America's Community Bankers Shaping Our Future

August 27, 2004

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Regulation B
File No. S7-26-04; 69 FR 39682 (June 30, 2004)

Dear Mr. Katz:

America's Community Bankers ("ACB")[1] is pleased to comment on the proposed new Regulation B.[2] Regulation B would implement the functional exemptions for banks from the definition of "broker" that were added to the Securities Exchange Act of 1934 by the Gramm-Leach-Bliley Act ("Gramm-Leach-Bliley").[3] The proposal follows interim final rules adopted by the Securities and Exchange Commission ("SEC") in 2001.[4] Implementation of these interim rules was temporarily suspended by the SEC until certain issues could be resolved.

Both the SEC and the industry have worked tirelessly over the last several years in an effort to arrive at a rule that allows the banking industry to retain certain types of business permitted by Gramm-Leach-Bliley and addresses SEC concerns that investors be sufficiently protected. Unfortunately, and for reasons that are discussed in this letter, the proposed Regulation B does not properly implement Gramm-Leach-Bliley and, in many cases, will not serve investors needs. It will, in fact, increase costs and complexity for investors.

ACB Position

[1] America's Community Bankers is the member-driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit *www.AmericasCommunityBankers.com.*

[2] 69 Fed. Reg. 39682 (June 30, 2004).

[3] Pub. L. 106-102 (1999).

[4] 66 Fed. Reg. 27788 (May 18, 2001).

ACB believes that any final rule on Regulation B must treat savings associations and savings banks (collectively referred to in this letter as savings associations) on a parity with commercial banks. We believe that full parity is the only fair result. While the rule would offer savings associations the right to conduct many of the activities permissible for banks under Title II of Gramm-Leach-Bliley, certain custody and other activities would not be allowed unless the SEC receives evidence that savings associations engage in these activities. We and others will provide that evidence, but believe that such evidence should not be needed. All commercial banks, whether or not they conducted the permissible activities prior to Gramm-Leach-Bliley, will be entitled to use the exemptions in Gramm-Leach-Bliley in the future. Savings associations should have the same right to change and grow their businesses so they can compete with banks on an equal footing. The final rule should apply equally to all depository institutions, whether they are banks or savings associations.

Although much work has been done over the last several years to resolve the issues that the banking industry had with the interim rule, many aspects of the proposed rule remain unworkable. It is perplexing to us how we again arrived at such a narrow reading of the provisions of Gramm-Leach-Bliley and we question who would benefit from such a complex rule. Congress quite clearly delineated certain activities that should remain in a bank, yet the SEC continues to propose definitions and conditions that will make it difficult for a bank to continue those activities without an unreasonable amount of burden.

The SEC frequently waives the flag of investor protection when describing its reasoning for some of the conditions and requirements. The concern seems to be that the SEC must prevent banks from running full-scale broker-dealer operations in their trust or custody departments. The SEC appears to believe that without all of the conditions and requirements, banks would simply disregard the law and banking supervisors would let them.

We believe that investors have been well served by banks in the past and will continue to be well served in light of the regulatory scheme covering all insured depository institutions. The SEC is not the only agency with investor protection in mind. Depository institutions are subject to examination every 12 to 18 months and are subject to significant oversight on a continuous basis. All aspects of the bank are examined, including trust and fiduciary activities, to ensure that laws and regulations are complied with and that bank customers are treated fairly. Depository institutions are subject to a full range of enforcement actions if their regulator discovers any issues in the way the institution is operated. This has always been the case, and the bank regulators will continue to review a depository institution's compliance with the securities-related activities permissible under Gramm-Leach-Bliley.

Furthermore, depository institutions also have their reputations to consider. Customers place a great deal of trust in their depository institutions and have high expectations of being treated fairly and honestly. Banking laws and regulations create a climate of compliance and an attitude somewhat different from securities firms. The brokerage and investment banking industry can view the payment of penalties for inappropriate conduct as the cost of doing business. For banks and savings associations, the initiation of an enforcement action and any subsequent finding of wrongdoing would deal a significant blow to the institution's reputation, particularly in connection with its trust activities.

In light of this, we implore the SEC to view our comments with an open mind and try to reach a middle ground so that banks and savings associations can engage in the activities permissible by Gramm-Leach-Bliley without undue burden while still protecting the rights of investors. We believe that the rule is unnecessarily complex and will be unworkable in many areas. We also believe that it would be unenforceable without significant intrusion by the SEC into the operations of banks and savings associations. Regulation of activities of insured depository institutions clearly has been left to the federal banking agencies under the functional regulation provisions of Gramm-Leach-Bliley.

Parity Issue

The SEC exercised its authority in the interim rule to provide savings associations with the same exemptions accorded banks under Title II. The SEC recognized it would be wrong to continue disparate, anomalous treatment between savings associations and banks. Unlike the interim rule, the new proposal would no longer treat savings associations the same as banks in all respects. In clarifying some of the provisions of Title II, the SEC has provided interpretations in the form of exemptions that apply only to banks. While we disagree with many of the conditions and requirements in these interpretations and exemptions and think changes need to be made, savings associations should be treated in an identical manner to banks whatever the outcome of the conditions and requirements in the final rule. The SEC describes three exemptions – general custody, employee benefit and regulation S transaction exemptions – as non-statutory exemptions targeted to the existing business practices of some banks. The SEC has questioned whether savings associations are engaged in the noted activities and will extend relief for savings associations only to the extent they are currently engaged in the activities. We also note that no mention is made in the preamble of the application of rule 710 (networking exception definitions), rule 740 (sweep arrangement definitions) and rule 750 (affiliate transaction definitions) to savings associations.

OTS General Counsel John Bowman recently testified that it appears that savings associations currently engage in some, if not all, of the securities activities covered by the three additional exemptions.[5] In addition, we note that three savings associations, Merrill Lynch Trust Company, A.G. Edwards Trust Company, and Nationwide Trust Company, submitted comment letters in connection with the SEC's proposed investment adviser rule changes indicating that they did engage in a broad range of custody activities.[6] SEI Private Trust Company has filed comments on this proposal indicating that it, too, engages in substantial custody activities for both institutional and retail customers. Furthermore, our members, engage in a full range of custody activities, including serving as custodian for IRA and employee benefit plans. The SEC's proposal would deny for these organizations the

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[5] *Hearing on Regulatory Burden Relief Before the Senate Committee on Banking, Housing, and Urban Affairs* (June 22, 2004) (Statement of John E. Bowman, Chief Counsel of the Office of Thrift Supervision).
[6] *See Certain Thrift Institutions Deemed not to be Investment Advisers,* 69 Fed. Reg. 25778 (May 7, 2004).

privileges accorded to banks and would make the competitive landscape that much more difficult for savings associations.

The SEC's discriminatory approach makes no sense because the bank exemption applies to all banks, whether or not they are currently engaged in one of the exempted activities. For savings associations that are not currently conducting these custody activities, the rule would limit their ability to evolve and grow their businesses. The projected massive wealth transfer between generations that is anticipated over the next ten to fifteen years has and will create a growing need for fiduciary, trust, wealth management and retirement and estate planning services. The ability to compete on an equal footing with banks should not be denied to savings associations.

In the preamble to the interim rule, the SEC notes "now that the general exemption for banks has been replaced, and the differences between savings associations have narrowed; it seems reasonable to afford savings associations and savings banks the same type of exemptions. Moreover, insured savings associations are subject to a similar regulatory structure and examination standards as banks. We find that extending the exemption for banks to savings associations and savings banks is necessary or appropriate in the public interest and is consistent with the protection of investors."[7]

Further, the preamble makes the point that, without extending these exemptions, there may be uncertainty for savings associations about whether registration is required if they wish to engage in the listed activities. "The exemption will allow savings associations and savings banks that are governed by a similar regulatory structure to operate under the same terms and conditions as banks."[8]

The preamble to the SEC's recent investment adviser proposal notes the evolution and history of the involvement of savings associations in the provision of trust services for their customers and communities.[9] The growth of this activity as part of the business of savings associations reflects the general transformation of the industry from one in which the institutions were primarily one- to four-family mortgage lenders to one in which the institutions provide the entire array of financial services products, including trust and custody services. Just like banks evolved and began to provide services not contemplated in earlier years, savings associations have similarly changed. We expect that both banks and savings associations will continue to change within the bounds of the law as customer demands change.

ACB vigorously supports providing parity for savings associations with commercial banks under the Securities Exchange Act and believes that full parity is the only fair result. We believe that parity will ensure that all insured depository institutions operate under the same basic regulatory requirements when they are engaged in identical trust, brokerage and other

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[7] 66 Fed. Reg. 27788 (May 18, 2001).
[8] Id.
[9] 69 Fed. Reg. 25778 (May 7, 2004).

activities that are permitted by law. As more savings associations engage in trust and custody activities, there is no substantive reason to subject them to different requirements. They should be subject to the same regulatory conditions as banks engaged in the same services.

After working with the industry and its primary regulator, the OTS, on these issues, the SEC has revised the interim rule in a way that still places savings associations at a competitive disadvantage to banks. The OTS has worked with the SEC to help the agency understand the industry, the nature of supervision and examination and the safety and soundness and customer protection oversight that as a primary regulator it provides all savings associations engaged in the trust, custody and wealth management business. To see this proposal withholding full parity is frustrating. We believe that this proposal will drive savings associations to consider converting their charter to a bank if they see conversion as the only way to be able to compete effectively. One of ACB's important policy objectives is that each institution should be able to choose the charter that best meets its needs.

If the SEC does not grant savings associations full parity, we will have to continue the time-consuming effort to seek legislative changes. While we are confident that legislation would eventually provide a resolution to the parity problem, savings associations should not have to continue that lengthy and expensive effort when the SEC has the authority to provide immediate relief.

On a technical note, the language in rule 773 does not work properly. Subparagraph (a) appears to give savings associations full parity with banks as to all of the rules in Regulation B. Subparagraph (b) appears to apply limitations to what is provided in subparagraph (a), even though there is no language indicating that subparagraph (a) is limited in its operation. For all of the reasons discussed above, we believe that subparagraph (b) should be eliminated. If there are to be limitations, then those limitations should be incorporated into subparagraph (a) to clarify the scope of activities permissible for savings associations.

General Approach

After the interim rules were issued, hearings were held before a joint session of two subcommittees of the House Committee on Financial Services: the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit.[10] In opening statements by Committee Chairman Oxley, Ranking Member LaFalce, and Subcommittee Chairman Bachus, the SEC was asked to revise the rule so that it was more in line with the intent behind Gramm-Leach-Bliley. Chairman Oxley, in particular, questioned whether the SEC had upheld the letter and the spirit of the law and emphasized that the legislation was never meant to make banks

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[10] *Pushing Back the Push-Outs: Hearing on the Securities and Exchange Commission's Broker-Dealer Rules Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises and the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Financial Services* (August 2, 2001).

disrupt their customer relationships and force traditional banking activities into a broker-dealer. Chairman Oxley went on to say that the strides made by the legislation were too important to be undone by misguided attempts to implement the law, no matter how well-intentioned.

In her testimony at the hearing, Acting SEC Chairman Laura Unger indicated that the SEC remained committed to adopting rules that faithfully upheld the language and intent of the legislation. However, Chairman Unger seized on the Congressional concern that banks should not be permitted to run full-scale brokerage operations shielded from SEC oversight. That fear and concern seem to be driving this rulemaking process. It is not reasonable to believe that without such narrow, complex rules, depository institutions would intentionally break the law and banking supervisors would let them. What would be more productive is to recognize that Title II permits certain types of traditional banking activities to continue, the history of compliance banks have in conducting brokerage activities in the bank, and the regulatory scheme already in place to ensure that investors are protected. With that kind of recognition and a less intense focus on the fear that depository institutions will use Title II to thwart the law, a more workable rule could be produced.

We understand that the SEC does not have an easy job in developing this rule and that it may be frustrated in its efforts to get the kind of data it is looking for on current bank operations. However, the amount of information the SEC is asking for is enormous and would take a great deal of effort to collect. Also, the data is not always easy to come by, particularly if institutions have to first work through the complicated rule to identify its true impact. We are not sure what the SEC would do with reams of data anyway. Would it continue to try and craft such narrow rules to take into account only the operations of those institutions that go through the significant burden of producing the data, and assume that those rules, with all of their limits and restrictions, would work for everyone? Also, after all of that effort, an institution would merely be having to provide proof that there was actually a reason why Congress passed the statutory exemptions to allow certain activities to remain within banks. That should not be required. The bank regulators provided the SEC with a wealth of information about the traditional business of banks covered by the statutory exemptions in their comment letter on the interim rule.[11]

We respectfully ask the SEC to revise this rule in a way that works well for everyone. As Subcommittee Chairman Bachus said at the hearing, the interim rule could not be squared with the clear expression of Congress that the agency should not disturb traditional bank trust activities. While the revised rule does provide some relief in certain areas in response to industry comments and concerns, in other areas the new proposal is far worse and problematic.

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[11] We also note that many of the data requests come after an exhaustive discussion of why the SEC believes certain conditions and requirements need to be met in order to be in compliance with the securities laws or some other law or regulation, such as ERISA laws. Many of the questions then ask whether banks operate in the manner that the SEC believes is necessary. Banks may be reluctant to provide details of their activities in light of that approach for fear of triggering investigations or enforcement action.

We hope that our comments provide useful information to the SEC in understanding the problems with the proposal. We remain available to continue to work with you to ensure that your concerns for investor protection are met.

Networking

The SEC has chosen to clarify in the rule some of the language and wording in the statutory exemption for third-party networking arrangements. Specifically, the rule defines what is meant by permitting the bank to pay unregistered bank employees a "nominal one-time cash fee of a fixed dollar amount" for making referrals to a broker-dealer.

The SEC provides that a nominal fee is either a payment equivalent to one hour of pay, $25, or $15 (subject to an adjustment for inflation).[12] We believe that the additional options, particularly the flat, fixed rate, is an improvement over the previous proposal and that many organizations with networking arrangements would be able to meet this condition. However, it is still unclear why the SEC chooses to so narrowly define a nominal fee. The SEC refers to dictionary definitions of "nominal" to conclude that the payment should be inconsequential or trifling, being so small as to be of no concern to the payor and little value to the payee. That is not the way the term has been defined and utilized in networking arrangements, nor would it make sense in the case of a referral fee. Banks want employees to refer customers to the broker-dealer. It is meaningful to the bank's business and the bank is willing to compensate the employee for the referral. It is hard to see how the bank's objective can be achieved if nominal is defined as trifling and the compensation provides little incentive to the employee. One might argue over what amount is nominal, but to say that it needs to be so small as to have little value to the payee cannot be an accurate implementation of Congressional intent. Congress was fully aware of the networking arrangements that had received the approval of the banking and securities industry prior to passage of Gramm-Leach-Bliley and nowhere in that legislation is there mention that an incentive fee can only be of an amount that has little value to the employee.

The SEC's concern appears to be that unregistered bank employees would be given an incentive not just to make referrals, but actually to sell securities brokerage services to bank customers. It is hard to see how that would happen in light of the other networking arrangement requirements, banking agency guidance and self-regulatory organization requirements that apply. Plus, there is no indication that that has happened in the many years that these arrangements have existed with no specific definition of a nominal payment. The SEC tries to again wave the flag of investor protection when, in fact, the narrow reading of nominal could merely interrupt the smooth operation of networking arrangements that have been conducted for years without the need for this additional restriction.

[12] We note that footnote 53 indicates that the $15 payment amount *could* be adjusted for inflation by order of the SEC, while the text of the rule seems to provide for automatic inflation adjustments. We believe that the preamble should be revised to provide that the amount will be automatically adjusted every year for inflation.

With regard to the SEC's preamble language regarding bonus payments, it is unclear how the SEC believes that its interpretation of the "cash fee" requirement would permit banks to continue using their point-based incentive programs. The conditions and requirements are so confusing and complex that it is impossible to know what is permitted. Gramm-Leach-Bliley did not give the SEC authority to regulate or limit bonus programs paid to bank employees. This is another area where the SEC has chosen to unnecessarily complicate the rule in the name of investor protection. We do not see how investors are protected by the SEC's intrusion into a bank's bonus programs. While there were problems with the wording in the initial proposal, that wording has been replaced by something that is entirely unworkable and is not necessary to make sure unregistered employees are not selling brokerage services to investors. The fact that the SEC believes the convoluted language in the proposal could be workable or enforceable shows that there is still a misunderstanding about traditional bank operations.

For example, in many unit or point-based programs, it would be impossible to provide a readily ascertainable cash equivalent value that would be known to the institution and the employee in advance. Many times in a bonus program, the amount would not be known until final allocation of bonus dollars is made. This interpretation will result in a restructuring, or possible termination, of bonus programs. In the changes made to the bonus program language from the interim rule, the SEC continues to try and address an unreasonable fear by intruding on bank operations.

Trust and Fiduciary

Unfortunately, the irrational fear that depository institutions will attempt to run a full scale brokerage in the trust department continues to produce a complex set of unworkable requirements that do nothing for investor protection. The requirements impose a far greater administrative burden than is necessary or appropriate to implement the statute. The fact that the SEC believes that the changes made in this area to the interim rule will permit banks to continue many of their current practices and ease the transition to the new statutory scheme means that the banking industry did not do an adequate job educating the SEC on trust and fiduciary practices, or that the SEC chooses to turn a blind eye to the needs of the industry. The only thing the depository institution is permitted to do under this provision of Title II is to accept orders from a trust customer. That order must be processed by a registered broker-dealer or be a cross-trade. In all cases, the depository institution will have a fiduciary duty to the customer, the compliance of which is enforced by the bank regulators, and the broker-dealer will be subject to SEC supervision.

The trust and fiduciary activities of depository institutions are subject to a wide range of federal and state fiduciary laws and regulations that will provide investors with adequate protection. The SEC should recognize this and implement the trust and fiduciary provisions of Title II in a way that allows these traditional banking activities to remain in the depository institution.

<u>Chiefly Compensated Requirement</u>.

The statute requires that the bank be chiefly compensated for transactions effected in a trustee or fiduciary capacity on the basis of an administration or annual fee, a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred in connection with executing securities transactions, or a combination of such fees. The banking industry never thought that this language would result in a requirement for account-by-account review, as the burden of such a requirement should be evident.

The SEC has offered an option in the new proposal that would allow a depository institution to determine compliance on a business line basis. However, account-by-account review is still required at the opening of the account and when fees are renegotiated, and the alternative requires a depository institution to separate fees into the sales and relationship categories that the SEC has proposed. Furthermore, in order to use the business line exemption, the ratio of sales to relationship compensation must be no more than one to nine.

A depository institution should be able to meet the chiefly compensated requirement as long as its trust fee schedules and policies reflect an emphasis on the types of administrative and other fees permitted by the statutory language and such fees represent the majority of fees received from the trust activities of the bank on a department-wide or business line basis. There are other conditions to the trust activity exemption in Title II, including limits on advertising and solicitation, which should prevent a depository institution from using this activity to operate a full-scale brokerage in the trust department. It is hard to believe that depository institutions would circumvent the statute in this way in any event and be allowed to do so by bank regulators that examine the operations on a regular basis. We respectfully ask the SEC to take another look at the chiefly compensated requirements and be open-minded about entirely different approaches.

If the SEC adopts the approach as proposed, we believe that the following requirements pose problems for depository institutions:

- Relationship compensation can include a flat or capped per order fee, but only if the fee is no more than the fee charged by a broker-dealer plus the direct marginal cost of bank resources used. The SEC will require precise and verifiable allocation of the marginal cost. The burden of requiring precise and verifiable allocations of cost is not warranted. Institutions should be able to establish costs based on a reasonable formula that allocates costs among products or business lines.

- The issues with the allocation of 12b-1 and other similar fees need to be addressed. The sale of shares by one significant account right before the end of the year can result in compliance problems in many other accounts.

- Line of business is defined as an identifiable department, unit or division organized and operated on an ongoing basis with similar types of accounts and for which the bank acts in a similar type of fiduciary capacity. The exception can be used only if the bank considers compensation from all trust and fiduciary activity accounts within the particular line of business (or all accounts established before a certain date). That appears to mean that if the bank utilizes another exemption for some but not all accounts in a business line, then the line of business alternative is not available.

- The one-to-nine ratio for the business line exemption is much too low. Sales compensation should be allowed to equal at least 49 percent of total compensation.

- An institution that uses the business line and account-by-account exemptions must maintain procedures reasonably designed to ensure that at account opening and again at the time of fee renegotiation, the institution is likely to receive more relationship compensation than sales compensation. It is impossible for an institution to know in advance what the trading frequency of an account will be. A new account that may require many trades to diversify holdings would pay more in sales fees than an account that does not do much trading. It is unclear how a bank could meet the standard that it is likely to receive more relationship compensation than sales compensation when it does not know what the trading level will be.

- The seven-to-one ratio in the safe harbor should be reduced and the exemption for the line of business should be two years rather than five.

- The SEC provides in footnote 124 various ways an institution could restructure its fee arrangements if it fell out of compliance with the line of business exemption. However, this restructuring of traditional trust and fiduciary activities is exactly what Congress did not intend to happen when it indicated that these traditional banking activities should remain in the bank. Other suggestions, like those about asking investment companies to convert fees currently being paid for sales and distribution to the types of fees that would constitute unrelated compensation, would not aid investors who would still be paying the same aggregate fees.

While we appreciate the SEC developing safe harbors to use in the event that an institution violates the account-by-account chiefly compensated requirement, we believe that there should not be such a requirement. Nowhere in the statute is there any indication that Congress expected such a burdensome, costly and unnecessary requirement. Also, it would be difficult to comment on whether the five years, the 10 percent threshold, and the 500 account or one percent threshold are adequate until this complex rule is operational and we could see the extent of missed targets notwithstanding an institution's best efforts. A much broader safe harbor exemption will be needed if the SEC institutes an account-by-account requirement. As the bank regulators indicated in their previous comment letter, it is essential that banks operating in good faith to confirm to Title II be given every reasonable opportunity to cure inadvertent or unforeseen violations.

Trustee Capacity.

We support the withdrawal of the definition of trustee capacity to allow that term to be given its plain and ordinary meaning under federal and state trustee laws and regulations. However, we believe that the SEC should remove the language that confuses the issue by indicating that IRA bank custodians are not acting in a trustee capacity. The additional discussion of fiduciary capacity fails to give meaning to the statutory term "in any other similar capacity." Acting in other types of capacities, such as trustee for an IRA account, are commonly considered traditional trust and fiduciary activities that should be permissible for a bank to engage in.

Investment Adviser Exemption.

The SEC amended the definition of this exemption to provide that it applies only when the bank has an ongoing responsibility to review, select, or recommend specific securities for its customers and has a duty of loyalty. The preamble expands this requirement to indicate that providing only general asset allocation advice not relating to specific securities is not sufficient, but does not explain why this should be so. If investment advice for a fee comes in the form of general asset allocation advice, then that account and subsequent transactions should be included within the exemption. It is difficult to see why the SEC insists on such a narrow definition and what the concern for investors could possibly be.

The SEC also continues to insist on applying a duty of loyalty requirement, rather than leaving that to federal banking and state fiduciary laws and regulations. The SEC insists that this duty is what differentiates a bank acting as an investment adviser from one acting as a broker. However, this reflects a failure to acknowledge that the investment advice is provided under fiduciary principles and duties, the compliance of which is regularly examined by bank supervisors.

Examination of Trust and Fiduciary Activities.

The rule would require that bank examiners regularly examine *all aspects* of effecting securities transactions under this exemption for compliance with fiduciary principles and standards. This requirement would severely limit the ability to use this exemption in a way not contemplated by Congress. Based on the preamble language, we take the phrase "all aspects" to mean just that. Each and every possible action that is involved in effecting the transaction must be regularly examined. This would limit the ability to outsource activities to third parties or use affiliates to aid in transaction processing and would have a devastating effect on smaller institutions that do not have all of the resources in-house to effect a transaction. The SEC should identify the steps in the transaction that it is most concerned about and work with the bank regulators to insure that those steps are reviewed during the examination process.

Sweep Accounts

The SEC limits the sweep of customer deposits to “no-load” money market funds. “No load” is defined to mean no sales or deferred sales load and that total charges against net assets, to provide for sales-related expenses and service fees, do not exceed .25 of one percent of average net assets annually. The only consequence of this definition will be that customers may start having to pay larger direct fees for participating in sweep programs, rather than having the fees paid from the income of the fund. We are not sure why the SEC believes that this is better for the customer. While we understand that there currently is debate over 12b-1 fees generally, that debate should be addressed directly in connection with supervision of the mutual fund industry, rather than through requiring a restructuring of sweep account programs.

The SEC has requested comment on whether rate spread or retained yield fee charges used by some depository institutions should be counted as sales charges. We believe that they should not be considered sales charges provided they are fully disclosed to customers. Some depository institutions charge these types of fees in lieu of, or in addition to, a charge to the account for participating in the sweep account program. In justifying the limit on 12b-1 and other types of fees based on fund net assets, the SEC indicates that depository institutions are not prohibited from directly charging their customers for sweep services. Institutions should be left with the flexibility to apply those direct charges in a way they find most appropriate. Rate spread or retained yield fee charges are among the methods that are used and should continue to be permissible account charges. They do not constitute sales charges and Gramm-Leach-Bliley did not give the SEC authority to regulate or limit bank account charges.

Custody

The SEC is offering three safekeeping and custody exemptions: a general custody exemption, an employee benefit custody exemption, and a small bank custody exemption. As discussed above, the SEC is limiting these first two exemptions to commercial banks. Only the small bank custody exemption is being offered to savings associations. For the reasons described in more detail above, this is simply wrong. Savings associations must be given full parity with commercial banks in order to compete effectively in an evolving and dynamic financial services industry.

<u>General Custody</u>

In the interim rule, the SEC chose to read the statutory safekeeping and custody exemption in Title II to limit the ability of banks to take securities purchase and sale orders for custody customers. Most importantly, the SEC took the position that the custody exemption would not allow a bank to effect transactions in securities for customers with self-directed IRA accounts. The order taking that was permitted was strictly limited and various conditions and requirements were imposed.

Despite the many conversations that have transpired since the interim rule was issued, and despite comment letters explaining the traditional custody business of banks, the SEC has again chosen to define the custody exemption in Title II to prohibit order taking except in very limited situations. The banking agencies, in particular, explained in detail the traditional custody activities that were addressed by Congress in Title II and made a persuasive case as to why these activities were allowed to continue under Gramm-Leach-Bliley. Instead of expanding the exemption in an appropriate manner in response to these comments, the SEC further limited the activity.

The new proposal would allow banks to take securities orders for existing custody customers or future customers who are qualified investors. Since individuals cannot be qualified investors unless they have at least $25 million of assets to invest, banks would be prohibited from acting as an IRA custodian for most of their customers. Also, the limitations could prevent banks from acting as custodian for health savings accounts to the extent that the custodian needs to be able to take orders for securities purchases and sales.

There is no justification for the SEC to read into the statute a limit on the ability of a bank to take securities orders from custody customers. If the SEC does not withdraw this narrow reading of Title II, it will put banks out of the custody business, particularly for IRA customers. This was not the intent behind the language adopted by Congress. The language specifically addresses individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive or other similar benefit plans and allows banks to continue to serve as a custodian of these accounts and plans. If a bank cannot accept an account holder's order to purchase or sell securities within the account or plan, the language in the statute would be meaningless. A bank would only be able to act as custodian in situations where the account could also fall within the trustee and fiduciary exemption, which would not cover self-directed IRA's or other retirement or pension plans.

Again, the SEC seems to think its restrictive rule is necessary to prevent banks from running full-scale broker-dealer operations through their custody departments. That, however, is prohibited by law and could not be done in light of the other conditions imposed by the SEC on the use of this exemption. The other conditions to the ability to take orders for custody customers are that

- The account cannot be a trustee or fiduciary account.
- The account cannot be an employee benefit account.
- The fee for order taking can not vary based on whether the bank accepts an order to purchase or sell securities, other than 12b-1 or other fees for personal service or maintenance of the account. (In other words, the fee is for the movement of money.)
- Employees cannot get compensation based on the size, value or completion of a securities transaction.
- There can be no general solicitation and advertising in connection with securities transactions for custody customers.
- The transaction must be effected through a registered broker-dealer.

Limiting the exemption of order taking to qualified investors has no justification in light of the plain language of the statute. The SEC should not limit the statute in a way that would require banks to give up a core business. The SEC takes the position that when brokerage is conducted through a custody account, the investor protections associated with order entry through a registered broker-dealer are not available. However, protections afforded by the banking laws and regulations, as well as continuous monitoring by bank supervisors, are available. It is disingenuous to pretend that customers are basically left to the whim of an employee taking an order. Also, that order has to be transmitted through a registered broker-dealer, providing the customer with additional protections.

With regard to the conditions placed on use of this exemption, we believe that the language in the preamble discussing restrictions on soliciting is confusing and we do not believe that the restrictions should limit sales literature that is prepared by an affiliated investment company. Depository institutions need to be able to advertise that these services are offered to custody customers whenever the bank or an affiliate is promoting the custody services of the bank. The language in the preamble states that the SEC is removing the condition that permits banks to solicit their existing customers for securities transactions in connection with solicitation of their other custody activities. However, the SEC does appear to permit advertising that securities transactions are offered with custody services. The SEC appears to be drawing a very fine distinction that will only cause confusion without further clarification. Our position is that depository institutions should be able to advertise and solicit customers for custody services that include securities transaction services, and that depository institutions should be permitted to respond to custody customers by providing literature from affiliated investment companies as well as nonaffiliated investment companies.

We also question why this exemption would not be available if the bank were also acting in a trustee or fiduciary capacity, the account was an employee benefit plan account, or the bank uses the small bank custody exemption. Depository institutions should be able to use whatever exemption is most beneficial, as long as the exemption is one permitted under Title II. The use of one exemption should not preclude the use of others, nor should a depository institution be limited in choice if more than one exemption were applicable.

Employee Benefit Exemption

The SEC has chosen to prohibit savings institutions from using this exemption. We have stated the reasons as to why this must be changed.

The SEC takes the position that the Securities Exchange Act does not specifically exclude from broker-dealer registration banks that administer employer-sponsored retirement plans. It can only reach that result from a narrow reading of Gramm-Leach-Bliley. The statute specifically permits banks to serve as custodian or provider of other related administrative services to any pension, retirement, profit sharing, bonus, thrift savings, incentive or other similar benefit plan. Furthermore, fiduciary capacity is defined to include capacities similar to those specifically listed in the statutory definition.

The question then is why the SEC continues to take the position that ERISA plans were not included in the statute and it is only because of the SEC's benevolence that banks are going to be able to continue in this business. Subject, of course, to a list of unnecessary and burdensome conditions and requirements. For example, because commenters mentioned that in some instances, compensation from mutual funds is credited against fees owed by an ERISA customer, the SEC adds that as a requirement to use the exemption.[13] This is an inappropriate condition for the SEC to impose. The SEC should leave the issue of fee offset to the Employee Benefits Securities Administration that enforces ERISA and will impose conditions that it thinks are appropriate. An overlay of requirements from the SEC is not warranted. Likewise, the SEC should delete the disclosure requirements and limits on incentive compensation to employees.

Small Bank Custody Exemption

The SEC has made revisions to the small bank custody exemption in an effort to make it available to a larger number of institutions. We are appreciative of those efforts and believe that it will help some smaller institutions continue to service IRA customers. However, there are savings associations that engage in the custody business that will not be able to meet the proposed conditions in this exemption and, therefore, need to be able to use an expanded general custody exemption that allows order taking for IRA customers. If the general custody exemption is expanded in the way we propose, we do not believe a small bank custody exemption would then be necessary. However, if the SEC does not take the appropriate action to expand the general custody exemption, the small bank custody exemption would benefit some smaller institutions, but we believe certain changes would have to be made.

The SEC has expanded the small bank definition to include institutions with less than $500 million in assets that are not affiliated with a bank or savings and loan holding company with more than $1 billion in consolidated assets in the two prior calendar years. The threshold should be based on assets and should not be changed to a deposit-based threshold. In addition, the size threshold for holding company affiliation should be increased to $10 billion or more to make the exemption meaningful.

A smaller institution should be able to use the exemption regardless of whether it is affiliated with a broker-dealer. The institution would merely be taking an order from a custody customer and submitting it to a registered broker-dealer for execution. The fact that the institution may be affiliated with a broker-dealer should have no relevance to whether an institution can operate a custody business allowed by law by being able to provide all of the necessary services related to that business. The SEC believes that those institutions affiliated with a broker-dealer have demonstrated their ability to put in place the infrastructure of a

[13] In a footnote, the SEC states that no bank has advised the SEC staff that it does not apply mutual fund fees for the benefit of the plans. It uses this as justification for applying the requirement even though it must know that it has not heard directly from each and every bank that administers ERISA funds. Again, the SEC is putting the burden of proof on the industry, rather than implementing Congressional intent to allow banks to continue their traditional business.

regulated broker-dealer to serve customers. That may be true, but it is irrelevant and ignores the fact that Congress provided that traditional custody business could stay in a bank regardless of what other entities are within the corporate family.

With regard to the $100,000 limit on sales compensation, it is difficult to understand how someone has reached a conclusion that that amount should be sufficient when institutions do not generally track and record the elements in the definition of sales compensation from other types of compensation. Since our members that provide custody generally fall outside the $500 million asset limit, we are unable to provide the SEC with information about the adequacy of the $100,000 limit. We would like to be very clear on this point, however. We are not saying that the exemption would not be useful for smaller depository institutions. We believe that it would be, but that our members engaged in the custody business mainly fall outside of the asset size threshold. We do know that institutions would have to set up expensive systems merely to track sales compensation separately from other types of compensation. This would be an unnecessary burden in that a compensation limit should not be necessary to prevent an institution from running a brokerage operation out of its custody department. The smaller institutions that would be able to use this exemption are not interested in doing that, but they do need to continue to service their custody customers in order to maintain that business. Any institution that would take advantage of this exemption to defy the law would be subject to enforcement action by the banking regulators.

The preamble of the rule indicates that small banks can use the custody exemption to effect transactions for trust and fiduciary accounts, which would free the bank from the requirements and conditions the SEC has placed on trust and fiduciary activities, particularly the chiefly compensated calculations. The scope of the ability to use the custody exemption for trust and fiduciary accounts is not clear in the preamble or the text of the rule. There is no affirmative provision in the rule that specifically allows the use of the custody exemption for trust accounts. The rule only includes as a condition that the exemption not be used for fiduciary or trust accounts unless an exemption from the chiefly compensated calculation is not used. This makes it appear as if a bank cannot freely choose which exemption to use when more than one could apply. Clarification of the scope of the exemption in this regard would be appreciated. If the exemption can be used for trust and fiduciary accounts, that should be included in the rule as an affirmative statement. If the SEC means to limit the ability of a bank to choose what exemption to use when it acts both as a custodian and in a fiduciary capacity, then we would object to any conditions on that ability.

We do not believe that the addition of an ERISA exemption for all banks excludes the need for this small bank custody exemption. The ERISA exemption is for employee benefit plans and does not cover IRA's or other types of custody accounts that are maintained by small banks.

Conclusion

While we appreciate the efforts made by the SEC to improve the interim rule, this proposed rule is still not a proper reflection of the language or Congressional intent behind Title II. A narrow, complex rule will not serve the needs of the banking industry or their customers in a way envisioned by Congress. We do not believe that a workable rule will be developed without a meeting of the minds on the purposes and goals of Title II. In addition, our expectations upon seeing savings associations treated equally in the interim rule have been dashed in the proposed rule. For all the reasons discussed in this letter, we believe that savings associations must be given full parity and aspects of the rule should be revised to give full effect to Title II of Gramm-Leach-Bliley.

ACB appreciates the opportunity to comment on this important matter. We remain available to assist the SEC in formulating a workable rule that provides sufficient protection to investors. If you have any questions, please contact the undersigned at (202) 857-3121 or via e-mail at cbahin@acbankers.org, or Diane Koonjy at (202) 857-3144 or via e-mail at dkoonjy@acbankers.org.

Sincerely,

Charlotte M. Bahin

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