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Via Email

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

RE: Docket No. OP-1158
Section 106 Anti-Tying Restrictions

Dear Ms. Johnson:

This letter is submitted on behalf of Federated Investors, Inc. in response to the Board's request for comments on a proposed interpretation concerning the anti-tying restrictions applicable to banks under section 106 of the Bank Holding Company Act Amendments of 1970.

Federated Investors, Inc. is an investment management organization with assets under management of approximately $202 billion. Federated serves as the investment adviser and distributor of the Federated family of mutual funds which are open-end investment companies registered under the Investment Company Act of 1940. The Federated funds are made available to trust customers of banks through approximately 1200 bank trust departments. Federated also serves as the administrator and/or subadviser of investment companies for which banks and/or their affiliates serve as investment adviser ("proprietary mutual funds").

Federated urges the Board to clarify the applicability of section 106 to certain arrangements involving proprietary mutual funds offered by banks as a fiduciary service to their customers.

Traditional Bank Products

Section 106 allows a bank to condition the availability and price of any bank product on the requirement that the customer obtain a "traditional bank product" from the bank. The Board has applied this exception to allow a bank to

restrict the availability or to vary the price of any bank product on the condition that the customer also obtain a traditional bank product from the bank or an affiliate of the bank. Section 106 defines a "traditional bank product" to include a loan, discount, deposit, or trust service. The statute defines a "trust service" to mean any service customarily performed by a bank trust department.

For the reasons that follow, Federated urges the Board to clarify that the meaning of "traditional bank product" includes proprietary mutual funds, sweep arrangements that use proprietary mutual funds, and the provision of investment advice for a fee.

Proprietary Mutual Funds are Traditional Bank Products

Banks have long been permitted to act as investment advisers to mutual funds and also traditionally have acted as administrators, custodians and transfer agents for such funds.[1] The Board in 1971 adopted an interpretation expressly authorizing bank holding companies to engage in this activity as "closely related to banking."[2] The Board's interpretation was upheld by the U.S. Supreme Court, which noted that banks had engaged in this activity for decades:

> The services of an investment adviser are not significantly different from the traditional fiduciary functions of banks. The principal activity of an investment adviser is to manage the investment portfolio of its advisee to invest and reinvest the funds of the client. Banks have engaged in that sort of activity for decades. . . . Moreover, for over 50 years banks have performed these tasks for trust funds consisting of commingled funds of customers.[3]

Banks also for a number of years have been authorized to invest fiduciary assets in proprietary mutual funds. The statute laws of nearly all of the states specifically authorize banks to invest fiduciary assets in such funds. Section 23B of the Federal Reserve Act specifically recognizes such statutes, permitting such

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[1] *See* Office of the Comptroller of the Currency, Comptroller's Handbook for Fiduciary Activities, Precedent 9.2105 ("A national bank may act as investment adviser for an investment company as one of its fiduciary powers under 12 U.S.C. 92a, requiring no additional specific approval."). *See also* Letter by David L. Chew, Senior Deputy Comptroller, *reprinted in* Fed. Banking L. Rep.¶ 85,468 (1984); Decision of the Comptroller of the Currency concerning an application by American National Bank of Austin, Texas (Sept. 6, 1983), *reprinted in* Fed. Banking L. Rep. ¶ 99,732.

[2] 12 C.F.R. 225.125 (1971).

[3] Board of Governors of the Federal Reserve System v. Investment Company Institute, 450 U.S. 46, 55-56 (1981).

investments when authorized under local law.[4] Banks for many years have offered proprietary mutual funds as investments for their fiduciary customers who maintain investment agency accounts or trust accounts with the bank.[5] It is not uncommon for a bank to rebate or credit to such accounts all or a portion of the advisory fee charged to proprietary mutual fund shareholders in order to address fiduciary law concerns. In the case of employee benefit plan accounts, for example, a bank generally is required to rebate its advisory fee.[6] If proprietary mutual funds were not treated as a trust service or traditional bank product for purposes of section 106, a question could arise as to whether such credits or rebates constitute a prohibited tying arrangement.

In acting as an investment adviser to a mutual fund and offering proprietary mutual funds to fiduciary customers, a bank performs functions similar to those when it manages a common trust fund or collective investment fund for its trust customers.[7] Indeed, those funds have all of the fundamental characteristics of investment companies and would be investment companies for purposes of the Investment Company Act of 1940 but for their exempt status under the Act.[8] The offering of such funds has been recognized as a traditional banking activity by the courts.[9] Many banks have converted their common trust funds and collective investment funds into proprietary mutual funds following the enactment by Congress of amendments to the Internal Revenue Code that facilitated such conversions by making them tax neutral.[10] Proprietary mutual funds are no less traditional bank products than are common trust funds or collective investment funds.

The Board's proposed section 106 interpretation gives as an example of a traditional bank product "discretionary asset management services provided as

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[4] 12 U.S.C. 371c-1(b)(1).

[5] *See* OCC Trust Interpretation No. 234 (Sept. 21, 1989); 12 C.F.R. 9.12 and 337.4(e) (1996). The Board in 1996 amended its interpretation concerning investment advisory activities of bank holding companies in recognition that banks are permitted to invest fiduciary assets in proprietary mutual funds when authorized by local law or the fiduciary instrument. 61 Fed. Reg. 45,873 (1996).

[6] *See* Department of Labor, Prohibited Transaction Class Exemption (PTCE) 77-4 (42 Fed. Reg. 18,732 (April 8, 1977).

[7] *See* 12 C.F.R. 9.18.

[8] *See* 450 U.S. 46, at 55-56 ("These common trust funds administered by banks would be regulated as investment companies by the Investment Company Act of 1940 were they not exempted from the Act's coverage.")

[9] Investment Company Institute v. Conover, 790 F.2d 925 (D.C. Cir.), *cert. denied*, 479 U.S. 939 (1986); Investment Company Institute v. Clarke, 793 F.2d 220 (9th Cir.), *cert. denied*, 479 U.S. 939 (1986); Investment Company Institute v. Clarke, 789 F.2d (2d Cir.), *cert. denied*, 479 U.S. 940 (1986).

[10] *See* Small Business Jobs Protection Act of 1996, adding new section 584(h) to the Internal Revenue Code.

fiduciary." We believe that this language would cover the activity of providing investment advice to a mutual fund inasmuch as a bank provides discretionary asset management services as a fiduciary when it acts as a mutual fund adviser. Nevertheless, it would be helpful for the Board to clarify that proprietary mutual funds are encompassed within this concept and are traditional bank products.

Sweep Accounts Using Proprietary Mutual Funds Are Traditional Bank Products

Banks traditionally have offered sweep services whereby customer deposits are transferred to a mutual fund on an overnight or longer basis for cash management purposes.[11] In exempting banks from broker-dealer registration in the Gramm-Leach-Bliley Act, Congress specifically included an exemption for a bank when it effects transactions "as part of a program for the investment or reinvestment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund."[12] For convenience and efficiency purposes, banks frequently use their own proprietary mutual funds in connection with their sweep services. Such services are a cash management function directly related to the deposit-taking activities of banks and as such are a traditional bank product.

Providing Investment Advice for a Fee is a Traditional Bank Activity

The Board's proposed interpretation gives as examples of traditional bank products or trust services: escrow services, cash management services, services provided as trustee or guardian or as executor or administrator of an estate, discretionary asset management services provided as fiduciary, custody services, and transfer agent services.

Noticeably absent from the proposed interpretation is the traditional bank activity of acting as a fiduciary by providing investment advice for a fee. This is activity is encompassed within the definition of "fiduciary capacity" in the regulations of the Comptroller of the Currency pertaining to the fiduciary activities of national banks.[13] Banks traditionally have provided investment advice for a fee to their customers.[14] This activity has been recognized as a traditional fiduciary activity by Congress. In the Gramm-Leach-Bliley Act, Congress granted an exemption from broker-dealer registration under the Securities Exchange Act of 1934 for banks acting in a fiduciary capacity and

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[11] *See* BankAmerica Corporation (Schwab), 69 Fed. Res. Bull. 105, 108 (1983); OCC Interpretive Letter No. 688 (May 3, 1995); FDIC Interpretive Letter 88-63 (1988).

[12] 15 U.S.C. 78c(a)(4)(B)(v).

[13] 12 C.F.R. 9.2(e).

[14] *See* Decision of the Comptroller of the Currency concerning an application by American National Bank of Austin, Texas (Sept. 6, 1983), *reprinted in* Fed. Banking L. Rep. ¶ 99,732.

specifically defined "fiduciary capacity" to include the activity of providing investment advice for a fee.[15] The purpose of this exemption is to allow bank trust departments to continue to engage in traditional fiduciary activities.

If the provision of investment advice for a fee is not treated as a trust service—and thus a traditional banking product—a question could arise, for example, as to whether a bank could condition the offering of a trust account on the condition that the customer obtain investment advice for a fee from the bank—a result surely unintended by Congress.

Accordingly, we would urge the Board to clarify in its proposed interpretation of section 106 that the activity of providing investment advice for a fee is included as a trust service for purposes of the traditional bank product exemption.

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Federated Investors, Inc. appreciated this opportunity to comment on the Board's proposed interpretation under section 106.

Sincerely,

Melanie L. Fein

Melanie L. Fein

cc: Eugene F. Maloney, Esq.
Federated Investors, Inc.

[15] 15 U.S.C. 78c(a)(4)(D).