Office of the Comptroller of the Currency

Interpretations - Letter 722

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Cites:

- *12 C.F.R. 9.18*

March 12, 1996
[ ]
Dear [ ]:
This responds to your February 22, 1996 letter requesting, on behalf of [ ] that the Office of the Comptroller of the Currency ("OCC") confirm its position on a national bank's ability to invest collective investment fund ("CIF") assets in mutual funds and to receive trustee fees notwithstanding the fees a mutual fund also charges participants or any corresponding mutual fund fee the bank may receive as a mutual fund servicer. We believe a national bank may invest CIF assets in mutual funds, including mutual funds that pay the bank servicing fees, without the bank having to reduce its trustee fees, if the bank in question concludes, based upon a reasoned opinion of trust counsel, that such an arrangement is authorized by applicable state law, is consistent with the trust instrument, is appropriate for the particular trust accounts, and is consistent with OCC regulations, including in particular, 12 C.F.R. 9.18(b)(12).

State law and the trust instrument govern the types of investments a national bank trustee may make. 12 C.F.R. 9.11(a). <**Note:** The recently proposed revisions to 12 C.F.R. 9.11 would require banks to invest fiduciary assets in accordance with "applicable law." 60 Fed. Reg. 66163, 66176 (1995). "Applicable law" under the regulation means Federal law, state fiduciary law, the trust instrument or court order. *Id*. at 66174. > Not only must banks invest trust assets in permissible types of investments, but the particular investment chosen from among the authorized types also must be appropriate. A particular investment is appropriate if it is consistent with the trust instrument's requirements or the state law's "prudent investor" standards and with the bank's other fiduciary duties. <**Note:** Employee benefit plans must adhere to the requirements set forth in the Employee Retirement Income Security Act of 1974, as amended, including its prudent investor standards. *See* 29 U.S.C. 1001, *et seq*.>

Investing trust assets in mutual funds that compensate a national bank trustee for advisory or other services creates a conflict of interest under 12 C.F.R. 9.12(a). *See Comptroller's Handbook for Fiduciary Activities*, Fiduciary Precedent 9.2105, p. 225. A conflict of interest arises when a bank trustee makes an investment that might lead the bank to disregard or ignore the trust beneficiaries' best interest. Under Section 9.12(a), a national bank may invest trust assets in proprietary mutual funds and receive compensation from the mutual funds to the extent authorized under state law, the trust instrument, or court order.

Most states have enacted statutes identifying both proprietary and nonproprietary mutual funds as permissible investments for trust assets. If appropriate, mutual fund investments offer certain advantages for trust accounts, such as enhanced investment diversification, economies of scale, and public information on values and returns.

Because investing CIF assets in mutual funds can result in CIF participants having to pay additional fees, a national bank must consider the fees it and the mutual fund receive when determining whether a particular mutual fund investment is appropriate. A mutual fund ultimately charges its shareholders, including any CIF participant investors, for investment management, administrative, brokerage, transfer agent, custodial, or other services that the mutual fund's service providers perform.

While such fees do not make mutual fund investments *per se* inappropriate for CIFs, the bank's overall fees, when considered with the mutual funds' fees, must comply with any state law requirement that fees be reasonable, necessary, or appropriate, <**Note:***See Restatement of the Law (Third) of Trusts*, 227(c)(3) (1992); and III Scott & Fratcher, *The Law of Trusts*, 188 (4th ed. 1988).> and the disclosure of the fee arrangement must conform to any relevant state law requirements. Absent state law, trust instrument, or other party agreement regulating or defining appropriate fiduciary compensation, OCC regulation requires that fees paid to a national bank fiduciary must be reasonable. 12 C.F.R. 9.15

The reasonableness of a fee, and the prudence of the investment creating additional fees, depends in part upon the services obtained for the fee. The *Restatement of the Law (Third) of Trusts* discusses the dual compensation problem that can arise when fiduciaries invest trust assets in mutual funds. According to the Restatement,

> Even assuming fiduciary care in comparing costs and avoiding excessive charges, fund managers inevitably must be compensated in one way or another. If the trustee also receives commissions from the trust, they must be appropriate to the duties performed; and overall management costs to the trust estate must not be unreasonable in light of alternatives realistically available to the particular trustee.

Restatement of the Law (Third) of Trusts, 227, comment m (1992).

In addition to these considerations applicable to all types of fees, OCC regulations also specifically limit the management fee a national bank can charge its CIF participants. According to the relevant portion of OCC regulation 12 C.F.R. 9.18(b)(12), a national bank

> may charge a fee for the management of the collective investment fund: *Provided*, That the fractional part of such fee proportionate to the interest of each participant shall not, when added to any other compensations charged by a bank to a participant, exceed the total amount of compensations which would have been charged to said participant if no assets of said participant had been invested in participations in the fund.

This management fee restriction is meant to prevent "double charging" and potential conflicts of interest where the fiduciary possesses investment discretion. 55 Fed. Reg. 4184, 4192 (1990). A national bank's management fees for CIFs invested in mutual funds must comply with the fee restrictions contained in 12 C.F.R. 9.18(b)(12).

Banks that invest CIF assets in proprietary and nonproprietary mutual funds must perform investment and compensation analysis to ensure that the investment and the attendant fees are appropriate. In our opinion, a national bank may invest CIF assets in mutual funds and receive fees for servicing the mutual fund without reducing its trustee fees provided that the bank concludes, on the basis of the particular facts presented, and supported by a reasoned opinion of trust counsel, that applicable state law, the governing trust instrument, and OCC regulation 12 C.F.R. 9.18(b)(12) permit such arrangements. A national bank must also determine that the investment is prudent and appropriate for the trust accounts, given the investment alternatives realistically available to the trustee, and trust counsel should also address whether the investment is otherwise consistent with state law fiduciary requirements, including the obligation to incur only reasonable expenses and to periodically review the prudence of retaining these investments.

If you have any further questions on this matter, please contact Ellen Broadman, Director of the Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,
/s/
Julie L. Williams
Chief Counsel