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March 26, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
Washington, DC 20549-1090

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
Washington, D.C. 20005

Re: Regulation R; File Number S7-22-06; Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks

Dear Ms. Morris and Ms. Johnson:

This comment letter is filed on behalf of Federated Investors, Inc. and its subsidiaries ("Federated") which perform investment advisory and other services for the Federated family of open-end investment companies registered under the Investment Company Act of 1940 (the "Federated Funds"). Federated is the largest institutional money market mutual fund manager and one of the top mutual fund complexes in the United States with over $200 billion in assets under management as of December 30, 2006.

Federated has customer relationships with over 1200 bank trust departments that utilize the Federated Funds as investments in their fiduciary or custodial capacity for personal trust accounts, managed asset accounts, 401(k) plan and individual retirement accounts, and corporate trust accounts, among others. These relationships have given Federated many years of experience with the operations of bank trust departments and the regulatory environment in which banks conduct their trust and fiduciary activities. Federated has a substantial interest in the applicability of the federal securities laws to banks and the effect of those laws on the ability of banks to continue making the Federated Funds available as investments for their customers.

Federated has reviewed proposed Regulation R to determine whether any of its provisions would disrupt its relationships with its banking clients in potentially

significant ways by imposing new regulatory requirements and/or compliance burdens on the banks, particularly with respect to servicing arrangements between Federated and its banking clients. Federated believes that the proposed regulation generally would allow banks to continue to their relationships with the Federated mutual funds without significant disruption, consistent with the intent of Congress in the Gramm-Leach-Bliley Act. Federated has some concerns regarding certain aspects of the proposal, however, which are included in Federated's comments below.

I. TRUST AND FIDUCIARY ACTIVITIES EXEMPTION

Federated believes that most banks will be able to qualify for the trust exemption as proposed in Regulation R. In particular, the treatment as relationship compensation of fees paid by mutual funds to banks for performing administrative and other services is very helpful in ensuring that banks can continue make available to their fiduciary customers a wide range of mutual fund products and continue to receive compensation for their services to the funds.

We note, however, that proposed Regulation R refers to the payment of fees "by an investment company" and does not specifically reference fees paid by investment advisers to investment companies. The proposed rule does not specifically exclude from relationship compensation fees paid by a mutual fund adviser. Indeed, the language of the rule, by using the words "including, without limitation," indicates that the list of mutual fund asset based fees is not intended to be exclusive. Moreover, the *Federal Register* notice of the proposal states that the rule is intended to "provide *examples* of fees that would be considered an administration fee or a fee based on a percentage of assets under management for these purposes." (emphasis added) The *Federal Register* notice further states that an asset based fee is considered to be part of a bank's fiduciary compensation regardless of what person or entity pays the fee:

> [A]n administration fee, annual fee or AUM fee attributable to a trust or fiduciary account is considered relationship compensation regardless of what entity or person pays the fee, and regardless of whether the fee is related to only securities assets, to a combination of securities and non-securities assets, or to only non-securities assets. These fees are part of the compensation for acting as a trustee or fiduciary.

Accordingly, Federated believes that the language of proposed Regulation R may be interpreted to include fees paid by a mutual fund investment adviser pursuant to an administrative services agreement with a bank. Indeed, in view of the broad definition of relationship compensation to include 12b-1 distribution and other fees,

it would seem highly incongruent for the agencies to interpret the final rule as excluding such fees.

Nevertheless, Federated believes that, rather than leave the matter to interpretation, the proposal should be revised to specifically include administrative service fees paid by mutual fund advisers within the definition of relationship compensation.

We addressed this matter in connection with the former proposed Regulation B as well. In our comment letter on Regulation B, we stated our view that the regulation did not include fees paid by a fund adviser as "sales compensation" and urged the SEC to retain the neutral treatment of such fees as unrelated compensation, or as relationship compensation. A copy of our earlier comment letter is attached.

This matter is important to Federated because of the way in which Federated has structured its administrative fee arrangements with banks. Rather than pay all of its administrative fees from fund assets, Federated pays a significant portion of its bank service fees directly from its own legitimate adviser profits.[1] These fees are not "revenue sharing" payments of the type that fund advisers typically pay to broker-dealers for fund distribution. Rather, these fees are paid pursuant to administrative services agreements with banks that perform some or all of the seven mutual fund administrative services enumerated in Regulation R in connection with the investment of fiduciary assets in the Federated Funds. These services otherwise would need to be performed for the Funds and, regardless of whether the service fees are paid by Federated or the Funds, the services benefit the Funds and the Funds' shareholders. Federated believes that these fees, which are paid pursuant to a written administrative services agreement, are fully consistent with the fiduciary obligations of banks. The appendices to our earlier comment letter describe in detail the fiduciary context in which Federated pays administrative service fees to banks.

Accordingly, we request the Board and the Commission to revise Regulation R to specifically provide that mutual fund service fees paid by an investment company adviser, or complex, be treated as relationship compensation to the same extent as fees paid to banks from fund assets. We note that, in the prior Regulation B, the Commission allowed the payment of fees paid to banks by investment company complexes in the special purpose exemption for employee benefit plans.

[1] We note that mutual fund advisers and other fund service providers often absorb fund expenses, including by waiving all or a part of their own fees, in order to maintain fund expense ratios with certain limits.

II. Exemption for Money Market Funds

Federated strongly supports the exemption that would allow banks to effect transactions in securities of money market mutual funds. This provision will enable banks to continue using such funds in connection with their corporate trust, escrow, and other services without becoming subject to broker-dealer registration, consistent with the intent of Congress.

We note that the Commission in Regulation B and its earlier proposal issued in 2001 included, at Federated's request, an exemption allowing indenture trustees to continue using money market mutual funds. That exemption is no longer needed in view of the broader proposed exemption in Regulation R for money market funds.

III. Conclusion

Federated applauds the Board and the Commission for working together to produce a regulation that, with some relatively minor adjustments, we believe will enable banks to continue most of their traditional securities brokerage activities without registering as broker-dealers, consistent with the intent of Congress.

Sincerely,

Melanie L. Fein

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

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September 1, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

RE: File Number S7-26-04—Proposed Regulation B

Dear Mr. Katz:

This comment letter is filed on behalf of Federated Investors, Inc. and its subsidiaries ("Federated") which perform investment advisory and other services for the Federated family of open-end investment companies registered under the Investment Company Act of 1940 (the "Federated Funds"). Federated is the largest institutional money market mutual fund manager and one of the top mutual fund complexes in the United States with over $183 billion in assets under management as of June 30, 2004.

Federated has customer relationships with over 1200 bank trust departments that utilize the Federated Funds as investments in their fiduciary or custodial capacity for personal trust accounts, managed asset accounts, 401(k) plan and individual retirement accounts, and trust indentures, among others. These relationships have given Federated many years of experience with the operations of bank trust departments and the regulatory environment in which banks conduct their trust and fiduciary activities. Federated has a substantial interest in the applicability of the federal securities laws to banks and the effect of those laws on the ability of banks to continue making the Federated Funds available as investments for their customers.

Federated has reviewed Regulation B to determine whether any of its provisions would disrupt its relationships with its banking clients in potentially significant ways by imposing new regulatory requirements and/or compliance burdens on the banks, particularly with respect to servicing arrangements between Federated and its banking clients. Federated's comments are as follows:

I. Trust and Fiduciary Activities Exemption

Under Regulation B, a bank must satisfy the so-called "chiefly compensated" test in order rely on the exemption for trust and fiduciary activities.

In general, the chiefly compensated test requires that a bank's "relationship compensation" exceed its "sales compensation."

The chiefly compensated test is complex and we are aware that many banks will be asking the Commission to simplify or otherwise change the test. Absent a fundamental restructuring of the chiefly compensated test, Federated believes that certain provisions in the test should remain unchanged. In particular, changes in the definition of "relationship compensation" and "sales compensation" potentially could affect the ability of banks to receive compensation for services performed in connection with the investment of fiduciary assets in mutual funds, including the Federated Funds.

As described in greater detail in Appendix A, the Federated Funds and/or Federated pay administrative service fees to compensate banks for performing administrative services in connection with the investment of fiduciary assets in the Federated Funds. Federated believes that these fees, which are paid pursuant to a written administrative services agreement, are fully consistent with the fiduciary obligations of banks.[1] Federated further believes that the treatment of these fees as "unrelated compensation" under Regulation B accurately reflects the nature of the fees and should remain unchanged (or changed to "relationship compensation").

Bank trust departments operate subject to strict fiduciary duties addressing conflicts of interest under well-established fiduciary principles derived from state trust law and the Employee Retirement Income Security Act of 1974 ("ERISA"), as described in Appendix A. Federated believes that the Commission should not interfere with these frameworks, especially since no abuses have come to light suggesting that, in the bank fiduciary context, mutual fund administrative service fees should be treated as "sales compensation" under Regulation B.

A. Service Fees Paid by an Investment Company Should Remain Excluded from the Definition of "Sales Compensation"

The definition of "sales compensation" in Regulation B excludes fees paid to a bank by an investment company for performing some or all of the following services (the "seven mutual fund administrative services"):

- Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;

[1] These fees stand in contrast to "distribution" fees and so-called "revenue sharing payments" which Federated does not believe are consistent with a bank's fiduciary duties.

- Aggregating and processing purchase and redemption orders for investment company shares;
- Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;
- Processing dividend payments for the investment company;
- Providing sub-accounting services to the investment company for shares held beneficially;
- Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or
- Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares.

These services are the types of services for which the Federated Funds pay banks administrative service fees. Federated's administrative services agreements with banks specifically enumerate these services as the type of services to be performed by the bank for compensation.

We urge the Commission to retain the exclusion of these fees from the definition of "sales compensation" in the final version of Regulation B.

B. Service Fees Paid by a Fund Complex Should Remain Excluded from the Definition of "Sales Compensation"

We note that, under the literal language of the Regulation, the seven mutual fund administrative services enumerated in Regulation B are excluded from the definition of "sales compensation" when "paid by an investment company." The Regulation does not refer to such fees when paid by a service provider that is an affiliated person of an investment company. Such fees are not included in the definition of "sales compensation" as we read Regulation B.

As noted, Federated may pay (from its own legitimate profits) fees to banks for performing some or all of the seven mutual fund administrative services in connection with the investment of fiduciary assets in the Federated Funds. These services otherwise would need to be performed for the Fund and, regardless of whether the service fees are paid by Federated or the Funds, the services benefit the Funds and the Funds' shareholders.

Mutual fund advisers and other fund service providers often absorb fund expenses, including by waiving all or a part of their own fees, in order to maintain fund expense ratios with certain limits. For example, a fund adviser may pay for

some or all of the cost of sub-accounting, recordkeeping and other services in connection with mutual fund “supermarkets.”[2]

We note that, in the special purpose exemption for employee benefit plans in Regulation B, the Commission has recognized that service fees may be paid by a mutual fund “complex” which Regulation B defines to include the fund itself as well as the fund’s investment adviser and any affiliated person of the fund.

As we read Regulation B, the payment of administrative service fees by Federated, like the payment of such fees directly by the Federated Funds, would *not* be characterized as “sales compensation.” The definition of “sales compensation” simply does not include service fees paid to a bank by affiliated persons of a mutual fund. In particular, such a fee is not a “fee paid for an offering of securities.” The fee is not paid pursuant to any selling agreement with the issuer of securities but is paid pursuant to a written administrative services agreement with a bank. The fee is a service fee, not a selling fee. The fee represents compensation for bona fide administrative services and is not a sales commission for promotional or distribution activities.[3] As noted in Appendix A, bank trust departments generally are precluded by fiduciary law from receiving sales commissions or distribution fees in connection with the investment of fiduciary assets.

Accordingly, we believe that, under Regulation B as proposed, administrative service fees paid to a bank by Federated would not constitute sales compensation. Nor would such fees constitute relationship compensation. Such fees rather would be “unrelated compensation” and would not be taken into consideration in the chiefly compensated equation.

We believe that this treatment accurately reflects the nature of the administrative service fees paid by Federated to bank trust departments as fees for bona fide services. We urge the Commission to retain this treatment of such fees in the final version of Regulation B.

II. Employee Benefit Plan Exemption

By letter dated February 25, 2002, and in meetings with the Commission’s staff, Federated requested an exemption for banks with respect to employee

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[2] *See* Lemke and Lins, Regulation of Investment Companies (LEXIS) § 7.05[3][f], 7.05[2][a] and [3][a].

[3] In particular, such fees are not “revenue sharing” payments of the type the Commission has addressed in other contexts. *See* Release No. 34-49148, Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, 69 Fed. Reg. 6438 (2004).

benefit plans that invest in mutual funds where the bank receives all of its compensation in the form of administrative fees from the mutual funds and does not receive any compensation at the account level. Accordingly, Federated was pleased to see the proposed special purpose exemption for employee benefit plan accounts in Subpart G of proposed Regulation B. For the reasons stated in our letter of February 25, 2002, attached as Appendix C, Federated supports this exemption.

We note, however, that Regulation B includes requirements and conditions to the exemption that we did not suggest and that we believe will substantially undermine the utility of the exemption. For the reasons detailed in the comment letter dated July 20, 2004, filed by Eugene F. Maloney, Executive Vice President and Corporate Counsel, Federated Investors, Inc., the offset requirement in the Regulation will add an unnecessary compliance burden. Moreover, the offset requirement represents an intrusion into the fiduciary framework applicable to employee benefit plan accounts under ERISA, as administered by the Department of Labor. Accordingly, for the reasons set forth in Mr. Maloney's letter, Federated urges the Commission to eliminate the offset requirement in the final version of Regulation B.

Federated also believes that the employee benefit plan exemption should be broadened to include all types of employee benefit plan accounts.

III. Money Market Mutual Fund Exemption

By letter dated November 19, 2002 (attached as Exhibit D), and in meetings with the Commission's staff, Federated urged the staff to exempt banks with respect to escrow and other agency accounts and urged a reading of the so-called bank "sweep" exemption to allow a bank to invest customer accounts in money market mutual funds without regard to the existence of any sweep arrangement. Accordingly, while the staff retained a strict reading of the sweep exemption, we were pleased that the Commission addressed this issue by proposing a special purpose exemption for the investment in money market mutual funds by qualified investors, escrow and other agency accounts, and trust and fiduciary accounts.

We urge the Commission to expand this exemption to allow banks to invest in short-term instruments in addition to money market mutual funds, such as unregistered investment products whose investment objective includes maintaining a stable net asset value of $1 per share.

We note that the Regulation B exemption requires a qualified investor to obtain from the bank "a financial product or service not involving securities." We believe that this restriction poses an unnecessary requirement on customers that

are qualified investors inasmuch as the customer could merely purchase a certificate of deposit in a nominal amount in order to comply. It seems pointless to impose such a meaningless requirement on an institutional investor or sophisticated customer that qualifies as a qualified investor.

IV. Indenture Trustee Exemption

By letter dated March 30, 2001 (attached as Appendix E), Federated requested the Commission to exempt banks from the definition of "broker" when they invest in money market mutual funds in the capacity of indenture trustee and receive all of their compensation for such services in the form of asset-based service fees paid by the funds or fund complex. Accordingly, Federated was pleased that the Commission included an exemption for indenture trustees in the Interim Final Regulations implementing the Gramm-Leach-Bliley Act exemptions in 2001 and retained it in proposed Regulation B.

The Commission has requested comment as to whether the indenture trustee exemption should be retained in light of the proposed special purpose exemption in Regulation B for investments in money market mutual funds. We note that the special purpose exemption includes certain conditions that are not included in the exemption for indenture trustees. If those conditions were eliminated (at least as to indenture trustees), the indenture trustee exemption would appear to be superfluous and, we believe, could be eliminated.[4] We would request, however, that the Commission specifically list indenture trustees as eligible for the special purpose exemption.

If the indenture trustee exemption is retained, we urge the Commission to amend the exemption to allow investments in money market mutual funds that are not no-load, as in the special purpose exemption.

V. Safekeeping and Custody Exemption

For the same reasons discussed above in connection with the trust exemption, Federated urges the Commission to amend the custody exemption to allow a bank custodian to receive service fees from an affiliated person of a mutual fund as well as the fund itself.

Federated is concerned about the impact of the Commission's interpretation of the general custody exemption on the ability of those bank

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[4] We also note that, because a bank relying on the indenture trustee exemption must meet the other requirements of the trust and fiduciary activities exemption, the special purpose exemption would be preferable.

custody customers that are not qualified investors or grandfathered accounts to hold their mutual fund investments in a consolidated bank custody account.

Under Regulation B as proposed, it appears that a custody customer that is not a qualified investor or grandfathered account no longer will be able to place orders for securities transactions directly through the custodian but will be required to place the order with a registered broker-dealer or fund transfer agent. If the transaction involves shares of stocks and bonds (as opposed to mutual fund shares), the broker-dealer may settle the transaction through the custodian and the custodian still may maintain custody of the customer's assets on a consolidated basis.

If the transaction involves mutual fund shares, however, the broker-dealer must place the order directly with the mutual fund's transfer agent (or the National Securities Clearing Corporation's Fund/SERV service) and open an account with the fund in the name of the customer or the broker-dealer as nominee. The transaction typically is not "settled" in the way that transactions in other securities are settled because mutual funds shares are purchased directly from the issuer and no secondary market exists. A custodian cannot take custody of fund shares without purchasing the shares directly and opening an account with the fund in nominee name on behalf of its customer.

This anomaly results solely because of the way in which mutual funds are purchased and redeemed and creates a problem for custody customers who want to maintain all of their investments in a single consolidated custodial account.

Bank customers benefit from the ability to maintain all of their invested assets in a single custody account. The bank custodian can provide consolidated holdings reporting, consolidated 1099 tax reporting, consolidated income collection and reconcilement, consolidated risk analysis, and comparative performance monitoring and reporting if the customer uses multiple money managers. The bank also can provide corporate action tracking and securities litigation class action tracking on a consolidated basis. These are significant benefits for bank custody clients, which frequently use banks specifically for these purposes and to avoid multiple custody relationships. Under Regulation B, however, a customer no longer could request his or her bank to purchase mutual fund shares directly on his or her behalf and the customer no longer could maintain mutual fund investments in a consolidated custody account.

Moreover, the customer would end up paying the broker-dealer a sales commission for mutual fund purchases and redemptions whereas, if the custodian were to execute the trade, no sales commission typically would be charged. Bank custodians that execute mutual fund transactions for their custody accounts generally are not in the business of selling mutual funds and have no selling agreements with mutual funds, unlike a broker-dealer. They do not provide

investment advice but rather merely take instructions from their customers, or their customers' money managers.[5]

Accordingly, under Regulation B, bank custodians will be forced to tell their customers that they no longer can hold all of a customer's assets in a custody account if those customers invest in mutual funds. These customers will be deprived of the convenience and other benefits of having a single custody account where all of their investments can be consolidated.

To prevent this result, Federated urges the Commission to amend the general custody exemption to permit a bank custodian to place orders for mutual fund purchases and redemptions in a custodial account, regardless of whether the customer is a qualified investor or the account is a grandfathered account.

* * * *

Federated Investors, Inc. appreciated this opportunity to comment on proposed Regulation B. We would be pleased to answer any questions you may have regarding this letter.

Sincerely,

Melanie L. Fein

cc: Eugene F. Maloney, Esq.
Executive Vice President and Corporate Counsel
Federated Investors, Inc.

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[5] A bank custodian may receive fees from a mutual fund for performing subtransfer agent and related administrative services that relieve the fund of expenses, but these fees are not the equivalent of distribution fees or brokerage commissions.

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APPENDIX A

Federated's Service Fee Arrangements with Banks

As discussed below, Federated's servicing arrangements with bank trust departments are designed to conform with applicable fiduciary law standards that allow banks to invest fiduciary assets in mutual funds and to receive compensation from the funds or fund advisers for performing services in connection with such investments.

Federated's Servicing Arrangements with Banks Compensate Banks for Performing Administrative Services

Federated relies on bank trust departments to perform important administrative services in connection with the investment of trust and fiduciary assets in the Federated Funds. Pursuant to a written administrative agreement with Federated and/or the Funds, banks typically perform some or all of the following administrative services:

- Sub-accounting;
- Aggregating and processing of purchase and redemption orders;
- Providing customer confirmations and sub-account statements;
- Processing dividend payments;
- Forwarding shareholder communications;
- Receiving, tabulating and transmitting proxies; and
- Tax reporting.

In consideration for the performance of these services, Federated pays compensation to banks that enter into a written administrative services agreement. The compensation may include fees paid by the Federated Funds as well as by Federated. The amount of compensation is designed to satisfy the standard of reasonableness that applies to fiduciary compensation.[6]

Federated's Service Fee Arrangements with Banks Are Designed to Comport with Applicable Fiduciary Law

The payment of service fees to bank trust departments—whether by Federated or the Federated Funds—is designed to comply with the framework of fiduciary law applicable to bank trust departments.

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[6] Federated has commissioned a number of market surveys and activity-based cost accounting studies of mutual fund administrative fees which provide empirical support for the amount of fees paid by Federated.

The Duty of Loyalty Does Not Bar a Bank from Receiving Fund Service Fees in Most States

The duty of loyalty is the most fundamental principle of fiduciary law. Under the duty of loyalty, a conflict of interest arises when a bank invests fiduciary assets in mutual funds and receives service fees from the fund or its adviser. Absent proper authority, a bank trust department may not receive such compensation or fees. Proper authority may be derived from the trust instrument, court order, beneficiary consent, or applicable law.

As of the past decade, nearly all of the states have amended their laws to expressly permit bank trust departments to invest fiduciary assets in mutual funds for which they perform services and receive compensation.[7] State statutes of this type overcome the conflict of interest that otherwise would prevent a trustee from receiving mutual fund service fees.[8] The adoption of these statutes reflects an evolution in trust law toward the principles of modern portfolio theory and the Prudent Investor Rule under which mutual funds are highly favored as fiduciary investments.[9]

The Uniform Trust Code also addresses the conflict of interest inherent in the investment of fiduciary assets in mutual funds that pay service fees to the fiduciary. The Code specifically states that such an investment is *not* presumed to entail a conflict of interest, provided it complies with the Prudent Investor Rule:

> An investment by a trustee in securities of an investment company or investment trust to which the trustee, or its affiliate, provides services in a capacity other than as trustee and which complies with the prudent investor rule…is not presumed to be affected by a conflict between personal and fiduciary interests.[10]

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[7] *See* Appendix B for examples of such state laws. The authority provided by these statutes generally is subject to disclosure requirements and reasonableness standards governing the bank's compensation.

[8] A bank relying on such a statute must be able to demonstrate through appropriate documentation that it has complied with any disclosure or other requirements under applicable state law.

[9] *See generally*, John H. Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 Iowa L. Rev. 641 (1996). *See also*, M. Fein, "The Fiduciary Investment Process and the Reasonableness of Fees, Appendix B—The Evolution of Trust Law."

[10] Uniform Trust Code § 802. The Code was approved by the National Conference of Commissioners on Uniform State Laws in 2000 as the first comprehensive national codification of the law of trusts. The purpose of the Code is to provide the states with "precise guidance on trust law questions and in an easily findable place." Uniform Trust Code, Prefatory Note. The Code is expected to be widely adopted by the states.

The duty of loyalty includes the duty to disclose conflicts of interest. As stated in the Restatement (Third) of Trusts, a trustee engaged in a self-dealing transaction with a beneficiary is under a duty to "deal fairly and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the transaction."[11]

The Duty of Loyalty Prohibits a Bank from Receiving "Distribution Fees" or "Revenue Sharing Payments"

It is important to note that the state statutes authorizing the receipt of mutual fund fees by bank fiduciaries do so in order to permit the bank to be compensated for the performance of bona fide administrative, advisory, transfer agent, and other services relating to the investment of fiduciary assets in mutual funds.

The fiduciary duty of loyalty does not permit a bank trust department to accept fees in the nature of brokerage commissions, "distribution" fees, or "revenue sharing" payments in consideration for the sale or promotion of mutual funds to fiduciary accounts. The state statutes authorizing banks to receive fund service fees generally do not authorize a bank to receive promotional fees.

Federated maintains that the fund service fees it pays to bank trust department are not "distribution" or "revenue sharing" fees but rather are compensation for the performance of bona fide administrative services performed by the bank pursuant to a written services agreement with Federated and/or the Federated Funds.

A Bank Also Must Satisfy the Duty of Prudence When Investing in Mutual funds that Pay Service Fees

The duty of loyalty is only part of the analysis a bank trust department must undertake when it invests fiduciary assets in mutual funds and receives service fees from the fund or its adviser. Even when the conflict of interest is addressed by state law, a bank trust department still may not invest fiduciary assets in a mutual fund and receive service fees from the fund or fund adviser unless the investment satisfies the duty of prudence.

The duty of prudence requires a trustee to invest and manage trust assets "as a prudent investor would, by considering the purposes, terms, distribution

[11] Restatement (Third) of Trusts: Prudent Investor Rule § 170, Duty of Loyalty.

requirements, and other circumstances of the trust."[12] In satisfying this standard, the trustee is required to exercise reasonable care, skill, and caution.[13]

In accordance with the duty of prudence, a bank trustee that invests trust assets in a proprietary or other mutual fund from which it derives service fees must conduct an appropriate due diligence process in selecting and monitoring the funds as trust investments. In particular, the trustee must be able to show that the investment is in the interests of the beneficiaries and consistent with the terms of the trust instrument.[14]

The Receipt of Mutual Fund Service Fees is Permitted Under ERISA

The Department of Labor ("DOL") has opined that 401(k) plan trustees, including banks, may receive 12b-1 fees for performing administrative and shareholder services for plans that invest in mutual funds, subject to certain conditions designed to ensure compliance with ERISA's prohibited transaction rules.[15] In general, a trustee of a participant-directed 401(k) plan must either offset the 12b-1 fees against any account level fees it charges or credit the plans with the amount of the 12b-1 fees on a dollar-for-dollar basis. No offset or credit is required if the trustee does not exercise discretion or control over the investment of plan assets in the mutual funds.

Recently, the DOL opined that the receipt by a trust company of 12b-1 or subtransfer agent fees from mutual funds for services performed in connection with the investment by employee benefit plans in the funds would not violate ERISA when the decision to invest in such funds is made by an independent fiduciary or by employee benefit plan participants.[16] The DOL noted that ERISA's general standards of fiduciary conduct would apply in such a case.[17]

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[12] Uniform Prudent Investor Act § 2(a). *Accord* Restatement (Third) of Trusts: Prudent Investor Rule § 227 (1992). *See also* Uniform Trust Code § 802, comments to subsection (f).

[13] Uniform Prudent Investor Act § 2(a).

[14] Uniform Prudent Investor Act § 2(c). Restatement of Trusts (Third): Prudent Investor Rule § 227, comments b and d (1992).

[15] *See, e.g.,* DOL Advisory Opinion 97-15A (May 22, 1997) (Frost National Bank); DOL Advisory Opinion 97-16A (May 22, 1997) (Aetna); Letters from Bette J. Briggs, Chief, Division of Fiduciary Interpretations, Pension and Welfare Benefits Administration, to the American Bankers Association (Aug. 20, 1997) and Jerry D. Shook, First American Bank (April 10, 1998).

[16] DOL Advisory Opinion 2003-09A.

[17] The DOL stated that, under ERISA, the responsible plan fiduciaries must act prudently and solely in the interest of the plan participants and beneficiaries both in deciding whether to enter into, or continue, service arrangements and in determining the investment options in which to invest or make available to plan participants and beneficiaries in self-directed plans.

Federal Banking Regulators Have Issued Guidance Regarding Mutual Fund Service Fees Received by Banks

The federal banking agencies have issued supervisory guidance to bank trust departments regarding the receipt of fees from mutual funds in which fiduciary assets are invested.

In particular, the Office of the Comptroller of the Currency ("OCC") has issued specific guidance on the conflict of interest that arises when a bank invests fiduciary assets in a proprietary mutual fund that pays service fees to the bank:

> A bank that invests fiduciary assets in proprietary mutual funds must first consider the legality of the investment. Bank counsel should determine that applicable law allows such an investment. Once the legality of the investment is established, the bank must keep in mind its obligation to act solely in the best interests of account beneficiaries.
>
> Before investing, the bank should make a positive determination that the investment meets the needs of the account. The bank should also document through the annual review process that the proprietary mutual fund continues to be an appropriate investment for the account. Factors such as the performance of the mutual fund, fees charged, liquidity, and the needs of account beneficiaries should be considered and documented as part of the annual review process.[18]

The Federal Reserve Board's staff also has issued supervisory guidance on fiduciary investments in mutual funds when the fiduciary bank receives fees from the fund or its adviser. The Board's staff cautioned banks as follows:

> Increasingly, banks and trust institutions are encountering various direct or indirect financial incentives to place trust assets with particular mutual funds. These incentives range from payments structured as reimbursements for services or for transferring business to an unaffiliated fund family, to the financial benefits arising from the use of mutual funds that are managed by the institution or an affiliate. In some cases, such as service fees for administrative and record-keeping functions performed by the trust institution, the permissibility of such payments may be specifically addressed under state law. In the case of other financial incentives, guidance under

[18] *Id*. at 43.

> applicable law may be less clear. In all cases, however, decisions to place fiduciary assets in particular investments must be consistent with the underlying trust documents and must be undertaken in the best interest of the trust beneficiary.
>
> The primary supervisory concern is that an institution may fail to act in the best interest of beneficiaries if it stands to benefit independently from a particular investment. As a result, an institution may expose itself to an increased risk of legal action by account beneficiaries, as well as to potential violations of law or regulation.
>
> Although many state laws now explicitly authorize certain fee arrangements in conjunction with the investment of trust assets in mutual funds, institutions nonetheless face heightened legal and compliance risks from activities in which a conflict of interest exists, particularly if proper fiduciary standards are not observed and documented. Even in the case of investments where the institution does not exercise investment discretion, disclosure or other requirements may apply. Therefore, institutions should ensure that they perform and document an appropriate level of due diligence before entering into any fee arrangements similar to those described above or placing fiduciary assets in proprietary mutual funds.[19]

In addition to obtaining a reasoned opinion of counsel addressing the permissibility of mutual fund investments and related fees, the Board's staff stated that the due diligence process for such investments should include the adoption of policies and procedures and documentation of the bank's investment decision:

> Establishment of Policies and Procedures—The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations and sound fiduciary principles, including any disclosure requirements or

[19] Federal Reserve Board, Supervisory Guidance Regarding the Investment of Fiduciary Assets in Mutual Funds and Potential Conflicts of Interest, SR 99-7 (SPE) (March 26, 1999).

> "reasonableness" standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.
>
> Analysis and Documentation of Investment Decisions—Where fees or other compensation are received in connection with fiduciary account investments over which the institution has investment discretion or where such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons to similar mutual funds, management fees and expense ratios, and ratings by recognized mutual fund rating services. The institution should also document its assessment that the investment is, and continues to be, appropriate for the individual account, in the best interest of account beneficiaries, and in compliance with the provisions of the Prudent Investor or Prudent Man Rules, as appropriate.[20]

Federal banking examiners review bank trust departments for compliance with these supervisory requirements.[21]

Federated Has Helped to Make Banks Aware of Their Fiduciary Duties When Receiving Fund Service Fees

Federated has undertaken a number of initiatives to address the fiduciary law implications that arise when a bank receives compensation in connection with the investment of fiduciary assets in the Federated Funds or other mutual funds. Before paying service compensation to bank trust departments that use the Federated Funds for fiduciary investments, Federated provides the bank with

[20] *Id. See also* FDIC Trust Examination Manual (2001) § 3.L (citing Federal Reserve guidance).

[21] *See generally* FDIC Trust Examination Manual (2001).

extensive materials addressing the bank's fiduciary obligations and the supervisory guidance issued by federal banking regulators.[22]

Federated also has hosted a number of seminars for bank trust departments regarding the fiduciary implications that must be addressed when a bank receives compensation in connection with the investment of fiduciary assets in mutual funds. The faculty members at these seminars have included representatives of federal and state banking agencies, academic experts, and members of the judiciary, along with practicing attorneys and consultants experienced in assisting bank trust departments in conforming their fiduciary investments to applicable fiduciary law.[23]

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[22] Among other information, Federated has provided bank trust departments with the following materials: "Fiduciary Issues Raised by the Payment of Mutual Fund Fees to Bank Fiduciaries," a videotaped roundtable discussion by fiduciary law experts, including Professor John H. Langbein, Sterling Professor of Law, Yale Law School, and author of the Uniform Prudent Investor Act, and Professor Edward C. Halbach, Jr., Dean Emeritus, University of California School of Law at Berkeley, and Author of the Restatement Third (Trusts); "The Uniform Prudent Investor Act," a videotaped lecture by Professor Langbein, author of the UPIA, discussing the UPIA and its implications for bank trust departments; "Fiduciary Investments in Proprietary Mutual Funds: A Best Practice Guide," prepared by Melanie L. Fein with Donald Myers of Reed Smith, LLP; "The Fiduciary Investment Process and the Reasonableness of Fees;" a white paper prepared by Melanie L. Fein, assisted by John H. Langbein; "Fiduciary Compensation in a Mutual Fund Environment," a white paper prepared by Melanie L. Fein and Thomas Richardson, Arnold & Porter.

[23] Among other educational programs offered to bank trust departments, Federated has hosted the following: "Proprietary Mutual Funds and Fiduciary Risk," a seminar at Boston University Law School on October 25, 2001; "Proprietary Mutual Funds and the Fiduciary Investment Process," a colloquium at the Princeton Club in New York on November 9, 2000; "Bank Trustee Compensation in a Mutual Fund Environment," a seminar in Pittsburgh on October 10, 1996.

APPENDIX B

Examples of state laws that permit banks to receive fees in connection with the investment of fiduciary assets in mutual funds

Florida:

> In addition to other investments authorized by law for the investment of funds held by a fiduciary, or by the instrument governing the fiduciary relationship, and notwithstanding any other provision of law, a bank or trust company acting as a fiduciary, agent or otherwise may, in the exercise of its investment discretion or at the direction of another person authorized to direct investment of funds held by the bank as fiduciary, invest and reinvest in the securities of an open-end or closed-end management investment company or investment trust registered under the Investment Company Act of 1940, as amended, so long as the portfolio of such investment company or investment trust consists substantially of investments not prohibited by the governing instrument.
>
> The fact that such bank or trust company or an affiliate of the bank or trust company provides services to the investment company or investment trust such as that of an investment adviser, custodian, transfer agent, registrar, sponsor, distributor, manager or otherwise and is receiving reasonable compensation for those services, shall not preclude such bank or trust company from investing or reinvesting in the securities of the open-end or closed-end management investment trust registered under the Investment Company Act of 1940. However, with respect to any funds so invested, the basis (expressed as a percentage of asset value or otherwise) upon which such compensation is calculated shall be disclosed (by prospectus, account statement or otherwise) to all persons to whom statements of such account are rendered.[24]

North Carolina:

> Unless prohibited or otherwise limited by an instrument governing a fiduciary relationship, a corporate trustee may invest in the securities of, or any other interest in, any open

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[24] Fla. Stat. Ann., Title 38 § 660.417.

end or closed end management type investment company or investment trust registered under the "Investment Company Act of 1940," notwithstanding that the corporate trustee or affiliate of the corporate trustee provides services to the investment company or investment trust such as that of investment advisor, custodian, transfer agent, registrar, sponsor, distributor, manager, or otherwise and receives or has received remuneration for those services; provided that the corporate trustee shall make such investment only if that investment is in the best interest of the beneficiary of the account. With respect to any funds so invested, the corporate trustee shall conspicuously disclose by statement, prospectus, or otherwise to all current income beneficiaries of an account the rate, formula, or other method by which the remuneration for those services is determined. This disclosure shall be in addition to such disclosure of any trustee fee charged by the corporate trustee with respect to said funds.

Notwithstanding any other provision of this section, the total amount all fees, charges, remuneration, and compensation derived from the trust assets by the corporate trustee, or its affiliate, or both, shall be reasonable.[25]

Illinois:

A trustee, including a trustee of a common trust fund, may invest and reinvest the trust estate in interests in any open-end or closed-end management type investment company or unit investment trust registered under the Investment Company Act of 1940 or any investment fund exempt from registration under the Investment Company Act of 1940, any of these investment companies, unit investment trusts, or investment funds being a "mutual fund" for purposes of this Section, or may retain, sell, or exchange those interests, provided that the portfolio of the mutual fund, as an entity, is appropriate under the provisions of this Act. A trustee shall not be prohibited from investing, reinvesting, retaining, or exchanging any interests held by the trust estate in any mutual fund for which the trustee or an affiliate acts as advisor or manager or in any other role solely on the basis that the trustee (or its affiliate) provides services to the mutual fund and receives reasonable remuneration for those services. Neither a trustee nor its

[25] N.C. Stat. Ann. 36A-66.2.

affiliate shall be required to reduce or waive its compensation for services provided in connection with the investment, management, and administration of the trust estate because the trustee invests, reinvests, or retains the trust estate in a mutual fund, so long as the total compensation paid by the trust estate as trustee's fees and mutual fund fees, including any advisory or management fees, in connection with the investment of a trust estate in a mutual fund is reasonable; provided, however, that a trustee may receive Rule 12b-1 fees equal to the amount of those fees that would be paid to any other party.[26]

[26] 760 Ill. Compiled Stat. 5-5.2.

APPENDIX C

Letter dated February 25, 2002 requesting an exemption for banks with respect to certain employee benefit plans that invest in mutual funds.

APPENDIX D

Letter dated November 19, 2002 requesting an exemption for escrow and other agency accounts and urging the Commission to allow a bank to invest customer accounts in money market mutual funds

APPENDIX E

Letter dated March 30, 2001 requesting an exemption for indenture trustees.