing,**
- **Lines of authority,**
- **Reporting,**
- **Procedural guidance, and**
- **Segregation of operational duties.**

10. Consider the effectiveness of the management information systems used to support trust activities and the timeliness and accuracy of management reporting.

Earnings

11. Determine whether trust department earnings have a significant impact on the earnings and capital of the bank.

12. Consider how future events (such as new products or services) may affect trust department earnings.

13. Determine whether procedures for monitoring fiduciary income and expenses are commensurate with the impact on bank-wide earnings.

Compliance

14. Determine whether trust and investment policies and procedures adequately address account and investment administration functions.

15. Determine whether the trust department effectively identifies and monitors conflicts of interest.

16. Review and assess compliance with SEC/FRB Regulation R and other state and federal regulations pertinent to trust activities.

Asset Management

17. Evaluate the investment process by reviewing the trust department's internal policies and holding discussions with management.

18. Assess management's procedures for promptly investing liquid assets.

19. Evaluate any outside investment services used and the trust department's oversight of those services. Review:

- **Contracts,**
- **Ongoing due diligence,**
- **Management reports, and**
- **Trust committee minutes.**

20. Determine whether account investments conform with governing instruments and comply with

applicable laws.

21. Determine whether account investments are diversified in accordance with the account's investment objectives, unless directed by the governing instrument, grantor/beneficiary(s), or court order.

22. Ensure that client accounts are rebalanced when necessary.

INDIVIDUAL ACCOUNT REVIEWS

Note: At the EIC's discretion, a discuss-only technique may be used to evaluate the bank's remediation of issues identified by examiners or management. For example, where prior examination reports contain account write-ups with similar weaknesses, examiners may wish to discuss actions management has taken to correct and prevent such weaknesses in general, rather than reviewing each individual account that was included in the previous report. A discuss-only technique may also be appropriate when assessing corrective actions or audit recommendations implemented by management.

23. Review individual accounts only to the extent necessary to assess the compliance and asset management components.
    - Non-managed (non-discretionary) accounts should receive equal consideration for review as managed (discretionary) accounts.
    - Maximize the use of internal account reviews where possible.

Management

24. Review and assess the governance framework to identify, measure, monitor and control the risks inherent in fiduciary activities, and respond appropriately to changing business conditions.

    (Note for FDIC: For more information see the Statement of Principles of Trust Department Management in the Trust Examination Manual.)

25. Assess management's use of exception reports to measure, monitor, and control risk.

26. Assess management's education, training, and expertise.

27. Assess the impact of client complaints and pending litigation.
28. Assess third-party, fee-sharing, or outsourcing agreements entered into since the previous examination. Review: • **Contracts,** • **Ongoing due diligence,** • **Management reports, and** • **Trust committee minutes**
29. Consider the department's practices regarding information security, backup planning, and safeguarding against cyber-attacks. (Contact the IT examiners if any concerns are identified.)
30. Evaluate the effectiveness of the governance and management reporting structure, including committee and governance processes. Consider items such as: • **Minutes,** • **Committee structure,** • **Authority and responsibility,** • **Attendance,** • **Strategic planning process, and** • **Response to audit and regulatory recommendations.**
End of Core Analysis.

CREDIT CARD RELATED MERCHANT ACTIVITIES
Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?

E.1.	**Are deficiencies immaterial to management's supervision of credit card merchant activities?** ***Refer to Expanded Analysis Procedures #1-7.***
E.2.	**Are deficiencies immaterial to the bank's financial condition?** ***Refer to Expanded Analysis Procedures #8-9.***

CREDIT CARD RELATED MERCHANT ACTIVITIES

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible guidelines specified for the Core Analysis also apply to the Expanded Analysis.

Expanded Analysis Procedures
1. Investigate why the policy deficiencies identified in the Core Analysis exist. Discuss recommendations with management. *Note: The Core Analysis reveals what the deficiencies are, whereas the Expanded Analysis is focused on the circumstances causing the deficiencies and management's ability to implement corrective action.* Possible reasons for policy deficiencies may include the following circumstances: • **Management overlooked issues.** • **Management is unfamiliar with prudent credit card related merchant activity guidelines and procedures.** • **Management is unwilling to create or enhance policies and procedures.**
2. If poor compliance with policies and procedures exist, determine the reasons. Possible reasons are detailed below: • **Lack of awareness of policy's existence.** • **Disregard for established policies.** • **Misunderstanding the intent of policy guidelines.** • **Poor internal communication of subsequent revisions to policy and procedures.** • **Weak internal controls, audit procedures, or reporting mechanisms.**
3. Determine why management and board reports are deficient. Seek management's responses to and corrective actions taken for these deficiencies. The cause(s) of deficient reports may stem from the following circumstances: • **Inaccurate information is contained in reports and input and output has not been tested.** • **Management information system is not able to generate necessary reports.** • **Management is unfamiliar with the information system's capabilities.** • **Management is unfamiliar with important monitoring reports.**
4. Determine if management supports proper controls and monitoring to ensure policy guidelines are followed in the future.
5. Research the reasons for weak controls and evaluate management's plan to correct these weaknesses.

Perform additional internal control evaluations as necessary:

- **Determine if access to merchant and ISO reserve accounts is restricted to authorized bank personnel.**
- **Review exception reports on merchants experiencing unusual activities. Determine the reasons for the exceptions.**

6. Investigate the causes of operating losses in the merchant credit card operations and evaluate the prospects for profitability.

7. Determine the reasons for inadequate chargeback reserves.

8. If the bank suffered significant losses on chargebacks from a particular merchant or group of merchants over the past several years, complete the following items:

- **Determine why certain merchants are generating significant chargebacks.**
- **Ascertain what actions management takes to reduce losses (implementing additional controls or terminating an arrangement with a merchant).**

9. Investigate reasons for merchants with low profitability or actual losses. Only review those that are significant.

- **Review a sample of written onsite inspections.**
- **Review a sample of merchant profitability accounts and compare actual pricing against the pricing policy.**
- **Review the most recent financial statement and assess the financial capacity of the merchant.**
- **Determine if the bank is giving the merchant a favorable discount rate because of an existing commercial loan or deposit relationship. (Although this is an acceptable practice for non-insiders, the bank should be able to measure the overall profitability of the merchant account to ensure the other banking relationship offsets the favorable discount rate.)**
- **Review any corrective actions management intends on implementing.**

End of Expanded Analysis. If needed, Continue to Impact Analysis.

CREDIT CARD RELATED MERCHANT ACTIVITIES

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Determine the impact merchant processing deficiencies have on the bank's earnings and capital. Consider potential losses due to inadequate reserves and any other contingent liability.
2. Consider whether an informal or formal enforcement action is warranted.
3. Discuss the possibility of administrative and enforcement actions with appropriate supervisory/agency personnel before discussing the matters with executive bank management and the board of directors.
4. Prepare appropriate recommendations for administrative and enforcement actions and associated memorandums.
End of Impact Analysis.

ELECTRONIC FUNDS TRANSFER RISK ASSESSMENT

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

E.1. **Are deficiencies immaterial to management's supervision of electronic funds transfers?** ***Refer to Expanded Analysis Procedures #1-28.***

E.2. **Are deficiencies immaterial to the bank's overall condition?** ***Refer to Expanded Analysis Procedures #1-28.***

ELECTRONIC FUNDS TRANSFER RISK ASSESSMENT

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible guidelines specified for the Core Analysis also apply to the Expanded Analysis.

Policies and Procedures

1. Investigate why the policy and procedure deficiencies identified in the Core Analysis exist. Possible reasons for policy deficiencies may include the following circumstances:

- **Management overlooked these issues.**
- **Management is unfamiliar with prudent electronic funds transfer guidelines and procedures.**
- **Management is unwilling to create or enhance policies and procedures.**

2. If poor compliance with policies and procedures exist, determine the reasons. Possible reasons are detailed below:

- **Lack of awareness of policies' existence.**
- **Disregard for established policies.**
- **Misunderstanding the intent of policy guidelines.**
- **Poor internal communication of subsequent revisions in policy and procedures.**

3. Determine whether management commits to and supports proper controls and monitoring to ensure policy guidelines are followed in the future. Determine whether proposed controls, if any, are reasonable.

Internal Controls

FUNDS TRANSFER REQUESTS

4. Determine whether the funds transfer function maintains a current list of bank personnel authorized to initiate transfer requests.

- **Ascertain if the bank limits the number of employees who initiate or authorize transfer requests.**
- **Determine whether authorized employee signature records are kept in a secure environment.**

5. Review a sample of funds transfer requests. Determine whether management uses standard, sequentially numbered forms or some other authentication system. Determine whether funds transfer requests include the following items:

- **The account title and number.**

- **A sequence number.**
- **The amount to be transferred.**
- **The person or other source initiating the request.**
- **The time and date.**
- **Authentication (callbacks, fax, personal identification numbers).**
- **Paying instructions.**
- **The name of the bank personnel authorizing the transfer and the dollar amount.**

6. Review the bank's procedures for recording all incoming and outgoing transfer requests. If calls are recorded, determine whether the bank advises its customers in written contracts, by audible signals, or by informing the caller that telephone calls are being recorded.

7. Determine whether transfer requests are recorded in a log, or another bank record, before execution.

- **Determine whether the funds transfer function maintains sequential control for requests it processes.**
- **If requests are not sequentially accounted for, determine whether there is an unbroken copy of all messages received via telex or other terminal printers kept throughout the business day.**
- **Determine whether someone not connected with equipment operations reviews sequence records and unbroken copies of messages.**

8. Determine whether incoming and outgoing messages are time stamped or sequentially numbered.

PAYMENT PROCESSING AND ACCOUNTING

9. Determine whether the funds transfer department verifies that work sent to and received from other bank departments agree with its totals.

10. Determine whether key fields are re-verified before transmission and messages are released by someone other than the individual originally entering the message.

11. Ascertain if transfer requests accepted after the close of business, or transfer requests with a future value date, are properly controlled and processed.

12. Determine whether open-statement items, suspense accounts, receivables or payables, and inter-office accounts related to funds transfer activity are controlled outside of the funds transfer operations. Determine whether the following controls exist:

- **Management prepares periodic reports on open-statement items, suspense items, and inter-office accounts.**
- **Reports include agings of open items, the status of significant items, and the resolution of prior significant items.**
- **Corrections, overrides, open items, reversals, and other adjustments are reviewed and approved by an officer.**

13. Determine whether all general ledger tickets, or other supporting documents, are initialed by the originator and supervisory personnel.

PERSONNEL

14. Determine whether screening procedures are applied to personnel hired for sensitive positions in the funds transfer area. Management should be implementing the following controls:

- **New employees working in sensitive areas are closely supervised.**
- **Temporary employees are either prohibited from working in sensitive areas or closely supervised.** ***(Note: The number of temporary employees allowed in sensitive areas should be limited.)***

15. Determine whether the bank requires statements of indebtedness for employees working in sensitive areas.

16. Review procedures governing personnel-related issues. Determine whether the following control activities exist:

- **Employees are subject to unannounced rotation of duties.**
- **Relatives of employees are precluded from working in the bank's bookkeeping, audit, data processing, or funds transfer requests departments.**
- **Employees are required to take a minimum number of consecutive days as part of their annual vacation.**
- **Employees who have given notice of resignation or have been notified of pending termination are re-assigned from sensitive areas.**

CREDIT EVALUATION AND APPROVAL

17. **Determine whether management establishes customer limits for daylight and overnight overdrafts. Management should complete the following tasks:**
    - **Ensure limits include groups of affiliated customers.**
    - **Monitor funds transfer requests during the business day to ensure that proper approval is granted before making payments that exceed limits.**
    - **Review and periodically update customer limits.**

18. **Determine whether management makes payments in anticipation of receiving funds that day to cover the daylight overdraft. Determine whether the following controls over daylight overdrafts exist:**
    - **Payments are approved by officers with appropriate credit authority.**
    - **Daylight exposures are limited to amounts expected to be received that same day.**
    - **Daylight overdraft limits are established after considering other types of credit facilities for the customer.**
    - **A daylight record is kept for each customer showing the following information:**
        - **Opening collected and uncollected balances.**
        - **Transfers in and out of the account.**
        - **Collected balance at the time payments are released.**

19. **Determine whether any overnight overdrafts exceed established limits:**
    - **Assess why the overdraft exceeded limits.**
    - **If a control failure caused the overdraft, Determine whether the following procedures were followed:**
        - **The cause was properly documented.**
        - **Adequate follow-up to obtain the covering funds in a timely manner.**

20. **Determine whether a person with appropriate credit authority approves payments that exceed established daylight and overnight limits.**

21. **If the bank is a participant of a net settlement system (CHIPS), determine whether bilateral-lateral credit limits are set based on a formal credit analysis. The limits should be reviewed by an appropriate level of management.**

PAYMENT SYSTEM RISK

22. **If the bank incurs overdrafts in its Federal Reserve account, determine whether it completed the payment system risk program (selected an appropriate net debit cap).**

23. If the bank has selected a self-assessment net debit cap, evaluate the adequacy of records supporting the bank's program and accuracy of the self-assessment rating.

INFORMATION TECHNOLOGY STANDARDS

24. Determine whether standards exist for the following activities:

- **Software and hardware acquisitions, including the following information:**
  - **Cost/benefit analysis.**
  - **Programming standards.**
  - **Documentation standards.**
  - **Ownership of programs, spreadsheets, etc., developed on the bank's time and equipment.**
  - **Escrow of source code of critical, tailor-made funds transfer software to ensure the bank can continue to maintain software in the event the vendor fails.**
- **Micro computer use including the following controls:**
  - **Use of the output or data.**
  - **Restrictions on personal and non-job related use.**
  - **Use of personal equipment and software.**
  - **Use of unauthorized software.**
  - **Modification of the hardware and software.**
  - **Copying or piracy of the software.**
  - **Requirements for file backup.**

OTHER

25. Review agreements that are in effect concerning funds transfer operations between the bank and its customers, correspondent banks, systems provider (Federal Reserve, CHIPS), servicers, and hardware and software vendors. Determine whether the agreements contain the following information:

- **Responsibilities of and accountability between all parties.**
- **Security procedures as defined by UCC Article 4A.**
- **Requirement that the bank obtain written waivers from customers who chose security procedures that differ from what the bank offers.**
- **Cut-off times for receiving, processing, and canceling or amending payment orders.**

Managerial Effectiveness

26. Determine why previously identified deficiencies remain uncorrected.

27.	**Determine the reasons for poor compliance with policy guidelines, accounting standards, or applicable regulations.**
28.	**Assess the adequacy and viability of management's corrective commitments.**

End of Expanded Analysis. If needed, Continue to Impact Analysis.

ELECTRONIC FUNDS TRANSFER RISK ASSESSMENT
Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Determine whether credit risk resulting from funds transfers will adversely affect overall asset quality and if the risk is included in determining the adequacy of the loan loss reserve.
2. Decide if the weaknesses identified in this area will negatively affect liquidity, earnings, or capital.
3. Determine the need for administrative and enforcement actions, formulate specific recommendations, and advise appropriate supervisory officials on the nature of the concern.
4. Discuss the possibility of administrative and enforcement actions with senior management and the board of directors.
End of Impact Analysis.

MORTGAGE BANKING

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

E.1. Are deficiencies immaterial to the supervision of mortgage banking operations? ***Refer to Expanded Analysis Procedures #1-34.***

E.2. Are deficiencies immaterial to the bank's overall condition? ***Refer to Expanded Analysis Procedures #1-34.***

MORTGAGE BANKING

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible procedures specified for the Core Analysis also apply to the Expanded Analysis.

Policies and Procedures

1. **Investigate why the policy and procedure deficiencies identified in the Core Analysis exist. Discuss recommendations with management. Possible reasons for policy deficiencies may indicate management:**
   - **Overlooked issues,**
   - **Is unfamiliar with prudent mortgage banking guidelines and procedures, and**
   - **Has not been responsive to previous recommendations to create or enhance policies and procedures.**

2. **If poor compliance with policies and procedures exist, determine the reasons. Possible reasons include:**
   - **Lack of awareness of the policies,**
   - **Disregard for established policies,**
   - **Misunderstanding of the intent of policy guidelines,**
   - **Poor internal communication of revisions to policy and procedures, and**
   - **Poor management oversight.**

3. **Determine whether management commits to and supports proper controls and monitoring to ensure policy guidelines are followed in the future.**

Internal Controls

ACCOUNTING

The following accounting pronouncements apply to mortgage banking activities:

- ***FASB ASC Subtopic 310-20 – Nonrefundable Fees and Other Costs***
- ***FASB ASC Topic 320 – Investments - Debt and Equity Securities***
- ***FASB ASC Topic 325 – Investments - Other***
- ***FASB ASC Topic 815 – Derivatives and Hedging***
- ***FASB ASC Topic 820 – Fair Value Measurements and Disclosures***
- ***FASB ASC Topic 825 – Financial Instruments***
- ***FASB ASC Topic 860 – Transfers and Servicing***
- ***FASB ASC Topic 948 – Financial Services - Mortgage Banking***
- ***SEC Codification Topic 5.DD – Written Loan Commitments Recorded at Fair Value***

4. **Determine whether held-for-sale assets are segregated from portfolio loans and recorded at the lower of cost or fair value as required by FASB ASC Topic 948.** ***(Note: Per FASB ASC Topic 815, the carrying value of assets held-for-sale may be adjusted to reflect the use of derivatives as hedges.)***

5. **Determine whether mortgage loans transferred from held-for-sale to held-for-investment are properly recorded (at the lower of cost or fair value) at the transfer date. Determine whether, after the transfer, any difference between the carrying amount of the loan and its outstanding principal balance is be recognized as an adjustment to yield by the interest method (as described in FASB ASC Subtopic 310-20).** ***(Note: If a bank elects to account for a loan under the fair value option for a loan held for sale, the assets remain to be accounted for at fair value when transferred to held for investment, since the election is irrevocable).***

6. **Determine whether loan sales are properly reported in regulatory reports.**

7. **Determine whether management continues to defer origination fees and costs in accordance with FASB ASC Subtopic 310-20 if the bank swaps loans for pass-through certificates issued by the investor.**

Audit or Independent Review

8. **Investigate why audit or independent review deficiencies identified in the Core Analysis exist.**

Information and Communication Systems

9. **Determine why management and board reports contain deficiencies. Determine management's response and consider corrective actions to address the deficiencies. The cause of deficient reports may stem from:**
   - **Inaccurate information contained in reports or input/output has not been tested,**
   - **Necessary information cannot or is not generated,**
   - **Management's unfamiliarity with the information system's capabilities, or**
   - **Management's unfamiliarity with necessary monitoring reports.**

10. **Review the quality of investor reporting. Investor reporting varies based on the servicing contract, but typically the servicing bank is responsible for reporting:**
    - **Detailed account reconciliations;**

- **Information such as the mortgagor's name, principal balance, and escrow balance; and**
- **Payment status, foreclosures, and transfers to their other real estate owned (OREO) account.**

Internal Loan Production (Origination, Underwriting, and Closing)

11. Review mortgage pricing strategies, and consider:

- **How prices are determined;**
- **If the pricing strategy is typically at, above, or below market; and**
- **The affect pricing strategies may have on current and future profitability.**

12. Determine the frequency of price changes for retail and wholesale channels by reviewing historic price levels. Evaluate the timing of changes relative to market rate movements.

13. Determine whether managers understand the marketability of new products and the bank's ability to price, deliver, and service the products. Ascertain that senior management approval is obtained prior to new product roll-out.

Pipeline, Warehouse, and Hedging

14. If the bank was unable to meet mandatory commitments, assess the reasons, and determine whether:

- **The situation was reported promptly to the directorate or other board committee.**
- **Management purchased loans from other sources or paid investors a pair-off fee.**

15. If hedging strategies are ineffective, determine the cause(s), such as:

- **Poor correlation of data,**
- **Unreliable data, or**
- **Speculation.**

16. Determine whether the following controls over forward sales activities exist:

- **Traders are prohibited from entering forward sales data into the system. (Trade tickets should be submitted to an independent person or unit for processing.)**
- **Third-party trade confirmations are received and reviewed by a separate unit.**
- **Management researches all unconfirmed trades and discrepancies.**

Mortgage Servicing

PORTFOLIO SUPERVISION

17. Review the procedures for receiving payments from borrowers, depositing funds into segregated custodial accounts, and remitting funds to investors.

- **Assess the bank's system for ensuring borrowers' payments are applied accurately and investors receive payments on schedule.**
- **Determine whether adequate controls exist over custodial accounts, such as daily balancing, monthly reconcilements, proper authority for disbursements, and segregation of administrative duties.**

18. Review written servicing agreements to determine investor servicing requirements, fund remittance schedules, contractual servicing fees, guarantee fees, and servicer representations and warranties.

- **Determine whether loan delinquencies prompted the use of bank funds to meet remittance requirements.**
- **Track the flow of funds from the investor cutoff date, the remittance of funds to investors and security holders, and the recognition of servicing revenue.**

19. If there is poor administration of servicer advances, assess these receivables for potential adverse classification and contingency reserves.

20. Review system reports to ensure the timely payment of taxes, insurance, and other obligations of the borrower.

21. Review the method for correcting shortages and surpluses in escrow accounts.

22. Review the procedures for ensuring tax and insurance payments are made on delinquent loans.

MORTGAGE SERVICING ASSETS (MSAs)

23. Determine whether the bank recognizes and initially measures at fair value a servicing asset or a

servicing liability that qualifies for separate recognition when it undertakes an obligation to service a financial asset. ***(For additional information, refer to ASC Subtopic 860-50, Transfers and Servicing – Servicing Assets and Liabilities; ASC 820, Fair Value Measurements; and Call Report-Glossary definitions for Servicing Assets and Liabilities, and Fair Value.)***

24. Complete an in-depth review of the valuation process (policies, procedures, and controls) for MSAs.

- **Determine whether management appropriately identifies servicing portfolio characteristics, such as:**
  - **Investors;**
  - **Product types;**
  - **Transactions made with or without recourse;**
  - **Geographic distribution of borrowers;**
  - **Average loan size;**
  - **Range of interest rates;**
  - **Projected life and average age of loans;**
  - **Delinquency, foreclosure, OREO, and bankruptcy levels; and**
  - **Loss experience.**
- **Review prepayment speed assumptions to determine if they are realistic and conform to acceptable industry standards.**
- **Determine whether discount rate assumptions are realistic and in-line with industry practices.**
- **If servicing costs exceed contractual servicing fees and other projected servicing income, determine whether the bank records a loss on the sale or a mortgage servicing liability.**
- **Determine whether changes in the servicing fee are caused by changes in the weighted-average coupon for each mortgage pool.**

25. For MSAs accounted for using the amortization method, determine whether the bank amortizes capitalized servicing assets (servicing liabilities) over the period of estimated net servicing income (net servicing loss).

- **Determine how the bank establishes amortization periods for its classes of servicing assets and servicing liabilities.**
- **Determine whether the bank adjusts the amortization when the actual prepayment speed is faster or slower than originally projected.**

26. If assumptions used in the MSA valuation appear unrealistic, or the reported MSA value appears materially overstated, consider recalculating the value of MSRs. If the bank's internal model is considered reliable, it may be used to recalculate the MSRs value, after substituting more realistic assumptions.

COLLECTIONS
27. Review loan delinquency reports. Select and review a sample of files for severely delinquent borrowers. • **Determine whether the bank initiates foreclosure proceedings in a timely manner and properly notifies borrowers, investors, and mortgage insurers.** ***(Note: Reference GSE Servicer Guides for state-specific foreclosure timelines.)*** • **Review a sample of loans in which the foreclosure action is delayed due to forbearance agreements. Determine whether the agreements are within investors' guidelines.**
28. Review procedures for filing mortgage insurance (MI) claims and the application of such funds. Select a sample for detail testing if procedures are inadequate or if there are indications that MI claims are not properly handled and posted.
29. Review a sample of investor-owned OREO properties to determine if administrative and marketing practices comply with investor guidelines.
30. Determine whether there are any contingencies resulting from improper administration of foreclosed properties.
Financial Analysis
31. Investigate the causes for operating losses in mortgage banking operations, and evaluate prospects for future profitability. • **Determine whether elevated operating costs or other inefficiencies are impairing profitability.** • **Determine whether repurchase demands have impaired profitability, the near and long-term effects on liquidity and capital, and the impact on earnings due to reserve implications.** • **Establish whether excessive borrowing activities have led to adverse changes in the cost of funds. Evaluate the impact that a change in the cost of funds would have on the net interest margin.** • **Determine the holding company's ability to provide capital support, if necessary.** • **Determine why hedging strategies have not appropriately controlled interest rate risk (improper hedging is often a major cause of poor profitability).**
End of Expanded Analysis. If needed, Continue to Impact Analysis.

MORTGAGE BANKING

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Determine which risks associated with mortgage banking pose material threats to earnings, capital, and liquidity. Consider credit, interest-rate, price, transaction, liquidity, reputation, legal, compliance, and strategic risks.
2. Consider the need for administrative and enforcement actions, formulate specific recommendations, and discuss the nature of the concerns with appropriate regulatory supervisors.
3. When appropriate, discuss the possibility of administrative and enforcement actions with executive management and the board of directors.
End of Impact Analysis.

RELATED ORGANIZATIONS

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

E.1. **Are deficiencies immaterial to management's supervision of transactions with related organizations? *Refer to Expanded Analysis Procedures #1-8*.**

E.2. **Are deficiencies immaterial to the bank's financial condition? *Refer to Expanded Analysis Procedures #1-8*.**

RELATED ORGANIZATIONS

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible procedures specified for the Core Analysis also apply to the Expanded Analysis. The procedures in the Expanded Analysis section focus on identifying risk exposures, verifying significant risks, and determining the capabilities and reliabilities of the internal measurement systems.

Expanded Analysis Procedures
1. Investigate why the internal policy and procedure deficiencies identified in the Core Analysis exist. Possible reasons for policy deficiencies may indicate: • **Management overlooked issues,** • **Management is unfamiliar with prudent guidelines and procedures, or** • **Management has not been responsive to previous recommendations to create or enhance policies and procedures.**
2. If poor compliance with internal policies and procedures exist, determine the reasons. Possible reasons include: • **A lack of awareness of policy existence.** • **A disregard for established policies.** • **A misunderstanding of the intent of policy guidelines.** • **Poor internal communication of policy and procedures or subsequent revisions.**
3. Determine whether management commits to and supports proper controls and monitoring to ensure internal policy guidelines are followed in the future. Determine whether proposed controls are reasonable.
4. Determine the effect on the bank of inappropriate employee allocation agreements or nonconformance with agreements.
5. Determine whether reimbursements are necessary for improper transactions.
6. Determine whether the affiliate's or subsidiary's financial position will require additional funding requirements. Identify the source of the additional funding and the effect on the bank.

7. Determine the cause of violations and identify responsible parties. Consider the following: • **Unfamiliarity with laws and regulations,** • **Negligence,** • **Misinterpretation of statutory or regulatory requirements or prohibitions, and** • **Willful disregard.**
8. If the bank is critically undercapitalized (under Section 38, Prompt Corrective Action definitions), determine whether the bank has engaged in any covered transaction as defined in Section 23A, without the prior approval of the FDIC or FRS.
End of Expanded Analysis. If needed, Continue to Impact Analysis.

RELATED ORGANIZATIONS

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Determine whether the risks associated with affiliate relationships pose a material threat to the institution's capital, asset quality, earnings, or liquidity. Assess the impact on the institution if these deficiencies continue.
2. Assess whether management can effectively reduce the risks associated with affiliated relationships.
3. Determine whether administrative and enforcement actions, Civil Money Penalties, or removal actions are necessary. Formulate specific recommendations, and advise the appropriate supervisory officials on the nature of the concerns. (FDIC: Field supervisor and regional office.)
4. After obtaining approval from appropriate supervisory officials, discuss the possibility of administrative and enforcement actions with executive management and the board of directors.
End of Impact Analysis.

RETAIL INSURANCE AND SECURITIES SALES ACTIVITIES

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

E.1. **Are management deficiencies immaterial to the supervision of the insurance and security-sales programs and activities?** ***Refer to Expanded Analysis Procedures #1-32*****.**

E.2. **Are performance deficiencies immaterial to the bank's overall condition?** ***Refer to Expanded Analysis Procedures #1-32*****.**

RETAIL INSURANCE AND SECURITIES SALES ACTIVITIES
Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible guidelines specified for the Core Analysis also apply to the Expanded Analysis.

Policies, Procedures, and Other Risk Limiting Methods

1. Investigate why policy or procedure deficiencies identified in the Core Analysis exist. Discuss recommendations for corrective action with management. Possible reasons for policy deficiencies may include:

- **Management overlooked issues;**
- **Management is unfamiliar with guidelines for retail insurance and security-sales activities, including those that ensure compliance with the GLBA broker exceptions and Regulation R rules applicable for bank networking arrangements with a broker-dealer; or**
- **Management is unwilling to create or enhance policies and procedures.**

2. Determine whether management commits to and supports proper controls and monitoring to ensure policy guidelines are consistently followed. Determine whether proposed controls, if any, appear reasonable and implementable.

3. For insurance programs:

- **Assess the risks to the institution caused by concentrations of sales of insurance products from troubled insurance carriers;**
- **If a represented insurance company is failing or will be placed in receivership, determine the effect on bank operations; and**
- **Review contingency plans for handling customer concerns.**

4. For bank proprietary insurance or securities activities, evaluate management's policies, procedures, and ability relative to potential cash injections or liquidity problems.

Internal Controls

5. When concerns with internal controls are identified in the Core Analysis, evaluate whether the internal control weaknesses may expose the bank to material loss.

6. Research any material deficiencies in management reports to determine the underlying cause.
7. If a bank or its subsidiary conducts insurance sales activities, evaluate internal controls designed to guard against misappropriation of funds for accounts that are used to hold payouts from insurers and deposits for insureds. Determine whether management established methods for fraud prevention and investigation.
8. Assess the internal controls employed to mitigate risks that accompany outsourcing arrangements, including contingency plans to address nonperformance by an external vendor.
Audit or Independent Review
9. Determine why audit or independent review deficiencies exist.
10. Verify the accuracy of independent-review reports to the board.
Information and Communication Systems
11. Review the deficiencies in information and communication systems and determine the underlying cause(s).
12. Determine whether management monitors insurance policy renewals, lapses, and surrender rates to identify fluctuations in the customer base that could result in loss of business and revenue.
13. Determine the impact weakness may have on the bank's liquidity posture and incorporate the analysis in the examination's liquidity assessments, where appropriate. Consider: • **Deposit run-off because of reputation concerns,** • **Deposit outflows to insurance or investment products, and** • **Deposit inflows associated with insurance or security-sales programs.**

14. In instances where the institution purchased an insurance agency, determine whether management properly accounts for intangibles (i.e., goodwill and restrictive management covenants).
15. If the bank owns an insurance agency, determine whether management follows accounting pronouncements that apply to insurance activities (e.g., premium recognition). Refer to the American Institute of Certified Public Accountants (AICPA) Audit Guide for more details.
Third Party Agreements and Reviews
16. Assess the magnitude of risk exposure arising from disputes with third parties or customers, such as contract breaches or pending lawsuits.
17. Determine whether management monitors an insurance agency's conformance with contractual servicing responsibilities. ***Note: Servicing responsibilities can range from file maintenance to premium collection and claims adjustment. Problems may indicate potential financial or operational supervisory concerns.***
18. Determine whether management periodically requests confirmation that third-party insurance agencies monitor represented insurers with respect to reinsurance agreements, if applicable.
Board and Senior Management Oversight
19. Determine the cause of any violations of Regulation R and identify the responsible party or parties. Consider the following: • **Lack of familiarity with laws, regulations, or policy statements;** • **Negligence;** • **Misinterpretation;** • **Willful disregard and noncompliance; and** • **Fraudulent activity.**
20. Determine whether any side letters to governing contracts exist.

Compliance with Insurance and NDIP Consumer Protections (Non-FDIC Only)
Note: FDIC: Defer to DCP for all compliance reviews.
21. Review the bank's sales records to verify that only qualified and licensed or registered personnel are recommending and selling insurance or securities products.
22. Review the personnel files that management should maintain for bank or dual employee insurance or security-sales representatives for background and regulatory histories.
23. Visit additional insurance or NDIP sales locations, and evaluate promotional materials and sample customer information.
24. Interview sales representatives and assess their knowledge of, and commitment to, providing adequate disclosures for insurance and NDIP sales programs. Consider required disclosures regarding: • **The uninsured nature of any insurance, annuity, or securities product offered for sale (i.e., the product is not insured by the FDIC or any other U.S. government agency or by the bank or, if applicable, by an affiliate);** • **The statement that an insurance, annuity, or securities product is not a deposit, other obligation of, or guaranteed by the bank or an affiliate;** • **The investment risk associated with any such product (in the case of an insurance, annuity, or securities product that involves investment risk);** • **Notice that the bank or a subsidiary may not condition an extension of credit on the consumer's purchase of an insurance, annuity, or securities product from the bank or any of its affiliates, and that the consumer is free to purchase insurance products or annuities from another source; and** • **In the case of NDIPs, other required disclosures, such as proprietary product risks, fees, commissions, and arrangements with affiliated investment advisors, as applicable.**
25. Assess the risk arising from customer confusion caused by inadequate observance of any consumer protection measures for insurance sales.
26. Review the sales operation for potential discriminatory, unsuitable, or deceptive sales practices. Analyze sales reports and promotional materials to determine whether the following situations exist: • **Questionable sales practices, such as churning; or** • **Unsuitable recommendations (for example, high volumes of volatile instruments or dramatic increases in the sale of a particular product may indicate suitability concerns).**

27. Review a sample of advertisements (including Internet related ads and telemarketing sales scripts) used in the sales program to market insurance products or NDIPs. Determine whether the promotions are misleading or confusing.

28. Determine whether referral incentives and other compensation packages are reasonable. Incentives and other packages should not be structured to promote or cause inappropriate insurance or NDIP sales practices.

29. Interview branch employees, including tellers and receptionists, to determine whether proper insurance and NDIP referral procedures are followed.

30. Review a sample of customer files to verify that the files contain the following items:

- **Signed disclosure acknowledgement statements.**
- **For NDIP sales programs:**
  - **Evidence of a registered representative's review of customer information for adequacy before offering investment recommendations,**
  - **Current customer data,**
  - **Evidence that registered representatives provide complete information to customers regarding risks, and**
  - **Recommendations that conform to customers' goals.**

31. In banks with multiple retail insurance and security-sales sites, evaluate a small sample of the sales locations to determine whether the bank conducts sales transactions in an area that is physically segregated, to the extent practicable, from areas where retail deposits are routinely accepted from the public.

32. Determine whether the independent review function:

Tracks customer complaints relative to insurance or NDIP sales activities,

- **Identifies documentation deficiencies, and**
- **Reports findings to the bank's board.**

End of Expanded Analysis. If needed, Continue to <u>Impact Analysis</u>.

RETAIL INSURANCE AND SECURITIES SALES ACTIVITIES
Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Assess the impact of the retail insurance and security-sales activities on the overall condition and risk profile of the bank. Consider the following issues: • **Settled, pending, and planned litigation against the bank.** • **Regulatory investigations and sanctions.**
2. Determine the effect that reputational, financial, operational and legal risk exposures resulting from insurance and security-sales programs have on the institution's safety and soundness.
3. Evaluate the effects that current or planned insurance and securities activities could have on capital, earnings, liquidity, and asset quality.
4. Gauge management's willingness and abilities to correct identified weaknesses and concerns.
5. Determine whether informal or formal administrative actions are warranted. Formulate recommendations, review implementation plans, and advise the appropriate supervisors of the nature of the regulatory concerns.
6. Consult with the functional regulator(s) of the insurance or securities unit regarding any significant.
End of Impact Analysis.

SECURITIZATION

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?

E.1. Are the deficiencies immaterial to securitization activities? *Refer to Expanded Analysis Procedures #1-8.*

E.2. Are the deficiencies immaterial to the institution's overall condition? *Refer to Expanded Analysis Procedures #1-8.*

SECURITIZATION

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible guidelines specified for the Core Analysis also apply to the Expanded Analysis.

Internal Controls

1. **Reconcile the dollar volume of loans serviced by a third party, including a subsidiary or an affiliate that has been transferred in a securitization, regardless of whether the securitization is accounted for as a sale or a secured borrowing.**
   - **Independently verify that the amount of loans being serviced ties to the institution's records.**
   - **For on-balance sheet loans (i.e., seller's interest), verify that the dollar volume of loans on the servicing statements ties to the dollar volume of loans on the institution's records.**
   - **For securitized loans, verify that the dollar volume of loans on the servicing statement ties to the dollar volume of loans reported to the trustee.**
   - **Verify that the servicing statement ties to the supporting cash flow documentation for the bank's initial and ongoing accounting for the securitization (including the measurement of any beneficial interests held by the bank transferor in securitizations accounted for as sales).**

2. **Review monthly held-for-sale loan account reconciliations.**

Risk Identification and Measurement

3. **If there are material differences between the credit quality of loans subject to the securitization, and on-balance sheet loans that have not been securitized, investigate the reasons(s) for the performance disparity by comparing characteristics such as:**
   - **Loan-to-value ratios;**
   - **FICO or other credit scores;**
   - **Behavioral patterns or scores; and**
   - **Loan characteristics such as weighted average coupon (WAC), weighted average maturity (WAM), variable vs. fixed rate.**

Valuation and Classification of Beneficial Interests in Securitizations held by the Transferor Bank

4. **Analyze the assumptions used to value beneficial interests in the securitizations.**
   - **Review the process for determining prepayment, default, loss, and discount-rate assumptions and verify calculations.**
   - **Compare the prepayment and loss assumptions used in valuing the beneficial interest to actual performance of the underlying collateral. If the underlying collateral does not have sufficient**

performance history, compare assumptions to those of deals with substantially similar underlying assets or proxies.

- **Compare the discount rate used in valuing the beneficial interest to the discount rate that other market participants use to value beneficial interests having substantially similar characteristics.**
- **Determine whether the discount rate is applied to the actual excess interest that the trust distributes to the beneficial interest (cash-out method). The discount rate should not be applied to the excess interest that the trust receives (cash-in method).**
- **Determine whether the following items are properly reflected in the cash flow waterfall attributed to the beneficial interests:**
  - **Payments from the securitized assets;**
  - **Payments to certificate holders;**
  - **Fees (e.g., trustee, servicer, insurer);**
  - **Release of, or additions to, a reserve or overcollateralization account;**
  - **Chargeoffs and recoveries;**
  - **Insurance coverage of losses (e.g., FHA guaranteed);**
  - **Interest earned on underlying investments from credit enhancements accounts (e.g., cash collection, reserve, spread accounts);**
  - **Net settlements from embedded derivatives; and**
  - **Servicer advancements and any associated losses or unreimbursed amounts.**

5. **Using the discount rate assumption, verify the present value calculations of the expected future cash flows to the beneficial interests.**

6. **Determine whether an other-than-temporary impairment occurred. Other-than-temporary impairment on certain beneficial interests held by the transferor bank in securitizations accounted for as sales must be recognized when:**
   - **The fair value of an individual beneficial interest is below its reference amount; and**
   - **Based on current information and events, there has been an adverse change in cash flows expected to be collected on the beneficial interest.[1]**

7. **If the servicer is funding payments to the trust that are delinquent (principal or interest), in escrow, or are collection-related, determine whether the servicing advance payments are included in management's loss assumption methodology.**

8. **If possible, obtain the valuation model and substantially change one or more valuation assumption to determine whether the model functions properly.**

[1] **Reference: ASC Subtopic 325-40, Investments - Other, Beneficial Interests in Securitized Financial Assets.**

End of Expanded Analysis. If needed, Continue to Impact Analysis.

SECURITIZATION
Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Assess the impact of securitization activity deficiencies on the bank's overall condition.
2. Assess the effect of credit, interest rate, liquidity, and reputational risks on the institution's safety and soundness.
3. Assess the effect of planned securitization activities on capital, asset quality, earnings, liquidity, and sensitivity to market risk.
4. Assess management's willingness and ability to correct deficiencies.
5. Determine whether formal or informal administrative actions are warranted, formulate specific recommendations, and advise the appropriate supervisors on the nature of the concerns.
6. Investigate potential recommendations for civil money penalties.
7. Determine whether the assumptions used to value the beneficial interests lack appropriate and verifiable support,[2] in which case, the beneficial interests should be classified Loss and disallowed for regulatory capital purposes.
8. Assess the effect on the bank's overall condition of: • **An improper initial or subsequent valuation of beneficial interests obtained by the transferor bank**

[2] **Refer to the *Interagency Guidance on Asset Securitization Activities* (FDIC: FIL 109-99, FRB: SR 99-37) for further discussion.**

in its securitizations accounted for as sales; and

- **An inappropriate level for the portion of the ALLL for loans transferred in securitizations accounted for as secured borrowings (i.e., securitizations not accounted for as sales, in which case the transferred loans remain on the bank's consolidated balance sheet, normally in the held-for-investment loan account).**

End of Impact Analysis.

TRUST

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

Do Expanded Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

E.1. **Are deficiencies immaterial to the supervision of the trust department?** ***Refer to Expanded Analysis Procedures #1-41.***

E.2. **Are deficiencies immaterial to the bank's condition?** ***Refer to Expanded Analysis Procedures #1-41.***

TRUST

Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible guidelines specified for the Core Analysis also apply to the Expanded Analysis.

Policies and Procedures

1. **Investigate why trust policy or procedure deficiencies identified in the Core Analysis exist. Discuss with management its response to examiner recommendations. Possible reasons for policy deficiencies may include the following:**
   - **Management overlooked these issues.**
   - **Management is unfamiliar with prudent trust guidelines and procedures.**
   - **Management is unwilling to create or enhance policies and procedures.**

2. **If poor compliance with policies and procedures exists, determine the reasons. Consider the following:**
   - **Poor internal communication of policy and procedures or subsequent revisions.**
   - **Lack of awareness of policy existence.**
   - **Disregard for established policies.**
   - **Misunderstanding of policy and procedures.**

Internal Controls

3. **Determine if management commits to and supports proper controls and monitors to ensure policy and procedures are followed in the future. Determine whether proposed controls, if any, are reasonable.**

4. **Determine whether all potential losses resulting from internal control or operational deficiencies have been identified and appropriately recognized.**

PROTECTING AND CONTROLLING ASSETS

5. **Perform a full or partial verification of assets held in the vault.**

6. **Perform a full or partial verification of assets held by third party custodians.**

7. Determine that securities held by brokers are properly titled in the name of the institution as fiduciary or its nominee name.

8. Determine that unissued trust checks are in sequential order and properly controlled.

9. Review a sample of issued trust checks for signature controls.

10. Review a sample of daylight overdrafts for evidence of customer free-riding activity.

11. Review a sample of worthless assets for appropriate documentation.

CONTROL ENVIRONMENT

12. Trace a sample of transactions from origination through posting.

13. Observe the in-house securities trading process to ensure that appropriate controls are in place.

14. Verify the accuracy of Consolidated Reports of Condition and Income Schedule RC-T.

15. Review proxy-voting records to determine if procedures are consistently applied.

RECONCILIATION

16. Reconcile subsidiary control and suspense accounts that are out of balance or have not been reconciled on a timely basis.

17. Reconcile bank, securities depository or brokerage accounts that are out of balance or have not been reconciled on a timely basis.

18. Research significant outstanding suspense items and evaluate the institution's follow-up procedures.

19. Review significant outstanding trust checks and evaluate the institution's follow-up procedures.

Audit or Independent Review

20. Determine why examination deficiencies have not been identified through the institution's audit program.

21. Determine why management has failed to take action to address audit deficiencies.

22. Contact the external auditor and determine if external audit work papers should be reviewed.

Information and Communication Systems

23. Determine whether lack of information, inaccurate information, or faulty communication processes compromise risk management activities or the effective implementation of strategic initiatives.

Earnings

24. Evaluate the effect of operating losses on the bank's earnings, capital, and liquidity.

25. Evaluate the viability of any plans to improve earnings.

26. Estimate the department's earnings if trust income and expenses are not adequately measured.
27. Evaluate methods for allocating indirect income and expenses or management's reasons for electing not to allocate such items.
28. Evaluate the effect of fee schedules and any discounts, fee waivers or uncollected fees on earnings.
29. Evaluate the reasonableness of salaries and other operating expenses.
Compliance
30. Assign and evaluate the materiality of any contingent liabilities, potential losses or estimated losses identified during the examination.
31. Expand the sample of accounts reviewed or transaction testing to evaluate the extent and severity of identified deficiencies or areas where additional analysis is necessary.
32. Determine the extent and severity of actual and potential conflicts of interest and self dealing.
33. Determine whether self-dealing issues in employee benefit plans and charitable foundations are subject to excise taxes under the Internal Revenue Code.
34. Sample written directives for holding own bank or parent holding company stock.
35. Obtain information regarding officers and directors and their outside interests and compare against a list of fiduciary assets.

36. Review soft dollar contracts and documentation to determine compliance with the safe harbor provisions of Securities and Exchange Commission Section 28(e).

37. Review reports of personal securities transactions (FDIC: Part 344; FRB: 12CFR 208.34) for noncompliance with the institution's ethics policies or other insider abuse.

Asset Management

38. Assess the reasonableness of assumptions used in securities evaluation models.

39. Determine if management uses consistent and reasonable methods for reporting investment performance.

40. Review trading account records for churning or excessive trading.

Board and Senior Management Oversight

41. Review incentive-based compensation programs to determine that they do not promote the assumption of excessive risk.

End of Expanded Analysis. If needed, Continue to **Impact Analysis.**

TRUST

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Determine if management has the ability and willingness to correct deficiencies.
2. Assess the impact of contingent liabilities, potential losses, and estimated losses on the institution's capital and earnings.
3. Determine the effect that reputation, operational, strategic, compliance, legal, financial and other risk exposures have on the institution's safety and soundness.
4. Determine whether any significant violations of the Employee Retirement Income Security Act should be referred to the Department of Labor. The interagency referral agreement states that the following violations will be considered significant: • **Violations of Sections 404 and 405 involving $100,000 or more;** • **Violations of Sections 406 or Section 407 involving prohibited transactions, except where the harm to the beneficiaries is minimal;** • **Violations of Section 411, relating to prohibition against certain persons holding certain positions;** • **Violations of Section 412, relating to bonding requirements for the institution itself.**
5. Consider whether informal or formal enforcement action regarding fiduciary activities is warranted, such as a board resolution, a Memorandum of Understanding, a Cease and Desist Order, or a removal action. Advise the appropriate supervisory officials.
6. Consider recommendations for Civil Money Penalties and prepare formal recommendations, as appropriate. (Refer to the guidance in the Management and Internal Control Evaluation module.)
7. Notify the appropriate bank regulatory officials of suspected activities and actions taken relating to Suspicious Activity Reports. (Refer to the guidance in the Management and Internal Control

Evaluation module.)
End of Impact Analysis.

ATTACHMENT 5

FINANCIAL SERVICES COMMISSION
OFFICE OF FINANCIAL REGULATION
AGENDA ITEM # 5: REQUEST APPROVAL TO PUBLISH NOTICE OF PROPOSED RULE

Action Requested

The Office of Financial Regulation ("OFR") requests approval to publish a Notice of Proposed Rule regarding Rules 69U-120.001, 69U-120.003, 69U-120.004, 69U-120.005, 69U-120.045, 69U-120.330, and 69U-120.670, Florida Administrative Code ("F.A.C."), pertaining to banks, trust companies, and associations.

Summary and Justification of Rules

Rule 69U-120.001, F.A.C.: The OFR proposes to amend Rule 69U-120.001, F.A.C., to delete language that duplicates section 658.16, Florida Statutes ("F.S."), regarding good faith reliance on a rule or order of the OFR.

Rule 69U-120.003, F.A.C.: The OFR proposes to amend Rule 69U-120.003, F.A.C., to remove language that is ambiguous or lacking in delegated authority regarding "foreseeably detrimental" stock option plans, director liability for certain losses, and direct stock bonuses.

Rule 69U-120.004, F.A.C.: The OFR proposes to amend Rule 69U-120.004, F.A.C., to replace a vague and ambiguous term ("appropriate") with clear, definite language.

Rule 69U-120.005, F.A.C.: The OFR proposes to amend Rule 69U-120.005, F.A.C., to update a citation in the introductory paragraph.

Rule 69U-120.045, F.A.C.: The OFR proposes to amend Rule 69U-120.045, F.A.C., to delete a reference to an outdated guidebook on auditing standards.

Rule 69U-120.330, F.A.C.: The OFR proposes new Rule 69U-120.330, F.A.C., to implement section 658.33, F.S., by incorporating by reference two new proposed forms. Proposed form OFR-U-658-List, List of Directors and Officers, will be used by banks and trust companies to submit the list of officers and directors elected during the annual shareholder's meeting as required by section 658.33(3), F.S. Proposed form OFR-U-658-Oath is the director's oath required pursuant to section 658.33(4), F.S.

Rule 69U-120.670, F.A.C.: The OFR proposes to amend Rule 69U-120.670, F.A.C., to: delete subsection (1), which duplicates statutory language in section 658.67(11), F.S.; delete the definition of "exposure" as a result of the deletion of the portion of the rule that references that term; and update material incorporated by reference (the federal rule on the 20 percent risk weight category in 12 C.F.R. § 324.32(d)(2) applicable to investments in foreign bank deposits).

Proposed Text of Rules

69U-120.001 List of Stockholders.

~~(1)~~ Within 2 calendar weeks of any demand therefor made by the Office of Financial Regulation (OFR), a state bank or trust company shall file with OFR a list containing the name of each stockholder of the bank or trust company together with the number of shares held by each according to its records as of the close of business on a date specified by OFR.

~~(2) Action in compliance with any such demand by OFR shall be deemed action in good faith in reliance upon a subsisting order or regulation by OFR and in reliance upon section 655.016, F.S.~~

Rulemaking Authority 655.012(2)~~(3)~~ FS. Law Implemented 655.057(8) ~~655.012~~ FS. History–New 7-31-75, Amended 6-30-81, Formerly 3C-11.15, 3C-11.015, 3C-120.001, Amended ______.

69U-120.003 Stock Options; Requirements for OFR Approval; Stock Bonuses Prohibited.

(1)-(2) no change

(3) ~~Any plan which is detrimental or which may be foreseeably detrimental to the bank, its depositors or creditors or which is contrary to safe and sound banking practices may not be approved.~~ OFR shall ~~may~~ not approve any stock option plan where:

(a) no change

(b) The number of shares subject to the plan is unreasonable in relation to the bank's capital structure and anticipated growth; or

(c) no change

(4) The option shall ~~may~~ not be assignable by the optionee, except that the personal representative or legal guardian of the optionee's estate may have a reasonable time to exercise such option.

(5) The plan or agreement shall not permit ~~board of directors of the bank may be liable to reimburse the bank for any loss sustained by reason of~~ the grant of an option at less than par value or fair market value where such grant would result in a loss to the bank.

~~(6) The Florida Financial Institutions Code does not authorize stock bonuses; accordingly, direct stock bonuses will not be permitted.~~

Rulemaking Authority 655.012(2)~~(3)~~ FS. Law Implemented 658.34, 658.35 FS. History–New 2-13-77, Amended 6-30-81, Formerly 3C-11.16, 3C-11.016, Amended 10-29-97, Formerly 3C-120.003, Amended ______.

69U-120.004 Loans Secured by Secondary Liens on Real Estate.

For computation of total loans to any one borrower, loans secured by secondary liens will be considered unsecured unless the following criteria are met:

(1) no change

(2) The state bank shall maintain records ~~Appropriate records shall be maintained~~ to fully establish the bank's equity in the ~~their~~ mortgage at the time the loan is made.

(3)-(4) no change

Rulemaking Authority 655.012(2) FS. Law Implemented 658.48 FS. ~~(See also 12 U.S.C. 371)~~ History–New 6-13-77, Amended 4-23-78, 6-30-81, Formerly 3C-11.17, 3C-11.017, 3C-120.004, Amended 10-29-12,______.

69U-120.005 Lease Financing; Purchase of Leases.

State banks may purchase leases (in addition to those leases where the bank is the owner and lessor) covering specified goods as defined in section 679.1021(1)(rr), ~~679.105(1)(h),~~ F.S., except the unborn young of animals and growing crops, with or without recourse or guarantee by the lessor, subject to the following conditions:

(1)-(3) no change

Rulemaking Authority 655.012(2)~~(3)~~ FS. Law Implemented ~~658.48,~~ 658.67(8) FS. History–New 9-26-78, Amended 6-30-81, Formerly 3C-11.19, 3C-11.019, 3C-120.005, Amended ______.

69U-120.045 Minimum Internal Audit Procedures.

(1)-(3) no change

(4) To satisfy the requirements of this section, each internal audit shall:

(a) Assess the effectiveness of the financial institution's internal control policies and procedures, including the electronic data processing function; and~~,~~

(b) ~~Be conducted in accordance with generally accepted auditing principles as set forth in the 1996 GAAS Guide and~~ S~~s~~hall include an assessment of each of the following areas:

(b)1.-5. no change

(5)-(7) no change

Rulemaking Authority 655.012(2)~~(3)~~ FS. Law Implemented ~~655.012(3),~~ 655.045 FS. History–New 7-18-74, Amended 1-5-77, 6-30-81, Formerly 3-1.13, 3C-11.13, 3C-11.013, Amended 1-31-96, Formerly 3C-120.045, Amended _____.

69U-120.330 List of Directors and Officers; Director's Oath.

(1) Within 30 days following the annual meeting or any other meeting at which directors or officers are elected as provided in section 658.33(3), F.S., each bank or trust company must file with OFR the names and residence addresses of those persons on Form OFR-U-658-List, List of Directors and Officers (effective __/____), incorporated herein by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX.

(2) The signed copy of the director's oath required by section 658.33(4), F.S., shall be completed on Form OFR-U-658-Oath, Director's Oath (effective __/_____), incorporated herein by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX, and filed with OFR within 30 days after election.

(3) Forms shall be filed with OFR by mail or email as follows:

Division of Financial Institutions
Office of Financial Regulation
200 East Gaines Street
Tallahassee, Florida 32399-0371
OFRFinancialInstitutions@flofr.com

Rulemaking Authority 655.012(2), 658.33(3) FS. Law Implemented 658.33(3)-(4) FS. History—New _____.

69U-120.670 Investments/Deposits in Foreign Banks.

~~(1) Sections 658.67(11) and 665.013(34), F.S., provides that the Financial Services Commission may, by rule, approve additional investments for banks, trust companies, or associations.~~

(1)~~(2)~~ As used in this rule, "foreign bank" ~~section, the following definitions shall apply:~~

~~(a) "Foreign bank"~~ means a person organized under the laws of a foreign country, or of a dependency or insular possession of the United States or a foreign country, which is principally engaged in the business of a commercial bank; recognized as a bank by the appropriate supervisory or monetary authorities of the country of its organization or principal banking operations; receives deposits to a substantial extent in the regular course of business; and has the power to accept demand deposits.

~~(b) "Exposure" means the potential that an obligation will not be paid timely or in full. Exposure includes credit and liquidity risks, including operational risks, related to intraday and interday transactions. It also includes the same credit risks and country risks as an extension of credit.~~

(2)~~(3)~~ State-chartered banks, trust companies, and associations may invest in foreign bank deposits, both demand and time, of the 20 percent risk weight category, as provided in 12 C.F.R. § 324.32(d)(2) (Apr. 13, 2020), which is adopted and incorporated herein by reference and available at http://www.flrules.org/Gateway/reference.asp?No=Ref-XXXXX, ~~Category 2-20% Risk Weight, as defined in the FDIC Rules and Regulations, Part 325, Appendix A, Procedure For Computing Risk-Weighted Assets (effective 1-27-94),~~ up to an aggregate of 25 percent ~~%~~ of the capital of the investing bank, trust company, or association in all foreign banks within a foreign country.

(3)~~(4)~~ The board of directors of each bank, trust company, or association shall adopt standards and policies for the investment of funds in foreign bank deposits. Such standards and policies shall be reviewed and approved at least annually by the board of directors with the approval recorded in the minutes of the meetings of the board of directors.

(4)~~(5)~~ At a minimum, the standards and policies shall include:

(a)-(b) no change

(c) An aggregate limitation on the currency of deposit; and~~,~~

(d) no change

~~(6) The board of directors shall assure itself that adequate procedures have been implemented to comply with its policy on foreign bank deposits and safeguard the bank, trust company or association against undue exposure.~~

Rulemaking Authority ~~120.53(1)(b),~~ 655.012(2)~~(3)~~ FS. Law Implemented 658.67(11), 665.013(32)~~(34)~~ FS. History–New 11-14-94, Formerly 3C-120.670, Amended ______.

Material Incorporated by Reference

[BEGINS ON NEXT PAGE]

LIST OF DIRECTORS AND OFFICERS OF

____
(Name of Financial Institution)

____
(Name of Holding Company, if applicable)

OFFICE OF FINANCIAL REGULATION
Tallahassee, Florida

The following are the directors and officers elected to serve this institution for the year **20__ __**, including the complete residence and mailing address(es) (both, if different) for each. On ________________________, the annual meeting was held and directors were elected by the stockholders. In addition, the stockholders authorized the elected Board to appoint _______ (not to exceed two) additional directors during the year (if provided for in the institution's Articles of Incorporation).

____
Chairman of the Board (or designee)

NAME OF DIRECTOR	MAILING/RESIDENCE ADDRESS (STREET OR BOX #)	CITY/TOWN	STATE	ZIP CODE

Attach additional pages, as needed.

<u>PLEASE NOTE</u>: ALL CHANGES OCCURRING IN THE BOARD FOR ANY REASON ARE TO BE REPORTED TO THIS OFFICE AT THE TIME THE CHANGE TAKES PLACE.

LIST OF OFFICERS OF

____
(Name of Financial Institution)

FOR THE YEAR **20__ __**

NAME OF OFFICER	TITLE	MAILING/RESIDENCE ADDRESS (STREET OR BOX #)	CITY/TOWN	STATE	ZIP CODE

Attach additional pages, as needed.

DIRECTOR'S OATH

I, ____, acknowledge that I am familiar
(Print Director's Name)

with my responsibilities as a director and will diligently and honestly administer the affairs of

____, and will not knowingly violate, or willfully
(Print Name of Institution)

permit to be violated, any of the provisions of the Florida Financial Institutions Codes or the Rules of the Office of Financial Regulation, Division of Financial Institutions.

____
Director's Signature

____
Date

(b) Total risk-weighted assets for general credit risk equals the sum of the risk-weighted asset amounts calculated under this section.

[Codified to 12 C.F.R. § 324.31]

§ 324.32 General risk weights.

(a) *Sovereign exposures*--(1) *Exposures to the U.S. government*. (i) Notwithstanding any other requirement in this subpart, an FDIC-supervised institution must assign a zero percent risk weight to:

(A) An exposure to the U.S. government, its central bank, or a U.S. government agency; and

(B) The portion of an exposure that is directly and unconditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency. This includes a deposit or other exposure, or the portion of a deposit or other exposure, that is insured or otherwise unconditionally guaranteed by the FDIC or National Credit Union Administration.

(ii) An FDIC-supervised institution must assign a 20 percent risk weight to the portion of an exposure that is conditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency. This includes an exposure, or the portion of an exposure, that is conditionally guaranteed by the FDIC or National Credit Union Administration.

(iii) An FDIC-supervised institution must assign a zero percent risk weight to a Paycheck Protection Program covered loan as defined in section 7(a)(36) of the Small Business Act (15 U.S.C. 636(a)(36)).

(2) *Other sovereign exposures*. In accordance with Table 1 to § 324.32, an FDIC-supervised institution must assign a risk weight to a sovereign exposure based on the CRC applicable to the sovereign or the sovereign's OECD membership status if there is no CRC applicable to the sovereign.

TABLE 1 TO § 324.32—RISK WEIGHTS FOR SOVEREIGN EXPOSURES

		Risk Weight (in percent)
CRC	0--1	0
	2	20
	3	50
	4--6	100
	7	150
OECD Member with No CRC		0
Non-OECD Member with No CRC		100
Sovereign Default		150

(3) *Certain sovereign exposures*. Notwithstanding paragraph (a)(2) of this section, an FDIC-supervised institution may assign to a sovereign exposure a risk weight that is lower than the applicable risk weight in Table 1 to § 324.32 if:

(i) The exposure is denominated in the sovereign's currency;

(ii) The FDIC-supervised institution has at least an equivalent amount of liabilities in that currency; and

(iii) The risk weight is not lower than the risk weight that the home country supervisor allows FDIC-supervised institutions under its jurisdiction to assign to the same exposures to the sovereign.

(4) *Exposures to a non-OECD member sovereign with no CRC*. Except as provided in paragraphs (a)(3), (a)(5) and (a)(6) of this section, an FDIC-supervised institution must assign a 100 percent risk weight to an exposure to a sovereign if the sovereign does not have a CRC.

(5) *Exposures to an OECD member sovereign with no CRC*. Except as provided in paragraph (a)(6) of this section, an FDIC-supervised institution must assign a 0 percent risk weight to an exposure to a sovereign that is a member of the OECD if the sovereign does not have a CRC.

(6) *Sovereign default*. An FDIC-supervised institution must assign a 150 percent risk weight to a sovereign exposure immediately upon determining that an event of sovereign default has occurred, or if an event of sovereign default has occurred during the previous five years.

(b) *Certain supranational entities and multilateral development banks (MDBs).* An FDIC-supervised institution must assign a zero percent risk weight to an exposure to the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, the European Stability Mechanism, the European Financial Stability Facility, or an MDB.

(c) *Exposures to GSEs*. (1) An FDIC-supervised institution must assign a 20 percent risk weight to an exposure to a GSE other than an equity exposure or preferred stock.

(2) An FDIC-supervised institution must assign a 100 percent risk weight to preferred stock issued by a GSE.

(d) *Exposures to depository institutions, foreign banks, and credit unions*--(1) *Exposures to U.S. depository institutions and credit unions*. An FDIC-supervised institution must assign a 20 percent risk weight to an exposure to a depository institution or credit union that is organized under the laws of the United States or any state thereof, except as otherwise provided under paragraph (d)(3) of this section.

(2) *Exposures to foreign banks.*

(i) Except as otherwise provided under paragraphs (d)(2)(iii), (d)(2)(v), and (d)(3) of this section, an FDIC--supervised institution must assign a risk weight to an exposure to a foreign bank, in accordance with Table 2 to § 324.32, based on the CRC that corresponds to the foreign bank's home country or the OECD membership status of the foreign bank's home country if there is no CRC applicable to the foreign bank's home country.

Table 2 TO § 324.32—RISK WEIGHTS FOR EXPOSURES TO FOREIGN BANKS

		Risk Weight (in percent)
CRC:	0--1	20
	2	50
	3	100
	4--7	150
OECD Member with No CRC		20
Non-OECD Member with No CRC		100
Sovereign Default		150

(ii) An FDIC--supervised institution must assign a 20 percent risk weight to an exposure to a foreign bank whose home country is a member of the OECD and does not have a CRC.

(iii) An FDIC--supervised institution must assign a 20 percent risk-weight to an exposure that is a self-liquidating, trade-related contingent item that arises from the movement of goods and that has a maturity of three months or less to a foreign bank whose home country has a CRC of 0, 1, 2, or 3, or is an OECD member with no CRC.

(iv) An FDIC--supervised institution must assign a 100 percent risk weight to an exposure to a foreign bank whose home country is not a member of the OECD and does not have a CRC, with the exception of self-liquidating, trade-related contingent items that arise from the movement of goods, and that have a maturity of three months or less, which may be assigned a 20 percent risk weight.

(v) An FDIC--supervised institution must assign a 150 percent risk weight to an exposure to a foreign bank immediately upon determining that an event of sovereign default has occurred in the bank's home country, or if an event of sovereign default has occurred in the foreign bank's home country during the previous five years.

(3) An FDIC-supervised institution must assign a 100 percent risk weight to an exposure to a financial institution if the exposure may be included in that financial institution's capital unless the exposure is:

(i) An equity exposure;

(ii) A significant investment in the capital of an unconsolidated financial institution in the form of common stock pursuant to § 324.22(d)(2)(i)(c);

(iii) Deducted from regulatory capital under § 324.22; or

(iv) Subject to a 150 percent risk weight under paragraph (d)(2)(iv) or Table 2 of paragraph (d)(2) of this section.

(e) *Exposures to public sector entities (PSEs)*--(1) *Exposures to U.S. PSEs*. (i) An FDIC-supervised institution must assign a 20 percent risk weight to a general obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof.

(ii) An FDIC-supervised institution must assign a 50 percent risk weight to a revenue obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof.

(2) *Exposures to foreign PSEs*. (i) Except as provided in paragraphs (e)(1) and (e)(3) of this section, an FDIC-supervised institution must assign a risk weight to a general obligation exposure to a PSE, in accordance with Table 3 to § 324.32, based on the CRC that corresponds to the PSE's home country or the OECD membership status of the PSE's home country if there is no CRC applicable to the PSE's home country.

(ii) Except as provided in paragraphs (e)(1) and (e)(3) of this section, an FDIC-supervised institution must assign a risk weight to a revenue obligation exposure to a PSE, in accordance with Table 4 to § 324.32, based on the CRC that corresponds to the PSE's home country; or the OECD membership status of the PSE's home country if there is no CRC applicable to the PSE's home country.

(3) An FDIC-supervised institution may assign a lower risk weight than would otherwise apply under Tables 3 or 4 to § 324.32 to an exposure to a foreign PSE if:

(i) The PSE's home country supervisor allows banks under its jurisdiction to assign a lower risk weight to such exposures; and

(ii) The risk weight is not lower than the risk weight that corresponds to the PSE's home country in accordance with Table 1 to § 324.32.

TABLE 3 TO § 324.32—RISK WEIGHTS FOR NON-U.S. PSE GENERAL OBLIGATIONS

		Risk Weight (in percent)
CRC	0--1	20
	2	50
	3	100
	4--7	150
OECD Member with No CRC		20
Non-OECD Member with No CRC		100
Sovereign Default		150

TABLE 4 TO § 324.32—RISK WEIGHTS FOR NON-U.S. PSE REVENUE OBLIGATIONS

		Risk Weight (in percent)
CRC	0--1	50
	2--3	50
	4--7	150
OECD Member with No CRC		50
Non-OECD Member with No CRC		100
Sovereign Default		150

(4) *Exposures to PSEs from an OECD member sovereign with no CRC*. (i) An FDIC-supervised institution must assign a 20 percent risk weight to a general obligation exposure to a PSE whose home country is an OECD member sovereign with no CRC.

(ii) An FDIC-supervised institution must assign a 50 percent risk weight to a revenue obligation exposure to a PSE whose home country is an OECD member sovereign with no CRC.

(5) *Exposures to PSEs whose home country is not an OECD member sovereign with no CRC*. An FDIC-supervised institution must assign a 100 percent risk weight to an exposure to a PSE whose home country is not a member of the OECD and does not have a CRC.

(6) An FDIC-supervised institution must assign a 150 percent risk weight to a PSE exposure immediately upon determining that an event of sovereign default has occurred in a PSE's home country or if an event of sovereign default has occurred in the PSE's home country during the previous five years.

(f) *Corporate exposures.*

(1) A FDIC-supervised institution must assign a 100 percent risk weight to all its corporate exposures, except as provided in paragraph (f)(2) of this section.

(2) A FDIC-supervised institution must assign a 2 percent risk weight to an exposure to a QCCP arising from the FDIC-supervised institution posting cash collateral to the QCCP in connection with a cleared transaction that meets the requirements of § 324.35(b)(3)(i)(A) and a 4 percent risk weight to an exposure to a QCCP arising from the FDIC-supervised institution posting cash collateral to the QCCP in connection with a cleared transaction that meets the requirements of § 324.35(b)(3)(i)(B).

(3) A FDIC-supervised institution must assign a 2 percent risk weight to an exposure to a QCCP arising from the FDIC-supervised institution posting cash collateral to the QCCP in connection with a cleared transaction that meets the requirements of § 324.35(c)(3)(i).

(g) *Residential mortgage exposures*. (1) An FDIC-supervised institution must assign a 50 percent risk weight to a first-lien residential mortgage exposure that:

(i) Is secured by a property that is either owner-occupied or rented;

(ii) Is made in accordance with prudent underwriting standards, including standards relating to the loan amount as a percent of the appraised value of the property;

(iii) Is not 90 days or more past due or carried in nonaccrual status; and

(iv) Is not restructured or modified.

(2) An FDIC-supervised institution must assign a 100 percent risk weight to a first-lien residential mortgage exposure that does not meet the criteria in paragraph (g)(1) of this section, and to junior-lien residential mortgage exposures.

(3) For the purpose of this paragraph (g), if an FDIC-supervised institution holds the first-lien and junior-lien(s) residential mortgage exposures, and no other party holds an intervening lien, the FDIC-supervised institution must combine the exposures and treat them as a single first-lien residential mortgage exposure.

(4) A loan modified or restructured solely pursuant to the U.S. Treasury's Home Affordable Mortgage Program is not modified or restructured for purposes of this section.

(h) *Pre-sold construction loans*. An FDIC-supervised institution must assign a 50 percent risk weight to a pre-sold construction loan unless the purchase contract is cancelled, in which case an FDIC-supervised institution must assign a 100 percent risk weight.

(i) *Statutory multifamily mortgages.* An FDIC-supervised institution must assign a 50 percent risk weight to a statutory multifamily mortgage.

(j) *High-volatility commercial real estate (HVCRE) exposures*. An FDIC-supervised institution must assign a 150 percent risk weight to an HVCRE exposure.

(k) *Past due exposures.* Except for an exposure to a sovereign entity or a residential mortgage exposure or a policy loan, if an exposure is 90 days or more past due or on nonaccrual:

(1) An FDIC-supervised institution must assign a 150 percent risk weight to the portion of the exposure that is not guaranteed or that is unsecured;

(2) An FDIC-supervised institution may assign a risk weight to the guaranteed portion of a past due exposure based on the risk weight that applies under § 324.36 if the guarantee or credit derivative meets the requirements of that section; and

(3) An FDIC-supervised institution may assign a risk weight to the collateralized portion of a past due exposure based on the risk weight that applies under § 324.37 if the collateral meets the requirements of that section.

(l) *Other assets.*

(1) An FDIC-supervised institution must assign a zero percent risk weight to cash owned and held in all offices of the FDIC-supervised institution or in transit; to gold bullion held in the FDIC-supervised institution's own vaults or held in another depository institution's vaults on an allocated basis, to the extent the gold bullion assets are offset by gold bullion liabilities; and to exposures that arise from the settlement of cash transactions (such as equities, fixed income, spot foreign exchange and spot commodities) with a central counterparty where there is no assumption of ongoing counterparty credit risk by the central counterparty after settlement of the trade and associated default fund contributions.

(2) An FDIC-supervised institution must assign a 20 percent risk weight to cash items in the process of collection.

(3) An FDIC-supervised institution must assign a 100 percent risk weight to DTAs arising from temporary differences that the FDIC--supervised institution could realize through net operating loss carrybacks.

(4) An FDIC-supervised institution must assign a 250 percent risk weight to the portion of each of the following items to the extent it is not deducted from common equity tier 1 capital pursuant to § 324.22(d):

(i) MSAs; and

(ii) DTAs arising from temporary differences that the FDIC-supervised institution could not realize through net operating loss carrybacks.

(5) An FDIC-supervised institution must assign a 100 percent risk weight to all assets not specifically assigned a different risk weight under this subpart and that are not deducted from tier 1 or tier 2 capital pursuant to § 324.22.

(6) Notwithstanding the requirements of this section, an FDIC-supervised institution may assign an asset that is not included in one of the categories provided in this section to the risk weight category applicable under the capital rules applicable to bank holding companies and savings and loan holding companies under 12 CFR part 217, provided that all of the following conditions apply:

(i) The FDIC-supervised institution is not authorized to hold the asset under applicable law other than debt previously contracted or similar authority; and

(ii) The risks associated with the asset are substantially similar to the risks of assets that are otherwise assigned to a risk weight category of less than 100 percent under this subpart.

[Codified to 12 C.F.R. § 324.32]

[Section 324.32 amended at 79 Fed. Reg. 20760, April 14, 2014, Effective April 14, 2014, mandatory compliance date: January 1, 2014, for advanced approaches FDIC-supervised institutions, January 1, 2015 for all other FDIC-supervised institutions; 84 Fed. Reg. 35275, July 22, 2019; 85 Fed. Reg. 4431, January 24, 2020, 85 Fed. Reg. 20394, April 13, 2020]

§ 324.33 Off-balance sheet exposures.

(a) *General*. (1) An FDIC-supervised institution must calculate the exposure amount of an off-balance sheet exposure using the credit conversion factors (CCFs) in paragraph (b) of this section.

(2) Where an FDIC-supervised institution commits to provide a commitment, the FDIC-supervised institution may apply the lower of the two applicable CCFs.

(3) Where an FDIC-supervised institution provides a commitment structured as a syndication or participation, the FDIC-supervised institution is only required to calculate the exposure amount for its pro rata share of the commitment.