MEMO# 5974

June 17, 1994

FEDERAL RESERVE'S EXAMINATION PROCEDURES ON MUTUAL FUND SALES

June 17, 1994 TO: BANK INVESTMENT MANAGEMENT MEMBERS NO. 23-94 BOARD OF GOVERNORS NO. 52-94 RE: FEDERAL RESERVE'S EXAMINATION PROCEDURES ON MUTUAL FUND SALES ____ The Federal Reserve Board recently issued the attached examination procedures concerning the sale of mutual funds and other nondeposit products. The procedures are more detailed than the Interagency Statement on bank sales of nondeposit products that the federal banking agencies recently released. The procedures state that, in view of the existence of SEC and NASD supervision of registered broker-dealers, the procedures "have been tailored to avoid duplication of examination efforts by relying on the most recent examination results or sales practice review conducted by the NASD and provided to the third party [broker]." (If no NASD examination has occurred within the last two years, the procedures direct the Reserve Banks to consult with the Board staff to determine an appropriate examination scope.) 1. Types of Products Sold The procedures state that bank management "should consider what products best meet the needs of customers." There should be periodic review of these products. 2. Common Names Banks may not offer nondeposit investment products with a name identical to the name of the bank or its affiliate. Moreover, "the bank should review the issuer's disclosure documents for compliance with SEC requirements, which call for a thorough explanation of the relationship between the bank and the mutual fund." 3. Third Party Arrangements The bank agencies' Interagency Statement requires depository institutions to enter into written agreements with third parties that sell nondeposit products on bank premises. The agreement should "authorize the institution and Federal Reserve examination staff to have access to third party records considered necessary" to evaluate compliance with the agreement. 4. Contingency Planning Bank management should develop contingency plans to address "a heavy volume of customer inquiries, complaints, and redemptions" in the event of "a sudden, sharp drop in the market value of nondeposit investment products." 5. Disclosure The procedures call for disclosure similar to that required by the Interagency Statement. But while the Interagency Statement requires disclosure of non-FDIC status in confirmations that have the name or logo of the bank or its affiliate, the examination procedures require disclosure in confirmations "that are provided by the bank or an affiliate" and that contain such a name or logo. 6. Compensation The examination procedures state that compensation paid by unaffiliated third parties such as mutual fund distributors to banking organization staff must be approved in writing by bank management. Incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations. If sales personnel "sell both deposit and nondeposit products, similar financial incentives should be in place for sales of both types of products." A compensation program that offers significantly higher remuneration for selling a specific product such as a proprietary mutual fund "may be inappropriate if it results in unsuitable recommendations to customers." 7. Other Requirements The examination procedures also address other matters covered by the Interagency Statement, including the physical location of nondeposit sales, training of sales personnel, and suitability. Paul Schott Stevens General Counsel Attachment