

# Managing Fiduciary Risk Associated With the Administration of Complex Financial Instruments and Structures in Fiduciary Accounts

**Financial institutions have made loans available to customers with immediate liquidity requirements who invested in auction rate securities through them and, in some cases, have purchased auction rate securities from customer accounts at par value.**

SUZANNE L. SHIER

**F**inancial institutions that act in a fiduciary capacity face increasing challenges in connection with the administration of complex financial instruments and structures in fiduciary accounts. Recent experience with auction rate securities in fiduciary accounts is a sobering reminder of the risks associated with the management of such investments. Hedge fund products are another example of increased complexity in fiduciary account administration, as over the past 30 years the hedge fund industry has grown to an estimated 8,000 funds with approximately \$2 trillion in assets and many fiduciaries have expanded their asset allocations to hedge funds.<sup>1</sup> This article discusses the

recent experience with auction rate securities in fiduciary accounts as a type or example of considerations germane to investment in any complex financial instrument, product or structure in a fiduciary account.

## **BRIEF HISTORY OF AUCTION RATE SECURITIES**

An auction rate security typically refers to a debt instrument (corporate or municipal bonds) with a long-term nominal maturity for which interest is regularly reset through a “dutch” auction (typically every seven to 35 days). In the auction, broker-dealers submit bids on behalf of potential buyers and sellers of the bonds. Based on the submitted bids, the auction agent sets the interest rate for the next period at the lowest rate at which all bids to purchase will be filled. A failed auction occurs if the auction fails to produce purchasers for all sellers at an interest rate that is at or below the maximum interest rate for the auction rate security.<sup>2</sup>

<sup>1</sup> The Asset Managers’ Committee to the President’s Working Group on Financial Markets issued Best Practices for the Hedge Fund Industry and the Investors’ Committee to the President’s Working Group issued Principles and Best Practices for Hedge Fund Investors on April 15, 2008. The Investors’ Committee report includes a Fiduciary Guide which provides guidelines for evaluation of the appropriateness of hedge funds as a component of an investment portfolio. The full reports can be found at [www.amaicmte.org](http://www.amaicmte.org).

*Suzanne L. Shier is a partner in the Chicago office of Chapman and Cutler LLP ([www.chapman.com](http://www.chapman.com)), a national finance firm. Ms. Shier works in the firm’s Trusts and Estates Department and concentrates her practice on the representation of corporate fiduciaries and estate planning.*

<sup>2</sup> Illiquidity issues have also arisen with respect to auction rate preferred stock. Auction rate preferred stock is preferred stock in which the dividend rate is reset periodically (typically every seven to 28 days), pursuant to an auction rate-setting process designed to produce the minimum dividend rate necessary to enable all interested sellers to sell the preferred stock at a price equal to the par amount of the applicable “liquidation preference,” plus accrued but unpaid dividends. A “failed” auction occurs if the auction fails to produce buyers for all interested sellers at a dividend rate that is at or below the maximum dividend rate specified by the terms of the auction rate preferred stock. Auction rate preferred stock generally is perpetual.

Auction rate securities were introduced in 1988. By early 2008, the auction rate securities market had grown to over \$200 billion. Due to the recent turmoil in the credit markets, resulting in a lack of purchasers at auction, auction markets experienced broad failures in February 2008, which have been ongoing. Thus, the historic liquidity provided by the auctions ceased to exist for many issues and holders of these auction rate securities have been unable to dispose of their securities. Certain municipal and student loan auction rate securities have proven to be particularly illiquid.

Although there were not widespread failures in the auction markets until February 2008, Securities and Exchange Commission investigations of certain broker-dealers were initiated in 2004, resulting in a consent decree with a number of broker-dealers on May 31, 2006.<sup>3</sup> Auction failures began in the summer of 2007 and increased in late 2007. On February 13, 2008, 87% of all auction rate securities auctions failed when major broker-dealers withdrew their support of the auctions, due in part to their high levels of inventory. Reporting of auction failures in the financial media appeared in the late summer of 2007 and continues to appear regularly along with reports of enforcement actions and investor litigation against financial institutions.

## ENFORCEMENT ACTIONS AND LITIGATION

Government agencies and private investors have initiated a number enforcement actions and lawsuits against financial institutions with respect to auction rate securities.<sup>4</sup> The claims generally revolve around deceptive sales practices and conflicts of interest.

<sup>3</sup> The SEC order found that between January 2003 and June 2004, the 15 broker-dealer firms it had initiated proceedings against engaged in one or more practices that were not adequately disclosed to investors in violation of Section 17(a)(2) of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. 77q. The violative conduct included allowing customers to place open or market orders in auctions; intervening in auctions by bidding for a firm's proprietary account or asking customers to make or change orders in order to prevent failed auctions, to set a "market" rate or to prevent all-hold auctions; submitting or changing orders, or allowing customers to submit or change orders after auction deadlines; not requiring certain customers to purchase partially filled orders even though the orders were supposed to be irrevocable; having an express or tacit understanding to provide certain customers with higher returns than the auction clearing rate; and providing certain customers with information that gave them an advantage over other customers in determining what rate to bid.

<sup>4</sup> Formation of a multi-state task force on auction rate securities was announced by the North America Securities Administrators Association (NASAA) in April 2008. Florida, Georgia, Illinois, Massachusetts, Missouri, New Hampshire, New Jersey, Texas, and Washington securities enforcement agencies are among the members of the task force. The Enforcement Section of the Massachusetts

These claims have been made under state and federal securities laws and include:

- *Failure to provide financial advisers with appropriate training.* Financial advisers did not receive training on auction rate securities other than marketing information provided for customers.
- *Lack of suitability.* Representations were made that auction rate securities were suitable for investors with relatively modest amounts of available cash and short periods in which to invest.<sup>5</sup>
- *Failure to disclose material facts.* Financial advisers knew but failed to disclose that auction rate securities were not cash alternatives, but rather were long-term financial instruments with 30- and 40-year maturity dates; liquidity at the time of sale was due to broker-dealers' support of the auction markets; and illiquidity in the auction markets was imminent upon broker-dealers ceasing to maintain the markets.
- *Dissemination of materially false and misleading information.* Financial advisers knew that statements and information disseminated to investors were materially false and misleading and knowingly and substantially participated in or acquiesced to such issuance and dissemination in violation of securities laws. Financial advisers were privy to confidential proprietary information concerning the auction rate securities market, giving rise to participation in fraudulent schemes.
- *Conflicts of interest and incentive to misrepresent nature of auction rate securities markets.* Financial advisers were motivated to materially misrepresent the nature of the auction rate securities markets to attract new investors, dispose of inventory of auction rate securities and continue collecting fees for management of auction rate securities auctions on behalf of

Securities Division of the Office of the Secretary of the Commonwealth of Massachusetts was the first state agency to commence an enforcement action with its administrative complaint filed in June 2008 against UBS Securities, LLC, and UBS Financial Services, Inc., based on M.G.L. c. 110A of the Massachusetts Uniform Securities Act. Andrew M. Cuomo, Attorney General of the State of New York, quickly followed suit with its complaint against UBS Securities, LLC, and UBS Financial Services, Inc., based upon the Martin Act and Executive Law § 63(12). Class action litigation against numerous broker-dealers has been brought under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. 78j(b) and 78t(a), and Sections 11 and 12(a)(2) of the Securities Act, 15 U.S.C. 77k and 771(a)(2).

<sup>5</sup> Of note in this regard is that money market funds cannot hold auction rate preferred stock because it lacks the requisite liquidity features necessary to enable it to qualify as an eligible security for purchase by such funds under the SEC's Rule 2a-7, 17 CFR 270.2a-7, issued under the Investment Company Act of 1940.

issuers. Key executives sold personal holdings at times when sales to investors were being promoted.

Remedies sought include orders to cease and desist further violations of applicable laws, required offers to rescind sales of auction rate securities at par value (or restitution of investors who already sold instruments below par value), censure, and administrative fines. According to company financial filings, the top five auction rate securities underwriters expended \$2.19 billion on auction rate security purchases and liquidity programs in the third quarter of 2008 and substantial fines have been imposed on certain broker-dealers.

### **REGULATORY LIMITATIONS AND APPLICABLE LAWS**

The regulatory limitations and applicable laws with respect to auction rate securities held in accounts at financial institutions depend on the type of account in which the securities are held and the type of financial institution at which the accounts are held. Auction rate securities are held in various types of accounts including revocable trusts; irrevocable trusts; individual retirement trusts; charitable trusts; and estate, guardianship, investment management (sole authority, shared authority and open architecture), brokerage and custody accounts, which may be broadly categorized as either fiduciary accounts or non-fiduciary accounts. The accounts are held at banks regulated by the Office of the Comptroller of the Currency or state bank regulators and at regulated investment advisers and broker-dealers regulated by the SEC and the Financial Industry Regulatory Authority.

The OCC considers trust, estate, guardianship, and discretionary investment management accounts (including open architecture accounts) “fiduciary” relationships, whereas it does not consider non-discretionary brokerage and custody accounts as fiduciary. Similarly, the SEC considers investment advisory accounts as fiduciary in nature, but not directed brokerage accounts. The nature of the legal risk associated with a particular

account depends in large part upon whether or not the account is considered a fiduciary relationship.<sup>6</sup>

“Reg. 9,” 12 CFR 9, which applies to national banks that act in a fiduciary capacity, requires that fiduciary accounts be invested in accordance with applicable law<sup>7</sup> and that a bank acting in a fiduciary capacity not engage in self-dealing or conflicts of interest.<sup>8</sup> Fiduciary accounts are to be reviewed at least annually<sup>9</sup> and annual or continuous audits of fiduciary activities by a fiduciary audit committee are required.<sup>10</sup> Reg. 9 provides further that a bank acting in a fiduciary capacity may charge a reasonable fee.<sup>11</sup> Reg. 9 does not create fiduciary law, but instead refers to substantive applicable laws.

**Trustees, Executors, and Guardians.** Under the common law a trustee has a duty of prudent investment,<sup>12</sup> a duty of loyalty (which includes a duty to avoid conflicts of interest), a duty of impartiality (which includes a duty to be impartial in the treatment of multiple similarly situated trusts), a duty to account and a duty to inform. These duties apply to executors and guardians as well.

The Prudent Investor Rule as adopted in many states provides that the trustee has a duty to invest and manage trust assets as a prudent investor would, considering the purposes, terms, distribution requirements, and other circumstances of the trust. This standard requires the exercise of reasonable care, skill and caution and is to be applied to the investments not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy

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that should incorporate risk and return objectives reasonably suitable to the trust. No specific investment or course of action is, taken alone, prudent or imprudent. The trustee may invest in every kind of property and type of investment, subject to the rule.

<sup>6</sup> Under the common law, trusts, estates and guardianships are considered fiduciary relationships. In its regulatory standards that apply to the fiduciary activities of a national bank, the OCC defines a “fiduciary account” as an account administered by a bank in a “fiduciary capacity” and broadly defines “fiduciary capacity” to mean an account administered by the bank as trustee, executor, administrator, guardian, and investment advisor, if the bank receives a fee for its investment advice or where the bank possesses investment discretion on behalf of another. 12 CFR 9.2(d), (e). The OCC defines a bank as having “investment discretion” when it has sole or shared authority to determine what securities or assets to purchase or sell on behalf of the account. 12 CFR 9.2(i). See also the Investment Advisers Act of 1940 (“Advisers Act”) §206, 15 U.S.C. 80b-6.

<sup>7</sup> 12 CFR 9.11.

<sup>8</sup> 12 CFR 9.12.

<sup>9</sup> 12 CFR 9.6; OCC Bulletin 2008-10 (March 27, 2008).

<sup>10</sup> 12 CFR 9.9.

<sup>11</sup> 12 CFR 9.15.

<sup>12</sup> Restatement 3d, Trusts §90 (Prudent Investor).

The trustee's investment decisions and actions are to be judged in terms of the trustee's reasonable business judgment regarding the anticipated effect on the trust portfolio as a whole and the facts and circumstances prevailing at the time of the decision or action. The Prudent Investor Rule is a test of conduct and not of resulting performance. The trustee has a duty to pursue an investment strategy that considers both the reasonable production of income and safety of principal, consistent with the trustee's duty of impartiality and the purposes of the trust. The trustee also has a duty to incur only reasonable and appropriate costs.

Permissible investments for an estate typically include those permitted for trusts, but may be affected by the limited period for administration of an estate and liquidity requirements to pay estate obligations, including taxes. Permissible investments for guardianships are defined by statute.

The duty of impartiality requires a fiduciary to treat beneficiaries equitably in light of the purposes and terms of the trust and to treat multiple fiduciary accounts equitably. By way of example, if a trustee determines that it has made an imprudent investment of a particular security in two separate trusts, and it has the opportunity to sell only one-half of the aggregate position, it should sell half of each trust's position, rather than all of one of the trusts' position.

The duty to account and the duty to inform are closely related. Both require that the beneficiary receive adequate information to protect the beneficiary's interests. Accounts for guardianships are subject to periodic review and approval by the court.

**Investment Advisers.** Regulated investment advisers are subject to the requirements of the Advisers Act and have additional fiduciary duties derived from

investment advice; a duty to ensure that its investment advice is suitable to its client's objectives, needs and circumstances; a duty to refrain from effecting personal securities transactions inconsistent with client interests; and a duty to be loyal to clients.<sup>14</sup> The fiduciary determination of whether an investment is suitable involves an assessment of the client's economic status, including financial obligations, income, and other investments, and the client's tax situation (typically documented in an investment policy statement). Updates are to be made at least annually and may be required upon material changes in a customer's circumstances.

**Non-Discretionary Broker.** In contrast to a trustee, executor, or guardian, and an investment adviser, a non-discretionary broker-dealer is not considered to have a fiduciary relationship with its customers. Rather, the duties that are applied to a broker-dealer arise out of the anti-fraud provisions of the Exchange Act. Such provisions generally prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities. In light of this broad prohibition, the SEC has adopted several rules and policies limiting the activity of broker-dealers. Specifically, a broker-dealer must have an "adequate and reasonable" basis for any recommendation that it makes. Such suitability standard requires a broker-dealer to investigate and obtain adequate information about the security it is recommending. Additionally, a broker-dealer has a customer-specific suitability requirement that places an obligation on it to learn its customer's financial situation, needs and other securities holdings on an ongoing basis. Although a broker-dealer must take reasonable "know-your-customer" steps prior to making recommendations, there is no requirement that a broker-dealer continue monitoring past advice. A broker-dealer's general duty of fair dealing with customers requires a broker-dealer to execute orders promptly, disclose certain material information, charge prices reasonably related to the prevailing market and fully disclose any conflict of interest. Unlike an investment adviser that is prohibited from engaging in activities that involve a conflict of interest, a broker-dealer is merely obligated to gain prior informed consent from the customer.

**The suitability standard requires a broker-dealer to investigate and obtain adequate information about the security it is recommending.**

the common law. Many similar requirements pertain to the investment advisory activities of a bank. An investment adviser is prohibited from engaging in fraudulent, deceptive, or manipulative conduct.<sup>13</sup> An investment adviser has an affirmative duty to act solely in the best interest of the client and to make full and fair disclosure of all material facts. The fiduciary duties of an investment adviser include a duty to have a reasonable, independent basis for its

<sup>13</sup> Advisers Act §206, 15 U.S.C. 80b-6.

<sup>14</sup> See *In re Alfred C. Rizzo*, Investment Advisers Release No. 897 (January 11, 1984); *In re John G. Kinnard and Co.*, SEC No-Action Letter, 1973 WL 11848, Fed. Sec. L. Rep. (CCH) ¶ 79,662 (November 30, 1973); Investment Advisers Act Release No. 203 (August 11, 1966); Investment Advisers Act Release No. 40, 1945 WL 5321 (February 5, 1945); Investment Advisers Act Release No. 232, 1968 WL 4015 (October 16, 1968).

**Custodian.** A custodian typically is responsible for the settlement, safekeeping and reporting of customer securities and cash. The custody relationship is contractual and is essentially a directed agency. Custody is not considered a fiduciary capacity. The OCC establishes minimum recordkeeping and confirmation requirements for securities transactions handled in custody accounts of national banks.<sup>15</sup>

## MANAGING LEGAL, COMPLIANCE, AND REPUTATION RISKS

There are a number of related and derivative issues to consider in formulating a financial institution's response to a sudden change in circumstances with respect to a particular type of investment held in customer accounts such as the widespread interruption in the auction rate securities market, which occurred in February 2008. There are legal, compliance, and reputation risks to consider.

**Assessing the Legal Risk.** Assessing the extent of potential legal exposure requires gathering complete and accurate information regarding business practices with respect to the investment at issue. This includes an assessment of the training and whitepapers provided to investment professionals, a review of the information provided to customers regarding the investment, a determination of how the investment was categorized and valued on account statements and a determination of how fees were charged with respect to the account. The assessment of business practices should take into account the timeline of developments with respect to market conditions and other factor affecting the investment and the extent to which such developments were reflected in training, whitepapers customer communications, asset purchase screening and periodic account reviews.

In addition to assessing general business practices, assessing the extent of potential legal exposure requires an account level review of accounts holding the affected security. Such review should include a determination of whether the investment objectives, needs and circumstances of the customer were appropriately documented. In the case of a trust, estate, or guardianship, a determination should be made as to whether the purposes, terms, distribution requirements and other circumstances of the trust, estate or guardianship were appropriately documented. Any issues with respect to whether the investment met the applicable investment standard (i.e., suitability

or prudence) at the time the investment was made should be identified. In addition, any issues with respect the decision to retain the asset in accounts where the fiduciary has an ongoing duty to review investments should be identified. Information which was known or reasonable should have been known about market conditions and material changes in market conditions affecting the investment should be noted. If an investment was purchased at the express direction of the customer, such direction also should be noted.

All potential conflicts of interest associated with the acquisition and retention of the investment should be identified and fully explored. The activities of key executives with respect to their personal holdings of the investment should be determined. In addition, any third party reporting obligations should be considered, such as the reporting of individual retirement account values to the Internal Revenue Service for purposes of the computation of required minimum distributions and judicial accountings in the case of guardianships.

**Structuring Remedies.** In considering potential remedies to be made available to customers, the financial institution should take into account any applicable duty of impartiality among all of its affected customers, any conflicts of interest associated with implementing remedies to be made available to its customers and any tax consequences associated with the remedies to be made available to its customers. In the case of auction rate securities, many financial institutions have made loans available to customers with immediate liquidity requirements and purchased auction rate securities from customer accounts at par value.

Implementing a financial institution's response to issues with respect to investment in auction rate securities or in any similar situation should also address the administrative aspects of such implementation, including provision for centralized reporting of customer inquiries and provision of information to employees regarding the affected investment generally and the procedure for responding to customer inquiries.

**Conflicts of Interests.** Conflicts of interest are of particular concern in connection with any offer by a financial institution to purchase assets from a fiduciary account. Where a financial institution is a fiduciary for an account a purchase generally may not be made by the institution in its corporate capacity unless the purchase is authorized by the governing instrument

<sup>15</sup> 12 CFR 12.

or applicable law.<sup>16</sup> Self-dealing asset purchases are not commonly authorized by governing instruments. Thus, the question becomes whether the applicable law authorizes the purchase.

State trust, estate and guardianship common law and statutes typically govern trust, estate and

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guardianship accounts where the financial institution is acting as the fiduciary for the account and is the legal title holder of the asset (e.g., as trustee, executor or guardian). State agency common law typically governs investment management and discretionary investment management accounts.

For revocable trusts and individual retirement trusts where the grantor or settlor is living and competent, a trustee typically may engage in a transaction that is otherwise prohibited due to a conflict of interest if the settlor or grantor (1) knows of the conflict and (2) specifically authorizes the transaction. The informed consent and direction of the grantor or settlor should be obtained prior to any purchase by a financial institution from such a trust account of which it is acting as trustee. The financial institution should refer the settlor or grantor to other financial and/or legal advisers for advice regarding the granting of the consent and direction and should refrain from providing such advice itself.

Under the laws of many states in an agency relationship, such as an investment management account, the agent can enter into a transaction on behalf of the principal which is a conflict of interest if the principal (1) has knowledge of the conflict, and (2) authorizes the transaction.<sup>17</sup> Thus, the informed consent and

<sup>16</sup> 12 CFR 9.12(b) provides that a national bank may not lend, sell or otherwise transfer assets of a fiduciary account for which it has investment discretion to the bank or any of its directors, officers or employees, or to individuals or organizations with whom there exists an interest that might affect the best judgment of the bank, unless (1) the transaction is authorized by applicable law; (2) legal counsel advises the bank in writing that the bank has incurred, in its fiduciary capacity, a contingent or potential liability, in which case the bank, upon the sale or transfer of the assets, shall reimburse the fiduciary account in cash at the greater of book or fair market value of the assets; (3) as provided in 12 CFR 9.18(b)(8)(ii) with respect to the purchase of defaulted assets in collective investment funds; or (4) required in writing by the OCC.

<sup>17</sup> Restatement (Third) of Agency § 8.06 (2006).

direction of the customer should be obtained prior to any purchase from a discretionary investment account. As in the case of a revocable trust, the financial institution should refer the customer to his or her other financial and/or legal advisers for advice regarding the granting of any such consent and direction and should refrain from providing such advice itself.

For irrevocable trusts, if there are co-trustees or trust advisers other than the financial institution with the authority to authorize and/or direct the sale of the affected investment to the financial institution, the purchase of the investment will not be considered a conflict of interest. If the transaction cannot be effected without the participation of the financial institution in its fiduciary capacity as the seller, a determination should be made as to whether a binding non-judicial beneficiary agreement may be entered into, authorizing the conflict.<sup>18</sup>

For non-fiduciary accounts such as non-discretionary brokerage accounts any purchase should only be made at the direction of the customer.

## TAX CONSIDERATIONS

Revenue Procedure 2008-58<sup>19</sup> provides guidance regarding the treatment of taxpayers receiving settlement offers relating to auction rate securities. This Revenue Procedure applies to taxpayers who, before June 30, 2009, receive settlement offers generally with respect to auction rate securities, which by their terms are not redeemable on a fixed date (or, if they are, the redemption date is at least two years later than the end of the window period of the settlement offer) that (1) include window periods that do not extend beyond December 31, 2012, and (2) require that the taxpayer deliver an auction rate security that the taxpayer purchased on or before February 13, 2008.

For taxpayers within the scope of Revenue Procedure 2008-58, the Internal Revenue Service will not challenge (1) the position that the taxpayer continues to own the auction rate security upon receiving or accepting (or “opting into”) the settlement offer (but not after tendering the security), (2) the position that the taxpayer does not realize any income as a result of receiving or accepting (or “opting into”) the settlement offer and does not reduce the basis of the

<sup>18</sup> Section 111 of the Uniform Trust Code adopted in many jurisdictions provides that interested persona may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust.

<sup>19</sup> Rev. Proc. 2008-58, 2008-41 IRB—856 (September 24, 2008).

auction rate security from its original purchase price, or (3) the position that the taxpayer's amount realized from the sale of the auction rate security during the window period to the person offering the settlement is the full amount of the cash proceeds received from that person.

In the case of charitable trusts and foundations exempt from income tax of which the financial institution is a trustee or director, consideration should be given to the private foundation federal excise tax rules, which prohibit "self-dealing" transactions between a disqualified person, such as a trustee or director, and the charitable trust or foundation.<sup>20</sup> Under the private foundation federal excise tax rules, if a financial institution acting as a trustee or director purchases assets from the charitable trust or foundation, it will be subject to an initial 10% excise tax

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<sup>20</sup> IRC Section 4941 imposes an excise tax on "self-dealing," which includes "any direct or indirect sale or exchange, or leasing, of property between a private foundation and a disqualified person."

on the fair market value of the asset purchased and a secondary 200% excise tax on the fair market value of the asset purchased unless the sale is corrected, i.e., rescinded.

## CONCLUSION

Financial institutions face increasing competitive pressures in providing wealth management services generally and in the administration of increasing complex financial investments and structures in fiduciary accounts in particular. Due diligence prior to making particular investments is central to risk management and requires a thorough understanding of the risks and rewards of the investment. Ongoing monitoring of quixotic market conditions to assess whether the investment continues to meet investment objectives is key. Where sudden changes occur in market conditions such as with the freezing of the auction rate securities market, consideration should be given not only to legal risks, but also to reputation risks and compliance risks in formulating responses to customer concerns. ■



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