



# Conflicts of Interest – Regulation W and Beyond

Mary Ann Lowney  
May 8, 2019

# Did you grab your coffee?



It's 9:15 a.m. and Tina is craving a dark roast coffee.

Tina is a sales associate working for Patriot Brokerage, and sits in the Patriot Bank office overlooking beautiful Boston Harbor. Tina proposes to Binita, her trust officer colleague, that they meet at the pop-up Organic Coffee Bar in the lobby for their monthly client review meeting. They both love supporting the Coffee Bar - the barista-turned entrepreneur is one of Tina's favorite clients. Binita had originally referred the business to Tina as part of Patriot Bank's successful referral process. Tina treats Binita to an extra large latte, using her Patriot Bank corporate card, as is allowed under the corporate policy.

What potential conflicts issues do you see? [Hint: think Reg W]

# Agenda

- I. Introduction
- II. Making Sense of the Conflicts Universe
- III. Conflict Categories
  - Firm vs. Client
  - **Firm vs. Bank Shareholders/Depositors (Reg W)**
  - Employee vs. Firm
- IV. Conclusion

Contact info: [Mary.A.Lowney@bankofamerica.com](mailto:Mary.A.Lowney@bankofamerica.com)

This presentation is provided for informational and educational purposes only. The opinions and views expressed represent thoughts of the author and do not necessarily reflect the opinions and views of Bank of America Private Bank, Bank of America Corporation, or any of its affiliates. Examples provided are hypothetical in nature, and any resemblance to persons living or dead is entirely coincidental.

# Introduction – Making Sense of the Conflicts Universe

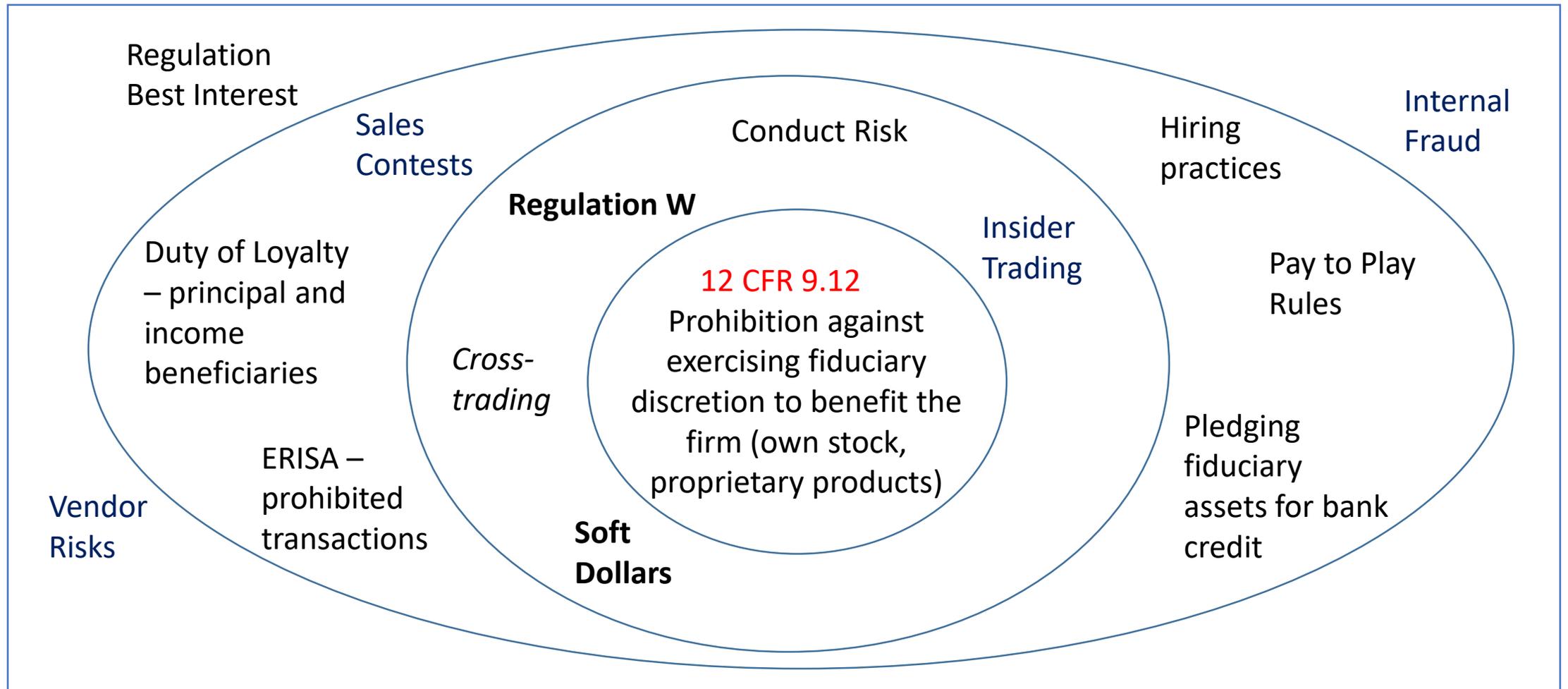


## Gold standard definition:

“**Conflicts** of interest arise whenever a bank engages in *self-dealing* and in any situation *where a bank’s ability to act in the best interests of its account beneficiaries or clients is impaired*. Conflicts of interest may also arise when a bank benefits from *undisclosed compensation* or receives *unreasonable compensation*, or when a bank or bank employee engages in *unethical conduct*... Bank fiduciaries have a heightened responsibility to avoid impermissible conflicts of interest and to ensure that they are acting in the best interests of fiduciary accounts... *the duty of loyalty has long been considered the most fundamental duty owed by a fiduciary to the beneficiaries of a fiduciary account.*”

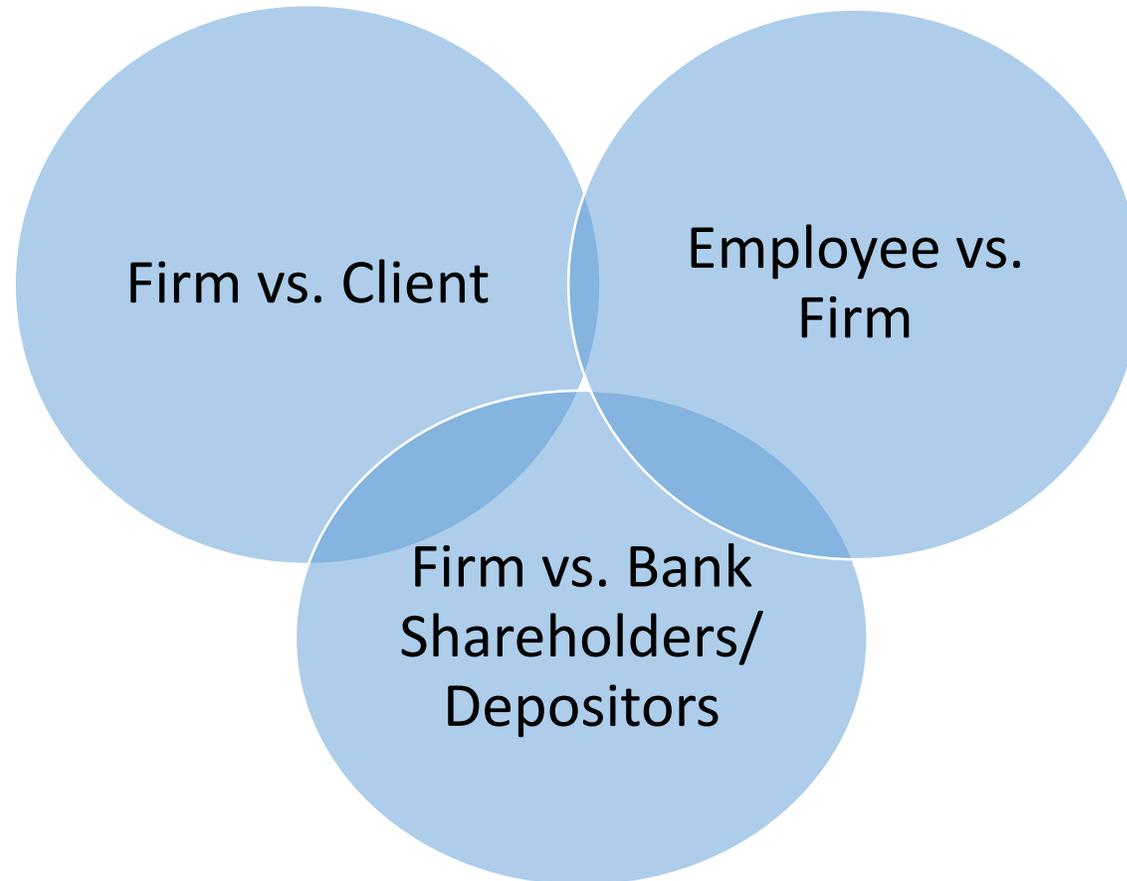
[OCC Conflicts of Interest Handbook 2015]

# Introduction – Making Sense of the Conflicts Universe



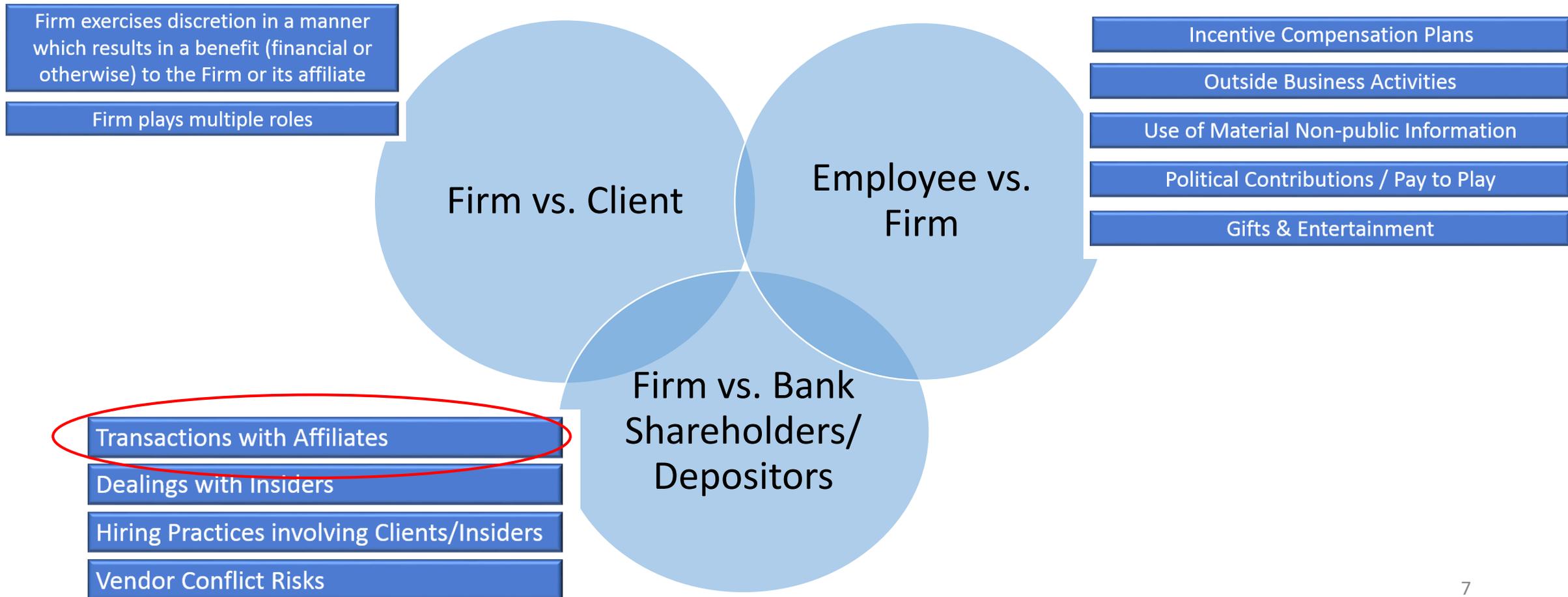
# Introduction – Making Sense of the Conflicts Universe

Conflict = Opportunity for Misaligned Interests



# Making sense of the Conflicts Universe

Conflict = Opportunity for Misaligned Interests



## Conflict Categories – Firm vs. Client



Firm vs.  
Client

Firm exercises discretion in a manner which results in a benefit (financial or otherwise) to the Firm or its affiliate

Firm plays multiple roles

# Conflict Categories – Firm vs. Client

Firm vs.  
Client

Firm exercises discretion in a manner which results in a benefit (financial or otherwise) to the Firm or its affiliate

Exercising discretion to invest in own bank securities

Exercising discretion to invest proprietary products – including bank deposit cash sweep

Receipt of benefits from a third party (soft dollars; retrocessions)

Be vigilant of ERISA rules; periodic rate check

Cross check income statement periodically; OCC Handbook App. B/C

# Conflict Categories – Firm vs. Client

Firm acts in multiple roles

Firm vs. Client

Fiduciary and lender: securities based lending where bank as fiduciary holds collateral for bank loan
Fiduciary and underwriter: investing in securities underwritten by firm
Fiduciary and broker: routing trades through an affiliated broker-dealer
Fiduciary and pricing agent: valuation of closely held assets

- Watch for “purpose credit”
- Regulation W
- 12 CFR 12.7(a); best execution

# Conflict Categories – Firm vs. Client

## A Word on Mitigation

Avoid – can/should; overlay of prudence

Comply with applicable exception to self-dealing prohibition through “applicable law”

Governing instrument

Court order

Beneficiary Consent

Mitigate (e.g., put client in same position - fee rebates, arm’s length)



Consider balance of power/ availability of information

## Transparency

# Conflict Categories – Firm vs. Bank Shareholders

Firm vs. Bank  
Shareholders  
/ Depositors

Transactions with Affiliates

Dealings with Insiders

Hiring Practices involving Clients/Insiders

Vendor Conflict Risks

# Conflict Categories – Firm vs. Bank Shareholders

## Transactions with Affiliates – Regulation W

- Focus is on protecting the depository entities; creates transparency
- Implements Federal Reserve Act 23A and 23B
- Regulation W consolidates interpretations
- Limits the types of transactions that member bank can enter into with its affiliates
- Applies to all federally insured banking institutions including:
  - National banks
  - State banks
  - Trust companies

### **Regulation W:**

- **prohibits certain transactions; and**
- **imposes specific requirements and restrictions on others**

# Conflict Categories – Firm vs. Bank Shareholders

## Transactions with Affiliates – Regulation W

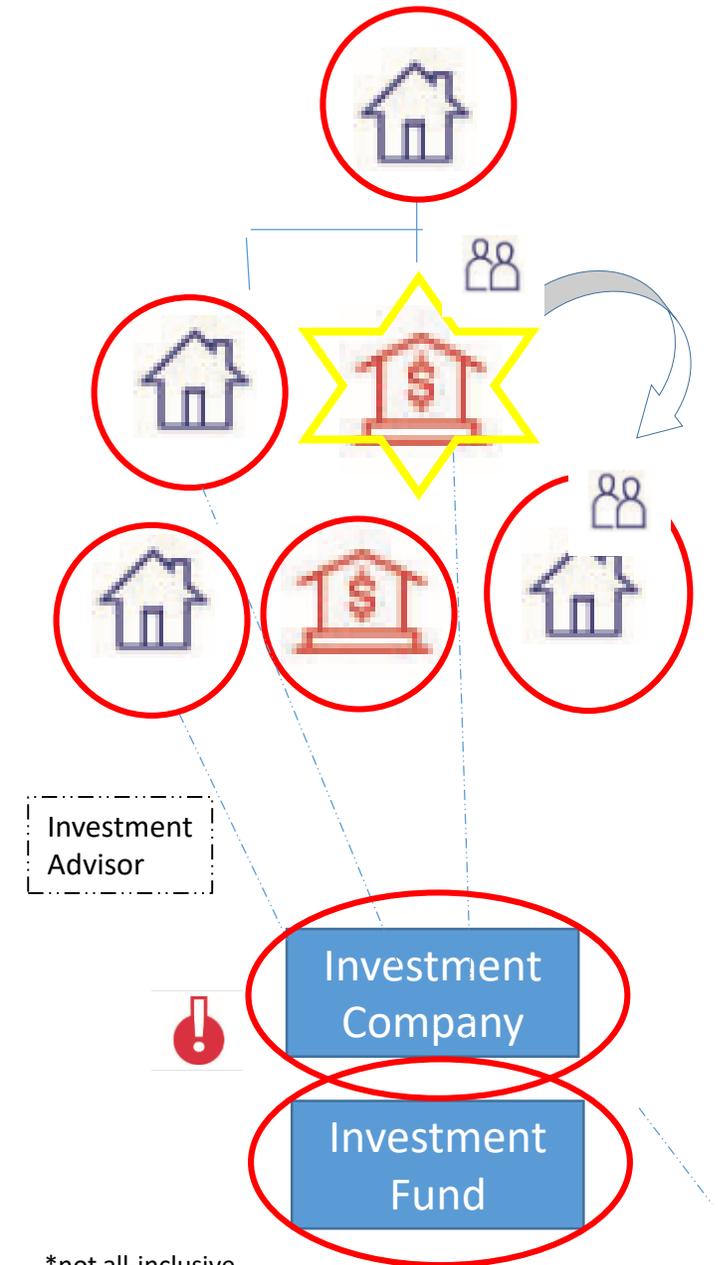
<b>23A</b>	<b>23B</b>
Defines “ <b>affiliate</b> ”	Requires affiliated transactions to be on “ <b>market terms</b> ”
Imposes <b>collateral</b> requirements and <b>quantitative limits</b> on aggregate amount of covered transactions	Imposes <b>restrictions on fiduciary purchases</b> from an affiliate
Imposes overarching requirement that transaction is on terms which satisfy <b>safe and sound</b> banking practices	Imposes <b>restrictions on purchases of affiliate underwritten securities</b>
Prohibition against purchase of <b>low-quality assets</b> or using certain assets as collateral	Prohibits Bank from stating it will be responsible for affiliates’ obligations in <b>advertising</b> or contracts
<b>Attribution Rules</b>	

# Transactions with Affiliates

## Who is Considered an “Affiliate”\*

12 CFR 223.2

Common ownership	Control, investment by member bank/ affiliate	Attribution Rule
Parent company	Companies with interlocking directorates	Certain transactions with a third party are treated as if they are with the member bank
Companies under common control by parent company	Company under “other” common control - controlled by a trust or otherwise by or for the benefit of shareholders who beneficially or otherwise control the member bank or any company that controls the member bank	
Bank subsidiary of the member bank	Any company (including REIT) sponsored and advised by contract by the member bank or an affiliate of the member bank	
Certain financial subsidiaries of the member bank	Investment company for which the member bank or affiliate serves as investment advisor	
Certain subsidiaries of affiliates	Investment fund for which the member bank or any affiliate serves as an investment advisor	
	Certain companies where holding company of member bank controls 15 percent or more of equity capital	



\*not all-inclusive

# What Kinds of Transactions are Covered – Part 1

**Quantitative Limits:** 10% to any affiliate; 20% to all affiliates  
 Terms and conditions consistent with safe and sound banking practices  
**Collateral** Requirements  
 Prohibition against most **low-quality asset** purchases

23A

<i><b>“Covered Transactions”</b></i>		
	<b>Credit</b>	<b>Purchases</b>
Exempt transactions	* Loan or extension of credit to affiliate including:	* Purchase of, or investment in, securities issued by the affiliate
Purchases of low quality assets prohibited	purchase or investment in debt securities issued by affiliate; advance by means of overdraft; lease that creates a credit risk exposure	* Purchase of assets from the affiliate (with except.)
	* Issuance of a guarantee, acceptance or letter of credit, including standby letter of credit	* Acceptance of securities or other debt obligations issued by the affiliate as collateral for a loan to any person or company

Covered transactions are a **subset** of the universe of “Affiliated Transactions” covered by Regulation W

“Covered Transactions” are those affiliated transactions subject to these limitations

# What Kinds of Transactions are Covered – Part 2

23B

Terms at least as favorable as non-affiliate  
("Market Terms")  
Advertising restriction

"Affiliated Transactions"

## "Covered Transactions"

### Credit

- \* Loan or extension of credit to affiliate
- \* Acceptance of securities or other debt obligations issued by the affiliate as collateral for a loan to any person or company
- \* Issuance of a guarantee, acceptance or letter of credit, including standby letter of credit

### Purchases

- \* Purchase of, or investment in, securities issued by the affiliate
- \* Purchase of assets from the affiliate (with exceptions)

- \* Sale of securities to an affiliate
- \* Payment of money or furnishing services to an affiliate under contract, lease or otherwise
- \* Transaction where affiliate acts as agent or broker / receives a fee for its services to the bank or another
- \* Transaction with third party if an affiliate has a financial interest in the third party or is a participant
- \* Prohibitions against certain purchases of assets from affiliate as fiduciary or principal unless...

# Conflict Categories – Firm vs. Bank Shareholders



## Test your Knowledge:

**Patriot Bank serves as trustee of an Equity Growth Collective Investment Fund.  
The portfolio manager, chronically fatigued from late nights of championship game watching, inadvertently mismatches trade dates, and overdrafts the Fund.**

**Thoughts?**

# Conflict Categories – Firm vs. Bank Shareholders

## Attribution Rule

“Any transaction by a member bank or its subsidiaries with any person shall be deemed to be a transaction with an Affiliate of such bank if any of the proceeds of the transaction are used for the benefit of, or transferred to, such Affiliate.”

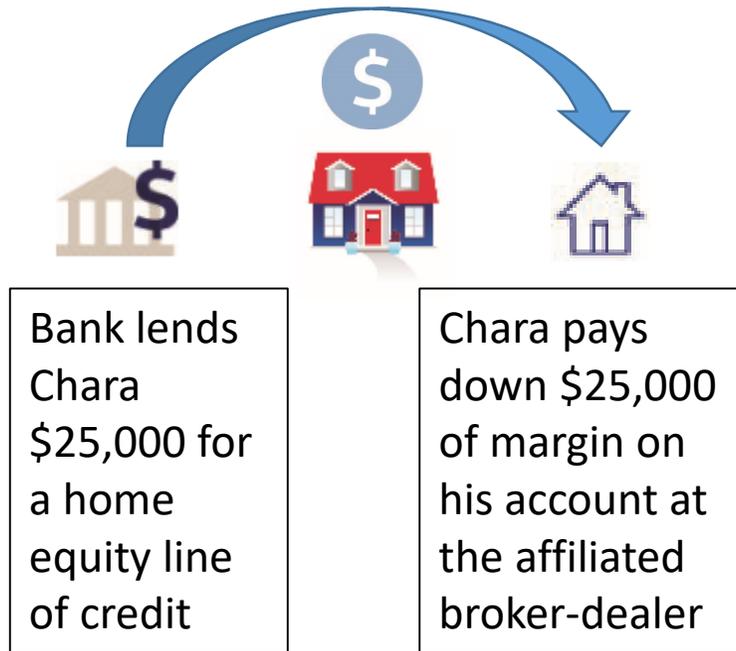
Examples: loan from member bank to third party where proceeds used to:

- pay a fee to an Affiliate
- pay off loan balances to an Affiliate
- post collateral in favor of an Affiliate

Amount of covered transaction = \$ flowing to Affiliate  
(can be less than the overall transaction amount)

# Conflict Categories – Firm vs. Bank Shareholders

## Attribution Rule – Credit Transaction Example



**Complexity:**

- Types of loans:** general purpose; revolving credit; multiple draws
- Timing:** date of loan vs. date of payment to affiliate
- Nature of client:** e.g., likely to be purchasing securities?
- Client's **other sources** of funds for repayment – where is the \$ coming from?
- Multiple lenders:** syndications – what's pro rata share?
- Covenants** or contractual requirements: limit use of proceeds?

Amount of **covered transaction** = \$25k subject to

- Quantitative Limits
- Collateral Requirements
- Safety and soundness rules
- Market terms

! Intent / actual knowledge that funds will benefit the affiliate is not necessarily determinative

# Conflict Categories – Firm vs. Bank Shareholders

**“So what” if the transaction is treated as a covered transaction?**

- **Quantitative Limits**
- **Collateral Requirements**
- Safety and soundness
- Market terms

Quantitative Limits	Collateral Requirements (223.14)
<p><b>Cannot engage</b> in covered transactions with Affiliates if:</p> <ul style="list-style-type: none"> <li>• Aggregate amount of member bank’s covered transactions with such affiliates would exceed <b>10 percent</b> of the capital stock and surplus of the member bank (223.11)</li> <li>• Aggregate amount of member bank’s covered transactions for all affiliates would exceed <b>20 percent</b> of the capital stock and surplus of the member bank (223.12)</li> </ul>	<p>For extensions of credit and certain other covered transactions, member bank must secure the transaction with collateral having a market value equal to at least:</p> <ul style="list-style-type: none"> <li>• 100% of transaction amount if collateral is US obligations or guaranteed by UST as to principal and interest; earmarked deposit account at the member bank set up strictly for this purpose</li> <li>• 110% of transaction amount if collateral is state obligations or state subdivision</li> <li>• 120% if collateral is debt instruments including loans</li> <li>• 130% of transaction amount if the collateral is stock, leases or real/personal property</li> </ul>
<ul style="list-style-type: none"> <li>• <b>Collateral rules include:</b> ineligibility (low quality assets; securities issued by any affiliate etc); member bank must have a perfected security interest; if not a priority interest then amount of collateral increases</li> </ul>	

# Conflict Categories – Firm vs. Bank Shareholders

**“So what” if the transaction is treated as a covered transaction?**

- Quantitative Limits
- Collateral Requirements
- Safety and soundness
- Market terms

## Market Terms (223.51)

Member banks may not engage in certain affiliated transactions unless the transaction is:

- On terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the member bank, as those prevailing at the time for comparable transactions with or involving non-affiliates; or
- In the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, non-affiliates

### **Documentation is critical**

- Valuation of transaction (223.21)
- Analysis of transaction – each critical material term
- Amount of collateral
- Timing of transaction for length of collateral hold
- Comparable arms-length transactions to justify market terms
- Re-assess if any modification to transaction



**Don't worry – some exemptions are coming up soon....**

# Conflict Categories – Firm vs. Bank Shareholders



## Test your Knowledge:

**Patriot Bank contracts with a third party vendor for statement printing. The affiliated trust company and broker-dealer also leverage this contract for their customer statement printing.**

**Thoughts?**

# Conflict Categories – Firm vs. Bank Shareholders



## Test your Knowledge:

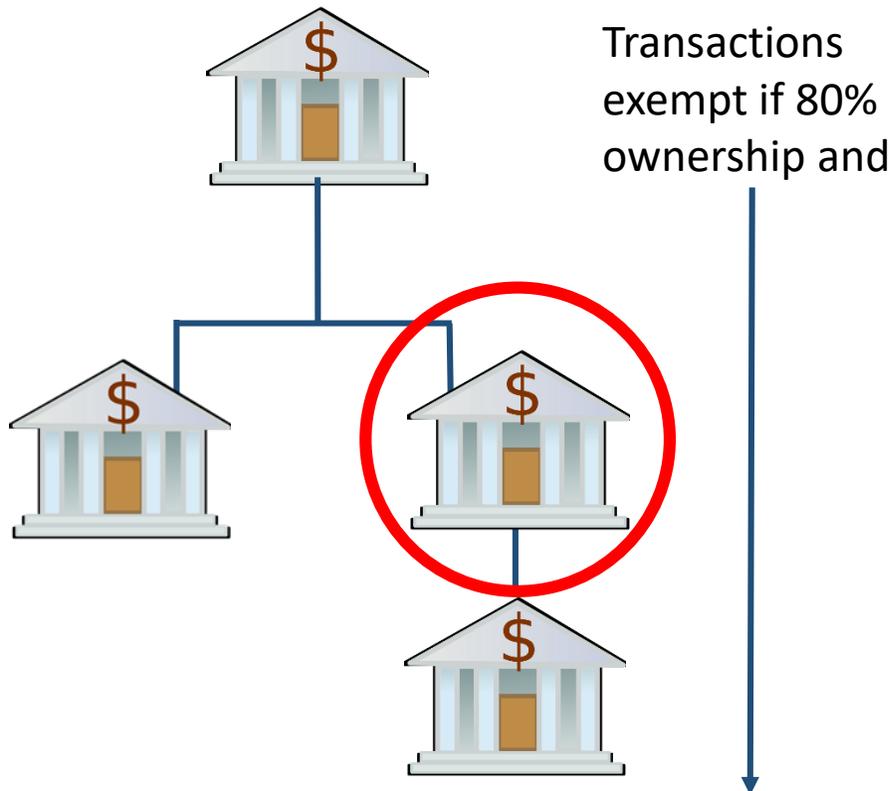
**Patriot Bank is proud to have recruited several top notch FIRMA-trained compliance professionals. These compliance professionals were hired by the Bank and are located in the Bank's North End branch. They provide both compliance and operational risk expertise nation-wide for topics including the Bank's fiduciary activities and the activities of its brokerage business.**

**Thoughts?**

# Conflict Categories – Firm vs. Bank Shareholders

Exemption

Covered Transactions Exempt from Quantitative Limits and Collateral Requirements (223.41)\*



- **Parent/subsidiary:** Transactions with a depository institution if the member bank controls 80 percent or more of the voting securities or the depository institution controls 80 percent or more of the voting securities of the member bank
- **Member bank and depository owned by same holding company:** Transactions with a depository institution if the same company controls 80 percent or more of the voting securities of the member bank and the depository institution
- **Certain loan purchases** on a nonrecourse basis from an affiliated depository institution

Safe and sound banking practices/  
Prohibition against low quality asset purchase

# Conflict Categories – Firm vs. Bank Shareholders

Exemption

## Covered Transactions Exempt from Quantitative Limits, Collateral Requirements and Low-Quality Asset Prohibition (223.42(a)-(o))\*

- **Making correspondent banking deposits** in an affiliated depository institution that represents an ongoing working balance maintained in the ordinary course of business
- **Giving credit for uncollected items** received in the ordinary course to an affiliate
- **Transactions secured by US government securities** or an earmarked **deposit account** with the member bank established for that specific purpose
- **Purchasing liquid securities** having a readily identifiable and publicly available market quotation at or below the asset's current market quotation
- **Purchasing marketable securities from a securities affiliate** if security has a ready market subject to conditions concerning pricing availability / price / size of transaction / affiliate not underwriting
- **Purchasing municipal securities from a securities affiliate** subject to conditions concerning pricing availability/price/size of transaction
- **Certain intraday extensions of credit** to an affiliate
- **Riskless principal transactions:** purchasing a security from a securities affiliate of the member bank where affiliate is acting exclusively as riskless principal in the transaction and the security purchased is not issued, underwritten or sold as principal by any affiliate

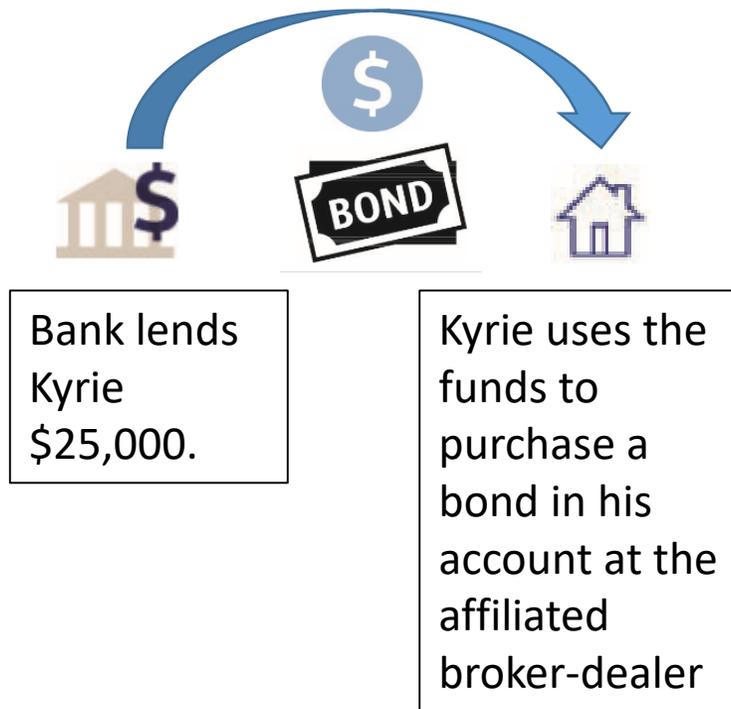
Comparable exemption  
to Attribution Rule



# Conflict Categories – Firm vs. Bank Shareholders

Exemption

## Exemption From Attribution Rule – Agency Transactions (223.16(b))



### Exempt from Quantitative Limits and Collateral Requirements if:\*

- Proceeds are used to purchase asset through an Affiliate;
- Affiliate is acting exclusively as agent or in a broker capacity (ie – does not sell from own inventory)
- Asset is not issued or sold as principal (except as riskless principal by any Affiliate)
- Asset is not currently being underwritten by any Affiliate (and not within 30 days)

*Still subject to safety and soundness / Market Terms requirements*



Compensation (fees, mark-ups, commissions) paid to the Affiliate in this situation also exempt if on Market Terms

Similar exemption from Attribution Rule for SEC-registered Affiliates when acting as Riskless Principal (223.16(c)(1))

# Conflict Categories – Firm vs. Bank Shareholders

## Section 23B Specific **Prohibitions** (222.53)

**Fiduciary purchases of assets from an affiliate** – A member bank may not purchase as fiduciary any security or other asset from any affiliate unless the purchase is permitted:

- (1) Under the instrument creating the fiduciary relationship;
- (2) By court order; or
- (3) By law of the jurisdiction governing the fiduciary relationship

**Purchases of a security underwritten by an affiliate**: Member bank, whether as principal or fiduciary, may not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of the member bank.

Unless: Purchase has been approved prior to security is offered for sale to the public by a majority of the directors of the member bank based on a determination that the purchase is a sound investment irrespective of the fact that an affiliate of the member bank is a principal underwriter of the security

Approval can be met if: A majority of the **directors** of the member bank **approves standards** for the member bank's acquisitions of securities; **each acquisition meets the standards**; and a majority of the **directors periodically reviews acquisitions** to ensure that they meet the standards and periodically reviews the standards to ensure they continue to meet the criteria

# Transactions with Affiliates

10% to any affiliate  
 20% to all affiliates  
 Terms and conditions consistent with safe and sound banking practices  
 Collateral

**23A**

**23B** Terms at least as favorable as non-affiliate  
 Advertising restriction

***“Covered Transactions”***

<p>Exempt transactions</p> <p>Purchases of low quality assets prohibited</p>	<p style="text-align: center;"><b>Credit</b></p> <ul style="list-style-type: none"> <li>* Loan or extension of credit to affiliate</li> <li>* Acceptance of securities or other debt obligations issued by the affiliate as collateral for a loan to any person or company</li> <li>* Issuance of a guarantee, acceptance or letter of credit, including standby letter of credit</li> </ul>	<p style="text-align: center;"><b>Purchases</b></p> <ul style="list-style-type: none"> <li>* Purchase of, or investment in, securities issued by the affiliate</li> <li>* Purchase of assets from the affiliate (w/ exceptions)</li> </ul>	<ul style="list-style-type: none"> <li>* Sale of securities to an affiliate</li> <li>* Payment of money or furnishing services to an affiliate under contract, lease or otherwise</li> <li>* Affiliate acts as agent or broker or receives a fee for its services to the bank or any other person</li> <li>* Transaction with third party if an affiliate has a financial interest in the third party or is a participant</li> <li>* Prohibitions against certain purchases of assets from affiliate as fiduciary or principal unless...</li> </ul>
--	--	--	---

Attribution Rule

# Conflict Categories – Firm vs. Bank Shareholders

## Transactions with Affiliates

### ASK:

Is the transaction with an Affiliate?

Is there an Affiliate involved in a third party transaction (ie, as “beneficiary” or recipient of proceeds) such that the Attribution Rule applies?

Is this a “covered transaction”?

Is there an exemption available? Is it prohibited? Does it involve low-quality assets?

Which restrictions/limitations apply?

10% to any affiliate  
20% to all affiliates  
Collateral

Terms at least as favorable as non-affiliate  
  
Advertising restriction

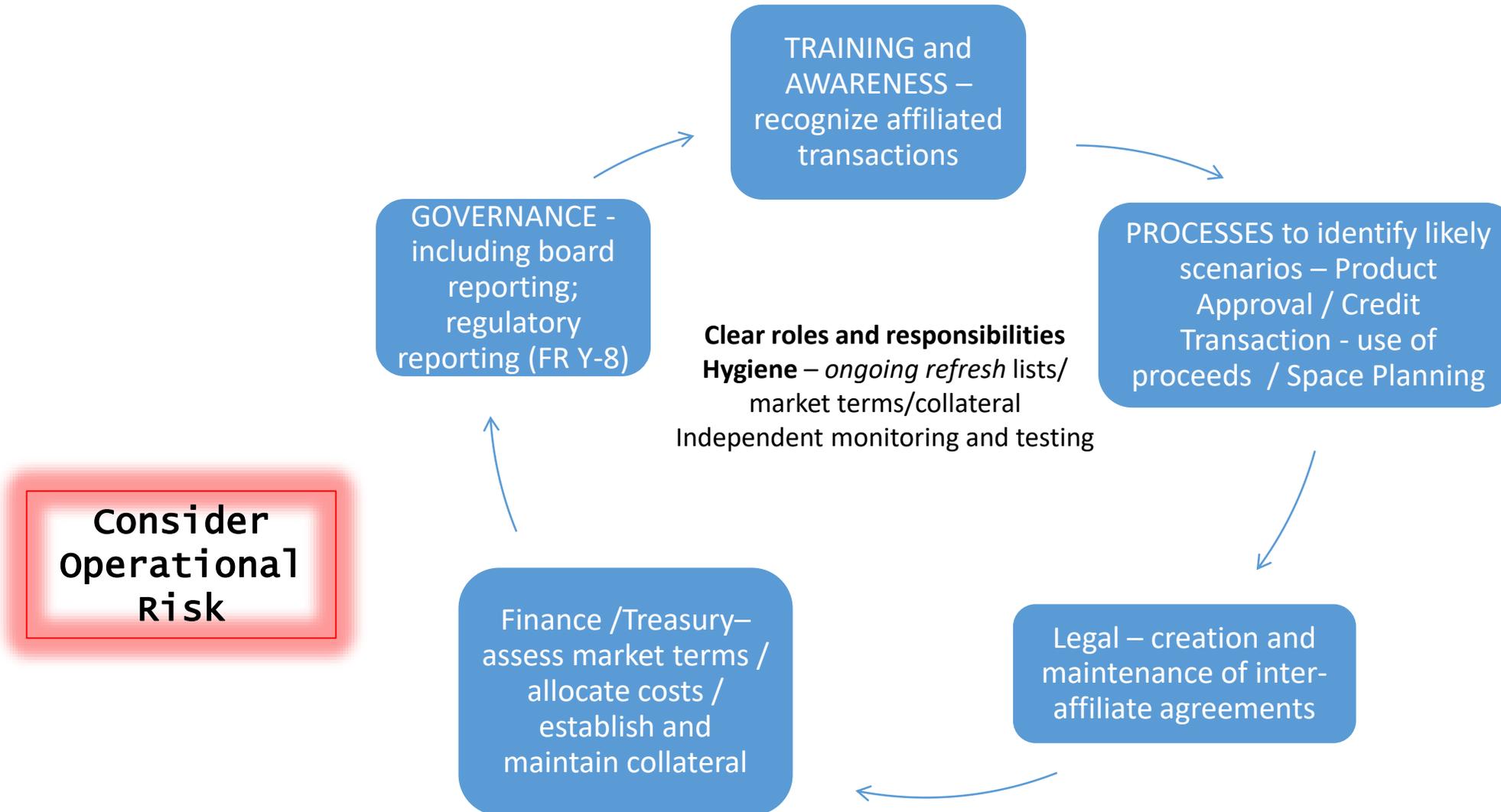
What documentation is needed to evidence Market Terms? Is a Service Agreement required?

Is there a need to allocate costs across affiliates?

Are board votes or document review required?

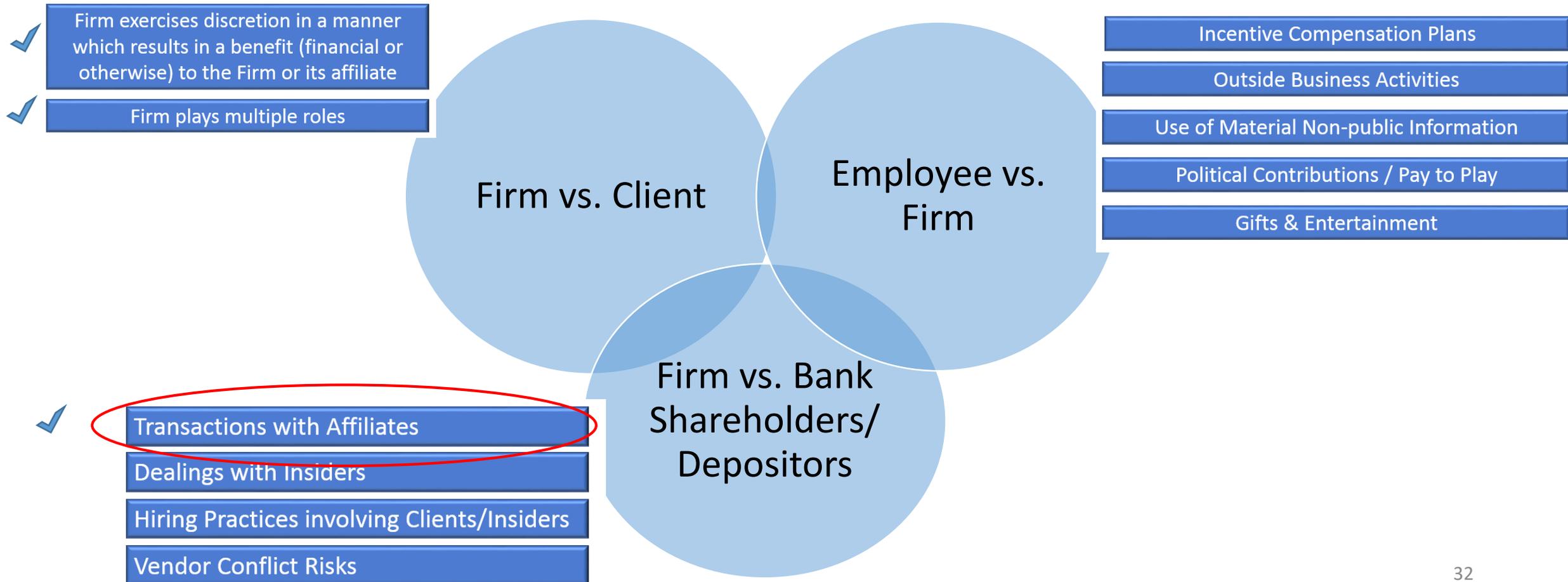
**Is it consistent with safe and sound banking practices?**

# Transactions with Affiliates – Regulation W Program Elements



# Making sense of the Conflicts Universe

Conflict = Opportunity for Misaligned Interests



# Conflict Categories – Firm vs. Bank Shareholders

## Dealing with Insiders

Firm vs. Bank  
Shareholders  
/ Depositors

Regulation O: extensions of credit to  
insiders – 12 CFR 215

Fee concessions to insiders – must be  
uniformly applied

Watch for  
unintended credit -  
overdrafts

Watch disclosure  
requirements –  
17 CFR 229.404

# Conflict Categories – Firm vs. Bank Shareholders

Firm vs. Bank  
Shareholders  
/ Depositors

## Hiring Practices

Do talent acquisition processes insulate the firm from undue influence of clients or insiders

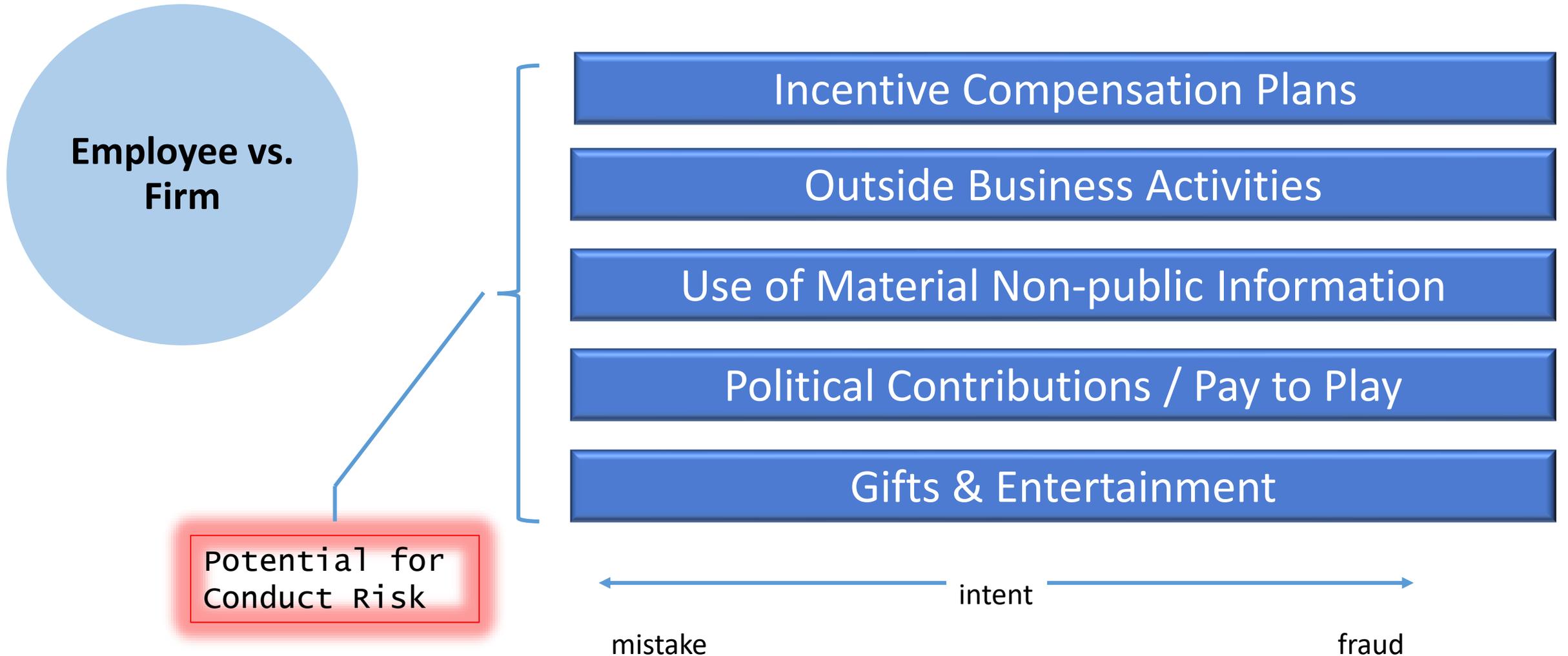
Does there exist any family relationships among employees/executives which could be perceived as unduly influencing decisions

## Vendor Conflict Risks

Is there a relationship between the vendor and the firm that could inappropriately influence decision to hire, retain or compensate

Does the firm comprise an outsize percentage of the vendor's business such that the vendor is tantamount to an "affiliate" or that the firm's decision to retain is inappropriately influenced

# Conflict Categories – Employee vs. Firm



# Conflict Categories – Employee vs. Firm

**Employee vs.  
Firm**

## Incentive Compensation Plans

Must: a) provide employees with incentives that appropriately balance risk and reward; b) be compatible with effective controls and risk management; and c) be supported by strong corporate governance, including active and effective oversight by bank's board [OCC Bulletin 2010-24]



Watch for :  
Sales Contests  
Product/Share-specific  
rewards

Watch: Section 926 Dodd-Frank; Reg BI; FINRA proposed rules

## Outside Business Activities

Serving on a for-profit, or non-profit, board

FINRA 3270

Serving in role which could cause confusion about whether the employee is acting in his personal capacity or bank capacity (serving as fiduciary for family and friends; serving as **treasurer, tax preparer, realtor**)

# Conflict Categories – Employee vs. Firm

**Employee  
vs. Firm**

## Political Contributions / Pay to Play

Activities which can be perceived as improperly influencing the award of government business; can result in fines, prohibition against broader firm doing certain business

Watch: use of bank resources (SEC Rule 206(4)-5); MSRB rule G-37; CFTC rule 23.451)

## Use of Material Non-Public Information

Insider trading; front-running 12 CFR 9.5(b) – Information walls

OCC expects employees who, in connection with their duties, obtain information concerning securities to be purchased, sold or recommended for purchase or sale, to report their securities transactions and that reports are independently reviewed to identify potentially suspicious activity.

## Gifts and Entertainment

Cannot be used as a quid pro quo for new/retention of business; can raise bribery and corruption concerns, especially vis a vis government officials

Heightened concerns re: labor unions; ERISA fiduciaries; credit ratings agencies etc

# Did you grab your coffee?



1, 2 Bank compensated for use of space?

It's 9:15 a.m. and Tina is craving a dark roast coffee.

Tina is a sales associate working for Patriots Brokerage, and **sits in the Patriot Bank, N.A. office<sup>1</sup>** overlooking beautiful Boston Harbor. Tina proposes to Binita, her trust officer colleague, that they meet at the pop-up Organic Coffee Bar in the lobby for their monthly client review meeting. They both love supporting the Coffee Bar - the barista-turned entrepreneur is one of **Tina's favorite clients<sup>2</sup>**. Binita had originally referred the business to Tina as part of Patriot Bank's successful **referral process<sup>3</sup>**. Tina treats Binita to an extra large latte, using her **Patriot Bank corporate card<sup>4</sup>**, as is allowed under the corporate policy.

4. Use of bank issued corporate card by brokerage employee is extension of credit to the affiliate

It's the ubiquitous Regulation W.....

3. Terms of referral program bank to broker- dealer appropriate?

# Conclusion – Making sense of the Conflicts Universe

Conflict = Opportunity for Misaligned Interests

