

## Networking Arrangements

### Program

# RESCINDED

#### EXAMINATION OBJECTIVES

To assess the adequacy of the savings association's policies and procedures and oversight by management and the board of directors to ensure that customers clearly understand the differences between insured deposits and nondeposit investment products.

To determine the effectiveness of the savings association's compliance and audit programs to ensure that the savings association conducts the networking arrangement in compliance with the Interagency Statement, the Chubb Letter, other OTS guidelines, and applicable law.

To determine whether the savings association monitors the networking arrangement's effect on the saving association's income, expenses, and deposits and takes appropriate action when necessary.

To obtain commitments for corrective action when policies, procedures, practices, or management oversight is deficient or the association has failed to comply with the interagency statement, OTS practices, or applicable law.

#### EXAMINATION PROCEDURES

The extent to which you will perform procedures depends on a number of factors. These factors include:

- Types of sales activity.
- Specific product offered.
- Size and complexity of the operation.
- Any relationships with affiliates or third parties and the savings association.

#### PRE-EXAMINATION ANALYSIS

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1. Review previous OTS examination reports, internal and external audit reports, management letters, supervisory correspondence, and any approval conditions or enforcement actions. Perform any necessary follow-up procedures to ensure the association has taken effective correction action or is complying with conditions.

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2. Review the following documents:

- The broker-dealer's most recent NASD, SEC, or state examination reports that the savings association has available.
  - Any financial reports related to the networking arrangement.
  - The most recent public accounting report of the broker-dealer.
  - All written agreements (and conditions of approval if applicable) pertaining to the networking arrangement.
  - Thrift Financial Report information regarding mutual fund and annuity sales.
  - Board minutes related to the networking arrangement.
  - Reports pertaining to internal audits and compliance reviews.
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## LEVEL I

3. Evaluate the savings association's procedures to implement corrective action in response to internal weaknesses or violations of applicable law or regulation identified through compliance reviews, monitoring systems, internal audits, and examinations by OTS.

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4. Review the Matters Requiring Board Attention and Corrective Actions from the three or four previous ROEs to ensure that the board and management have taken appropriate corrective action where necessary and persistent problems have not recurred.

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5. Determine whether the board of directors adopted, and periodically review, a written statement that addresses the risks of the networking arrangement and the policies and procedures the association has in place to address those risks?
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6. Confirm that the savings association has compliance and internal audit controls and procedures to ensure adherence to board approved policies and procedures and determine:
- Whether the compliance program is independent of the networking arrangement.
  - Whether the savings association implemented robust transaction quality controls, such as: exception-reporting systems, review of customer satisfaction, and internal and external audits.
  - Whether the compliance program, at a minimum, includes a system to monitor to detect and prevent improper practices in the networking arrangement.
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7. Determine how the board develops and approves the policies and procedures for the networking arrangement. Review the policies and procedures to determine if they address the following:
- Compliance procedures.
  - Supervision of personnel involved in sales.
  - Types of products sold, selection criteria.
  - Permissible use of customer information.
  - Designation of employees to sell investment products.
  - Disclosures and advertising.
  - Setting and circumstances.

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- Qualifications and training.
- Compensation.

8. Determine if the savings association conducted a thorough review of broker-dealer (affiliate or non-affiliate) before entering into the networking arrangement. If so, did the review include the following information:

- Competence, experience and integrity.
- Financial condition.
- Checking the broker-dealer's credit rating through a nationally recognized rating system.
- Business reputation, complaints and litigation, past and present.
- Staff's competence, qualifications and training.
- Internal control environment.
- Information and reporting system including its ability and willingness to deliver reports to the savings association regarding the networking arrangement.
- Contingency and recovery plan.
- Insurance coverage.

9. Determine if the savings association periodically checks the disciplinary history of the broker-dealer and broker-dealer's registered representatives that work on the savings association's premises.

10. Was the review of the broker-dealer performed by savings association personnel with appropriate knowledge, experience, and analytical skills?

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11. Determine if the broker-dealer is an affiliate of the savings association. If so, do all transactions comport with regulations on transactions with affiliates?

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12. Evaluate the reports management is regularly receiving from the broker-dealer regarding the networking arrangement. Determine if the reports contain the following:

- Transactions for each registered representative.
  - All transactions per individual customer.
  - Transactions by investment products.
  - All transactions in proprietary products.
  - Transactions by customer type.
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13. Verify that a written agreement exists, and review the agreement to determine that, at a minimum, it addresses the following:

- The duties and responsibilities of each party to include the type of reports the broker-dealer is required to provide the savings association in connection with the networking arrangement.
- A description of permissible activities by the broker-dealer on the premises of the savings association.
- A description of the broker-dealer's internal controls that will ensure compliance with applicable law.
- Define the terms of the broker-dealer's use of the savings association's space, personnel and equipment.
- The types of investment products and services to be provided and related restrictions.
- Insurance requirements.

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- An assurance that the broker-dealer will not disclose or use the savings association's customer's personal information for any purpose other than in connection with the networking arrangement and will comply with OTS Privacy regulations.
- Broker-dealer's authorization of the savings association and OTS, in accordance with functional regulation guidelines, to have access to its examination reports, records, personnel, and premises as necessary or appropriate to evaluate compliance with the terms of the agreement.
- A copy of all employment contracts.
- A description of the compensation arrangements of the registered representatives involved in the networking arrangement.
- Indemnification of the savings association by the broker-dealer for the conduct of its employees (or independent contractors) in connection with the networking arrangement.

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14. Does the savings association have policies and procedures regarding dual employees that describe the circumstances in which the dual employee will be acting on behalf of the savings association and the circumstances in which the dual employee will be acting on behalf of the broker-dealer as a registered representative?

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15. Identify the person(s) at the savings association responsible for the management of the networking arrangement. Review their backgrounds, qualifications and employment history with the savings association.

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16. Review the savings association's training material for nonregistered savings association employees. Is it clear that the savings association trains these individuals in acceptable referral practices that would prohibit them from discussing the features of investment products, soliciting sales, or offering investment advice?

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17. Determine whether the savings association's board of directors has established adequate procedures for evaluating and determining investment products offered through the networking arrangement.
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18. Determine if the savings association's policies and procedures and training material as well as the broker-dealer's training material state that each dual employee is to comply with the requirement that they disclose to the customer that they represent the broker-dealer, rather than the savings association, when discussing investment services or products.
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19. Review advertisements and other promotional material to determine if the savings association clearly distinguishes information regarding nondeposit investment products from that of the savings association's FDIC insured products. Does the savings association ensure that a clear and accurate explanation of coverage follow any references to insurance coverage other than the FDIC (such as SIPC, state funds, or private companies)?
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20. Review advertisements and other promotional material of the networking arrangement to determine whether they contain the following minimum disclosures (or in the shorter logo format):
- Investment products are not insured by the FDIC (Not FDIC insured).
  - Investment products are not deposits or other obligations of the savings association and are not guaranteed by the savings association (No Bank Guarantee).
  - Investment products are subject to investment risks, including the possible loss of the principal invested (May Lose Value).
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21. Review advertisements and other promotional material to determine if the minimum disclosures are on the front of brochures, in the top portion of any text regarding nondeposit investment products, and at the beginning of any sales presentations, customer referrals or solicitations. Such disclosures should be highlighted in a box, with bold type or with bullet points.

22. Review advertisements and other promotional material regarding the networking arrangement to determine if they clearly state the name of the broker-dealer.

23. Review advertisements and other promotional material to determine if they omit material facts or mislead customers regarding the characteristics of, and risks associated with, particular investment products.

*Note:* Procedures from Section 1425, Advertising, in the Examination Handbook are also applicable to advertisements.

24. Determine if customers are receiving the required minimum disclosures. Any No answers are not consistent with interagency policy.

- Does the savings association's customer account agreement (or a separate disclosure form) contain the following information:
  - Investment products are not insured by the FDIC.
  - Investment products are not deposits or other obligations of the association or guaranteed by the savings association.
  - Investment products are subject to investment risks, including possible loss of principal invested.
- Are the above disclosures conspicuous, in that they are:
  - On the front of materials or adjacent to the signature block.

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- Highlighted in a box, with bold print, or with larger typeface.
- Does the broker-dealer's training material and the savings association's policies and procedures indicate that the disclosures are to be given to all customers in the following form at the following times:
  - Orally, during a sales presentation.
  - Orally, when the registered representative provides investment advice concerning nondeposit investment products.
  - Orally, and in writing, prior to or at the time the customer opens an investment account.
- Does the broker-dealer's training material and the savings association's policies and procedures provide that customers are to be given prospectuses that list material relationships and disclosure regarding fees, penalties, or surrender charges. Do the training materials and the policies and procedures indicate that these written disclosures are to be given to the customer before or at the time an account is opened to purchase investment products?
- Does the broker-dealer's training material and the savings association's policies and procedures provide that all registered representatives are to advise prospective customers to review information such as offering circulars or prospectuses before purchasing an investment product?
- Does the broker-dealer's training material and the savings association's policies and procedures require customers to sign a certification form acknowledging that they have received and understand the minimum disclosures?

25. Review account statements provided by the savings association that contain information regarding deposit insurance products and nondeposit investment products sold through the networking arrangement.

- Determine if information concerning the nondeposit investment products is clearly separate from information regarding deposit account activity.
- Determine if the statement includes the required minimum disclosures.

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- Determine if the statement includes the identify of the broker-dealer.
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26. Determine if the savings association offers proprietary funds as an investment product. Determine if the name(s) and logos of the proprietary funds are similar to that of the savings association. Determine whether savings association management can demonstrate that they observe applicable SEC requirements when the name of a proprietary mutual fund is similar to that of the savings association. Refer to Appendix D, SEC Policy on Bank Mutual Fund Names.

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27. Review savings association's policies and procedures to determine whether the savings association conducts sales of nondeposit investment products in a physical location distinct from deposit taking activities of the savings association. Use the following criteria:

- The area where the broker-dealer offers nondeposit investment products is physically separate from teller windows and other areas where the savings association conducts traditional deposit-taking activities.
  - The savings association locates literature and information on nondeposit investment products in areas that are clearly separate from material on traditional savings association products.
  - Signs and literature should clearly state that nondeposit investment products are not FDIC insured.
  - The savings association locates broker-dealers signs and advertisements in areas other than at teller windows.
  - The savings association posts rates for insured deposits and nondeposit investment products separately.
  - The savings association prohibits employees, while located in the nondeposit-taking areas such as teller windows, from making any recommendations regarding nondeposit investment products or engaging in any activities related to offering or selling such products.
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28. Does the association have an interactive web site where customers can conduct both insured and uninsured transactions? If so, does the association observe the following safeguards to prevent customer confusion:

- Appropriate disclosures.
- Firewalls, or notices, or speed bumps to ensure the customer knows they are leaving an insured deposit area and entering a nondeposit investment or securities area.

29. Does the association have a noninteractive web site where they advertise both insured and nondeposit investment products? Does the association appropriately segregate the information and does the association prominently place the interagency disclosures with information about nondeposit investments?

30. Review the broker-dealer's written employment agreement for each dual employee and the broker-dealer's method of compensation for each registered representative. Determine whether the method of compensation is in accordance with applicable law, OTS policy and the savings association's policies and procedures by considering the following:

- Whether broker-dealer's compensation plan for registered representatives strongly favors proprietary or other specific products.
- Whether compliance or audit personnel are excluded from incentive compensation programs directly related to the results of the networking arrangement.

31. Determine if the referral fee arrangement complies with SEC requirements.

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32. Determine whether the networking arrangement's operating results are consistent with business plan projections and that management periodically addresses long-range strategic planning.

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33. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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## LEVEL II

34. Determine if the savings association has blanket bond insurance that extends to the networking arrangement.

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35. Verify that the broker-dealer has insurance as required under the networking agreement.

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36. Determine if the savings association reviews customer complaints regarding the networking arrangement. If so, determine who reviews these complaints and what actions they take as a result.

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37. Evaluate the networking arrangement's operating results and the volume of business against business plan estimates for overall operations and specific types of investment products. Savings association management should be able to explain material variances.

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38. If applicable, confirm that the networking arrangement is operating in accordance with the conditions contained in the OTS application approval.
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39. Determine whether on-premise sales of a savings association's securities, or those of an affiliate, comply with the restrictions in 12 CFR § 563.76 and are consistent with the safeguards listed in TB 23a, Sales of Securities.
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40. If proprietary mutual funds are being sold through the networking arrangement, review the savings association's policies and procedures and the broker-dealer's training material to determine whether registered representatives are to provide prospectuses or other written disclosures about the fund before the purchase.
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41. Review registered representative compensation arrangements. Determine whether there are any incentives to sell proprietary investment products. Review broker-dealer training material on suitability to ensure that compensation is not a factor in determining suitability.
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42. Review the association's earnings and evaluate the profitability of networking activities.
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43. Ensure that the review meets the Objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.
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## LEVEL III

44. Sample customer files and determine if the broker-dealer made all applicable disclosures and obtained the customer's signature on the disclosure form.
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45. Visit all branch locations where the broker-dealer sells nondeposit investment products on the savings association's premises.
- Ensure that any required physical distinction is obvious to customers.
  - Review the promotional material on-site.
  - Interview employees to determine adequate training.
46. Determine if the broker-dealer and savings association have a contingency plan for handling adverse events, such as a sudden market downturn that may result in a large volume of customer calls.
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47. In accordance with functional regulation guidelines, verify the accuracy of the broker-dealer's reports to management of the savings association and management's reports to the board regarding the networking arrangement.
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48. Determine if the savings association conducts customer satisfaction surveys or mystery shopping trips regarding the networking arrangement. If so, determine who reviews these surveys and what actions they take as a result.
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49. For proprietary funds, review current ratings from rating agencies such as Standard and Poors (S&P is a rating agency of many mutual funds). Try to determine if there are any circumstances or recent events that would be a reason for the rating agency to change (especially downgrade) the current rating.
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## EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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