

Custodial or Safekeeping Agreements

Specific requirements related to an insurance company's utilization of systems for holding and transferring securities are included in the NAIC's *Model Act on Custodial Agreements and the use of Clearing Corporations* (Model # 295) and the NAIC's *Model Regulation on Custodial Agreements and the use of Clearing Corporations* (Model #298). When conducting financial examinations, the custodial or safekeeping agreements should be considered and evaluated with this guidance.

1. An insurance company may, by written agreement, provide for the custody of its securities with a custodian. If permitted by the state of domicile, the custodian must either be a broker/dealer that is registered with and subject to jurisdiction of the Securities and Exchange Commission, maintains membership in the Securities Investor Protection Corporation, and has a tangible net worth equal to or greater than \$250,000,000; or a national bank, state bank, or trust company which is adequately capitalized and qualified to accept securities as determined by the standards adopted by the U.S. banking regulators and regulated by state banking laws or a member of the Federal Reserve system. Custodial agreements shall be authorized by a resolution on behalf of the board of directors or an authorized committee of the insurance company. The agreement should state that certificated securities of the insurance company shall be held separate from all other securities. Those securities held indirectly by a custodian or in a clearing corporation shall be separately identified on the custodian's official records as being owned by the insurance company. Registered custodial securities shall be registered in the name of the company, in the name of a nominee of the company, in the name of the custodian or its nominee, or clearing corporation or its nominee. The securities, other than those held to meet deposit requirements, shall be held subject to the instructions of the insurance company, and shall be withdrawable upon the demand of the insurance company. Confirmation of all transfers should be provided to the insurance company in hardcopy or in electronic format.
2. Custodial or safekeeping agreements with an agent, or clearing corporation meeting the requirements herein should contain satisfactory safeguards and controls, including but not limited to the provisions provided below. For the purpose of this guidance, an agent is a national bank, state bank, trust company or broker/dealer with an account in a clearing corporation, or a member of the Federal Reserve System. A clearing corporation is a corporation as defined in Article 8 of the Uniform Commercial Code that is organized for the purpose of effecting transactions in securities by computerized book-entry, including the Treasury/Reserve Automated Debt Entry Securities System (TRADES) and Treasury Direct book entry securities systems, except those securities issued under the laws of a foreign country.
 - a. The custodian is obligated to indemnify the insurance company for any insurance company's loss of securities in the custodian's custody, except that, unless domiciliary state law, regulation or administrative action otherwise require a stricter standard (Section 2.b. sets forth an example of such a stricter standard), the custodian shall not be so obligated to the extent that such loss was caused by other than the negligence or dishonesty of the custodian;
 - b. If domiciliary state law, regulation or administrative action requires a stricter standard of liability for custodians of insurance company securities than that set forth in Section 2.a., then such stricter standard shall apply. An example of a stricter standard that may be used is that the custodian is obligated to indemnify the insurance company for any loss of securities of the insurance company in the custodian's custody occasioned by the negligence or dishonesty of the custodian's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction;

- c. In the event of a loss of the securities for which the custodian is obligated to indemnify the insurance company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced;
- d. The custodian shall not be liable for any failure to take any action required to be taken hereunder in the event and to the extent that the taking of such action is prevented or delayed by war (whether declared or not and including existing wars), revolution, insurrection, riot, civil commotion, act of God, accident, fire, explosions, stoppage of labor, strikes or other differences with employees, laws, regulations, orders or other acts of any governmental authority, or any other cause whatever beyond its reasonable control;
- e. In the event that the custodian gains entry in a clearing corporation through an agent, there should be a written agreement between the custodian and the agent that the agent shall be subjected to the same liability for loss of securities as the custodian. If the agent is governed by laws that differ from the regulation of the custodian, the Commissioner of Insurance of the state of domicile may accept a standard of liability applicable to the agent that is different from the standard liability;
- f. If the custodial agreement has been terminated or if 100% of the account assets in any one custody account have been withdrawn, the custodian shall provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner;
- g. During regular business hours, and upon reasonable notice, an officer or employee of the insurance company, an independent accountant selected by the insurance company and a representative of an appropriate regulatory body shall be entitled to examine, on the premises of the custodian, its records relating to securities, if the custodian is given written instructions to that effect from an authorized officer of the insurance company;
- h. The custodian and its agents, upon reasonable request, shall be required to send all reports which they receive from a clearing corporation, which the clearing corporation permits to be redistributed including reports prepared by the custodian's outside auditors, to the insurance company on their respective systems of internal control;
- i. To the extent that certain information maintained by the custodian is relied upon by the insurance company in preparation of its annual statement and supporting schedules, the custodian agrees to maintain records sufficient to determine and verify such information;
- j. The custodian shall provide, upon written request from a regulator or an authorized officer of the insurance company, the appropriate affidavits, with respect to the insurance company's securities held by the custodian;
- k. The custodian shall secure and maintain insurance protection in an adequate amount; and
- l. The foreign bank acting as a custodian, or a U.S. custodian's foreign agent, or a foreign clearing corporation is only holding foreign securities or securities required by the foreign country in order for the insurer to do business in that country. A U.S. custodian must hold all other securities.

3. Except as provided below, the examiner shall verify such securities by actual inspection and count and whenever necessary ascertain whether the securities are the specific ones acquired by the company:
 - a. Securities on deposit with state officials need not be counted (provided) if a certificate of verification is secured directly from the custodian or insurance commissioner.
 - b. Where domiciliary state law, regulation, or administrative action does not prohibit the use of custodial arrangements under which actual inspection or count of specific securities acquired is not possible, and the insurance company uses such an arrangement, the examiners shall:
 - Apply the provisions of Sections d. and g. below, in cases where the custodian, under the controlling custodial or safekeeping agreement, is permitted to carry securities indirectly or otherwise commingled form;
 - Apply the provisions of Sections e. and g. below, in cases where the custodian, under the controlling custodial or safekeeping agreement, directly or indirectly participates in the Treasury Reserve Automated Debt Entry Securities System (TRADES) or Treasury Direct system. These systems are computerized programs sponsored by the United States department of the Treasury and certain agencies and instrumentalities of the United States for holding and transferring securities of the United States government and the agencies and instrumentalities, respectively, in Federal Reserve Banks through banks which are members of the Federal Reserve System or which otherwise have access to such computerized systems; and
 - Apply the provisions of Section f. and g. below, in cases where the facilities of a clearing corporation are used, either directly or indirectly through a custodian, under the controlling custodial or safekeeping agreement.
 - c. Securities held by a custodian under other custodial or safekeeping arrangements need not be counted, at the discretion of the examiner-in-charge, if the following criteria are met (provided the domiciliary state laws do not require that such securities be counted and inspected during an examination):
 - Examiners are furnished a copy of the custodial or safekeeping agreements;
 - They are satisfied such agreement has the necessary safeguards and controls;
 - The securities are held by a custodian licensed by the United States or any state thereof, and such custodian is regularly examined by the applicable licensing authority;
 - The securities so deposited are at all times kept separate and apart from other deposit accounts with the custodian, so that at all times they may be identified as belonging solely to the company for which they are held;
 - If such a deposit is not counted, a verification certificate signed by an authorized signatory of the custodian holding the deposit shall be secured by the examiners directly;

- Such certificate shall be in sufficient detail to permit adequate identification of the securities; and
 - Such certificate may be accepted in lieu of actual count provided it meets the above requirements and the examiners are satisfied that the representation thus made is in accordance with the facts.
- d. Where not prohibited by domiciliary state law and if permitted by the terms of the controlling custodial or safekeeping agreement containing satisfactory safeguards and controls, securities held by a custodian that meets the requirements of Section c. above, may be held by the custodian, in bulk as a part of a “jumbo” certificate, or other system under which there is a commingling of securities held in custody. In such cases, the examiners shall:
- Obtain directly from the custodian a certified listing of the securities held as of the date of examination for the account of the insurance company under examination;
 - Obtain a copy of the insurance company’s listing of the securities held by the custodian for the insurance company’s account as of the date of examination; and
 - Match the positions shown on the custodian’s listing to the positions shown on the company’s listing, and reconcile any differences.
- e. Custodians which meet the requirements of Section c. above, and which either are members of the Federal Reserve System or non member banks redepositing securities with a member bank, may, when acting as custodians for insurance companies, use the Treasury/Reserve Automated Debt Entry Securities System (TRADES) or the Treasury Direct book entry securities systems under a written agreement with the insurance company permitting such utilization. In such cases, the examiners shall follow the procedures set forth in Section c. above.
- f. Where not prohibited by domiciliary state law, an insurance company may, under a written agreement, use the facilities of a clearing corporation, either directly or through a custodian, subject to the requirements of Section c. above. In such cases, the examiners shall:
- Obtain directly from the depository if direct deposit is used, or from the custodian if indirect deposit is used, a certified listing of the securities held in the clearing corporation as of the date of examination for the account of the insurance company under examination;
 - Obtain a copy of the insurance company’s listing of its securities held by the clearing corporation as of the date of examination;
 - Match the positions shown on the clearing corporation’s or custodian’s listing to the positions shown on the company’s listing, and reconcile any differences; and
 - Ascertain that the securities are held by a clearing corporation regulated by the Securities and Exchange Commission, the Federal Reserve System, or the banking authorities in its state of domicile.

- g. In carrying out their responsibilities under Section d, e, and f above, it is important that the examiners satisfy themselves as to the integrity of the accounting controls and verification and security procedures of the custodian and/or the clearing corporation, as the case may be. This satisfaction may be obtained by securing the most recent report on the review of the custodian's system of internal controls pertaining to custodian record keeping issued by the respective organization's independent auditors.