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CHAPTER: Asset Management

SECTION: Introduction to Closely-Held Business Interests

Section 840

Any attachments to this document are rescinded only as they relate to national banks and federal savings associations.

Introduction to Closely-Held Business Interests

For purposes of this section, a closely-held business can be defined as one in which ownership of a business is concentrated in the hands of only a few shareholders and in which there is no publicly traded market for the shares. A principal characteristic of closely-held business interests is that ownership and management is often the same person. Closely-held business interests held in fiduciary accounts most often include closely-held corporations but may also include sole proprietorships and joint venture arrangements. In most instances, these assets are used to fund the trust and are not purchased by the savings association acting in a fiduciary capacity. The governing instrument should have specific language regarding the trustee's responsibilities and powers for such assets.

There are a number of complex issues associated with the administration of closely-held business interests. The savings association must be guided by well-developed policies and procedures to ensure sound and prudent administration and to safeguard against exposure to potential liability. The savings association must also have sufficient skills, either internally or through external arrangements, to properly administer these assets. Any losses resulting from improper administration of the closely-held business will be the responsibility of the savings association.

Managing a closely-held business interest can present a number of problems, not the least of which is acquiring detailed knowledge about the business interest. Regardless of whether the savings association owns a majority or a minority interest, the time necessary to actually manage or be involved in the management is often quite extensive. Shared responsibilities with cofiduciaries also present problems to the trustee. While cofiduciaries can be both cooperative and knowledgeable concerning the business interest, others may be neither.

The savings association, as a discretionary trustee, may need to make decisions regarding the disposition of the closely-held business interest. In those instances where an interest in a closely-held business is used to fund the trust and the governing instrument is silent regarding the disposition of the asset, the trustee must analyze the business interest and determine, in the best interest of the account, whether to continue to operate the business interest or to dispose of it by sale or liquidation. The following items should be considered in the analysis:

- Financial condition
- Management
- Earnings
- Growth
- Marketability
- Product lines and services
- Competition

The savings association and its board of directors are exposed to potential liability when the institution, acting as fiduciary, undertakes the administration of closely-held business interests. In addition to the

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concerns listed above, the savings association must always deal with closely-held business interests at arm's length to avoid any conflict of interest or self-dealing transactions.

One way to manage the closely-held business interest, if policy permits, is to have an employee of the savings association (officer) serve as an officer or director of the closely-held business interest. However, this involves a certain degree of potential liability to the savings association and to the employee/officer. Therefore, consideration should be given to obtaining indemnity insurance for these situations.

Closely-Held Business Interests Examination Program

Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's administration of closely-held business interests. Consider whether:

- policies and procedures regarding acceptance and administration for closely-held business interests have been established;
- the scope and nature of responsibilities in connection with closely-held business interests have been identified;
- there is expertise available for administering closely-held business interests;
- policies and procedures are in place to ensure compliance with governing instruments, applicable law and accepted fiduciary principles; and
- deficiencies are identified and corrective action is promptly initiated.

Examination Procedures **Wkp. Ref.**

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products and/or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform particular Level II procedures.

1. Review examination scoping materials related to closely-held business interests. Scoping material should include:

   - Risk profile
   - Relevant PERK documents
   - Previous trust and asset management examination report

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- Workpapers from the previous examination
- Policies and procedures for closely-held business interests
- Board and committee minutes

2. Review and evaluate policies and procedures pertaining to the acceptance and administration of closely-held business interests.

3. Review the qualifications of management, personnel or third party agents responsible for the administration of closely-held business interests. Observe any changes in personnel, which have occurred during the review period. Evaluate the adequacy of expertise available. If existing staff does not have the expertise to manage the business interests, is there a prudent selection process for hiring outside agents?

4. Is documentation of the history and the nature of the business interests part of the account acceptance process?

5. Prior to accepting an account that is funded by a closely-held business interest, is a review process performed to determine the current condition of the business, such as contingent liabilities and expenses that must be incurred in order to run the business properly?

6. Consider whether the following risk contributors (if applicable) have been addressed:

   - the sufficiency of policies, procedures and internal controls;
   - the adequacy of management expertise in administering closely-held business activities;

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- the thoroughness of internal audit and compliance;
- the effectiveness of management supervision; and
- the reliability and timeliness of management reports.

The completion of Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents, such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification procedures.

1. Review the trust department's list of holdings of closely-held business interests.

2. Review the complexity of the businesses and the abilities of the trustee to exercise its responsibilities. What are the reasons for the continued existence of the business, e.g. income, employment, sentimental reasons?

3. Review the types of assets of the businesses and any special considerations regarding liability (e.g. environmental liability, personal injury or hazard liability). Are there any prior violations of laws or regulations?

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4. Review the level of family intervention regarding decisions made in the business. Consider whether such intervention increases the savings association's liability and/or risk and if so, what actions has management taken to address this situation.

5. Review the level of compensation the savings association receives for the services it renders and liabilities it assumes.

6. Inquire whether there are any potential conflicts with the commercial lending side of the savings association.

7. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I or Level II procedures or data contained in department records or internal or external audit reports to form a conclusion; proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of the Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

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1. Review the trust department's list of holdings of closely-held business interests. Identify those interests that have been added to discretionary accounts since the previous review. Determine if sufficient documentation is on file to support the trust department's decision to accept, purchase, retain or sell the business interest, including:

   - proper authorization for the purchase, retention or sale of any interest, either in the governing instrument, through specific authorization or direction from appropriate parties;
   - the trust department's operational, management or administrative duties;
   - financial information on the company, including annual financial statements, and comparative information on the industry in which the business operates;
   - information related to the review of the business' financial condition and the results of operation; and
   - information related to the business' operation, including a review of corporate structure, management quality, capitalization, operational risks, potential legal liabilities, etc.

2. Select a sample of accounts for review, and determine whether investments in closely-held business interests are of trust quality, suitable as investments for the affected accounts and consistent with the needs and objectives of the accounts. Determine whether the trust department has met its fiduciary responsibility in the operation of the business interest.

3. Review a sample of dispositions/liquidations of closely-held business interests. Evaluate whether the decision to dispose of or liquidate the business was consistent with the account objectives. Review management's efforts to maximize the value of the investment.

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4. For interests held in directed accounts, determine that proper authorization exists, such as a recent direction letter and whether the direction came from a party authorized to make investment decisions.

5. Determine if any business relationships exist between the business interest and the savings association (i.e., lending or depository relationships, use of other services provided by the savings association, etc.). Review these relationships for propriety.

Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 840P

Laws

Code of Federal Regulations

Office of Thrift Supervision Publications

TB 76-2	Conflicts of Interest Relating to Fiduciary Activities

Other

Workpaper Attachments - 840P

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Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Policies and Procedures

• Does the policy include criteria for the purchase, sale and retention of interests in closely-held businesses?
• Are procedures set forth for monitoring any transactions between the savings association (including its employees and affiliates), trust department and the business?
• Are circumstances described where attending stockholders' meetings of companies is required or desirable (i.e., those relating to management)?
• Are policies for the representation by trust department officers on the boards of companies set forth?
• Does the policy address the extent of control to be exercised over the management of companies in which the trust department has sole or majority voting control, as well as other proxy voting responsibilities?
• Do the policies consider circumstances where the company should be sold as a going concern vs. continued retention?

Management Qualifications

• Does management have appropriate training or experience in operating closely-held business interests?
• Does management have knowledge and experience in the industry in which the business operates?
• For outside agents, are the qualifications of the agent thoroughly reviewed?
• Does a detailed, written agreement exist between the trust department and the agent?
• Are the fees paid to outside agents commensurate with the requirements of the agreement?

Documentation

• Is there proper authorization for purchasing or retaining any closely-held interest, either in the governing instrument or other specific authorizations?
• Is there adequate financial and/or other information regarding the market in which the closely-held companies operate?
• Is information reviewed, at least annually, of the company’s financial condition and results of operations?
• Are audit report results reviewed?
• Is other information that may be relevant maintained, such as insurance coverage or partnership agreements?

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Disposition/Liquidation

• Is the decision to dispose of or liquidate the business interest properly authorized by the governing instrument?
• Has management thoroughly analyzed the propriety of disposition or liquidation and is the decision consistent with the account objectives?
• Have appropriate valuation techniques been utilized to set sale prices?
• Has management taken steps to maximize the value of the business interest?

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