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15 August 2012

Courier #56-20-45
Mr. Vance Holloman
Deputy State Treasurer
State and Local Government Finance Division
Department of the State Treasurer
325 North Salisbury Street
Raleigh, NC 27603-1385

Re: Advisory Letter - - Local Government Assets Held in Commercial Bank Safekeeping Accounts

Dear Mr. Holloman:

This will respond to your amended request to me for an advisory letter regarding a safekeeping arrangement being offered by Wells Fargo Bank, N.A., to local units of government in the State of North Carolina. In particular, you asked the following questions:

(1) Are local government assets held in a safekeeping account by a commercial bank authorized to do business with North Carolina local governments as secure as those held in the trust department of a bank authorized to do business in this State? If so, what specific elements need to be present in the safekeeping agreement in order to provide the highest level of security over those assets?

(2) Are the assets held in a safekeeping account that meet the criteria of the first question protected from the creditors of the bank or brokerage firm should either party fail?

(3) Is the safekeeping and security of an investment improved by the investment being held in the name of the unit of government? Conversely, if the investment is not held in the unit's name, does this pose a greater risk to the unit of government?

General Observations.

Very generally, a safekeeping arrangement is an agency account managed by a trustee for holding securities. Typically, a bank, acting as an agent, may receive and hold stock certificates and other securities in its vault to be returned at the request of the owner. Safekeeping accounts require a bank to maintain an itemized record of property in its possession and to issue a receipt for the securities held (referred to as a "safekeeping certificate" evidencing ownership of the security). A safekeeping arrangement is somewhat different from a "custody arrangement" in which a bank buys, sells and receives securities when instructed.[1]

A safekeeping arrangement is in practice a bailment which is created upon the delivery of personal property by the bailor (the owner) and the acceptance of that delivery by the bailee (the safekeeping agent).[2] Unless the bailment is coupled with an agency or trust, it is not a fiduciary relationship.[3] Under a bailment, title to the property remains vested in the owner and is not subject to the claims of a creditor of the bailee.

Banks Offering Safekeeping Services.

Traditionally, safekeeping services, which may also be provided in conjunction with a custody account, are managed in the trust department of a bank for two reasons. First, trust departments are more likely to have accounting systems in place to identify and account for the property, and second, the assets held and managed by a bank in its fiduciary capacity are held separate and apart from the assets of the bank. While our research into the matter consistently presented safekeeping arrangements as a service offered in the trust department of a bank, I did not find anything that expressly prohibited safekeeping services from being offered through the commercial department of a bank. In fact, the North Carolina "Multistate Trust Institutions Act" expressly provides that "[r]eceiving, holding, administering or distributing real or personal property for or on behalf of another person solely incidental to [a] lawfully conducted

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[1] THOMAS P. FITCH, BARRON'S DICTIONARY OF BANKING TERMS 402 (Dr. Irwin L. Kellner, et al. eds., 4th ed. 2000).

[2] 4 STRONG'S NORTH CAROLINA INDEX, 41 (___ ed. 2011).

[3] CHARLES E. ROUNDS, JR. & CHARLES E. ROUNDS, III, LORING AND ROUNDS: A TRUSTEE'S HANDBOOK (2012).

activity or transaction," does not require a trust license, charter or approval.[4] One may reasonably conclude that this exception to the requirement for a trust license or trust charter allows a bank doing business in this State to conduct safekeeping services in its commercial department.

The Comptroller of the Currency, the administrator of national banks, may grant a national bank the authority to "act as trustee, executor, administrator registrar of stocks and bonds, guardian of estates, assignee, receiver, committee of estates of [incompetents], *or any fiduciary capacity in which State banks, trust companies or other corporations which come into competition with national banks are permitted to act . . . .*" so long as it is not contrary to state law.[5] In other words, if banks and trust companies in North Carolina are authorized to perform named services, "the exercise of such powers by national banks would not be contrary to State or local law."[6] Further, the North Carolina "State Trust Company Charter Act" permits a State trust company to act as a "custodian," and as a "safekeeping agent."[7] In that a trust company chartered in North Carolina may engage in safekeeping services, so may a national bank doing business in this State.

As is pointed out in the Comptroller's Assets Management publication on custody services, a custodial bank is responsible for maintaining the safety of custodial assets held in physical form at one of the custodian's premises, a sub-custodian facility, or an outside depository. A custodian's accounting records and internal controls should ensure that assets of each custody account are kept separate from the assets of the custodian and maintained under joint control. National banks may hold assets off-premises if they maintain adequate safeguards and controls, and if such care is consistent with applicable law.[8] The G-30 marketplace settlement goal of T+1 will make it virtually impossible for bank custodians to hold marketable securities in physical form. A custodian will not be able to remove a certificate from a vault and ensure delivery to the broker in time for settlement.[9]

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[4] N.C. Gen. Stat. § 53-304(13) (2011).

[5] 12 U.S.C. § 92a(a) (emphasis added).

[6] 12 U.S.C. § 92a(b).

[7] N. C. Gen. Stat. § 53-333(b)(2).

[8] COMPTROLLER OF THE CURRENCY ADM'R OF NAT'L BANKS, CUSTODY SERVICES: COMPTROLLER'S HANDBOOK 15 (2002).

[9] *Id.* G-30 is an abbreviation for the "Group of Thirty" a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia which has developed, among other things, standards for securities trading. One goal of the organization is clearing a securities trade (T) in one day, or T + 1. *See also*, GROUP OF THIRTY CONSULTATIVE GROUP ON INTERNATIONAL ECONOMIC AND MONETARY AFFAIRS, INC., www.group30.org (last visited May 24, 2012).

The majority of securities are now held in "book entry form," an electronic entry on the records of a private depository or, in the case of U.S. government securities, a Federal Reserve Bank, rather than paper form. It is thought that book entry securities are less vulnerable to theft, cannot be counterfeited, and do not require accounting or recording by certificate numbers. Further, the security owner does not have to worry with clipping coupons to collect bond interest payments.[10]

The Wells Fargo Bank, N.A., Safekeeping Agreement.

In your amended request, you provided to me a standard Wells Fargo Bank, N.A. ("Wells " or "Bank") Safekeeping Agreement (hereinafter the "Wells Agreement" or "Agreement") which, as I understand it, would be used by a unit of local government to open a safekeeping account with the Bank. The Agreement does not specify whether the safekeeping service will be provided within the commercial or trust department of the bank. But, for the reasons expressed above, this is, in my opinion, immaterial as I have not found anything to prohibit a bank from offering safekeeping services through its commercial department.

Section 1 of the agreement clearly provides that Wells will act as safekeeping agent for "certain securities of the customer (i.e., a unit of local government) "together with the income, proceeds and profits" arising from the securities. Section 2 defines the services that will be offered. Consistent with any safekeeping arrangement, these services are ministerial in nature and provide for: (i) receiving and delivering cash and securities (2.1 and 2.7); (ii) acting upon directions from the unit of government, or designated investment managers or agents, and settling securities transactions (2.2 and 2.3); (iii) collecting and investing income (2.4 and 2.6); (iv) presenting for payment maturing securities or securities called for redemption (2.5); (v) delivering proxy and other material and clarifying that Wells has no voting authority (2.8); (vi) account summaries (2.10); and, (vii) bond call information (2.11). Perhaps most important among these is that the Wells Agreement confirms that it will hold securities "by nominee or through third party depositories" meaning a third party agent such as Depository Trust Company. This is to be expected in view of current securities trading practice goals described by G-30 (referenced above).

Sections 4 and 5 require Wells to disclose shareholder information and to provide full information on securities transactions in accordance with Securities and Exchange Commission rules and regulations. Section 6 is a *pro forma* indemnity agreement from

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[10] FITCH, *supra* note 1, at 64.

any losses, expenses and damages for acting as agent under the agreement except liability, losses, claims, damages or expenses by reason of negligence, malfeasance, violation of applicable laws or regulations or alleged fraud on the part of the Bank. The Bank is not responsible for actions or failures to act or for errors of judgment made in good faith. Section 7 provides for fees in accordance with the Bank's schedule of compensation at the time it performs its duty, and Section 8 confirms that the Securities Investor Protection Corporation ("SIPC") does not insure securities held in the safekeeping account to this agreement. The SIPC covers losses, up to the maximum stated limit and under the prescribed circumstances, for a failed or financially troubled brokerage firm, not a bank.

Finally, Sections 9 through 17 are essentially boiler-plate contract provisions with Section 15 specifying that the provisions of the Agreement are enforceable under Minnesota law. The Agreement incorporates by reference an addendum which provides for use of automated and non-automated cash investments (sweep funds) plus a disclosure, required by most states, that the Bank may use money market mutual funds (for which it may be paid a fee by the fund to advise) as a short term money market investment.

The Wells Fargo Safekeeping Agreement is straight forward and customary in the banking business. Most of the provisions are designed to comply with federal banking and securities laws and regulations.

Conclusions.

Based on the general legal principles governing a safekeeping agreement, and the Wells Safekeeping Agreement in particular, there is no reason to conclude that local government assets would be any less secure if held in a safekeeping account within the commercial department of a bank provided that: (1) these assets are held separate and apart from bank assets; and (2) the same can readily be identified and accounted for as local government assets. Holding safekeeping assets separate and identifying those assets as those of a particular customer is required by federal banking regulations.[11] See also, Section 2.1 and 2.10 of the Wells Safekeeping Agreement.

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[11] See, Note 8.

With regard to your second question, local government assets held by the bank in safekeeping are not assets of the bank; thus, they are not subject to the claims of the bank's creditors. Again, as a protection to the local unit of government, the bank's records should clearly identify investments as assets of a local government unit and the same should be held separate from assets of the bank. In my opinion, this would hold equally true for a non-bank brokerage firm. Again, separation and identification are federal banking regulatory requirements.

Finally, with regard to your third question, as noted above, it will become increasingly difficult to hold marketable securities in paper form and as suggested, the latter may pose the greater risk of loss, theft or counterfeiting. The norm has become and will continue to be holding marketable securities in book entry form. Again, if assets are held in paper form, there needs to be vault receipts and/or accounting records to identify assets as those of a particular unit of local government. While there is always some inherent risk in electronic transactions (for book entry form), records of the transaction by way of accounting/brokerage statements with appropriate descriptions, would validate proof of ownership and should protect the interest of the local unit of government.

The Wells Safekeeping Agreement requires securities to be held "by nominee or through third party depositories" all of which are permitted by federal banking regulations. There is no reason to conclude that Wells would not follow the requirements of federal banking and securities laws and regulations of requiring that assets in a safekeeping agreement be held separate from banks assets and to identify those investments as belonging to a customer and not the bank.

I trust this responds to your inquiries of our office. If I may be of further assistance, please let me know. This is an advisory letter based on the information you provided to us. It is not been prepared in accordance with the procedures for a formal opinion from the Office of the Attorney General.

With best regards, I am

Sincerely yours,

L. McNeil Chestnut
Special Deputy Attorney General