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The trust company — an old tool for a new age

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Trust companies in the United States trace their roots back nearly two centuries, to the formation of the United States Trust Company of New York in 1853. Until recently, trust companies were often viewed as staid, perhaps sleepy, institutions that safeguarded "old" wealth. Today, however, innovation in the delivery of financial services, and in the nature of money itself, is creating renewed interest in the trust company charter among financial institutions, asset managers, and fintechs.

What is a trust company?

A trust company is a statutory form of business organization with special powers that conventional business entities like corporations and limited liability companies lack. Trust companies are authorized to act in a fiduciary capacity with respect to their customers' assets. Most other forms of business entity, aside from banks, do not have legal authority to act as a fiduciary. A fiduciary has a legal duty to act in the best interests of its principal (customer), even if doing so is contrary to the fiduciary's own interests. The ability to act as fiduciary is a powerful business advantage for trust companies.

Some states have recently enacted changes to their trust company laws to make them more appealing to certain 21st century financial services providers, such as cryptocurrency businesses.

Trust companies may be formed and are regulated under state or federal law. State-chartered trust companies are typically authorized under provisions of a state's banking law and regulated by the state banking agency. Generally, state-chartered trust companies cannot take deposits — a limitation which distinguishes them from banks. (States that do authorize certain kinds of trust companies to take deposits — for example, Massachusetts — usually also charter a separate form of trust company that cannot take deposits.)

The Office of the Comptroller of the Currency (the OCC) charters and regulates limited purpose national trust banks under federal law. Limited purpose national trust banks are authorized under federal law to exercise fiduciary powers in all states, market their services to customers in all states, and administer assets from any state in a trust.

Historically, trust companies held and safeguarded client assets, such as stocks, bonds, and valuable tangible personal property. Often this would be done by the trust company serving as professional trustee of private trusts for individuals and families. Trust companies also have been used extensively in the asset management industry to form and act as trustee for common trust funds and collective investment trusts. Collective investment trusts are bank-administered, unregistered pooled investment vehicles governed under state law or the regulations promulgated by the OCC, which may hold assets of certain types of retirement plans.

How has trust company law changed to accommodate new business models?

Some states have recently enacted changes to their trust company laws to make them more appealing to certain 21st century financial services providers, such as cryptocurrency businesses. Wyoming created an entirely new type of charter — the special purpose depository institution — designed for institutions that wish to provide custody, assets servicing, fiduciary asset management, and related activities for digital assets.

Additionally, certain banking agencies that supervise and regulate trust companies have taken actions to interpret existing trust company laws in a manner that is favorable to cryptocurrency and other fintech firms. For instance, in 2020 the OCC confirmed that providing custody services for cryptocurrency falls within the longstanding authorities permitting national banks to engage in safekeeping and custody activities, as well as the authority of national banks to perform traditional banking activities by electronic means. This interpretation affects not only national banks, but also state-chartered trust companies that by state parity laws are granted similar authority and powers as national banks.

These legal and regulatory changes underscore the renewed interest in, and the enduring utility of, the trust company charter.

There are numerous examples of cryptocurrency and other fintech firms taking advantage of these legal and regulatory changes. For example, the cryptocurrency exchange Gemini, founded by Tyler and Cameron Winklevoss of Facebook fame, chose to license as a New York limited purpose trust company, choosing a trust company charter over New York's cryptocurrency specific "BitLicense". Similarly, Coinbase established Coinbase Custody Trust Company as

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a New York limited purpose trust company to hold custody of digital assets.

How can a trust company charter be useful?

The primary benefit of the trust company charter is the ability to engage in fiduciary activities and perform related functions. These include acting as a trustee, administrator, agent, custodian, investment manager, escrow agent, or fiscal or transfer agent, and generally holdings, safekeeping, investing, managing, or administering the property of another person.

Trust companies must segregate the assets they hold in a fiduciary capacity from their own assets. These assets are generally protected from a trust company's creditors — a distinct competitive business advantage for trust companies. Further, state and federally chartered trust companies are deemed "qualified custodians" under the custody rule of the U.S. Securities and Exchange Commission, another competitive advantage given that registered investment advisers must place client funds with a qualified custodian.

Fintech companies that wish to engage in the custody and transfer of digital assets are finding that the trust company charter is well-suited for their operations. The traditional activities of a trust company — holding financial assets on behalf of customers — are analogous to certain of the core activities conducted by cryptocurrency exchanges and providers of digital wallet services. Just as trust companies have long been utilized by traditional investment advisers, a fintech offering investment products may wish to use a trust company charter, particularly if its business involves retirement assets.

In addition, organizing as a trust company may allow a fintech to avoid having to itself comply, or having to contract with a bank to comply, with certain laws and regulations. For example, trust companies are exempt under the laws of certain states from state money transmitter licensing requirements.

In this way, trust companies are like banks, which also have fiduciary powers and are exempt from certain legal, regulatory, and licensing requirements that apply to ordinary business entities. Yet the trust company charter is more efficient than the bank charter for organizations that wish only to engage in fiduciary or custody activities.

Nondepository trust companies do not qualify for and have no need for deposit insurance, which avoids the expense of deposit insurance premiums and the need to comply with Federal Deposit Insurance Corporation regulations and oversight. Trust companies do not fall within the definition of "bank" for purposes of the federal Bank Holding Company Act, meaning that the parent company of a trust company is not deemed a bank holding company. Thus, a trust company and its affiliates are not subject to regulation by the Board of Governors of the Federal Reserve, and its affiliates are not generally restricted in the types of activities they may conduct.

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The regulatory and compliance burden on trust companies is thus substantially less than that on banks, as they are typically subject only to one regulator — i.e., the state regulator who chartered them, or in the case of a limited purposed national trust bank, the OCC. Furthermore, while trust companies, like banks, are subject to capital requirements, they are generally less onerous and complicated than those that apply to banks. For example, many states require a set capital amount of few hundred thousand dollars, the amount which is generally established by statute or at the time of the formation of the trust company.

What are some of the limitations of the trust company charter?

Due to the limitations of their charter powers, trust companies are generally not the right choice for a fintech that wishes to engage in traditional banking activities such as deposit-taking or lending. Trust companies are not authorized to accept deposits, which not only precludes their use for deposit-taking activities but also means that they do not have access to the low-cost funding provided by deposits.

Trust companies may not fall within bank exemptions from state lending license requirements and cannot export interest rates from their home states, and may be subject to further regulatory restraints on their authority to lend. However, a trust company could potentially be a useful part of the overall corporate structure of such a business, if such business model included fiduciary aspects or required the safekeeping of assets other than fiat currency.

The powers granted to trust companies, and their freedom from some of the more onerous obligations of the bank regulatory regime, have long made it an attractive charter type for asset and wealth managers and traditional fiduciaries. Today, this old charter is being put to new uses and proving a valuable tool for a variety of cutting-edge financial services business models.

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