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## FEDERAL RESERVE SYSTEM

### 12 CFR Part 225

**[Regulation Y; Docket No. R–0868]**

### Investment Adviser Activities

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Final rule.

**SUMMARY:** The Board is adopting a final rule amending its interpretive rule regarding investment adviser activities of bank holding companies to allow a bank holding company (and its bank and nonbank subsidiaries) to purchase, in a fiduciary capacity, securities of an investment company advised by the bank holding company if the purchase is specifically authorized by the terms of the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered. This amendment would reflect changes that have occurred since the rule was adopted; and would conform the Board's interpretive rule to rules applied to banks by the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, and the standard in section 23B of the Federal Reserve Act for this type of activity.

**EFFECTIVE DATE:** September 30, 1996.

**FOR FURTHER INFORMATION CONTACT:** Thomas M. Corsi, Senior Attorney (202/452–3275); or David S. Simon, Attorney (202/452–3611), Legal Division, Board of Governors of the Federal Reserve System. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452–3544).

**SUPPLEMENTARY INFORMATION:**

Background

In 1972, the Board permitted bank holding companies to serve as investment advisers to mutual funds and other registered investment companies, and adopted an interpretive rule setting forth limitations on this activity. Among the restrictions in the rule is a requirement that a bank holding company not purchase in its sole discretion in a fiduciary capacity any securities of an investment company advised by the bank holding company. The Board adopted this restriction because of concern that a bank holding company might use its position as a fiduciary to support an investment company that the bank holding company advises, increase the asset size of the investment company, or increase advisory fees.

The Board has sought public comment on a proposal to relax this restriction to permit a bank holding company to purchase in its sole discretion in a fiduciary capacity securities of an investment company advised by the bank holding company if the purchase is specifically authorized by the terms of the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.[1] This change would reflect current practice in this area.[2]

Since the Board adopted its investment advisory interpretive rule, Congress enacted section 23B of the Federal Reserve Act, which permits a bank or its subsidiary to purchase securities, as a fiduciary, from an affiliate if such purchases are permitted by the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction governing the fiduciary relationship.[3] Both the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) recently permitted the banks that they regulate to purchase, in a fiduciary capacity, securities of an investment company advised by an affiliate of the bank if the purchase is specifically authorized by the terms of the instrument creating the fiduciary relationship, by court order, or by local law.[4] In addition, many states have amended their laws to permit a fiduciary to purchase, on behalf of customer accounts, shares of an investment company advised by the fiduciary or its affiliate.[5] In an analogous area, the Board has permitted fiduciary purchases of securities that are underwritten by a section 20 affiliate if the purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.[6]

The proposed amendment would have required that a bank holding company disclose to its fiduciary customers in writing that the bank holding company or its subsidiary serves as investment adviser to the investment company whose shares are purchased in a fiduciary capacity. The Board specifically requested public comment on whether the proposed disclosure requirement is necessary. The Board also requested public comment on whether the proposed disclosure requirement would be adequate if given only at the time the fiduciary relationship is created, or whether written disclosure should be given immediately prior to each initial investment in an investment company advised by the bank holding company.

Summary of Public Comments

The Board received 21 comments on its proposal.[7] Overall, the comments supported the Board's proposal. Regarding disclosures, twelve commenters stated that the Board should not require any special disclosure when a bank holding company purchases as fiduciary shares of an investment company advised by the fiduciary or its affiliates. Several commenters argued that special

[1] 59 FR 67,654 (December 30, 1994).

[2] The Board's proposal was in response to requests by several bank holding companies. These bank holding companies indicated that a mutual fund advised by the holding company is often the most cost-effective method of providing investment advice to customers and is increasingly attractive to customers because a mutual fund provides customers with a readily marketable and easily valued investment product. *See* Letter dated August 12, 1994, from the American Bankers Association to Chairman Greenspan.

[3] 12 U.S.C. 371c–1(b)(1).

[4] *See* OCC Trust Interpretation No. 234 (September 21, 1989); 12 CFR 9.12; and 12 CFR 337.4(e).

[5] *See, e.g.*, Mich. Comp. Laws § 487.485 (1992) (amended in 1992); Md. Code Ann., Est. & Trusts § 15–106 (1993) (amended in 1991); Ind. Code Ann. § 28–1–12–3 (Burns 1993).

[6] *Citicorp, J.P. Morgan & Company Incorporated, and Bankers Trust New York Corporation*, 73 Federal Reserve Bulletin 473 (1987) (*Citicorp Order*), *aff'd sub nom. Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988).

[7] These commenters included 17 banking organizations, two trade associations, one law firm, and one bank consulting firm.

disclosures are unnecessary in cases in which the purchase is permitted by court order or by the instrument creating the fiduciary relationship because the court or person creating the fiduciary relationship would be aware of the potential conflicts of interest. Commenters also stated that, in the case in which the purchase of shares is permitted by state law, the timing and content of disclosures should be governed exclusively by the laws of the state. These commenters generally maintained that the proposed disclosure would unnecessarily interfere with state law, could confuse fiduciary customers, and could be expensive and cumbersome.[8]

Discussion

After further review, the Board has determined that it is unnecessary to impose a general disclosure requirement when a bank holding company purchases as fiduciary shares of an investment company it advises. The Board believes that existing disclosure requirements are generally sufficient to ensure that fiduciary customers are aware of potential conflicts of interest that may arise from this activity.

As noted by commenters, the instrument or court order creating the fiduciary relationship, or state law, often contains or requires the disclosure of any potential conflict of interest. In addition, the common law has addressed conflicts of interest, disclosures, and other remedies in this area. Thus, any disclosure requirement adopted by the Board may be duplicative or conflict with other disclosure requirements.

In addition, other federal statutes require certain fiduciaries, including nonbanking subsidiaries of bank holding companies, to disclose potential conflicts of interest that may affect the fiduciary's recommendations. For example, under the Investment Advisers Act of 1940 (Advisers Act), an investment adviser has a fiduciary duty to disclose to a client any compensation it receives that may affect its recommendations.[9] Thus, according to the Securities and Exchange Commission (SEC), an investment adviser that receives fees from an investment company in which the adviser places trust funds as fiduciary must disclose to the trust customer the receipt of those fees and the potential conflict of interest presented.[10]

Although banks, trust companies, and bank holding companies themselves are exempt from the definition of investment adviser under the Advisers Act, the Act covers the advisory activities of affiliates of banks and bank holding companies.[11] According to the SEC, a nonbank subsidiary of a bank holding company—other than a trust company—has an obligation under the Advisers Act to disclose to its fiduciary customers that it may acquire for them shares of investment companies from which the nonbank subsidiary or its affiliate receives advisory fees.[12]

Neither the OCC nor the FDIC generally require a bank to specifically disclose to its fiduciary customers that the bank serves as investment adviser to an investment company whose shares the bank purchases in a fiduciary capacity.[13] The OCC recently indicated that a national bank that invests fiduciary assets in mutual funds that pay fees to the bank for services may, if the bank also receives fees for acting as a fiduciary, do so only to the extent authorized under state law, the trust instrument, or court order. The OCC further indicated that a trustee's overall fees must be consistent with any state law requirements that fees be reasonable, necessary, or appropriate, and the fee arrangement must be disclosed pursuant to any relevant state law disclosure requirements.[14]

While the Board is not adopting a disclosure requirement, the Board believes, as a general matter, that the disclosure of potential conflicts of interest is consistent with sound fiduciary principles. Accordingly, the Board encourages bank holding companies not already required to disclose potential conflicts of interest (by the instrument or court order creating the trust or by state or federal law) to make such disclosures. Bank holding companies engaging in this activity should recognize that their activities may be subject to disclosure requirements under state and federal laws, and should engage in the activities in a manner consistent with common law principles of trust law.

Other Comments

Four commenters stated that the Board should seek public comment on amending other restrictions contained in paragraph (g) of the interpretive rule. In particular, these commenters suggested that the Board reconsider the appropriateness of paragraphs (g) (1), (3) and (4) of the interpretive rule, which prohibit a bank holding company and its bank and nonbank subsidiaries from (i) purchasing for their own account securities of any investment company for which the bank holding company acts as investment adviser, (ii) extending credit to any such investment company, or (iii) accepting securities of such investment company as collateral for a loan which is for the purpose of purchasing securities of the investment company. Two of these commenters stated that national and state-member banks can engage in these activities subject only to the limitations contained in sections 23A and 23B of the Federal Reserve Act. Another commenter stated that these prohibitions prevent bank holding companies from competing effectively with other organizations because bank holding companies cannot provide the initial seed or start-up capital for advised investment companies or provide liquidity to such funds. One commenter also stated that the restrictions of paragraph (g) should apply to investment companies advised by subsidiary banks of bank holding companies.[15] The Board has decided to seek comment on amending other provisions of paragraph (g) in a separate proceeding.

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 95–354, 5 U.S.C. 601 *et seq.*), the Board of Governors of the Federal Reserve System certifies that adoption of this final rule would not have a significant economic impact on a substantial number of small entities that would be subject to the regulation.

[8] One commenter argued that the proposed disclosure was appropriate and should be required immediately prior to each initial investment in an investment company advised by the bank holding company, as well as at the time the fiduciary relationship is created.

[9] 15 U.S.C. § 80b–6. *See* Hornor Townsend & Kent, Inc., SEC No-Act. LEXIS 495 (April 4, 1995), *citing SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194–95 (1963).

[10] *See* Neuberger & Berman, SEC No-Act. LEXIS 1496 (May 29, 1984).

[11] *See, e.g.*, First Commerce Investors, Inc., SEC No-Act. LEXIS 221 (January 31, 1991) (* * * the Advisers Act does not specifically except a subsidiary of a bank or a bank holding company from the definition of investment adviser, unless that subsidiary is itself a bank or bank holding company.); 15 U.S.C. § 80b–1(11).

[12] Bank holding companies acting as fiduciaries to employee retirement plans also may be required to make disclosures under the Employee Retirement Income Security Act (ERISA) and Department of Labor Regulations. *See* 29 U.S.C. §§ 1106 and 1108; Prohibited Transaction Exception 77–4, 42 FR 18,732 (April 8, 1977).

[13] *See* 12 CFR 9.12 and 337.4(e). In addition, section 23B does not require a bank or its subsidiary to disclose to its fiduciary customers that it may purchase securities from an affiliate. Moreover, the *Citicorp Order* does not require specific disclosure of fiduciary purchases of securities underwritten by a section 20 affiliate.

[14] *See* OCC Interpretive Letter No. 704, November 2, 1995.

[15] The restrictions contained in paragraph (g) only apply to investment companies advised by a bank holding company or its nonbank subsidiaries. *See Norwest Corporation*, 76 Federal Reserve Bulletin 79, 80 n.3 (1990).

This amendment will remove a restriction currently contained in the Board's regulations that the Board believes is no longer necessary. The amendment does not impose more burdensome requirements on bank holding companies than are currently applicable.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the final rule under the authority delegated to the Board by the Office of Management and Budget. No collections of information pursuant to the Paperwork Reduction Act are contained in the final rule.

List of Subjects in 12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, the Board amends 12 CFR Part 225 as set forth below:

## PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for 12 CFR 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

2. Section 225.125 is amended by revising paragraph (g) to read as follows:

**§ 225.125 Investment adviser activities.**

* * * * *

(g) In view of the potential conflicts of interests that may exist, a bank holding company and its bank and nonbank subsidiaries should not:

(1) Purchase for their own account securities of any investment company for which the bank holding company acts as investment adviser;

(2) Purchase in their sole discretion, any such securities in a fiduciary capacity (including as managing agent) unless the purchase is specifically authorized by the terms of the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered;

(3) Extend credit to any such investment company; or

(4) Accept the securities of any such investment company as collateral for a loan which is for the purpose of purchasing securities of the investment company.

* * * * *

By order of the Board of Governors of the Federal Reserve System, August 26, 1996.

William W. Wiles,

*Secretary of the Board.*

[FR Doc. 96–22168 Filed 8–29–96; 8:45 am]

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## NATIONAL CREDIT UNION ADMINISTRATION

### 12 CFR Parts 705, 747 and 790

### Changes in Office Description and References

**AGENCY:** National Credit Union Administration (''NCUA'').

**ACTION:** Final rule.

**SUMMARY:** Last year, the NCUA Board established the Office of Chief Financial Officer, transferring to it the functions of the Office of the Controller and some of the responsibilities of the Office of Examination and Insurance. The description of and references to the Office of the Controller are deleted, and a description of and references to the Office of Chief Financial Officer are added. The description of the Office of Examination and Insurance is updated to reflect redistribution of duties. Two references in other parts of the Regulations are also updated. These changes update the Regulations to reflect the current structure and responsibilities of various agency offices and make technical corrections to references within the regulations.

**EFFECTIVE DATE:** August 30, 1996.

**ADDRESSES:** National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314–3428.

**FOR FURTHER INFORMATION CONTACT:** Hattie Ulan, Special Counsel to the General Counsel, at the above address or 703–518–6540.

**SUPPLEMENTARY INFORMATION:** Part 790 of the NCUA Regulations sets forth NCUA organization, including descriptions of duties of all agency components. On July 25, 1995, the NCUA Board established the Office of Chief Financial Officer, transferring to it the functions of the Office of the Controller and some of responsibilities of the Office of Examination of Insurance. This document deletes the description of the Office of the Controller, and replaces it with a new description of the Office of Chief Financial Officer. It also makes changes to the description of the Office of Examination and Insurance to reflect current duties. Two additional technical changes are made. First, in Section 705.3, the reference to § 701.32(d)(1) is changed to § 701.34(a)(1) to reflect a recent change to Part 701. Second, the reference to 12 CFR part 4 in § 747.25(b) is corrected to read 12 CFR § 792.5(b). Section 747.25 was recently amended with the incorrect reference.

Regulatory Procedures

*Regulatory Flexibility Act*

The Regulatory Flexibility Act requires the NCUA to prepare an analysis to describe any significant economic impact a regulation may have on a substantial number of small credit unions (primarily those under $1 million in assets). The types of changes made by this rule have no economic impact on credit unions. These are merely housekeeping changes. Therefore, the NCUA Board has determined and certifies that, under the authority granted in 5 U.S.C. 605(b), this final rule will not have a significant economic impact on a substantial number of small credit unions. Accordingly, the Board has determined that a Regulatory Flexibility Analysis is not required.

*Paperwork Reduction Act*

This final rule does not change any paperwork requirements.

*Executive Order*

Executive Order 12612 requires NCUA to consider the effect of its actions on state interests. Since these are housekeeping changes only, there is no effect on state interests.

List of Subjects in 12 CFR Parts 705, 747 and 790

Credit unions.

By the National Credit Union Administration on August 8, 1996.

Becky Baker,

*Secretary of the Board.*

Accordingly, for the reasons set out in the preamble, 12 CFR Ch. VII is amended as set forth below.

## PART 705—COMMUNITY DEVELOPMENT REVOLVING LOAN PROGRAM FOR CREDIT UNIONS

1. The authority citation for part 705 continues to read as follows:

Authority: Pub. L. 97–35, 42 U.S.C. 9822; Pub. L. 99–609, note to 42 U.S.C. 9822; Pub. L. 101–144, 12 U.S.C. 1766(k).

2. Section 705.3 is amended by revising the reference ''§ 701.32(d)(1)'' to ''§ 701.34(a)(1)'' in paragraph (b).