Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

**Interpretive Letter #804**
**November 1997**
**12 U.S.C. 15**
**12 U.S.C. 24(7)70**
**12 U.S.C. 80A**

September 30, 1997

Dear [ ]:

This letter responds to your request of June 30, 1997 that the Office of the Comptroller of the Currency ("OCC") confirm the permissibility of the proposed marketing and advertising activities and arrangements of [ ] (the "Bank") described below (the "proposed marketing arrangement"). The proposed marketing arrangement primarily relates to the advance of retail commissions for mutual fund shares sold under a "back-end load structure" and the receipt of 12b-1 fees and contingent deferred sales charges as compensation. Based on the information and representations provided, and for the reasons discussed below, we agree with your conclusion that the proposed activities are permissible.

## 1. Background

The Bank has an operating subsidiary that is a broker-dealer ( or "[ *Co.1* ]") and two operating subsidiaries that are investment advisors ( [ *Co.2* and *Co.3* ] ). The Bank, itself and through its subsidiaries, is now the sixth largest bank investment advisor to mutual funds and advises registered mutual funds having in the aggregate over $30 billion in assets (the "Proprietary Funds"). A large part of the sales of Proprietary Fund shares is made through [ *Co.1* ], which is one of many selling brokers for the Proprietary Funds. [ *Co.4* ], which is completely owned by [ *Co.5* ] and is unaffiliated with the Bank, serves as distributor for the Proprietary Funds.

### A. Existing Arrangements

The Bank's Proprietary Funds have a back-end fee structure to sell shares (typically referred to as "Class B shares"). As currently structured, the distributor pays to the selling broker (either [ *Co.1* ] or an unaffiliated broker-dealer) a commission at the time of sale between 3-4 percent of the current net asset value of the Class B shares being purchased. This is known as the "retail commission."

No sales charge is imposed on the investor at the time of purchase of the Class B shares, but there may be a sales charge imposed on the investor at the time these shares are redeemed. This charge is typically 4-6 percent of the amount redeemed in the first year after purchase and a declining percentage over time to zero after a specified number of years; the charge is based on the lesser of the net asset value at the time of purchase or redemption. This back-end fee is called the "contingent deferred sales charge" or "CDSC." CDSCs are payable by the investor to the selling broker, who is obligated to repay it to the registered broker-dealer serving as distributor.

The Proprietary Funds using the back end fee structure and offering Class B shares have adopted plans pursuant to Rule 12b-1 under the Investment Company Act. These plans are intended to provide compensation for marketing activities, including the payment of retail commissions, through the payment by the Funds of an ongoing annual fee, which are referred to as 12b-1 fees.

Under this Class B share structure, a designated party advances the retail commissions to the selling brokers and incurs marketing expenses, in each case in anticipation of ultimately being compensated over time for such advances and expenses through a combination of CDSCs and annual 12b-1 fees. Currently, the designated party in the case of the Proprietary Funds is the distributor. The Bank finances the distributor's payment of retail commissions by means of a loan to the distributor (or special purpose entity which provides financing services to the distributor) secured by an assignment of the 12b-1 fees and the CDSCs. The distributor also receives administrative fees from the Proprietary Funds and pays administrative fees to the selling brokers.

### B. Proposed Marketing Arrangement

You note that the Bank or its subsidiaries would continue to provide the following marketing services: [1]

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[1] You also assert that the proposed marketing activities would not violate restrictions contained in 12 U.S.C. §§ 371c, 371c-1 ("sections 23A and 23B of the Federal Reserve Act"). Based on the information and representations set forth in your letter, we concur with your belief that the distributor and selling brokers are not affiliates and that marketing activities do not constitute covered transactions between the Bank and the Proprietary Funds. The selling brokers simply do not fall within the definition of affiliate. 12 U.S.C. § 371c. See also, Interpretive Letter 730, reprinted in [1995-96 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-047 (May 29, 1996). The proprietary funds are deemed to be affiliates of the Bank, because they are advised by the Bank. 12 U.S.C. § 371c(b)(1)(D). See also, Conditional Approval No. 143, 1994 OCC Ltr. LEXIS 81 (April 15, 1994)("Lieber Letter"). The transactions in question are not, however, "covered transactions" under sections 23A and 23B of the Federal Reserve Act. The Bank is not extending credit to the proprietary funds; the payment of 12b-1 fees and CDSCs are for services provided by the Bank and the Bank has no recourse against the proprietary funds if these fees are insufficient to pay the retail commissions. Nor do the 12b-1 fees and CDSCs represent a security of the proprietary funds or a purchase of assets from them; they are merely a form of compensation. Further, the proposed transactions will be conducted to satisfy the arm's length standard; the specific arrangements would be approved by the Board of Trustees of each Proprietary Fund and there are comparable arrangements involving other mutual fund complexes.

- general marketing and advertising services, including the preparation and distribution of general and fund-specific marketing brochures and informational materials; the preparation and distribution of direct marketing materials; and the placement of advertising in print and broadcast media;

- marketing support for selling brokers by personnel who would provide liaison and communication services with selling brokers and who would be responsible for maintaining the ongoing relationships with selling brokers; and

- the printing and mailing of prospectuses (other than to current shareholders and other than in connection with sales) and sales literature.

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Under the Bank's proposal, the Bank or a subsidiary would directly provide the retail commissions to the selling broker and receive the 12b-1 fees and the CDSCs, rather than accomplishing the same result by the additional steps involved with making a loan to the distributor.[3] The Bank or a subsidiary would also collect administrative fees from the Proprietary Funds and pass them through to the selling brokers.

The Bank asserts that its proposal would allow the elimination of the substantial administrative burden and expense related to the current loan structure.[4] The Bank believes that its proposal

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[2] See Lieber Letter, supra. As the OCC explained in connection with the marketing activities it approved in the Lieber Letter, the Supreme Court found that under its incidental powers, a national bank can advertise any service that the bank lawfully offers. See id. (citing Franklin National Bank v. New York, 347 U.S. 373, 377-78 (1954)). Further, it has been clearly recognized that the selling of securities necessarily involves soliciting buyers and that "no sensible construction of the statute [section 16 of the Glass-Steagall Act] could say that otherwise permissible selling activities cannot involve the solicitation of buyers." Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 807 F.2d 1052, 1062 (D.C. Cir. 1986), cert. denied, 483 U.S. 1005 (1987)("Bankers Trust II"). In connection with brokerage services, the OCC has also permitted national banks and their operating subsidiaries to provide a variety of administrative and shareholder services with respect to the operation of mutual funds. See Lieber Letter (citing various services previously approved). The Federal Reserve Board ("FRB") has also approved similar administrative services. See Mellon Bank Corporation, 79 Fed. Res. Bull. 626 (1993).

[3] There is no requirement that fees under a 12b-1 plan be paid only to the distributor of a mutual fund (as opposed, for example, to the advisor or some other party providing marketing services).

[4] The Bank represents that to reflect the new marketing arrangements, it will make appropriate changes in disclosures to customers in compliance with all applicable provisions of law and the Interagency Statement on Retail Sales on Nondeposit Investment Products, OCC Bulletin 94-13, reprinted in [Vol. 6] Fed. Banking L. Rep. (CCH) ¶ 70-113 (Feb. 15, 1994).

will also eliminate the potential for confusion and negative impact on the Proprietary Funds and the Bank if the Distributor were unable to repay the loans. The Bank further believes that the proposed structure would also eliminate the need to use an intermediary to provide retail commissions, thereby removing an additional level of administration and risk. The Bank states that the proposed marketing arrangements will not change in any significant respect the ultimate cash flows arising under the current loan structure.

## 2. Legal Analysis

### A. Permissible Activities

The National Bank Act provides that national banks shall have the power:

> To exercise. . .all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes.

12 U.S.C. § 24 (Seventh). The Supreme Court has held that this powers clause is a broad grant of power to engage in the business of banking, including, but not limited to, the five specifically recited powers and the business of banking as a whole. See NationsBank of North Carolina, N.A. v. Variable Life Annuity Co., 115 S.Ct. 810 (1995).

In the mutual fund context, the OCC has previously determined that investment advisory, brokerage, and administrative services are part of, or incidental to, the business of banking. Interpretive Letter 648, reprinted in [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,557 (May 4, 1994)("Mellon Letter"); Lieber Letter, supra. The OCC has stated that various administrative functions are "incidental to the related provision of investment advisory and brokerage services." Mellon and Lieber Letters, supra.[5] Further, the OCC has previously stated "[b]ased on existing judicial and agency precedent, we find that providing advertising and marketing support relating to mutual funds is an integral part of permissible brokerage and advisory services and thus is part of, or incidental to, the business of banking."[6]

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[5]The FRB has also permitted nonbanking subsidiaries to provide various administrative and advisory services. These include maintaining and preserving Fund records, computing net asset value and other performance information regarding the Funds, preparing and filing with the SEC and state securities regulators registration statements and other required materials, preparing and filing tax returns, providing office facilities for the Funds, and coordinating communications and activities between the investment advisor and other service providers. See Mellon Bank Corporation, 79 Fed. Res. Bull. 626 (1993)(Appendix A).

[6]See Lieber and Mellon Letters, supra (citing letters on making lobby materials available, placing newspaper advertisements, sending statement stuffers, preparing and distributing explanatory materials concerning the investment portfolios, furnishing prospectuses or sales literature upon request, having advertisements and brochures

The various aspects of the Bank's proposal are clearly just that -- advertising and marketing activities -- designed to provide customers with clearly permissible brokerage and investment advisory services. This is no less the case with respect to the payment of retail commissions than with respect to the Bank's other marketing activities. The marketing of mutual funds can be divided into two basic types. The first is direct marketing to possible purchasers of the funds, such as through newspaper advertisements and mailings. The second is marketing to the intermediaries selling the funds (that is, the selling brokers). The payment of retail commissions is part of the latter approach to marketing.

Furthermore, it is beyond doubt that a national bank can sell, as agent, shares of mutual funds. See Mellon and Lieber Letters. Banks certainly may pay others to assist in the provision of banking functions as part of, or incidental to, the business of banking.[7] Accordingly, the retail commissions are provided to compensate and motivate selling brokers for doing exactly what a national bank can do, and what the Bank does through [ *Co.1* ] -- sell, as agent, shares of registered mutual funds, including Proprietary Funds.

The proposal also represents the functional equivalent of, or logical outgrowth of, a permissible lending or marketing activity. The OCC has previously approved the financing of retail commissions.[8] In these prior cases, the financing activity was a permissible lending function for the bank. Under the Bank's proposal, the Bank will continue to finance retail commissions with the expectation that it will be compensated from the same sources.[9] The

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listing mutual funds available through the bank, and generating and distributing advisory newsletter).

[7]12 U.S.C. § 24(Seventh). See Mellon and Lieber Letters ("an integral part of full-service brokerage is the ability to attract customers by advertising and marketing the services and products available"). The Bank generally characterizes the function of advancing retail commissions as a form of permissible advertising and marketing. Further support for this point may be found outside of the context of mutual funds. For example, a bank may use the services of, and compensate persons not employed by, the bank for originating loans. 12 C.F.R. § 7.1004. Banks may establish and operate a messenger service or use third party messenger services; if a third party service is used, a national bank may defray all or part of the costs incurred by a customer. 12 C.F.R. § 7.1012. Further, banks may pay transaction fees to supermarkets for the bank customers' use of ATMs owned by supermarkets. Independent Bankers Ass'n. of New York State v. Marine Midland Bank, N.A., 757 F.2d 453 (2d Cir. 1985), cert. denied, 476 U.S. 1186 (1986).

[8]Interpretive Letter 730, supra. These loans are secured by the distributor's rights under its distribution contract to receive future distribution fees and CDSCs. The 12b-1 fees and CDSCs are expected to provide funds to repay these loans. The OCC has stated that the terms of the loans could provide that the Bank may receive interest, principal, and the excess of 12b-1 fees and CDSCs over the distributor's payments of interest, principal, and service charges. Id. See also, Interpretive Letter 656, reprinted in [1994-95 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,604 (March 13, 1995) (not objecting to proposed bank loans to distributor that would be repaid from CDSCs and 12b-1 fees.)

[9]The Bank notes that to its knowledge, for the entire mutual funds industry, the combination of 12b-1 fees and CDSCs have always been sufficient to repay the retail commissions. Further, this record enables the Bank to make the credit judgment necessary to provide loans to the distributor under its present arrangements. Unlike a loan

Bank's proposal avoids the administrative burdens previously associated with structuring the financing as loans. The proposal to advance retail commissions is simply a restructuring of existing activities and this restructuring has no substantive impact on the legal permissibility of these activities. Further, the Bank has committed that the distributor would continue all of its other functions and be paid a fee commensurate with industry practice.

### B. Glass-Steagall Analysis

Apart from the authorities permitting national banks to engage in the proposed activities as part of or incidental to the business of banking, we have also examined the proposal's treatment under the Glass-Steagall Act ("GSA").[10] We find that the proposed activities are not precluded under the GSA.

No Glass-Steagall Act Section 16 underwriting or dealing is involved under the proposed marketing arrangement, whether these terms are defined in terms of their plain meaning or their underlying policy, because the Bank will not assume any principal or underwriting risk. See 12 U.S.C. § 24(Seventh). The GSA does not define the terms underwriting or dealing. Underwriting as commonly used, however, refers to the process by which newly issued securities are purchased by another firm for its own account for distribution and sale to investors. Similarly, dealing in securities generally encompasses purchase and sale activities as principal with respect to the securities of other issuers.[11] The Bank is not purchasing any shares; it will incur no principal risk; it will have no potential for market gain with respect to the fund shares; and it will have no indicia of ownership of record or beneficial ownership.

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to the distributor, there is no obligation to repay retail commissions.

[10]The Glass-Steagall Act is the popular name for essentially four provisions in the Banking Act of 1933. Section 16 (12 U.S.C. § 24(Seventh)) places limits on national bank underwriting and dealing in securities and stock and prohibits national banks from purchasing and selling securities except upon the order and for the account of customers. Section 20 (12 U.S.C. § 377) prohibits Federal Reserve member bank affiliation with a company "engaged principally in the issue, flotation, underwriting, public sale or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ." Section 21 (12 U.S.C. § 378) prohibits organizations that are engaged in underwriting and other securities activities from simultaneously engaging in the business of receiving deposits. This restriction however does not "prohibit national banks . . . from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of Section 24 of [Title 12]." 12 U.S.C. § 378(a)(1). Section 32 (12 U.S.C. § 78) prohibits officer, director, or employee interlocks between member banks and companies that are primarily engaged in the securities activities listed in Section 20.

[11]See Interpretive Letter 388, reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612 (June 16, 1987). The FRB has also recognized that underwriting and dealing involve the banking entity's purchase of shares for its own account thereby incurring a principal risk. See Board of Governors of the Federal Reserve System Letter, reprinted in [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 86,620 (June 1986)("Sovran Letter"). See also, Securities Industry Ass'n v. Board of Governors of the Federal Reserve System , 468 U.S. 207, 218 n.18 (1984)("Schwab")(as underwriter and dealer, a securities firm engages in buying and selling securities on its own account, thereby assuming all the risk of loss).

The prohibitions in Section 20 of the GSA on affiliations between national banks and companies engaged principally in the "issue, flotation, underwriting, public sale, or distribution" of securities do not apply to the Bank's proposal. See 12 U.S.C. § 377.[12] The mutual funds are not "affiliates" of the Bank under 12 U.S.C. § 221a because the common ownership and control required under the definition of an affiliate in Section 221a does not arise under the proposal.[13] In fact, the Proprietary Funds will meet the independence requirement from the Bank dictated by the Investment Company Act of 1940, requiring that the Proprietary Funds' boards of directors consist of a majority of persons who are not directors, officers, or employees of the Banks. See 15 U.S.C. § 80a-10(c). Because the Funds must operate under the control of independent boards, the relationship with the Bank cannot be viewed as prohibited by Section 20.[14]

In addition, the Bank would not be involved in impermissible distribution under the GSA. As the Supreme Court has noted, "it is a familiar principle of statutory construction that words grouped in a list should be given a related meaning." Schwab, 468 U.S. at 218 (citing Third Nat'l Bank v. Impac, Ltd, 432 U.S. 312, 322 (1977)). The Supreme Court concluded that the term "public sale" in Section 20 refers to sales as an underwriter or dealer and not sales to the public as agent. See Schwab, 468 U.S. at 218. Further, the Court suggested that

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[12]The FRB has stated that under section 20, "a company that owns a member bank may not control 'through stock ownership or in any other manner' a company that engages principally in distributing, underwriting, or issuing securities." Mellon Bank Corporation, 79 Fed. Res. Bulletin. 626 (1993)(citing 12 U.S.C. §§ 221a, 377). The FRB has specifically found that banks may perform five of the six major services needed by a mutual fund; they may serve as investment advisors, transfer agents, custodians, registrars, and administrators. Id. The sixth function is acting as distributor.

[13]The term "affiliate" for GSA purposes is generally defined as any corporation, business trust, association or similar organization: (1) of which the member bank, directly or indirectly, owns or controls a majority of voting shares or more than 50 percent of the number of shares voted for the election of its directors or trustees or controls in any manner the election of a majority of its directors; (2) of which control is held, directly or indirectly, by the shareholders of a member bank who own or control either a majority of shares of the bank or more than 50 percent of the shares voted for the election of directors of the bank or by the trustees for the benefit of the shareholders of the bank; (3) of which a majority of its directors, trustees, or other persons exercising similar functions are directors of any one member bank; or (4) which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more than 50 percent of the shares voted for the election of directors or controls in any manner the election of a majority of the directors of a member bank or for the benefit of whose shareholders or members all the capital stock of a member bank is held by the trustees. 12 U.S.C. § 221a(b). None of these relationships exist between the mutual funds and the Bank.

[14]See Mellon and Lieber Letters. In its decision on Mellon Bank Corporation, the FRB noted that the policy-making function and control would rest with the board of directors of the fund, which must meet the requirements of the 1940 Act. Mellon Bank Corporation, 79 Fed. Res. Bulletin. 626 (1993). See also, The Governor and Company of the Bank of Ireland, 82 Fed. Res. Bulletin 1129 (Oct. 21, 1996)(also relying on the independence of the board of directors).

"distribution" for GSA purposes has a meaning similar to "underwriting."[15] Id. at 217-18. There is no impermissible underwriting occurring under this proposal, nor any analogous, impermissible distribution.

The conclusion that the proposed marketing arrangement does not constitute impermissible "distribution" activities is confirmed by an analysis of the list of responsibilities that will be performed by the independent distributor for the Proprietary Funds. These include the distributor acting as a "principal underwriter" for purposes of the 1940 Act and having responsibility for:

(1) entering into distribution agreements with the Proprietary Funds;

(2) being named as the distributor in all prospectuses and sales literature for the Proprietary Funds;

(3) confirming to investors or broker dealers all sales of Proprietary Fund shares with a confirmation complying with Rule 10b-10;

(4) providing the required seed money for any new Proprietary Funds;

(5) entering into agreements with selling brokers for the Proprietary Funds; and

(6) collecting front-end sales charges from broker-dealers or investors.

Section 21 of the GSA restricts any person or organization "engaged in the business of issuing, underwriting, selling or distributing . . . stocks, bonds, debentures, notes, or other securities" from receiving deposits. 12 U.S.C. § 378. Despite the different terminology, the Supreme Court has held that Section 16 and Section 21 seek to draw the same line.[16] Thus, a finding

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[15]The Court stated that

> In the typical distribution of securities, an underwriter purchases securities from an issuer, frequently in association with other underwriters. The distribution of these securities to the public may be effected by the underwriters alone, or in conjunction with a group of dealers who also purchase and sell the securities as principals. Underwriters may also distribute securities on a "best efforts" agreement pursuant to which large blocks of specific issues of securities are offered to the public by the investment banker as agent for the issuer. A "best efforts" distribution is not technically an underwriting. 1 L. Loss, Securities Regulation 172 (2d ed. 1961).

Id. at 217. Like the brokerage activities at stake in Schwab which the Court stated "involves none of these distribution plans," the Bank's proposal does not involve distribution.

[16]Securities Industry Ass'n. v. Board of Governors of the Federal Reserve System, 468 U.S. 137, 149 (1984). Courts have found that Section 21 cannot be read to prohibit what Section 16 permits. See Bankers Trust II, 807 F.2d at 1057; Board of Governors of the Federal Reserve System v. Investment Company Institute, 450 U.S.

that the proposed activities are permissible under Section 16 necessarily leads to the conclusion that they are not prohibited by Section 21. For the reasons noted above, we believe that the Bank's proposed activities are permissible under section 16. Further, for the reasons noted by the Court in Schwab (which interpreted section 20), the term "distribution" should connote an activity that has the same general attributes as "underwriting" and "dealing." And, as noted above, there is no impermissible underwriting or dealing in the Bank's proposal.

Finally, the Bank's proposal does not involve any changes in employee interlocks and therefore does not raise any issue of prohibited employee interlocks between the Bank and the mutual funds prohibited by section 32.[17] In sum, we find that the proposed activities are permissible under the GSA.

## 3. Conclusion

Based on the above analysis, we find that the proposed activities are permissible banking activities and are not prohibited by the Glass Steagall Act. Other than as noted herein, we are not expressing any opinion on compliance with other federal banking laws, regulations or directives or compliance with federal securities laws.[18]

If you have any questions, please contact Nancy Worth, Senior Attorney, Securities and Corporate Practices Division, at 202-874-5210.

Sincerely,

/s/

Julie L. Williams
Chief Counsel

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46, 63 (1981).

[17] 12 U.S.C. § 78. See also, Lieber Letter, supra (finding no prohibited relationships).

[18] We also note that examiners will review the safety and soundness of the advances being made as part of the normal supervisory process.