September 7, 2004

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

RE: Proposed Regulation B under Section 3(a)(4) of the Securities Exchange Act of 1934, as amended, Release No. 34-49879; File No. S7-26-04.

Dear Mr. Katz:

The Charles Schwab Trust Company ("CSTC") appreciates the opportunity to comment on proposed Regulation B issued under Section 3(a)(4) of the Securities Exchange Act of 1934 ("Regulation B"), as amended by the Gramm-Leach-Bliley Act of 1999 ("GLBA"). Regulation B implements a series of exemptions from the definition of broker which were contained in Title II of the GLBA and were intended to permit banks to continue to engage in securities transactions that were part of traditional bank activities. In proposing Regulation B, the Securities and Exchange Commission ("SEC") also incorporated new exemptions including an exemption to permit bank securities activities for employee benefit plans (the "Employee Benefits Exemption"). CSTC commends the Securities and Exchange Commission ("SEC") for creating the Employee Benefits Exemption to address the critical role banks play in the administration of employee benefit and retirement plans.

The proposed Employee Benefits Exemption would exempt banks from the definition of broker when they effect transactions in securities of open-end investment companies in an account for qualified plans for which the bank acts as a trustee or custodian. Banks would also be able to effect securities transactions for participant-directed brokerage accounts offered as part of qualified plans. The exemption, which is contained in proposed Rule 770, contains a number of conditions including a requirement that a bank offset or credit any compensation that it receives from a fund complex against fees and expenses that the plan owes to the bank. Rule 770 also contains disclosure requirements regarding a bank's fees and expenses.

CSTC is a state-chartered non-depository trust company subsidiary of the Charles Schwab Corporation with over $35 billion in retirement plan assets. Its business consists exclusively of acting as a directed trustee or custodian of qualified and nonqualified retirement plans in an "unbundled" service model in which the bank works closely with various third party administrators ("TPAs" or "recordkeepers") to provide servicing jointly to the retirement plans through an efficient and cost-effective processing relationship

There are three standard service models in the industry:

- The "Unbundled Sole-Provider" model - where the bank and the TPA independently service the plan with minimal or no operational or systems interaction between the two providers. Either the TPA or the bank independently receives the fees with no sharing between them, and the providers price their services completely independently;

- The "Unbundled TPA-Directed" model - where the bank and the TPA jointly service the plan pursuant to the TPA being appointed as an agent of the plan sponsor in directing trade orders to the bank. There is significantly greater operational and systems interaction between the two providers, and the bank shares any mutual fund revenue it receives with the TPA in order to offset in part the fees charged by the TPA to the plan sponsor;

- The "Bundled" model - where the bank acts as either directed trustee or custodian and as recordkeeper for the plan, and there is maximum operational and systems leveraging between the bank's trust and custody and recordkeeping functions. The bank receives mutual fund revenue and applies the revenue to offset in part the fees charged to the plan sponsor.

CSTC's business fits solely into the Unbundled TPA-Directed model and is similar to that of a large number of providers in the industry that provide their services strictly to retirement plans that have been brought to them by the third party administrator acting as agent for the retirement plan sponsor. The banks sell their products and services to the TPA, rather than marketing directly to the plan sponsors. In these arrangements, the banks work directly with the TPAs on a daily basis, while the TPAs act as the daily relationship contacts with the plan sponsors.

The value of the Unbundled TPA-Directed model is that the TPAs and banks, including CSTC, that utilize the model are able to complete directly against bundled providers in a manner generally not available to the Unbundled Sole Provider model. The Unbundled TPA-Directed model offers plan sponsors greater service and price competition among all retirement plan providers, expands choice and a more open architecture for plan sponsors, provides internal cost efficiencies to the TPAs and banks, and generally reduces overall plan sponsor costs in the industry. In the unbundled industry, mutual fund revenue is then either received directly by the TPAs or is received by the bank and shared with the TPAs, both of which allow the TPA to offset their fees in part against fees owed by the plan sponsor to the third party administrators.

Regulation B, as proposed, would have a significant, negative impact on CSTC as a directed trustee and custodian for qualified and nonqualified employee benefit plans in the unbundled retirement plan industry. Our concern is that the exemption in Rule 770, as proposed, is too limited in scope. In particular, Rule 770, as proposed:

- does not recognize different compensation arrangements approved under the Employee Retirement Income Security Act of 1974 ("ERISA") by the Department of Labor ("DOL")

- does not recognize that banks may offer their trustee or custodial services to employee benefit plans through intermediaries such as third party administrators

- does not cover all of the employee benefit and retirement plans available.

- establishes a scheme of oversight regarding aspects of bank relationships with employee benefit plans which duplicates and may be inconsistent with the Department of Labor's supervision as set out in ERISA.

Revising Rule 770 therefore is critical because the Trust and Fiduciary Exemptions (Rules 721 and 722) and the Custody Exemption (Rule 760) are not workable alternatives for banks like CSTC that provide services to the retirement plan industry. The implementation of Rule 770 as proposed would force CSTC and many other banks to restructure drastically their relationships with retirement plan sponsors, mutual fund complexes, and other financial intermediaries, including third party administrators, significantly increasing costs for plan participants and the financial providers and further reducing competition in the field.

As such, CSTC strongly recommends that the SEC adopt the proposed revisions suggested below which would protect investors while permitting banks to continue to offer the services to plans that they offer today.

Scope of Rule 770

Requirement that Mutual Fund revenue be offset on a dollar for dollar basis

The proposed Employee Benefit Exemption documented in Rule 770 is based on the conclusion that all banks that act as trustee or custodian for employee benefit plans follow DOL guidance provided in ERISA Advisory Opinion 97-15A (referred to as the "Frost Letter") which requires banks which advise on mutual fund selection to offset or credit on a dollar for dollar basis revenue received from mutual funds against fees owed by the plan sponsor. While the SEC acknowledges in the preamble to proposed Regulation B that ERISA Advisory Opinion 97-16A (referred to as the "Aetna Letter") does not require offsets on a dollar for dollar basis if the trustee does not exercise discretion or provide advice regarding mutual fund selection, the SEC indicated that no bank had advised the SEC staff that it does not apply mutual fund revenue for the benefit of the plans.

CSTC, as directed trustee and custodian for various retirement plans, and many other financial providers in the unbundled retirement plan business comply with the requirements of the Aetna Letter which does not require the revenue received from mutual funds be offset against fees charged to plan sponsors. CSTC does not exercise any discretion or provide any advice with regard to the mutual funds made available to plan participants or chosen by a retirement plan's investment fiduciary for investment by the plan. As a result, CSTC is not a plan fiduciary and is therefore not required under the DOL's guidance to offset mutual fund revenue on a dollar for dollar basis. However, CSTC does share a portion of the revenue received from mutual funds with TPAs associated with its retirement plan accounts in order to reduce the costs incurred by plans.

Receipt of revenue from mutual funds by banks in this industry is intended to reduce the cost of plan administration. As the Commission noted in the preamble to proposed Rule B, "banks do not typically charge plan participants directly for the cost of plan administration." Rather the cost of the banks' fees and other plan administration fees are offset in part by revenue received from mutual funds. These relationships and any actual or potential conflicts of interest are subject to extensive oversight and supervision by the Department of Labor pursuant to ERISA; The SEC acknowledged this by incorporating some of the guidance issued by the DOL in Regulation B. It would be anomalous and extremely disruptive to plan sponsors, plan participants, third party administrators, and trustees and custodians for the SEC to recognize only certain DOL-approved arrangements while not recognizing others.

Revision of Rule 770 is also necessary because neither the Trust and Fiduciary Exemption nor the Custody Exemption would permit CSTC to continue to offer its current services. CSTC could not use the Trust and Fiduciary Exemption for those accounts for which it acts as a directed trustee without significantly restructuring its compensation arrangements to meet the "chiefly compensated" test. It would require that CSTC either charge retirement plan sponsors a higher fee for the services it provides or implement new fees to third party administrators, which they would of necessity, expect to pass through to plan sponsors for their recordkeeping services.

CSTC would also not be able to use the Custody Exemption for those plans for which it acts as a directed custodian for a number of reasons. First, the Custody Exemption does not apply to accounts covered by the Employee Benefits Exemption. As such, CSTC would not be able to use the Custody Exemption for any of its accounts, as they are all either qualified or nonqualified employee benefit plans. Second, while the Custodial Exemption is available for nonqualified employee benefit plans, it appears that it would not apply unless each of the plans has more than $25 million in assets. In our understanding, the majority of

CSTC's (and many other small- to mid-size custodial banks') retirement plan custody accounts have less than $25 million in assets, and CSTC would not be able to continue to support these types of clients without significant impact to its business model and revenues.

Unbundled TPA-Directed Model

The proposed Employee Benefit Exemption documented in Rule 770 does not contemplate the situation where the bank or trust company acts as a directed trustee or custodian for qualified and nonqualified employee benefit plans in an "unbundled" service model in which the bank works with TPAs to provide servicing jointly to the retirement plans. These arrangements involving TPAs operate under the guidance and supervision of the DOL. A TPA's status as a plan fiduciary will determine whether it must offset the fees that it receives from mutual funds against fees owed by the plan sponsor. A TPA must offset fees it receives from a mutual fund, whether directly or indirectly, if it exercised investment discretion regarding the plan and is not required to do so, if it does not exercise any investment direction. We, therefore, believe that the SEC should amend Rule 770 to recognize the role of intermediaries in plan administration as plan participants are fully protected under ERISA and DOL oversight. By not covering such relationships, the SEC is favoring one type of employee benefit plan administration over another although there are no clear investor benefits in doing so.

Nonqualified Plans

The proposed Employee Benefit Exemption documented in Rule 770 covers only plans that qualify under section 401(a) of the Internal Revenue Code ("Code") or a plan described in sections 403(b) or 457 of the Code. Such plans include defined benefit and defined contribution plans. Nonqualified plans, such as deferred compensation plans, etc., are not covered. CSTC strongly recommends that Rule 770 be revised to cover all employee benefit arrangements.

Banks, such as CSTC, provide their trustee and custodial services in the same manner to both qualified and nonqualified plans, essentially treating them together as one line of business. As currently proposed Regulation B would not permit banks to continue to treat these plans in the same manner. As discussed above, the Trust and Fiduciary and Custody Exemptions are not workable alternatives under which banks could continue to provide trustee and custodial services to nonqualified arrangements. At a minimum, Regulation B, as proposed, would force banks to stop serving nonqualified plans for which they act as a directed custodian reducing competition in the market and increasing costs for small business owners and employees.

There is little reason not to treat nonqualified plans in the same manner as qualified plans, particularly where the plans are supported by the bank and trust company in exactly the same manner as they cover qualified plans. We suggest that the SEC amend Rule 770 to permit banks to continue to effect securities transactions for nonqualified plans provided that the bank follows the same guidance on conflicts of interest that they do for qualified plans. This suggestion would permit banks to continue to act as trustee or custodian for these plans while insuring that the participants receive the same protections as the participants in qualified plans. As most banks including CSTC, already treat the plans in the same manner, there should not be an increase in burden.

Additional disclosure

In order to qualify for the exemption set out in Rule 770, banks would have to comply with the disclosure requirements contained in the rule. Under ERISA, banks and TPAs already must comply with disclosure requirements regarding compensation received from mutual funds and fees and expenses charge to funds so that the plan sponsors can meet their fiduciary obligations. To avoid duplicative and inconsistent disclosure to retirement plan sponsors, CSTC recommends that the SEC require that banks that operate under Rule 770 comply with the applicable DOL disclosure requirements. We further suggest that the same disclosure requirements apply to both qualified and non-qualified retirement plan accounts.

Suggested revisions to Rule 770

CSTC strongly recommends that Rule 770 be revised to recognize DOL oversight by providing that banks may effect transactions for qualified plans if their compensation arrangements comply with DOL guidance. Furthermore, Rule 770 should also be amended to include nonqualified plans if the compensation arrangements for those plans follow the DOL's guidance for qualified plans. Revising Rule 770 in this manner would avoid unnecessarily disrupting current relationships and increasing costs for plans and plan participants. Moreover, it recognizes DOL's expertise in supervising conflicts of interest involving employee benefit plans and avoids potential overlapping and inconsistent regulation.

The effect of not amending Rule 770 to recognize arrangements that have been reviewed and approved by DOL under the strict ERISA conflict of interest protections would be significant. Under Rule 770, CSTC and other banks that provide trustee and custodial services to qualified and nonqualified plans cannot continue to provide the services they offer utilizing their current service models and simply would not be able to do so under the Trust and Fiduciary and Custody Exemptions. At the very minimum, a bank acting as a directed trustee would have to renegotiate all of its relationships with plans and mutual funds complexes to adjust fees under either the Employee Benefits Exemption or the Trust and Fiduciary Exemptions, as proposed. The result would be an increase in costs to the plan and plan participants without any increase in investor protection. A bank acting as a custodian for nonqualified plans could not continue to serve those plans under the Employee Benefit Exemption or the Custody Exemption. Directed custodial relationships for small nonqualified plans would have to be dissolved forcing those plans to seek broker-dealer custodians. Certainly there would be an increase in cost and not a clear increase in investor protection.

Conclusion

For the reasons discussed above, CSTC urges the SEC to amend Rule 770 to recognize DOL supervision of employee benefit plans and to permit banks to continue to serve nonqualified plans if banks acting as a directed trustee or custodian are compensated in the same manner as they would be for qualified plans. CSTC would be pleased to provide further comments or information to the SEC or its staff. If you have any questions, please feel free to contact me at (415) 667-2823.

Sincerely,

Scott A. Glave
Vice President
The Charles Schwab Trust Company