

Date: May 5, 2000

Referral Fees

A federal savings bank may collect referral fees for referring its small business customers to a registered investment adviser for investment management services, subject to certain limitations. Receiving referral fees is an activity incidental to a thrift's statutorily enumerated powers.

Subject: Home Owners' Loan Act/Savings Association Powers.

P-2000-7



Office of Thrift Supervision
Department of the Treasury

P-2000-7

Chief Counsel

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6000

May 5, 2000

[

]

Re: Referral Fees

Dear []:

This responds to your inquiry whether [] (the "Association") may collect referral fees for referring its small business customers to a registered investment adviser for investment management services. In brief, we conclude that this activity is permissible for the Association as an activity incidental to its statutorily enumerated powers, subject to the limitations set forth below.

I. BACKGROUND

The Association is a "Federal savings association" as defined in the Home Owners' Loan Act ("HOLA").¹ You represent that the Association offers several customer services, including certain account services, certain loan services, and retirement accounts, such as Keogh and simple Individual Retirement Account plans. You state that the Association has received inquiries from customers for Qualified Retirement Plan services, which the Association is unable to provide because the Association does not offer 401(k) plans. Also, you state the Association does not presently have a trust department and has no plans to establish one.

You represent that [], ("Investment Adviser") is an investment adviser registered with the Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940 ("Investment Advisers Act")² and operates in three states. The Investment Adviser is not affiliated with the Association and the

¹ 12 U.S.C.A. § 1462(5) (West Supp. 2000).

² 15 U.S.C.A. §§ 80b-1 - 80b-21 (West 1997 & Supp. 2000).

Association reviewed several potential companies before selecting the Investment Adviser as a candidate for this activity. You further indicate that you have conducted a limited due diligence review of the Investment Adviser and learned no negative information regarding the Investment Adviser's standing. Your submission describes the proposed referral activity as follows:

The Association intends to inform its customers of the Investment Adviser's services through personal contacts, sponsorship of small business seminars and events, and mailings. The Association will not provide the Investment Adviser with any list, or information as to the identities of its small business customers for solicitation or any other purposes. The Association will provide written material to its customers describing the relationship between the Association and the Investment Adviser, as well as a detailed "disclaimer" of liability on behalf of the Association. Key elements of the written disclaimer, a copy of which you provided to us, include the following statements:

- The Association is not affiliated in any manner with the Investment Adviser or its affiliates.
- The Investment Adviser and its affiliates, not the Association, will perform the services requested by the customer; the Association does not warrant or guarantee satisfactory performance of the Investment Adviser or of its affiliates, agents or employees.
- Customers should contact their own attorneys, accountants, and advisers to ensure that the Investment Adviser and its affiliates can satisfy the customers' particular business needs.
- The Investment Adviser will pay the Association a referral fee should the customer establish a business relationship with the Investment Adviser.
- The referral fee paid by the Investment Adviser to the Association will not cause the referred customer to pay a higher or greater fee to the Investment Adviser than non-referred customers pay.

You represent that the referred customer will be responsible for initiating all contact with the Investment Adviser. At no time will the Association provide the Investment Adviser with names of customers of the Association or other customer information for solicitation or any other purposes.³ If the Investment Adviser and the

³ It is crucial that the Association not provide its customers' names or other customer information to third parties without first addressing any issues raised in the proposed interagency rule regarding privacy of consumer financial information. See 65 Fed. Reg. 8770 (February 22, 2000). This proposed interagency rule was proposed pursuant to section 504 of the Gramm-Leach-Bliley Act (Pub. L. 106-102, codified at 15 U.S.C. §§ 6801 et seq. (West Supp. 2000)). Section 504 authorizes certain agencies, including OTS, to issue regulations as may be necessary to implement notice requirements and restrictions on a financial institution's ability to disclose nonpublic personal information about consumers to nonaffiliated third parties.

referred customer agree, they will enter into a contract for investment management services, with the Investment Adviser acting in an investment fiduciary capacity. You also indicate that the contracts between the customer and the Investment Adviser will be the Investment Adviser's standard forms, which contain all necessary disclosures and other information as required of registered investment advisers. The Association will not be a party to these contracts. If the Association's customer engages the Investment Adviser for services, the Investment Adviser will pay the Association referral fees as follows: during the first year, the referral fee will be equal to []% of the amount of the fee the Investment Adviser charges to the customer; during the second and subsequent years, the referral fee will be equal to []% of the fee the Investment Adviser charges to the customer.

You further represent that the Investment Adviser will charge a referred customer the same fees as the Investment Adviser charges a non-referred customer. In other words, the Investment Adviser will not charge the referred customers higher fees to recapture the referral fees paid to the Association. You state that the Association will not receive any additional referral fees if a referred customer contracts with the Investment Adviser's affiliates for non-investment advisory services. You have submitted two opinions of counsel addressed to the Investment Adviser. The first opinion states the proposed arrangement does not violate the Investment Adviser's "obligations as a service provider or fiduciary for the affected qualified retirement plans".⁴ The second opinion concludes that the proposed arrangement does not violate the law of [], the state in which the Association is located.⁵

⁴ You represent that this opinion, dated December 16, 1999 and signed by [], was intended to state that the proposed fee arrangement does not violate the Employee Retirement Income Security Act of 1974 ("ERISA"), however, the opinion does not mention ERISA. Accordingly, as discussed below in Section A.3., we are requiring that the Association obtain an opinion of counsel that expressly and unambiguously concludes that the proposed referral fee arrangement will not cause the Association to violate any provisions of ERISA.

⁵ The second opinion is dated December 15, 1999 and is signed by []. You state that both opinions were obtained by the Investment Adviser regarding the proposed activity with the Association. Both opinions specifically refer to the Association by name, however, only the second opinion includes a discussion of the proposed transaction. The second opinion also addresses whether the sharing of commissions with a third party (the Association) may require the third party to become subject to the registration requirements of an investment adviser under [] law. This issue is the subject of our condition, discussed below in Section A.3., that the Association must obtain its own opinion of counsel that the Association need not register as an investment adviser in order to engage in the proposed activity.

II. DISCUSSION

A. Incidental Powers Analysis

The HOLA does not expressly authorize federal savings associations to receive referral fees from investment companies for referring customers.⁶ OTS and its predecessor, the Federal Home Loan Bank Board, have concluded, however, that in order for federal savings associations to retain their customer base and to compete effectively, associations must be able to provide new services for their customers.⁷

OTS has long recognized that federal savings associations possess “incidental powers,” i.e., powers that are incident to the express powers of federal savings associations, as set forth in the HOLA. OTS uses a four-factor analysis in determining the incidental powers of federal savings associations under the HOLA. Briefly, these factors are: (1) Is the activity similar to, or does it facilitate the conduct of, an activity that Congress expressly authorized; (2) Does the activity relate to the financial intermediary role that all federal savings associations were intended to play; (3) Is the activity necessary to enable the federal savings association to remain competitive and relevant in the modern economy; and (4) Is the activity consistent with the purpose and function Congress envisioned for federal savings associations?⁸ The relative weight given to each factor may vary depending upon the type of activity in question, and it is not critical that each question be answered in the affirmative.⁹

Based on our analysis of the Association’s proposed activity under these four factors, we conclude that the Association has incidental authority to conduct the proposed activity, subject to the conditions set forth below.

⁶ 12 U.S.C.A. §§ 1461 *et seq.* (West Supp. 2000). We note that in the reverse situation, OTS has authorized federal savings associations to pay referral fees for the referral of trust business to the associations. *See* OTS Op. Chief Counsel (December 21, 1998). In that opinion, we imposed certain conditions on the payment of referral fees, including how long the fee-paying arrangement may continue. OTS is in the process of preparing general guidance on the referral of trust business, which will modify that condition.

⁷ *See* OTS Op. Chief Counsel (November 22, 1995) (federal savings associations may contract with affiliates for investment management and advisory services); FHLBB Op. by Williams (May 4, 1988) (federal savings associations may contract with companies offering discount brokerage services at the institution’s offices).

⁸ OTS Op. Chief Counsel (March 25, 1994) (surveying law related to incidental powers).

⁹ *Id.* at 8.

1. *The Activity Facilitates or is Similar to the Conduct of an Activity That Congress Expressly Authorized.*

Congress expressly authorized federal savings associations, with the approval of OTS, to exercise fiduciary trust powers.¹⁰ Federal savings associations may provide investment advisory services to customers through their trust departments.¹¹ Moreover, federal savings associations may provide investment advice to customers through their service corporations that are registered as investment advisers with the SEC.¹²

The Association's proposed activity will facilitate its expressly authorized trust powers and investment adviser authority in two ways. First, the activity will help the Association accommodate its small business customers needs with services that the Association is expressly authorized to provide, but for business reasons, elects not to offer. Second, the Association will not have to undertake the expense of educating and establishing a professional investment advisory staff, but will be able to refer its customers to a registered investment adviser the Association deems reputable.¹³

2. *The Activity Relates to the Financial Intermediary Role That All Federal Savings Associations Were Intended to Play.*

In conducting the proposed activity, the Association will act as a facilitator of services for its small business customers, without providing investment advisory services directly. In this role, the Association will act as a financial intermediary by providing information to customers regarding where they may chose to seek investment services, if the customers elect to do so. You represent that the Association will make available to its customers information regarding investment services that are not offered by the Association. We note that the Office of the Comptroller ("OCC") has addressed similar activities for national banks and expressly permits national banks to refer customers to registered investment advisers based on

¹⁰ 12 U.S.C.A. § 1464(n) (West Supp. 2000). See 12 C.F.R. Part 550 (2000) (OTS regulations governing the fiduciary operations of savings associations).

¹¹ OTS Op. Acting Chief Counsel (December 30, 1993).

¹² 12 C.F.R. §§ 545.74 and 559.4(f)(2) (2000).

¹³ We note that our analysis and conclusions concerning the proposed transaction are based in part on the Association's "due diligence" review of the Investment Adviser's reputation and standing. Also, the Association has ascertained that the Investment Adviser has registered with the SEC, which regulates the Investment Adviser. We further note that any other federal savings association that may wish to receive fees for making referrals to a third party should first contact its OTS Regional Office, which may inquire as to the federal savings association's level of due diligence review of the entity to which referrals are proposed to be made.

the rationale that acting as a “finder” is part of the business of banking.¹⁴ The proposed activity relates to the financial intermediary role that federal savings associations were intended to play because the Association will act as a facilitator of financial services, i.e., investment advisory services, for its small business customers, without providing investment advisory services directly.

3. *The Activity is Necessary to Enable the Federal Savings Association to Remain Competitive and Relevant in the Modern Economy.*

Federal savings associations compete with national banks and others in the banking industry for the generation of fees and income. The OCC permits national banks to act as finders in bringing buyers and sellers together,¹⁵ and to receive a fee for entering into referral arrangements with third parties for the provision of investment advice.¹⁶ The proposed activity will allow the Association to compete more effectively with national banks by offering a service that national banks can already provide to their customers. As noted above, some of the Association’s customers have requested that the Association provide certain investment services directly. If the Association cannot meet, or assist in meeting, the needs of its existing customers, some of these customers may decide to look elsewhere to obtain the services they need. The proposed activity will allow the Association to keep pace with the changes in the modern economy by accommodating customers’ needs in an area that the Association is, for business reasons, not in a position to provide.

Your letter indicates that the fee arrangement has the potential to continue over a number of years and that the Investment Adviser will continue to pay referral fees to the Association so long as the Investment Adviser receives fees from the referred customer. Receiving fees over an extended period of years for referring customers for investment adviser services potentially could create an inference that the Association is acting as an investment adviser, subject to SEC and state of [] registration requirements. There might be other factors that the securities regulator would consider such as additional services provided by the Association, the amount of the referral fee, and the sharing of commissions. In this regard, one of the opinions of counsel obtained by the Investment Adviser states:

¹⁴ 12 C.F.R. § 7.1002 (2000) (express authorization for national banks to act as a “finder,” to receive a fee for its services, and to advertise the availability of the service). See also, OCC Interpretive Letter # 850 (January 27, 1999) (national banks may enter into arrangements with registered investment advisers whereby the banks, for a fee, would refer their customers to the investment advisers for the provision of investment advice).

¹⁵ 12 C.F.R. § 7.1002 (2000). See, e.g., OCC Interpretive Letter # 824 (February 27, 1998) (a national bank may receive a fee for referring customers to a corporation that provides insurance products and services).

¹⁶ OCC Interpretive Letter # 850 (January 27, 1999).

The parties should proceed with caution, however, given the prior interpretation of § [], [[] Revised Statutes], by the Commissioner of Securities, [] (“Commissioner”), defining “investment adviser.” The Commissioner has taken the position that any such arrangement, in general, constitutes the sharing of commissions with a third party (the referring party) which requires that third party to be registered as an investment advisor [with the state of []].

The same opinion of counsel also states, however, that the definition of “investment advisor” under [] law does not include a bank or savings institution.

Given that the Association does not intend to register as an investment adviser but that its referral arrangement with the Investment Adviser may create an issue, we condition our approval of the proposed activity on the Association obtaining an opinion of counsel stating that the proposed activity will not cause the Association to be deemed an investment adviser subject to registration with the SEC under the Investment Advisers Act or with the state of [] under equivalent investment adviser registration requirements. Moreover, because an analysis of whether the proposed activity raises any issues under ERISA is beyond the scope of this letter, we further require as a condition of our approval that the Association also obtain an opinion of counsel stating that the Association’s proposed activities will not violate any provision of ERISA.

4. *The Activity is Consistent With the Purpose and Function Congress Envisioned for Federal Savings Associations.*

Congress provided for the creation of federal savings associations and provided that they may request authority to exercise trust powers and provide trust services to their customers.¹⁷ Federal savings associations also may provide investment advisory services to customers through service corporations that are registered as investment advisers.¹⁸ The proposed activity will facilitate the Association’s retaining and potentially attracting new customers who may need particular types of investment services, as discussed above. The proposed activity will strengthen, facilitate, and therefore be consistent with, the purpose and function of providing fiduciary and investment advisory services to meet customers’ needs.

¹⁷ 12 U.S.C.A. § 1464 (n) (West Supp. 2000).

¹⁸ 12 C.F.R. §§ 545.74 and 559.4(f)(2) (2000).

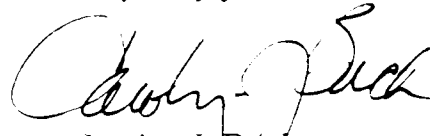
B. Compliance With Applicable Law and Conditions

Although we conclude that the Association has incidental authority to conduct the proposed activity, the Association also must comply with applicable laws and certain conditions in conducting such activity. As a condition of our approval the Association, prior to engaging in the proposed activity, must obtain opinions of counsel stating the proposed referral fees arrangement will not cause the Association (i) to become subject to the registration requirements of an investment adviser under the Investment Advisers Act or equivalent state investment adviser registration requirements, or (ii) to violate any provisions of ERISA. The Association also must comply with any other safety and soundness conditions and limitations the OTS West Region deems appropriate.¹⁹

In reaching the foregoing conclusions, we have relied upon the factual information and representations you have provided to us, as set forth in the background discussion above. Our conclusions depend on the accuracy and completeness of those representations. Any material change in facts from those set forth herein could result in different conclusions.

If you have any questions regarding the foregoing, please contact Valerie J. Lithotomos, Counsel (Banking and Finance), at (202) 906-6439.

Very truly yours,



Carolyn J. Buck
Chief Counsel

cc: Regional Directors
Regional Counsel

¹⁹ As stated above, other federal savings associations that may be interested in conducting referral activities for a fee should first contact their OTS Regional Office. In evaluating and approving such proposals from other institutions, the OTS Regional Office may set appropriate supervisory guidelines on the proposed activities.