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**Federated**

WORLD-CLASS INVESTMENT MANAGER®

July 20, 2004

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549-0609



**RE: Regulation B – File No. S7-26-04**

Dear Mr. Katz:

Federated Investors, Inc. appreciates this opportunity to comment on proposed Rule 770 in the Commission's proposed Regulation B. By way of background, Federated is the sponsor and distributor of the Federated family of mutual funds registered under the Investment Company Act of 1940 with approximately $200 billion in total assets under management. Many of Federated's mutual funds are made available through bank trust departments acting in various fiduciary capacities, including as trustee and/or custodian for personal trust accounts, managed asset accounts, 401(k) plan and individual retirement accounts, and trust indentures. Federated thus has a substantial interest in the applicability of the federal securities laws to such services offered by banks.

Regulation B, in relevant part, would exempt a bank from the definition of the term "broker" under the Securities Exchange Act of 1934 "to the extent that it effects transactions in securities of an open-end company in an account for a plan that is qualified under section 401(a) of the Internal Revenue Code of 1986 … or a plan described in sections 403(b) or 457 of the Internal Revenue Code of 1986 … for which the bank acts as a trustee or custodian …." This relief is subject to a series of conditions, one of which requires that the bank "offsets or credits any compensation that it receives from a fund complex related to securities in which plan assets are invested against fees and expenses that the plan owes to the bank."

The discussion in the proposal of proposed Rule 770 acknowledges that banks may be compensated for their services to plans through Rule 12b-1 fees and other fees that would be classified as "sales compensation" under Rule 3b-17. Because the trust and fiduciary activities exception may not be available to these banks if their receipt of such fees causes them to fail that exception's "chiefly compensated" test, the employee benefit plan exemption in Rule 770 would provide them alternative relief. The condition in Rule 770 requiring that these 12b-1 and other fees be offset or credited is based, according to the proposal, on banks having advised the staff "that they do a dollar-for-dollar offset, or credit, of the compensation they receive from the funds that they offer to plans against the fees imposed on the plans themselves." The proposal further states that this practice is consistent with Department of Labor ("DOL") guidance, citing ERISA Advisory Opinion 97-15A. While the proposal acknowledges that the DOL also has issued ERISA Advisory Opinion 97-16A, which describes circumstances that do not require an offset or credit of mutual fund fees received by a plan service provider acting in a non-discretionary capacity, the staff said that no bank has advised it that it operates under that advisory opinion.

In fact, in Federated's experience, a number of banks are operating under the legal framework described in ERISA Advisory Opinion 97-16A and a more recent advisory opinion, ERISA Advisory Opinion 2003-09A, which does not require that the mutual fund fees received by a bank or other plan service provider be offset or credited if certain conditions are met.

The starting point for the DOL's analysis of this issue is section 406(b)(1) of ERISA, which prohibits a fiduciary from dealing with the assets of the plan in his own interest or for his own account. According to the DOL, section 406(b)(1) prohibits a fiduciary from using the authority, control or responsibility that makes the person a fiduciary to cause a plan to pay an additional fee to the fiduciary itself, or to a person in which the fiduciary has an interest that may affect the exercise of its best judgment.[1] By contrast, if the fiduciary does not use any of the authority, control or responsibility that makes it a fiduciary to cause a plan to pay itself additional fees, there is no violation of section 406(b)(1).[2]

The key issue in the opinions is whether the service provider receiving the mutual fund fees is acting as a fiduciary with respect to the plan's selection of the mutual funds. In the arrangements described in Advisory Opinion 97-15A, the service provider – the plan trustee – did play a role in mutual fund selection. It would advise an independent plan fiduciary regarding which mutual funds to use as plan investments, and would therefore be acting as a fiduciary in the selection of the funds (since the definition of a fiduciary under ERISA, section 3(21)(A), includes the provision of "investment advice"). In addition, even if the trustee would not advise on mutual fund selection, it would (1) select a range of investment funds for plans to choose from as investment alternatives, and (2) then monitor the performance of those funds, possibly adding or substituting funds over time. The DOL was unable to conclude that the trustee would not be acting as a fiduciary where it had the unrestricted right to add or remove the mutual funds used by its client plans. Therefore, to avoid a section 406(b)(1) violation (as well as a violation of section 406(b)(3), which prohibits a fiduciary from receiving consideration from a third party in connection with a transaction involving the plan), the trustee was required not to receive any additional fee as

1 29 C.F.R. § 2550.408b-2(e)(1).

2 29 C.F.R. § 2550.408b-2(e)(2).

a result of the mutual fund fee payments. It accomplished this result by offsetting the mutual fund fees against the compensation the plan was otherwise obligated to pay to itself or to a third-party recordkeeper, and/or crediting those fees directly to the plan, thereby receiving no additional benefit from the fees.

Unlike the trustee described in Advisory Opinion 97-15A, the plan service provider described in Advisory Opinion 97-16A – a recordkeeper – was not providing investment advice to plans on the selection of mutual fund investments. However, it would be putting together a mutual fund "menu" from which plan fiduciaries independent of the service provider would select plan investment options. The DOL staff was concerned about the service provider's ability to make changes to the menu that could affect the mutual funds in which the plan was invested. In the DOL staff's view, if the institution could cause the plan's investments to be shifted to another mutual fund, possibly one that pays higher 12b-1 fees, the institution may be exercising such discretion over the plan's choice of mutual funds that would make it a fiduciary.

However, the recordkeeper described in Advisory Opinion 97-16A was subject to a series of limitations on its ability to make changes to its fund menu. It was required to provide advance notice to an independent plan fiduciary of any change to the menu, including any changes in the fees to be received. The independent fiduciary would be afforded a reasonable period of time within which to decide whether to accept or reject the change and, in the event of a rejection, to secure a new service provider. The time period for advance notice and changing service providers described in the advisory opinion was 120 days (60 days for the notice and 60 days to effect the change), although the DOL added that what constitutes a "reasonable period" will depend on the particular facts and circumstances of each case.

Under these circumstances, the DOL found that the service provider was not an ERISA fiduciary with respect to mutual fund selection, nor could it use any of the authority, control or responsibility that made it a fiduciary to cause a plan to pay itself additional fees. Therefore, there was no violation of section 406(b)(1), and no need for an offset or credit of the mutual fund fees. In response to a query from the American Bankers Association, the DOL subsequently acknowledged that while Advisory Opinion 97-16A dealt with an institution other than a bank, the standard described could be readily applied to a bank serving as a directed trustee that receives 12b-1 and other fees.[3]

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3 *See* DOL letter to the American Bankers Association (Aug. 20, 1997) ("it is the view of the Department that the foregoing legal principles, as expressed in A.O. 97-15A and A.O. 97-16A, would apply in the case of a bank that serves as a directed trustee for employee benefit plans in the context of a bundled services product").

In Advisory Opinion 2003-09A, there was no issue of the trust company that requested the opinion becoming an ERISA fiduciary by reason of adding or deleting mutual funds from a fund menu, because it did not limit fund selection by use of a menu. Instead, the trust company required each client plan to select at least one of its proprietary mutual funds to offer as an investment option, and provided incentives to use a larger number of its proprietary mutual funds through charging lower fees, because greater use of proprietary funds covered more of its costs of providing plan services. Significantly, as with the limitation to a mutual fund menu, the DOL did not view this condition in itself as giving the trust company sufficient control to become an ERISA fiduciary with respect to mutual fund selection. Instead, the DOL characterized these facts as "similar" to the arrangement described in Advisory Opinion 97-16A, indicating that the proprietary fund condition did not affect the crucial consideration that an independent fiduciary have complete control over fund selection. Therefore, the trust company could retain the mutual fund fees it received without the need for a dollar-for-dollar offset or credit.

In the experience of Federated and its outside ERISA counsel, a number of banks rely on Advisory Opinions 97-16A and 2003-09A to receive and retain mutual fund fees, including 12b-1 fees, that are paid in connection with investments by plans for which they serve as trustee or custodian, or to which they may provide other types of services. These fees serve as either complete or partial payment of compensation to the banks for the services they provide. In these arrangements, there is no offset against an explicit contractual fee being charged directly to the plan – the mutual fund fees instead take the place of, or supplement, an explicit contractual fee. The bank typically discloses its receipt of these fees in its fee schedule or other contractual or disclosure materials provided to the plan, and either includes a schedule describing the fees paid by each fund or prospectuses that contain this information.

For these reasons, the condition requiring an offset or credit of fund compensation against fees or expenses owed by the plan should not be necessary. While an offset or credit is required to avoid an ERISA violation in the types of arrangements described in Advisory Opinion 97-15A, many banks retain fund fees without an offset or credit and without violating ERISA by meeting the conditions described in other advisory opinions. If, pursuant to those opinions, the bank is not acting as an ERISA fiduciary with respect to mutual fund selection, and all fund selection and investment decisions for the plan are being made by plan fiduciaries independent of the bank and/or the plan participants following appropriate disclosure, then, in the DOL's view, no further protection against conflicts of interest on the part of the bank is necessary. Because ERISA otherwise protects against such potential conflicts, an offset/credit condition is not needed in the employee benefit plan exemption of Regulation B for that purpose.

The offset requirement in Rule 770 thus imposes a stricter standard than that under ERISA. Federated does not believe that a bank should be held to a stricter standard in order to qualify for the exemption from broker registration under Rule 770, especially in view of the DOL's view that an offset requirement is not necessary to protect against conflicts of interest when a bank is acting in the circumstances described in Advisory Opinions 97-16A and 2003-09A.

We appreciated this opportunity to comment on Rule 770.

Sincerely,

Eugene F. Maloney
Executive Vice President and
Corporate Counsel

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