ABA Center for Securities, Trust and Investments

2009 OUTLOOK

2008 Year in Review

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Table of Contents

Welcome 3

Outlook for 2009 5
- **Stabilizing the Economy** 5
  - Economic Recovery Legislation 5
  - Shoring up the Financial System 5
- **Regulatory Restructuring** 7
  - Securitization Reform/Covered Bonds 8
  - Credit Rating Agencies 8
  - Hedge Funds 9
  - Short Selling 10
  - Commodities 10
- **Trust Issues** 10
  - Update on Regulation R Trust Taxation 10
  - Trust Taxation 12
    - *Estate Tax Changes* 12
    - *IRS Section 67(e) Proposal – Unbundling of Trustee Fees* 14
    - *Shortened Tax Filing Extensions for Trusts* 14
- **Employee Benefits** 15
- **Valuation of Assets** 16
- **Trust Schedule Changes in Call Reports** 16

Major Issues of 2008 18
- **Economic Crisis** 18
  - Bond Insurer Downgrades and ARS Failures 18
  - FRB Opens Discount Window to Investment Banks 19
  - Safety of Trust, Custody, and Managed Assets 19
  - Congress Passes Housing/GSE Bill 19
  - September 2008 Meltdown 19
  - Money Market Fund “Breaks the Buck” 20
  - SEC Temporarily Bans Short Selling 20
  - Emergency Economic Stabilization Act of 2008 21
  - Federal Guarantee Programs and Funding Facilities 21
- **Trust Taxation** 22
  - Cost Basis Reporting 22
  - HEART Act and Expatriates 23
  - Tax-Free IRA Rollovers to Charities 24
- **Employee Benefits** 24
  - Pension Funding Relief 24
  - Investment Advice Rule Delayed 25
  - DOL Fee Disclosure Proposals 25
  - Miscellaneous DOL Rules 25
- **Municipal Market Disclosure System Implemented** 25

2008-2009 Trust Committees 27
- **Trust Counsel Committee** 27
- **Council on Retirement and Employee Benefits** 28
- **Trust Taxation Committee** 29
- **Corporate Trust Committee** 30

Center for Securities, Trust and Investments 31
- **Staff** 31
- **Resources** 32

Welcome

In the last few weeks, President Obama signed into law the American Recovery and Reinvestment Act of 2009, otherwise known as the economic stimulus package; delivered the Administration's plan for addressing the mortgage crisis, and submitted to Congress the Administration's 2010 proposed budget. Just recently, Treasury Secretary Geithner announced the Administrations' Financial Stability Plan. Late last year, the Congress provided assistance to two car manufacturers and enacted the Emergency Economic Stabilization Act. With the economy under severe stress, the Administration and Congress are responding with extraordinary measures at an extraordinary speed.

Those of us at the ABA who work on wealth management and trust and custody issues have focused on the current market crisis and the legislative and regulatory responses to it through the lens of our wealth management and trust and custody constituencies. When bank stock prices were falling late last spring and into the summer causing bank fiduciary customers to express concern about the safety of their assets, we issued a backgrounder, entitled *Are My Trust, Fiduciary and Custody Assets Safe?,* to assist trust bankers to educate their customers about the protections afforded to trust and custody account holders. That backgrounder met with overwhelming and appreciative support from ABA members who used it in a variety of ways to communicate with their customers. The document has since been updated to reflect the changes made last fall by the Federal Deposit Insurance Corporation (FDIC) to deposit insurance coverage and I urge you to share it, as appropriate, with your customer base.

Recently, we issued another backgrounder to assist bankers in answering customer questions regarding the safety of assets when the bank serves as both adviser and custodian. That document, *ABA Backgrounder—Safety of Managed Assets,* is intended to help address customer inquiries regarding the recent wave of press reports regarding fraudulent and unscrupulous behavior engaged in by non-bank affiliated advisers. We expect ABA members will find this document just as helpful as the previous one. Both of these two documents can be found on ABA's web site at **http://www.aba.com/Solutions/Trust.htm.**

Two other examples warrant some mention.

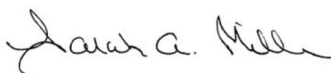
When the Money Market Investor Funding Facility (MMIFF) was announced in October 2008 as a government effort to restore liquidity to U.S. money market

mutual funds, it was originally limited to registered money market mutual funds operating under the Securities and Exchange Commission's Rule 2a-7. Recognizing the competitive inequity that would be visited on unregistered bank funds, particularly securities lending collateral pooled funds, ABA went to work and urged the Federal Reserve Bank of New York to expand the parties eligible to participate in the MMIFF to include common and collective trust funds. The regulators agreed, and in early January 2009 announced that common trust funds, collective investment funds, and other U.S.-based investment funds that operate in a manner similar to money market mutual funds are eligible to participate in the facility.

In addition, ABA staff, on behalf of corporate trustee banks, has gotten involved in the housing and securitization debate by encouraging servicers of residential mortgage-backed securities to consider loan modifications as an appropriate loss mitigation strategy in appropriate cases.

Of course, we in the Center for Securities, Trust and Investment have focused — and will continue to focus – on issues that are important to trust bankers, including estate tax reform, unbundling of trustee fees, valuation issues, and pension reform. Inside you will find a prospective look at these and other issues that are likely to occupy our time in 2009, as well as a more complete guide to legislative and regulatory developments that occurred in 2008. Please remember that the Center exists to serve you—let us know where we can help you, especially during these difficult times.

Sally



Sarah "Sally" Miller

Outlook for 2009

Stabilizing the Economy

Economic Recovery Legislation

2009 has ushered in a new Democrat Administration with its own views on how to strengthen the struggling economy. First out of the box was the American Recovery and Reinvestment Act of 2009, the massive emergency economic stimulus legislation designed to jump-start the economy with an infusion of $787 billion. The legislation includes funding for job preservation and creation, infrastructure investment, energy efficiency and science, assistance to the unemployed, and state and local fiscal stability. Included in the package are tax provisions that (1) make it easier for banks to invest in municipal bonds and (2) make municipal bonds a more attractive investment generally. Specifically, the legislation:

- Permits banks to exclude purchases of tax-exempt bonds issued in 2009 and 2010 from the determination of interest expenses allocable to tax-exempt bonds to the extent that such investments are less than two percent of the average adjusted bases of all the assets of the bank;

- Permits banks to deduct 80 percent of the cost of buying and carrying tax-exempt bonds issued by states, counties, local governments in 2009 and 2010 whose annual bond issuance is $30 million or less, an increase from the current $10 million limit (including applying that limit at the borrower rather than issuer level in pooled financings);

- Repeals the alternative minimum tax on private-activity bonds issued in 2009 and 2010; and

- Applies a temporary "patch" to the alternative minimum tax for 2009 tax returns.

Shoring up the Financial System

The Obama Administration and Congress are currently crafting legislation to help homeowners and shore up the financial system. Both have expressed dissatisfaction with the lack of transparency over how the first $350 billion of funds under the Troubled Asset Recovery Program were used, and the fact that the funds were used to recapitalize healthy banks in an effort to increase overall lending, rather than being directed to modify the mortgages of homeowners facing foreclosure.

Help for Homeowners

With the second $350 billion released by Congress, the Obama Administration, on February 18, 2009, released the outline of its "Homeowner Affordability and Stability Plan" which includes three main elements.

Refinancing for homeowners affected by falling home prices. The Plan would help homeowners who are current on their traditional mortgages owned or guaranteed by Fannie Mae or Freddie Mac to refinance those loans into 15- or 30-year mortgages with lower interest rates. Eligible loans will now include those where the new first mortgage (including any refinancing costs) will not exceed 105% of the current market value of the property, a change from the current 80% loan-to-value limit.

Homeowner Stability Initiative. This three-year, $75 billion initiative will provide loan modifications designed primarily for borrowers with subprime loans or loans that are underwater who are willing to stay in their homes. The program provides incentives to servicers who bring down interest rates to a level no great than 38 percent of the borrower's income. The government will then match further reductions in interest payments dollar-for-dollar with lenders down to a 31 percent debt-to-income ratio. The program also provides $1000 for each eligible modification as well as payments to both the lender and borrower if the borrower stays current on his/her payments.

Finally, the Treasury Department will create a $10 billion insurance fund, together with FDIC, to discourage lenders from choosing to foreclose out of fear that home prices will fall further. Mortgage holders would receive an additional insurance payment on each modified loan linked to declines in the home price index to be set aside as reserves if prices fall further than expected.

Support low mortgage rates through confidence in Fannie Mae and Freddie Mac. The Plan would foster confidence in the ability of Fannie Mae and Freddie Mac to continue supporting low mortgage rates by increasing the Treasury's Preferred Stock Purchase Agreements to $200 billion each, an increase from the initial level of $100 billion each. Treasury will also increase the size of their retained mortgage portfolios by $50 billion.

Support for the Financial System

On February 10, 2009, the Obama Administration released an outline of the key elements of its Financial Stability Plan – a program to shore up the financial system which includes:

- Requiring banking organizations to undergo a comprehensive review or "stress test" of their current financial condition; institutions that need additional

capital will be able to access a new funding mechanism – the Financial Stability Trust – that employs funds from the Treasury as a bridge to private capital;

- Establishing a Public-Private Investment Fund to help leverage private capital to deal with toxic debt so that private markets can begin working again;
- Expanding the FRB's Term Asset Backed Securities Loan Facility from $200 billion to $1 trillion to lend against newly securitized small business, student, consumer and auto finance loans; and
- Assisting small business by increasing the federally guaranteed portion of loans from the Small Business Administration.

The Administration is expected to release more details on its efforts to support the financial system in the near future.

Regulatory Restructuring

This economic crisis has exposed the fragmented nature of the existing system of regulation governing commercial banks and investment banks as well as the interconnectedness of players in the financial markets. Although there have been attempts to reform the regulatory system for decades, calls for restructuring were voiced with greater urgency in the aftermath of the forced sale of Bear Stearns to JPMorgan Chase in March 2008. ABA expects that this year we will have a serious debate on the future shape of the regulatory system and the effective regulation of those players to bring much needed transparency and accountability to the system.

After the failure of Bear Stearns, the Treasury Department immediately called for a systemic regulator to oversee the risks to the overall economy, a prudential regulator to enforce safety and soundness, and a consumer protection regulator to protect consumers and investors. The Group of 30, under the direction of former Federal Reserve Board Chairman Paul Volcker, issued its recommendations, and numerous think tanks, industry groups and law firms have contributed to the current discussion. Volker is also chairman of the President's Economic Recovery Advisory Board, a new executive branch institution established by President Obama.

A number of these proposals have called for the Federal Reserve Board (FRB) to become a systemic risk regulator with broad authority over all facets of the financial services industry. Others have called for the merger of the Office of the Comptroller of the Currency and the Office of Thrift Supervision which regulate respectively national banks and federal thrifts. Still others have called for the merger of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

Securitization Reform/Covered Bonds

Often cited as a factor in the subprime mortgage meltdown is the disconnect between the originator of a subprime loan that is securitized and holder of a bond backed by the mortgages. Congressional leaders and industry commentators have clearly stated that the entire securitization process should be reviewed to more properly align the incentives of the participants.

In Europe, mortgages are funded through the use of "covered bonds." This process is similar to securitization in the U.S., except that the loans are retained on the books of the originator in a cover pool that backs the issuance of bonds. In addition, the originator must replace any underperforming loans in the pool with qualified performing loans.

The market for covered bonds in the U.S. has been quite limited, in part because foreign investors have been uncertain about their access to the collateral backing the covered bonds in the event of a failure of an insured institution. During the summer of 2008, the FDIC issued a policy statement on covered bonds clarifying the collateral treatment of the cover pool. The Treasury Department followed with a statement of best practices for covered bonds. Although this is currently a nascent market in the U.S., ABA expects that covered bonds may become a significant factor in U.S. financing of home mortgages and possibly an important source of investment revenue.

Credit Rating Agencies

Credit ratings agencies will almost certainly face greater accountability in the future. Before the subprime crisis, investors and insurers widely relied upon the ratings to judge the creditworthiness of the issuers of asset-backed securities and the safety and prospective performance of the investments.

In December, the SEC approved a series of measures to increase transparency and accountability at credit rating agencies, and ensure that firms provide more meaningful ratings and greater disclosure to investors. The SEC also proposed additional measures related to transparency and competition among credit rating agencies.

The new SEC Chairman, Mary Schapiro, has criticized the conflict of interest arising from the issuer-paid compensation model used by the major credit raters, and has suggested that she favors a major overhaul of the industry. She has proposed creating an exchange-funded system for rating agencies to maintain their independence when rating securities and ultimately improve investor confidence. Numerous groups have also called for the development of payment models that improve the alignment of incentives among providers of risk ratings and their clients and users.

Hedge Funds

On January 16, 2009, two committees established by the President's Working Group on Financial Markets (PWG), each issued final reports detailing best practices for hedge fund asset managers and for investors in hedge funds. The Asset Managers' Committee report states that, "No set of best practices can resolve the complex issues facing the financial industry today. However, we believe that [recent] events underscore the need for hedge funds, along with other market participants, to evaluate and implement strong practices to manage their businesses."

The Investors' Committee (IC) report, *Principles and Best Practices for Hedge Fund Investors,* notes that two major events have rocked the global capital markets since the IC issued its report for public comment in April 2008—the extreme dislocation across all capital markets since September 2008 and the massive fraud allegedly perpetrated by Bernard Madoff.

The IC report addresses both the decision to invest in hedge funds and the management and oversight of hedge fund investments. It contains two guides: one for "fiduciaries" (who are charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio); and one for "investors" (who are charged with executing and administering a hedge fund program once a hedge fund has been added to the investment portfolio). The report stated that "hedge fund investments are only for sophisticated investors, are not necessarily suitable for all investors and require deep, meaningful due diligence in relation to investment strategy and operations both at the outset of an investment and on an ongoing basis. If an investor does not understand the sources of a hedge fund's risk and return and cannot otherwise conduct the due diligence necessary to fully appreciate the risks of an investment, the investor should forego the opportunity."

The IC report strongly emphasizes comprehensive due diligence by hedge fund investors in specific recognition of the low level of regulatory protection afforded to them. When considering an investment in hedge funds, the guide for fiduciaries includes detailed questions fiduciaries should address when deciding whether a hedge fund investment is appropriate.

ABA believes that 2009 will likely bring renewed attention to the regulation of hedge funds. Several policymakers and academics have voiced concerns about the ability of hedge funds and other private pools of capital to cause systemic risk to the nation's financial system. Sen. Charles Grassley (R-IA) has reintroduced legislation to require hedge funds to register with the SEC. Rep. Michael N. Castle (R-DE) has also introduced legislation requiring the PWG to study the hedge fund industry. In addition, he has introduced legislation requiring defined benefit pension plans to disclose plan investments in hedge funds in their annual reports.

At her confirmation hearing, SEC Chairman Mary Shapiro stated that she would support the registration of hedge funds to ensure better checks and balances. Similarly, the Group of Thirty issued a report in early January that called for a national prudential regulator for hedge funds whose assets exceed a certain threshold.

Short Selling

ABA and many industry participants are calling for the development of a practical short selling regulatory regime, and it is very likely that the SEC will respond to these calls in early 2009. SEC Chairman Mary Schapiro has expressed her desire to examine the entire area of naked short selling and consider how to regulate in this area. She has specifically indicated a willingness to consider whether the up-tick rule should be re-instituted. In addition, Rep. Gary Ackerman (D-NY) has reintroduced legislation that would require the SEC to reinstate the uptick rule.

Commodities

Commodity speculation and the risks posed by credit default swaps and other over-the-counter derivatives will be a focus of Congressional deliberations in 2009. Already, in February 2009, the House Agriculture Committee favorably reported to the full House legislation that would generally limit institutional investors from investing in commodities, mitigate perceived excess speculation in the marketplace, and require the CFTC to study the regulation of over-the-counter derivatives. Trustees are concerned that the restrictions in this legislation will limit their investment options when managing a diverse portfolio. In addition, potential regulation of over-the-counter derivatives by the CFTC will likely create a jurisdictional battle with the SEC.

Trust Issues

Update on Regulation R

Nine years after passage of the Gramm-Leach-Bliley Act eliminating banks' blanket exemption from registration for securities activities conducted inside the bank, the rules implementing that provision have finally become effective for all banks. In place of the blanket exemption, the legislation carved out fifteen specific exemptions from registration for traditional bank activities involving securities. Activities that do not fall within one of the exemptions must be "pushed out" into a broker-dealer.

Since enactment, regulators and the industry have struggled to fashion rules that would enable banks to continue to provide traditional products and services within

the bank, including trust and fiduciary and custody and safekeeping. The final rules – Regulation R – were adopted in September 2007 with a rolling effective date not later than January 1, 2009.

Highlights of Regulation R

Trust and fiduciary exception. The trust and fiduciary exception applies to all personal, institutional, charitable, corporate trust, managed agency and investment advisory accounts. A bank may effect securities transactions in these accounts in a trustee or fiduciary capacity without registering as a broker-dealer if it is "chiefly compensated" for those transactions on the basis of "relationship compensation." Relationship compensation generally includes assets under management fees, performance-based fees, custody services fees and shareholder services fees. Banks may choose to satisfy this compensation test on either a bank-wide or account-by-account basis.

Safekeeping and custody exception. Under a statutory exemption, a bank may offer safekeeping and custodial services (including clearance and settlement services) and conduct securities lending and borrowing on behalf of such accounts without registering as a broker-dealer. In addition, under Regulation R, banks may accept securities orders from their custodial customers or their advisors subject to several conditions.

Sweep accounts and money market fund transactions. Banks may sweep deposits into a no-load money market funds without registering as a broker dealer. A conditional exemption is also available for transactions in money market funds that are not no-load and for transactions that are not sweeps.

Where Are We Now?

As both banks and their regulators implement Regulation R for the first time, examiners are beginning to ask banks about their implementation and compliance plans for Regulation R. From the ABA's perspective, the process appears to be collaborative – with bankers and examiners learning from each other and sharing information. Forthcoming recordkeeping rules from the bank agencies should assist with the compliance process.

In addition, there are several other issues that remain to be resolved, including the following:

Status of dual employees. ABA has been working with FINRA (formerly the National Association of Securities Dealers) for a number of years to clarify the status of dual employees – those bank employees that are also registered representatives of broker-dealers. FINRA has proposed to except from broker-dealer oversight

those bank securities activities that are exempt from registration under the statute or Regulation R. As proposed, the exception comes with numerous conditions including (1) that the broker-dealer have a comprehensive view of the dual employee's securities activities; and (2) the bank have policies and procedures intended to achieve compliance with the anti-fraud provisions of the federal securities laws. FINRA has not finalized its proposal, and ABA has offered comments regarding the proposal while, at the same time, reiterating its view that FINRA should eliminate the conditions. ABA believes that the proposal will most likely be adopted substantially as proposed.

Application of the custody exemption. ABA is exploring with regulators our concerns regarding the possibility that the custody exemption for banks that accept non-employee benefit customer securities orders on an accommodation basis may not be used in conjunction with other Regulation R exemptions. Regulation R specifically states that if more than one exemption is available, the bank may choose which exemption it relies upon. We believe that an interpretation that would prohibit the use of other applicable exemptions once a bank has chosen to use the accommodation order exemption is wholly inconsistent with the rule as well as the philosophy of GLBA and Regulation R.

Repurchase transactions. ABA's affiliate, the ABA Securities Association, has written to the FRB and SEC seeking clarification that banks may enter into repurchase and reverse repurchase transactions with securities that are not exempt under federal securities laws without being subject to broker-dealer registration. Repurchase and reverse repurchase transactions are economically equivalent to secured financings and squarely fall within the traditional banking activity of providing and obtaining secured financing. As a result, ABA believes that to treat these transactions as the purchase or sale of a security is elevating form over substance. Indeed, banks have increasingly used these types of transactions with non-exempt securities to provide a source of funding to securities market participants in need of short-term liquidity to finance their holdings of such securities. We are currently awaiting a response to the letter.

Trust Taxation

Estate Tax Changes

Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the federal estate tax will be repealed for calendar year 2010, reverting in 2011 to the $1 million exclusion amount and 55 percent tax rate that applied in 2001. Because these provisions are set to expire, the Senate Finance Committee held a series of hearings in 2008 on estate tax reform looking for ways to address liquidity problems encountered by family-owned businesses, the portability of the marital exemption, the unified tax credit, and charitable giving.

ABA submitted a statement for the record that expressed strong support for comprehensive reform that gives "significant, general relief to smaller estates" and made the following specific recommendations:

Use a higher exemption and reduce rates. The exemption should go up to at least $5 million per person. The long-term capital gains rate should be applied for assets between $5 million and $25 million, and twice the long-term capital gains rate should be applied for assets exceeding $25 million.

Index the new exemption amount for inflation. Indexing would avoid the need for continuous congressional action to keep the levels fair over time and would be consistent with the treatment of other Internal Revenue Code provisions such as income tax brackets, standard deductions, and personal exemptions.

Maintain the step-up in basis rule. The current cost basis rule that provides for estate assets to be marked to market at death is better than transitioning to a modified carryover basis regime in 2010, which would be unduly burdensome and costly for heirs. Carryover basis was previously legislated and then repealed after the difficulties inherent in trying to prove a decedent's cost basis in long-held assets became apparent.

Reunify the estate, gift, and generation-skipping transfer (GST) tax systems. Reunification would avoid unnecessary complexity in estate planning and keep more family-owned businesses and farms within families over generations.

Reinstate the state estate tax credit. Reinstatement of the tax credit would avoid complex estate planning and unnecessary taxes for married couples. When the tax credit was repealed by Congress, many states decoupled from the federal system to preserve their own state estate tax revenues. This situation forced married couples to choose between taking advantage of the amount they could protect from federal estate tax and incur some state estate tax when the first spouse dies, or limiting themselves to the state exclusion amount, ultimately paying more federal taxes after both spouses have died.

Allow portability of credit between spouses. The unified credit and the GST exemption should be portable from the spouse who dies first to the surviving spouse. This portability would simplify planning for married couples and reduce legal and estate administration expenses.

As Congress considers legislative changes, ABA will work closely with representatives on their amendments to federal wealth transfer taxes to promote the recommendations made in its statement for the record.

IRS Section 67(e) Proposal – Unbundling of Trustee Fees

In late 2008, the Internal Revenue Service (IRS) notified fiduciaries that they will not be required to unbundle their trust and executor fees for 2008. The IRS announcement confirmed that until the agency issues a final rule, fiduciaries are not subject to the unbundling requirements in its proposed rule implementing Internal Revenue Code Section 67(e).

In January 2008, the Supreme Court issued its opinion on the meaning of Section 67(e) in *Knight v. Commissioner of Internal Revenue.* The Court held that generally third-party investment advisory fees are not fully deductible. However, the Court did acknowledge that there are circumstances in which all or part of an investment advisory fee may be fully deductible.

In 2007 and 2008, ABA submitted two comment letters to the IRS detailing the many problems with the "unbundling" proposal and pointing out, among other things, that the "unbundling" of a fiduciary fee is not required by the statute or case law and would complicate rather than simplify the process of deducting miscellaneous expenses.

ABA expects the IRS to issue the final rule in 2009. ABA is also pursuing a legislative amendment to Section 67(e) that would clarify that all fees incurred in connection with the administration of a trust are fully deductible, including investment management fees. With such a legislative fix, the IRS proposal would no longer be relevant.

Shortened Tax Filing Extensions for Trusts

In 2008, the Internal Revenue Service (IRS) issued final regulations that amend the automatic filing extension for pass-through entities, including trusts, partnerships, and estates. The amendments shorten the period for filing tax returns for these entities from six to five months in order to alleviate the burden on individual taxpayers who rely on Schedule K-1s to complete their own tax returns.

In a comment letter to the IRS and in testimony at a public hearing, ABA opposed the shorter extension period, arguing that such a change will impede the efficient and timely processing of fiduciary income tax returns as well as the individual tax returns of bank clients. ABA pointed out that trusts commonly hold partnership interests in hedge funds and private equity funds as part of their investment portfolios. As a result, trusts must also wait for partnership Schedule K-1 information to complete their own fiduciary income tax returns and the Schedule K-1s for trust beneficiaries.

The IRS has indicated that it may give trusts a five and one-half month filing extension, until September 30, to address many of the concerns ABA raised in its letter and testimony. If the IRS does not modify its regulation, trustees will only be able to extend the 2008 trust and estate tax filings until September 15, 2009.

Employee Benefits

One of the biggest changes in 2009 will be a fresh look by both the new Obama Administration and Congress on employee benefits issues. During the Bush Administration, ABA had focused many of its efforts on working with Department of Labor (DOL); however, that focus in the coming year is expected to move to the legislature.

While the Employee Benefit Security Administration, a department of DOL, continues to work to finalize its proposals on fee disclosures to plan sponsors and plan participants, this Congress has indicated that they would like to see a more expansive proposal with increased disclosures. Specifically, Congress is focused on direct and indirect compensation, fees between service providers and information about conflicts of interest. They expect to introduce new legislation and to hold multiple hearings in the coming year.

In 2009, ABA will continue its efforts to educate policy makers about the specific rules for collective investment funds. In 2008, ABA discussed with DOL the types of disclosures currently made by collective funds, as well as the opportunities and low fee options that collective funds provide due to their unique regulatory structure.

Congress is also expected to work on providing further funding relief for defined benefit pension plans. Because of the current economic crisis, many pension plans have taken large hits to their current pension funding. As a result, plan sponsors will be required to make large contributions for 2009 to meet the requirements of the Pension Protection Act. ABA is part of a coalition working to allow for amortization of the 2008 losses over a longer period of time and to ease the rules regarding the application of benefit restrictions.

ABA also expects Congress to be interested in payroll deduction Individual Retirement Accounts (IRA). Payroll deduction IRAs are seen as a way to expand coverage, particularly in the small employer context. This proposal, sometimes called an “automatic IRA”, would require that any employer that does not provide a pension plan must allow for a payroll deposit IRA arrangement. Such an arrangement would allow an individual to elect to contribute to an IRA through payroll deduction.

Valuation of Assets

This coming year ABA expects to become more involved in valuation issues. As market tensions result in more distressed and illiquid assets, valuation becomes a greater challenge for fiduciaries. Valuations are necessary for calculating payouts to trust beneficiaries, fees to investment advisors and required minimum distributions for 401(k) and IRA holders, as well as providing accurate defined benefit plan year filings and investor disclosures.

In addition to market forces creating more distressed assets, recent changes to FAS 157 and FAS 132-R have affected the valuation methodology used in the employee benefit industry by plan sponsors, trustees and auditors. The ERISA Advisory Council studied valuation issues this past year to help resolve tensions among plan sponsors, trustees, and auditors. The Council's report on the matter is expected to guide future discussions.

Trust Schedule Changes in Call Reports

In January 2009, the federal banking regulators announced they will implement with some modification the proposed changes to Schedule RC-T of the Consolidated Report of Condition and Income and Schedule FS of the Thrift Financial Report. Trust departments use these schedules to fulfill their required reporting of fiduciary and related services.

Despite serious concerns ABA raised in a comment letter, the agencies will eliminate confidential treatment for fiduciary income, expense, and loss data in Schedules RC-T and FS as of March 31, 2009. In addition, effective December 31, 2009, the agencies will require a number of new reporting lines for certain types of accounts and investments, including:

- Breaking out foundations and endowments, as well as investment advisory agency accounts, as separate types of fiduciary accounts in the schedule's sections for reporting fiduciary and related assets and income;
- Adding items for Individual Retirement Accounts, Health Savings Accounts and other similar accounts included in fiduciary and related assets;
- Expanding the breakdown of managed assets by type of asset to cover all types of fiduciary accounts;
- Adding new asset types in the breakdown of managed assets by type of asset;
- Revising the manner in which discretionary investments in common trust funds and collective investment funds are reported in the breakdown of managed assets by type of asset;

- Adding items for the market value of discretionary investments in proprietary mutual funds and the number of managed accounts holding such investments; and
- Adding items for the number and principal amount outstanding of debt issues in substantive default for which the institution serves as indenture trustee.

The banking regulators have asked for additional comment, but it is not clear that they will modify their announced changes to Schedules RC-T and FS.

Major Issues of 2008

Economic Crisis

From interest rate cuts and the establishment of liquidity facilities, to pressuring the private sector to increase its efforts to stem the tide of home foreclosures, to shoring up and taking over financial giants, the FRB, two Administrations and the Congress have undertaken a number of efforts aimed at restoring investors' trust in markets shaken by the mortgage, liquidity and credit crises.

As events unfolded, ABA and the Center for Securities, Trust and Investments have worked with the Treasury Department, the FRB, the SEC, and other agencies as they shape the government's response to the financial crisis. Among other things, ABA has pushed for restrictions on naked short selling of bank stocks bearing in mind banks' involvement with securities lending, argued for comparable treatment of bank deposits and bank pooled products with money market mutual funds, and called for a comprehensive approach to rectify the unintended consequences to banks brought on by the conservatorship created for Fannie Mae and Freddie Mac.

Bond Insurer Downgrades and Auction-Rate Securities Failures

Early in 2008, mounting foreclosures impacted the ratings of the municipal bond insurers that had "wrapped" complex mortgage-related securities with their triple-A ratings. With so many defaults occurring, the credit rating agencies determined that the bond insurers did not have sufficient capital to cover the potential losses and still maintain their triple-A ratings, leading to uncertainty about their ability to support the bonds they had insured.

The uncertainty about the municipal bond insurers spilled over to the auction-rate market, causing it to freeze in early 2008. Auction-rate municipal bonds are long-term bonds with interest rates that reset every 5, 28 or 35 days and were, before this freeze, considered an equivalent to cash. Because auction-rate securities do not have a put option, when the auctions failed, holders were not able to liquidate their bonds. The failures in the auction-rate market bled over to the variable-rate demand note market as issuers changed their auction-rate bonds to other types of tender option bonds that, in turn dramatically affected that market.

As these disruptions rippled through the markets, trustees who had purchased such short-term instruments on behalf of their trust clients were affected. In addition, corporate trustees, who often act as paying agent for these types of short-term debt,

were significantly affected by operational difficulties when tender option bonds could not be resold. ABA worked closely with corporate trustees and the Depository Trust Clearing Corporation to resolve those issues.

FRB Opens Discount Window to Investment Banks

Further evidence of the spreading crisis was the run in March 2008 on Bear Stearns which led to its swift sale, coordinated by the Federal Reserve Bank of New York, to JPMorgan Chase. At the same time, the FRB agreed to provide liquidity to investment banks collateralized by securities, including mortgage-backed securities, something it had not done since the Great Depression. That action led to calls for a systemic risk regulator, and opened the door, for the first time in decades, to the real possibility of reforming the fragmented regulation of the U.S. financial services industry.

Safety of Trust, Custody, and Managed Assets

The dismal second quarter performance of bank stocks led to increased concerns by customers about the safety of their trust and custody assets. ABA prepared a press backgrounder, *Are My Trust, Fiduciary and Custody Assets Safe?,* available for bankers to educate their customers on the protections associated with assets held in bank trust and custody accounts.

In early 2009, ABA published another backgrounder for ABA members to educate customers with investment management accounts held in the trust department. *ABA Backgrounder - Safety of Managed Assets* briefly discusses how extensive regulation, examination, and sound practices protect a bank customer's interests. Both backgrounders are available on the Center's web page at **www.aba.com/Solutions/Trust.**

Congress Passes Housing/GSE Bill

As foreclosures continued to skyrocket, Congress, in July, enacted omnibus housing legislation – the Housing and Economic Recovery Act of 2008 – that combined regulatory reform of Fannie Mae and Freddie Mac with a program to use the resources of the Federal Housing Administration to help homeowners caught up in the subprime loan crisis. The legislation created a new voluntary "Hope for Homeowners Program" that authorized the FHA to refinance up to $300 billion in mortgages of troubled borrowers living in their only home. It also provided $4 billion to allow states and cities to buy, rehabilitate, and resell foreclosed or abandoned properties.

September 2008 Meltdown

The month of September marked a watershed as one unprecedented event after another triggered a rapid worsening of the crisis of confidence plaguing

the economy. The September downward spiral began with the conservatorship of Fannie May and Freddie Mac and ended with the demise of several of the large independent investment banks. The fall-out from the bankruptcy of Lehman Brothers on September 15, 2008 spread throughout financial markets with consequences for numerous market participants.

Money Market Fund "Breaks the Buck"

One of the immediate casualties of the Lehman bankruptcy was Reserve Primary, an independent money market fund holding Lehman paper that had to stop redeeming its shares at the standard net asset value of $1.00. Reserve Primary's decision to "break the buck" caused panic among investors that led to a massive run on money market funds. To stop the run and provide liquidity to MMMFs, the Treasury Department established a temporary program to guarantee, for one year, MMMF balances as of the close of business on September 19, 2008, so long as eligible MMMFs pay a fee to participate in the program.

SEC Temporarily Bans Short Selling

To address concerns that financial institution stocks were unfairly being manipulated, in mid-September the SEC invoked emergency powers under the Administrative Procedure Act to issue an order temporarily banning all short selling of financial institution stocks. This came on the heels of earlier SEC action, encouraged by ABA, to stop "naked short selling" strategies. ABA – in letters, meetings, and news interviews – had been strongly advocating such protections since July when the SEC first issued a temporary order banning naked short selling. That order, however, applied only to the securities of financial firms with access to the FRB's primary credit facility

Legitimate short selling can operate as a mechanism for generating market liquidity, securing price discovery, and fostering corporate accountability and responsibility. However, precipitous drops in stock prices, extremely high trading volumes, and huge spikes in failures to deliver among publicly traded member banks and bank holding companies led many ABA member banks to conclude that the stock in their companies were being unlawfully manipulated through naked short selling.

As part of those same efforts, the SEC also proposed interim final temporary rules relating to short sales. ABA commented on the interim final rules suggesting additional ways to improve the transparency and efficiency of the securities settlement process. It has been widely recognized that naked short selling has a higher risk of settlement failure and may distort the operations of financial markets by causing increased price volatility and potentially facilitating market manipulation. In its December comment letter, ABA explained that there is a stark contrast between

allowing legitimate short selling to continue, and failing to take the actions necessary to prevent manipulative and abusive naked short selling from flourishing.

Emergency Economic Stabilization Act of 2008

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (EESA) that authorized $700 billion in taxpayer funds to purchase troubled assets from financial institutions and directly invest capital in financial institutions. ABA supported enactment of the legislation.

EESA included an array of provisions intended to restore liquidity and stability to the U.S. financial system – including a temporary increase in standard FDIC insurance coverage to $250,000 – and to achieve related goals, including homeownership preservation, job promotion, and economic growth. The law required Treasury to encourage servicers of underlying mortgages to use the HOPE for Homeowners Program and other available programs to assist borrowers in avoiding foreclosure. It also authorized Treasury to use loan guarantees and credit enhancements to facilitate loan modifications.

Federal Guarantee Program and Funding Facilities

FDIC Temporary Liquidity Guarantee Program

Shortly after enactment of EESA, the FDIC used its systemic risk authority to establish a program to temporarily guarantee the senior debt of all FDIC-insured institutions and certain holding companies, as well as the full amount of deposits in non-interest bearing deposit transaction accounts, typically checking accounts. The transaction account guarantee is a separate category of ownership under FDIC's deposit insurance rules, meaning that funds in eligible accounts are fully guaranteed without any aggregation of accounts.

Any transaction account that does not bear interest, no matter the ownership structure, is eligible for the temporary guarantee, including non-interest bearing trust accounts. Because only funds that are actually in an eligible account when the bank fails are eligible for the full guarantee, funds that are swept out of the account prior to failure are not fully guaranteed. The FDIC has determined that the guarantee is the equivalent of deposit insurance. Accordingly, banks that are required by applicable law to collateralize trust account funds held in deposit accounts may, if the accounts are eligible for the guarantee, not have to collateralize those funds.

Commercial Paper Funding Facility

On October 27, 2008, the FRB began a Commercial Paper Funding Facility (CPFF), to fund purchases of commercial paper. The CPFF is intended to improve liquidity in short-term funding markets and thereby increase the

availability of credit for businesses and households. Under the CPFF, the Federal Reserve Bank of New York will finance the purchase of unsecured and asset-backed commercial paper from eligible issuers through its primary dealers. The CPFF will finance only highly rated, U.S. dollar-denominated, three-month commercial paper.

Money Market Investor Funding Facility

On October 21, 2008, the FRB announced that as a complement to the CPFF, it would support a private sector initiative to restore liquidity to U.S. money market fund investors. The MMIFF, which became effective on November 24, 2008, is authorized to lend to a series of private sector special vehicles so that they may purchase a maximum of $600 billion in eligible assets from eligible investors.

The program was initially limited to U.S. money market mutual funds registered under Rule 2a-7, but the FRB acknowledged the possibility from the start that other U.S. money market investors could be included. In November 2008, ABA wrote the FRB urging the expansion of eligible investors to include bank-managed funds that are exempt from Rule 2a-7 registration, but provide similar investment options as Rule 2a-7 funds. On January 7, 2009, the FRB agreed to make common trust funds, collective investment funds, and other U.S.-based investment funds that operate in a manner similar to money market mutual funds eligible to participate in the MMIFF. This change is especially important to those banks that use these pooled funds to invest collateral from securities lending transactions.

Term Asset-Backed Securities Loan Facility

On November 25, 2008, the FRB announced that it would establish a $200 billion credit facility designed to revive the market for asset-backed securities collateralized by auto loans, student loans, credit card loans, and guaranteed small business loans. On February 10, 2009, Treasury Secretary Geithner announced that the facility would receive increased funding to $1 trillion. Operated by the Federal Reserve Bank of New York, the program will extend non-recourse loans fully secured by eligible collateral.

Trust Taxation

Cost Basis Reporting

After a number of attempts over several years, Congress finally passed a requirement for additional tax reporting of securities transactions. This reporting requirement applies to bank trust departments, broker-dealers, stock transfer agents, and others who regularly buy or sell securities on behalf of their customers (the Internal Revenue Code refers to all of them collectively as “brokers”).

Under the new reporting requirements, brokers must soon report two new pieces of information when completing IRS Form 1099-B after the sale of a "covered security": (1) the customer's adjusted basis in the security; and (2) whether the gain or loss from the sale is short or long-term.

2008 Public Laws

- Housing and Economic Recovery Act of 2008
- Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act)
- Emergency Economic Stabilization Act of 2008 (EESA)

The law defines a "covered security" as any stock in a corporation purchased after December 31, 2010, shares in mutual funds purchased after December 31, 2011, and certain other securities (such as bonds) purchased after December 31, 2012. In addition, a broker that transfers on behalf of a customer – by sale, gift, or bequest – a "covered security" to another customer's account must furnish information, as prescribed by the IRS, to enable the receiving broker to fulfill its reporting responsibilities. Although the new law is not effective until 2011, banks will likely need to make significant changes to their recordkeeping systems in the intervening years.

HEART Act and Expatriates

In the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act), Congress has subjected certain wealthy expatriates (i.e., individuals who renounce their citizenship or residents who surrender their green cards) to an immediate mark-to-market tax on the inherent gain on all assets. The law also subjects U.S. citizens and residents to a tax on gifts or bequests made by certain expatriates. For affected expatriates all of their property including an ownership interest in a grantor trust is treated as sold the day before expatriation. Any net gain from this deemed sale above $600,000 is subject to taxation.

Trust Provisions

The HEART Act has implications for covered expatriate beneficiaries and trustees of nongrantor trusts. Under the new law, trustees must deduct and withhold 30 percent of the taxable portion of any direct or indirect distribution from a nongrantor trust to a covered expatriate. The taxable portion is that which would be included in the expatriate's gross income if the expatriate was a citizen. In addition, if any property distributed to the expatriate exceeds its adjusted basis, the trust must recognize a gain as if the property were sold to the expatriate at its fair market value. These new rules for nongrantor trusts only apply if the expatriate was a beneficiary of the trust on the day before expatriation.

Tax-Deferred Accounts

The new law deems the expatriate to have received a distribution of his entire interest in any tax deferred account the day before expatriation. However, no early distribution taxes shall apply to this distribution.

Gifts and Bequests

The HEART Act also taxes the recipient of gifts and bequests made by a covered expatriate to a U.S. citizen or resident. The tax applies to any portion of the gift or bequest that exceeds the annual exclusion amount during the calendar year. If a covered gift or bequest is made to a U.S. trust, the trust is taxed as if it were a U.S. citizen. The tax is assessed at the highest marginal estate or gift tax rate at the time the gift or bequest is made. The new law does not apply to qualified transfers made to a spouse or charity.

Tax-Free IRA Rollovers to Charities

The Emergency Economic Stabilization Act of 2008 (EESA) extended until December 31, 2009 a very popular tax break for certain rollovers from IRA to charities. Under the provision, IRA beneficiaries, who have reached the age of 70 ½, may initiate tax-free distributions of up to $100,000 during the tax year to tax-exempt charitable organizations. Congress created this tax break to spur charitable contributions made during a donor's lifetime.

Employee Benefits

Pension Funding Relief

As 2008 came to a close, Congress passed the Worker, Retiree and Employer Recovery Act of 2008 which included some relief for plan sponsors trying to meet their pension funding obligations. The bill includes pension funding relief and certain technical corrections to the Pension Protection Act of 2006 (PPA), as well as clarification of pension plan "smoothing," allowing plans to recognize unexpected asset gains and losses over 24 months. In addition, there is a new transition to the new funding rules (which were passed in the PPA), in which the phased-in funding threshold would hold at 92 percent for another year.

The other key provision in the law was a waiver of required minimum distributions (RMDs) for IRAs and defined contribution plans for 2009. As a result of this change, no distribution will be required to be taken from an IRA, a 401(k) plan, or comparable plan for 2009. In Notice 2009-09, the IRS made it clear that financial institutions are not required to issue a notice of RMD for 2009, as would normally be required under Notice 2002-27.

Investment Advice Rule Delayed

DOL also issued final investment advice regulations implementing the statutory exemption in the PPA for the provision of investment advice. However, because regulations had not yet become final, at the request of the Obama Administration, the effective date of final rule has been delayed to May 22, 2009 and the comment period has been reopened until February 18, 2009.

DOL Fee Disclosure Proposals

As part of our advocacy efforts on DOL's several fee disclosure proposals, ABA worked to educate DOL on the workings of and benefits of collective investment funds. This effort was undertaken because DOL's fee proposals were largely based on the mutual fund model which differs significantly from the collective fund model. ABA held many meetings with DOL to educate them on the differences between these products, highlighted the benefits of the regulatory structure that provides oversight for collective funds, and how that structure allows for flexibility for plan sponsors, while keeping pension plan fees low. As a result of these meetings, DOL revised their proposals to accommodate the differences between mutual funds and collective investment funds.

Miscellaneous DOL Rules

In 2008, DOL issued multiple regulations implementing various aspects of the PPA including the fidelity bonding requirement, the cross trading exemption and the guidance for the Qualified Default Investment Alternative. DOL also finalized Form 5500, and provided clarifying FAQs.

Separately, the IRS issued proposed regulations on automatic contribution arrangements, which have yet to be finalized.

Municipal Market Disclosure System Implemented

2008 saw the culmination of the efforts of the SEC and the Municipal Securities Rulemaking Board to improve disclosure in the market for municipal securities with the establishment of the Electronic Municipal Market Access, known as EMMA. EMMA is an Internet-based disclosure portal which provides free public access to disclosure documents and real-time municipal securities trade price data for the municipal securities market accessible at **emma.msrb.org.**

The MSRB launched EMMA in stages, first providing access to official statements for new issues of municipal securities and related documents for advance refundings of outstanding municipal securities together with real-time municipal securities

trade price data. The first phase was followed by a pilot program for voluntary submissions of continuing disclosure documents. Finally, on December 15, 2008, the SEC amended its secondary market disclosure rule – 15c2-12 – to require that secondary market disclosures be provided electronically to the MSRB through EMMA instead of to the several nationally recognized municipal securities information repositories as is currently the case. The amendments to the rule become effective on July 1, 2009. To avoid issuers having to amend existing disclosure agreements that refer to the existing NRMSIRs, the SEC will withdraw its letters to the existing NRMSIRs that authorize them to accept continuing disclosure filings.

ARDS/VRDO Disclosure System

Separately, in response to the collapse of the auction-rate market, the MSRB has established the Short-term Obligation Rate Transparency System to collect and disseminate information about municipal auction-rate securities and municipal variable-rate demand obligations. The system, which is slated to become effective this spring, will provide free public access to that information through EMMA.

2008 ABA Comment Letters

- ABA Comment Letter on DTC Amended Proposed Revisions to FAST and DRS Limited Participant Rules (3/20/08)
- ABA Statement for the Record on Senate Finance Committee Estate Tax Reform Hearing (4/3/08)
- ABA Comment Letter to IRS Re Section 67(e) Proposal (5/9/2008)
- ABASA Comment Letter to SEC on Proposed Amendments to Reg S-P (5/22/08)
- ABA Comment Letter to IRS on Priority Guidance (5/30/2008)
- ABA Comment Letter to FINRA on the Dual Employee Proposal (6/13/08)
- ABA Comment Letter to FDIC on Covered Bond Policy (6/23/08)
- ABA Comment Letter to the SEC on Third Amendment to DTC FAST Proposal (7/10/08)
- ABA Comment Letter to the SEC on Naked Short Selling (8/7/08)
- ABA Comment Letter to the SEC on DTC Settlement Procedures (8/13/08)
- ABA Comment Letter to the SEC on DTC Disincentive Fee (8/28/08)
- ABASA Comment Letter to the SEC and FRB re: Bank Repurchase (9/8/08)
- ABA Comment Letter on DOL's Fee Disclosures for Plan Participants Proposal (9/12/08)
- ABA Comment Letter to IRS Re Filing Extension Proposal (9/29/08)
- ABA Comment Letter Re Call Report Changes (11/24/08)
- ABA Comment Letter Follow-up re: Executive Compensation (12/12/08)
- ABA Comment Letter on Amendments to Regulation SHO (12/16/08)
- ABA Letter to FHFA Re Mortgage Loan Modifications for RMBS Transactions (2/6/09)

2008-2009 Trust Committees

Trust Counsel Committee

The Committee researches, coordinates and advises the Center on legislative, regulatory and judicial matters affecting trust and fiduciary services offered by ABA member organizations, as well as develops strategies to amend applicable laws and regulations in the best interests of the industry and the public it serves.

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The Council provides a forum for the discussion and development of legislation and regulatory recommendations and actions on issues relating to retirement and benefits policy. The Council consists of management executives from ABA member institutions' employee benefit business.

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Maria Serra
Senior Vice President
Client Service, US Securities Services
The Bank of New York Mellon

Gisele M. Sutherland
Vice President & Employee Benefits Counsel
Marshall & Ilsley Trust Company

Trust Taxation Committee

The Committee researches, coordinates and advises the Center, and educates the membership on federal tax proposals and initiatives affecting the trust business and develops strategies to amend applicable tax laws and regulations in the interest of the industry and the public it serves.

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Corporate Trust Committee

The Committee promotes the interests of ABA members engaged in providing indenture trustee services for corporate and municipal debt securities; trustee and custodial services for asset-backed, mortgage-backed and structured finance transactions; and agency services, including registrar, paying agent, transfer agent, exchange agent and related agency functions.

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Center for Securities, Trust and Investments

ABA first established a Trust Division in 1897. In 1999, ABA created the Center for Securities, Trust and Investments to assist member banks, savings associations and trust companies offering, among other things, trust and fiduciary services. The Center monitors federal legislation, regulatory agency rulings and judicial decisions to ensure that laws, regulations and policies under review favor trust and fiduciary services offered by banking organizations.

Our mission at the Center is three-fold:

- To be a trusted, timely resource for banks seeking information on how to best serve customers' investment needs;
- To assist bankers in interpreting opportunities prescribed by legislative and regulatory changes; and
- To vigorously advocate the competitive interests of banks involved in investment activities by working with policymakers, legislators and regulators on relevant laws, rules and decisions.

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Center for Securities, Trust & Investments Resources

Visit our website at:
http://www.aba.com/Solutions/Trust.htm

Electronic Bulletins

The Center invites ABA Members to join one of our E-Bulletins by visiting the ABA website at www.aba.com. There are over thirty such bulletins, including:

- ***Wealth Management Update:***
  News, information and regulatory updates on issues affecting trust, wealth management, and private banking departments.
- ***ERISA Bankers Forum:***
  Relevant and timely news from the employee benefit plan world for attorneys, compliance officers and others who work on ERISA issues.
- ***Corporate Trust News:***
  Periodic news concerning the bond and structured finance markets of interest to corporate trustees.

Publications

ABA publishes a number of topical newsletters and magazines:

- ***ABA Trust Letter***
- ***ABA Trusts & Investments Magazine***
- ***Trust Basics: An Introduction***
- ***Wealth Advisory and Personal Trust Series***

Conferences/Schools/E-Learning

The Center also provides content for a number of important ABA educational opportunities, including:

- **ABA Advanced Program for Trust Professionals**
- **ABA National Trust School**
- **ABA Graduate Trust School**
- **ABA Wealth Management and Trust Conference**
- **ABA Capital Markets Seminar for Corporate Trust Professionals**
- **ABA Telephone/Webcast Briefings**
- **ABA eLearning – Personal Trust Curriculum**