AMERICAN BANKERS ASSOCIATION
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ABA SECURITIES ASSOCIATION

September 1, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Regulation B, Release No. 34-49879, File No. S7-26-04, 69 Federal Register 39682 (June 30, 2004)

Dear Mr. Katz:

The American Bankers Association ("ABA")[1] and the ABA Securities Association ("ABASA")[2] appreciate the opportunity to comment on proposed Regulation B recently issued by the Securities and Exchange Commission ("Commission"). Regulation B proposes a number of new exemptions for banks[3] from the definition of "broker" under Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act"), as amended by Title II of the Gramm-Leach-Bliley Act ("GLBA"). In addition, the proposal would define certain terms used in the GLBA.

OVERVIEW

Regulation B revises and restructures the Interim Final Rules issued by the Commission in May 2001.[4] In connection with this rulemaking, the ABA and ABASA expressed opposition

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[1] The ABA brings together all categories of banking institutions to best represent the interest of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks—makes ABA the largest trade association in the country.

[2] ABASA is a separately chartered affiliate of the ABA representing those holding company members of the ABA that are the most actively engaged in securities underwriting and dealing activities, offering proprietary mutual funds, and derivatives activities.

[3] Except where otherwise noted, we use the term "banks" in this comment letter to include all state and federally-chartered commercial banks, savings associations, savings banks and trust companies.

[4] Bank Broker-Dealer Interim Final Rules, Release No. 34-44291, 66 Fed. Reg. 27760 (May 18, 2001) (hereinafter cited as "Interim Rules").

to the interim final rules.[5] Our opposition was grounded upon the belief that the interim final rules did not comport with the plain meaning of the GLBA and its legislative history. In addition, we were opposed to the regulatory burdens placed on the banking industry by the interim final rules.

The Commission subsequently suspended implementation of the exceptions in light of these, and other, concerns raised by the industry. As the Commission notes in its proposing release, the staff has met numerous times during this period with representatives from the banking industry, staff from the Banking Agencies, and other interested parties to learn more about the banking industry and to refine further the guidance provided by the Interim Rules.

As we have said on many occasions, the staff has been most generous with its time, meeting frequently in person and by phone to discuss issues and later explaining to the industry various aspects of the Regulation B proposal. Unfortunately, we continue to have very grave concerns about the guidance proposed. While some of our concerns have been addressed and we point these out below, most of our original concerns have not. In fact, with respect to two of the exceptions—the safekeeping and custody and networking exceptions—the Commission's position is far worse than that originally suggested in the Interim Rules.

Specifically, in recognition that the Interim Rules were unworkable for the industry's trust and custody businesses, Regulation B provides for several grandfathers or exceptions. Some of these, particularly those dealing with the industry's corporate trust business, are most welcome. Others, however, cripple the industry's ability to grow or even continue its traditional business lines. This is especially true with respect to the Commission's refusal to allow banks to engage in order taking for any new custodial client that does not have an investment portfolio of $25-$50 million.[6] Without the ability to grow, banks will be forced out of the business. This is clearly not what the Congress intended when it stated that the exceptions were intended "to facilitate certain activities in which banks have traditionally engaged." *See* Conf. Rep 106-434, 106th Cong. 1st Sess. at 164 (1999). Crippling the banking industry's ability to engage in traditional banking activities cannot, in any way, be viewed as "facilitating" that activity.

Bank bonus plans are also at serious risk under the Commission's proposal. The legislative history is very clear that Congress did not intend that the Commission regulate <u>bank employee bonus plans</u>. Yet Regulation B clearly does just that. All businesses set performance goals and objectives for their employees. We see no reason why banks should be prohibited from setting employee performance objectives that encourage employees to grow assets for their institution.

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[5] *See* Letter to Jonathan G. Katz, dated July 17, 2001, from Edward L. Yingling, Deputy Executive Vice President and Executive Director, ABA, and Beth L. Climo, Executive Director, ABASA.

[6] Our discussions with the staff with respect to the safekeeping and custody exception have always centered on the bank's ability to accept a securities movement fee when a customer communicates an order to the bank. At no time did our discussions ever hint at the idea that order taking would be prohibited for all but a select group of clients.

Finally, while the Commission has made marginal improvements to the trust and fiduciary exception, we are still concerned about the regulatory burdens imposed by the Commission on the banking industry. Nothing in GLBA would indicate that the Congress intended the Commission to apply its admonition that "the SEC… not disturb traditional bank trust activities under …[the trust and fiduciary] provision" in such a manner as to impose huge regulatory burdens on the industry. *See* Conf. Rep. at 164.

The banking industry would like nothing more than to have the legal uncertainties associated with the lack of final rules implementing Title II to be resolved. Legal uncertainty costs money. So too, does the time and effort bank employees have spent focused on these issues. The banking industry has met with the staff on numerous occasions to discuss these issues and supplemented those meetings by providing hard data relating to bank compensation programs and trust and fiduciary fees. In addition, the industry has responded in writing to several detailed sets of staff questions regarding everything from trust and fiduciary accounts to sweep services.

Bankers want to get on with the business of banking and take advantage of what was promised to the industry with the enactment of GLBA, namely, the ability to offer, through affiliation, a wide range of financial products and services without the costly restraints of outdated laws. Unfortunately, we cannot agree to rules that do not comport with this congressional intent and add significant costs to the industry's bottom line—costs that the Commission would have banks incur to prove they are doing precisely what the law allows them to do.

We would strongly encourage the Commission to take the time to get Regulation B correct. In this connection, we pledge to double our efforts to help resolve these issues.
The Commission will find that, throughout the body of this letter, we offer solutions for revising the proposed rules. Many of these solutions are simple, less complex, and, we believe, fairly reflect the intent of the Congress. If the Commission later determines that additional time is needed to remedy many of the problems we identify below, then the Commission should not hesitate to delay the current effective of November 12, 2004.

As the Commission reviews the industry's comments and solutions and, hopefully, revises proposed Regulation B, we would respectfully request that they consider whether the changes proposed for adoption are beneficial to the industry's customers and, if so, at what cost. Regulation B as it now stands forces banks to change their existing relationships with their traditional customers and makes serving those customers so much more difficult. We would also urge the Commission to take note that all the activities we discuss below are activities that are conducted within the bank and are subject to strict regulation by the banking supervisors. This is what the Congress envisioned and it is guidance to which the Commission should adhere.

DISCUSSION

I. NETWORKING EXCEPTION

The networking exception is the only exception in which the Congress chose to address employee compensation.[7] Specifically, it provides that bank employees may not receive incentive compensation for any brokerage transactions, but "may receive compensation for the referral of any customer if the compensation is a nominal one-time cash fee for a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction."

The networking exception's compensation provision closely parallels similar requirements found in then-existing bank regulatory guidance.[8] Indeed, the Congress drew from bank regulatory guidance to ensure that the limited exception it was granting for bank networking activities would include the types of activities in which banks had traditionally engaged.

A. The Congress did not intend for the Commission to regulate bank bonus programs.

In proposing definitions for many of the terms used in the statute, the Commission has unfortunately ignored the Congress' directive by adding new conditions not required by the statute or redefining terms contrary to what was intended by the Congress. Chief among these is the Commission's determination to regulate bank bonus plans.

The networking exception uses the term "incentive compensation." In the Interim Rules, the Commission seized upon that term when it argued that the prohibition on paying incentive compensation reached bonus plans. Specifically, the Commission claimed that "[w]hile bonuses sometimes fall within the category of a one-time payment, by their very nature they are incentive compensation. The networking exception prohibits unregistered bank employees from receiving incentive compensation for any brokerage-related activity except for nominal one-time cash payments of a fixed dollar amount for a referral."[9] An analysis of the legislative history reveals that Congress never intended that "incentive compensation" be interpreted in such a manner.

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[7] The networking exception permits bank employees to provide support services to third-party and affiliated broker-dealers in connection with the sale of securities to bank customers. In order to qualify for the exception, the networking services must satisfy a number of conditions including physical separation of brokerage and banking services, compliance with advertising conditions, disclosures, conditions on banks acting as carrying brokers, and employee compensation. *See* Section 3(a)(4)(B)(i), 15 USC 78c(a)(4)(B)(i).

[8] *See Interagency Statement on Retail Sales of Non-deposit Investment Products,* NR 94-21, February 17, 1994; SR 94-11, February 17, 1994; FIL 9-94, February 17, 1994; OCC Bulletin 94-13 (February 24, 1994); FRB Examination Procedures for Retail Sales of Nondeposit Investment Products (May 31, 1994); FDIC Examination Procedures for Retail Nondeposit Investment Product Sales, FIL 48-97; 1997 FDIC Interp. Ltr. LEXIS 41 (May 7, 1997); FIL 80-98, 1998 FDIC Interp. Ltr. LEXIS 74 (July 16, 1998); Letter re: Chubb Securities Corp., 1993 SEC No-Act. LEXIS 1204 (Nov. 24, 1993). More recently, the Office of Thrift Supervision has issued guidance on these arrangements. *See* OTS Regulatory Bulletin 32-24 (January 7, 2004)

[9] Interim Rules at 27766.

While the GLBA did not specifically define "incentive compensation," earlier versions of the legislation did.[10] For example, the Proxmire Financial Modernization Act of 1988, passed by the Senate by a 94-2 margin, permitted banks to enter into networking agreements with brokerage firms so long as "bank employees do not receive <u>incentive compensation</u> for any brokerage activities …." (emphasis added).[11] Incentive compensation was defined to mean "…payment of <u>commissions or similar remuneration</u> based on effecting transactions in securities (excluding fees calculated as a percentage of assets under management) in excess of the bank's incremental costs directly attributable to effecting such transactions." (hereinafter referred to as "<u>incentive compensation</u>") (emphasis added). Even as far back as 1988, the Congress intended that "incentive compensation" clearly means brokerage commissions, not bonus plans.

This same language was included in the Financial Services Competition Act of 1997, which was later approved by the House of Representatives on May 13, 1998.[12] All prior versions of the legislation that preceded H.R. 10 and addressed bank networking arrangements included identical language defining "incentive compensation" to mean brokerage commissions.[13]

Even bills introduced that did not reference the ability of banks to enter into networking agreements included provisions addressing transaction-based compensation, not bonus plans. Specifically, a 1991 Energy and Commerce Committee bill provided that a bank would not be deemed a broker when engaging in fiduciary activities so long as it was not "compensated for such business by the payment of commissions or similar remuneration based on effecting transactions in securities (excluding fees calculated as [*sic*] percentage of assets under management)…"[14]

In addition to the various bills defining "incentive compensation" to mean brokerage commissions, the regulatory guidance emanating from both the Commission and the bank

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[10] Unfortunately, the clause where "incentive compensation" was originally defined for purposes of the rest of the clause governing broker exceptions was dropped prior to GLBA being enacted. The drafters forgot to carry forward the definition to the networking agreement provision.

[11] S. 1886, 100th Cong., 2d Sess. Section 301.

[12] H.R. 10, 105th Cong., 1st Sess. Section 201.

[13] *See* H.R. 1501, 102d Cong., 1st Sess. Section 242; 1991 Senate Banking Committee bill, S. Rep. No. 167, 102d Cong., 1st Sess. Section 731; 1995 Banking and Commerce Committee versions of Glass-Steagall reform, H.R. Rep. No. 127, Parts 1 and 3, 104th Cong., 1st Sess. Section 201; H.R. 2520, 104th Cong., 1st Sess. Section 201 (this bill reflected a compromise reached between the chairmen of the House Banking and Commerce Committees in an effort to move the legislation to the floor of the House of Representatives).

[14] *See* H. Rep. No. 157, Part 4, 1st Sess. Section 451 (1991). *See also* 1988 Energy and Commerce Committee bill, H.R. Rep. No. 822, Part 2, 100th Cong., 2d Sess (1988) (amending H.R. 5094). The House Energy and Commerce Committee's focus on transaction-related compensation exclusively can be directly traced to the Commission's original Rule 3b-9. In that Rule, the Commission did address bank networking arrangements and specifically provided that a bank was prohibited from publicly soliciting brokerage business for which it receives transaction-related compensation unless the bank entered into a networking arrangement where bank employees did not receive compensation for brokerage activities.

regulators prior to enactment of GLBA referenced only brokerage commissions and referral fees.[15] Clearly, the Congress was aware of this when it provided that bank employees under the networking exception could receive referral fees as an exception to the general prohibition on the payment of incentive compensation.

Presumably aware of the legislative history, the Commission now asserts that it has authority to regulate bank bonus plans based on the statute's "one-time" requirement. Specifically, "any bonus or other incentive compensation that is payable based in part, directly or indirectly, on a referral for which the employee has already received a referral fee, would violate the exception's requirement that brokerage-related incentive compensation paid to unregistered employees under the exception be limited to 'one-time' referral fees." (emphasis added).[16] This passage reveals the Commission's continued refusal to recognize that Congress did not intend to equate "incentive compensation" with bonus plans.

In addition, we understand that even if a bank did not violate this "one-time" requirement by paying its employees only bonuses and not referral fees, the staff would still take the position that the bonus must be nominal in nature. We strongly disagree that Title II gives the Commission this authority. The Commission should follow congressional directives to regulate only brokerage commissions and referral fee plans.

B. If adopted as proposed, Regulation B will effectively disrupt many existing bank bonus plans.

Many banks have bonus plans that set performance goals or objectives for their employees. These performance objectives are intended to provide incentives for employees to grow the business and maintain the profitability of the bank and its affiliates. Each bank's incentive plan is unique, as such no one simple formula exists. Objectives can be established on, for example, a branch basis, department-wide basis, line-of-business basis and, or entity-wide basis. Further, it is not uncommon to find a variety of performance objectives one of which could be expressed in terms of asset gathering, i.e., new business brought into the unit or referred to other units or affiliates, at a single institution.

Typically, bonuses are paid to employees when performance objectives are met. The pool of money made available to pay bonuses is generally established by senior executives, and may be based on the overall profitability of the bank or bank holding company or the profitability of several business units. Once the pool is established, senior management then allocates

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[15] *See* Interagency Guidance, n. 8 *supra* ; Chubb No-Act Letter, n. 8 *supra*.

[16] In this connection, we note that the Commission has taken the position that a bank employee cannot be paid "more than one referral fee based on multiple referrals of the same customer, and an unregistered bank employee who referred a customer more than once could receive only one fee related to that customer." *See* Release No. 34-49879, 69 Fed. Reg. at 39689 n. 60. We would submit that a plain reading of the statute reveals that the "one-time" requirement is a one-time per referral, not per customer. To read it any other way would require banks to keep detailed records in perpetuity tracking the identity of the customer referred, even if that referral did not result in any transaction. This is just another example of the undue complexity Regulation B foists on the banking industry.

the pool to various business units, based on the overall performance of that unit. Business unit heads then, in turn, award employee bonuses.

The Commission's suggestion that only permissible bank bonus plans based on the profitability of the bank or bank holding company, that are determined and paid regardless of the brokerage-related activities of an employee receiving such a bonus, are permissable raises serious concerns regarding the continued viability of many industry bonus plans. First, we note that the Commission conditions the availability of even these plans on banks and bank holding companies not having broker-dealers that contribute significantly to the bottom line of the institution. It is unclear what significant means and, in our view, the condition will prevent many of our members that have large broker-dealer affiliates from paying those bonuses which include any hint of profitability of the broker-dealer or its contribution to assets or other measures, a result which was not intended by Congress.

Second, the Commission's position would appear to prohibit all bonus programs where awards are made based, in even some small part, on goals for directing business to a securities affiliate, no matter how attenuated or separated the award of any bonus is from the asset gathering activity itself. While we continue to adhere to the position that the Commission has no authority to regulate these plans, we note that its position will have a huge impact on our members and require significant revisions to be made to industry bonus plans. Even our community bank members have told us that their very simple bonus plans may be suspect under the Commission's position.[17]

We are strongly opposed to the Commission's position as it discourages bank employees from growing the bank's business and maintaining its profitability. Contrary to what some might think, banks are not utilities and the continued profitability of the industry is good for the country's economy. Where the actual award of a bonus is so attenuated from the direction of securities business to an affiliated broker-dealer, we believe unregistered employees will have no undue promotional interest in the brokerage services offered by an affiliate and should not be discouraged from informing customers about the availability of the services of a registered broker-dealer whose employees can assist the customer with financial planning and investing. Of course, any business directed to affiliated brokers must be conducted in accordance with investor protection rules of the Commission and the self-regulatory organizations.

In this connection, we note that the Commission's abhorrence for bonus plans with asset gathering performance goals or objectives is limited only to bank plans covering unregistered bank employees. Bonus plans for registered employees may contain limitless asset gathering performance goals. Consequently, if all bank employees subject to a bonus plan with a securities component were registered, the Commission would not oppose the plan.

[17] One community bank with $525 million in assets has informed us that branch performance goals are set in terms of growth of deposits and loans. Should a branch meet the goals, all employees receive a bonus based on the percentage of the business grown. The higher the employee, the larger the percentage. So as not to discourage employees from directing business to its securities affiliate, all business so directed is counted as deposits. This bonus plan would appear to violate the Commission's proposed guidance. Notwithstanding broad statements to the contrary, commercial banks are not prohibited from rewarding supervisory employees for business directed to an affiliate. *See* Release No 34-49879, 69 Fed. Reg. at 39691. But see Chubb No-Action Letter n. 8 *supra.*

However, registering all bank employees is not practical for the banking industry or a cost effective investment for its shareholders. The primary activity unregistered bankers should be performing relate to banking. The investing public is served by their ability to identify resources that are readily available for financial planning and investment needs. In addition, the increase in the number of registered representatives and branches that would result if bank employees were to register would force the Commission and National Association of Securities Dealers ("NASD") to devote in additional resources to examining bank locations where little, if any, activity outside of the referral occurs. Such an approach is not a good use of the banking industry's or regulators' resources.

Moreover, we believe the position taken by the Commission with respect to these bonus plans is anti-competitive. Brokers affiliated with banks are not precluded from having bonus plans that set performance goals in terms of business directed to the bank or other non-broker affiliates. Nor are we suggesting that they should be. All financial service firms, like any other business, should not be precluded from managing employees to fully serve customer needs through employee bonus plans with performance goals and objectives that include all products and services offered by the financial holding company.

We note that registering bank employees so that they are both employees of the bank and the broker in order to pay these type of bonuses is also not an option at present. Since August of 2001, the ABA and ABASA have had a request into the ("NASD") seeking clarification that the NASD's Rule 3040[18] does not apply to persons employed concurrently by banks and broker-dealers. As we explained to the NASD, under the "functional regulation" approach adopted under the GLBA, the use of dual employees has become vital to implementation of this business model in a manner consistent with the GLBA's provisions. Dual employees permit financial service institutions to comply with the GLBA and the differing requirements of the functional regulators, while consolidating in one relationship manager the delivery of several types of financial services and products to consumers. Understandably, the NASD has not responded to our request while the Commission's rules implementing Title II are not yet final. We note, however, that the Commission has opined that Rule 3040 does apply to bank networking activities.[19] Until the NASD is able to respond to our request for clarification, our members are extremely reluctant to register bank employees without full knowledge of what dual licensing entails.

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[18] Rule 3040 requires registered representatives involved in securities transactions outside of their employment and member firms to comply with certain notice, approval, record retention, and supervision requirements. Specifically, registered representatives must provide written notice to the employer member firm describing, in detail, each transaction it proposes to execute outside of the member firm, i.e., in a bank. The employer member firm is frequently required to pre-approve the transaction and monitor and supervise the employee's participation to the same extent as if the transaction were executed on behalf of the member firm itself. Moreover, duplicate books and records must be maintained at the member firm.

[19] *See* Release No. 34-49879, 69 Fed. Reg. at 39686, n. 37. We strongly disagree that a dual employee effecting a securities trade as a bank employee under one of the Title II exceptions is required, among other things, to get approval from the broker-dealer before executing the transaction.

Should the Commission, nevertheless, determine to regulate bank bonus plans, we would suggest that that regulation should be limited solely to prohibiting bonus plans that otherwise serve as a conduit for the payment of impermissible referral fees.

C. <u>The Commission should refrain from engaging in rate-making by establishing set dollar limits for referral fees.</u>

The Commission defines a "nominal one-time cash fee of a fixed dollar amount" as:

- An employee's base hourly rate of pay;
- Twenty-five dollars; or
- A dollar amount that does not exceed the whole dollar amount nearest to fifteen dollars in 1999 dollars adjusted by the cumulative annual percentage change in the Consumer Price Index All Consumers—(CPI-U) published by the Department of Labor that was reported on June 1 of the preceding year.

We are opposed to the Commission's rate-making in this area. For the last 10 years, banks and brokerage firms have operated under bank regulatory and Commission guidance requiring retail referral fees to be "nominal." "Nominal" has never been defined as it requires a facts and circumstances-type of analysis. "Nominal" for one institution may not be "nominal" for another. Bank regulators have policed bank activities in this area, while securities regulators have policed securities firms that enter into networking arrangements with banks. At no time has any regulator needed to adopt specific numerical limitations on the term "nominal." Nor did the Congress in enacting GLBA deem it necessary to define "nominal." We see no reason why the Commission should do so now.

The Commission suggests that the numerical limits proposed will not inhibit current bank referral fee programs. This is simply not true with respect to institutional referral programs. It is not uncommon for employees in the bank's credit department to refer potential capital markets business to an affiliated broker-dealer and receive a fee for that referral. None of the fees paid pursuant to these programs would satisfy the Commission's definition of "nominal."[20]

Moreover, even if it were true that most retail referral fee programs would be able to comply with the proposed definition of "nominal," this may not be true in the future and would necessitate the industry to petition the Commission to raise the "nominal" referral fee rate. The Commission has historically been reluctant to engage in rate-making as it could potentially distract the Commission from its important goals of protecting investors and preserving fair and orderly markets. We would strongly encourage the Commission to avoid rate-making in this area as well.

[20] The staff is aware that institutional referral fee programs cannot comply with the proposed definition of "nominal." *See* Request for exemptive relief filed by the Clearing House on April 16, 2004.

In this connection, the Commission has requested comment on whether "nominal" should be defined by reference to what a bank would pay its employees for the sale or renewal of a certificate of deposit. As we have previously informed the staff, no bank that we are aware of pays its employees referral fees for renewing a certificate of deposit ("CD") and only a few do so with respect to an initial sale of a CD. We do not think referencing CD sales or renewals in connection with defining "nominal" is helpful.

We do, however, think it is helpful that the Commission has clarified that banks may condition the payment of a referral fee on whether a customer contacts or keeps an appointment with a broker-dealer as a result of a referral and whether the customer has assets meeting established minimum requirements. It should also be permissible to condition the payment of a referral fee on a customer meeting a certain minimum tax bracket.

Finally, we note that the Commission's discussion on what activities constitute "clerical and ministerial" under the exception may be misinterpreted.[21] The Commission's suggestion that "clerical and ministerial" includes those activities that do not require specific qualifications or licensing by an employee of a broker-dealer ignores the fact that the Congress provided that "bank employees may forward customer funds or securities and may describe in general terms the types of investment vehicles available from the bank and the broker or dealer under the [networking] arrangement." [22]

II. TRUST AND FIDUCIARY EXCEPTION

Under the statute, if a bank effects securities transactions in connection with providing trust or fiduciary services, the bank is exempt from pushing these activities out of the bank and into a registered broker-dealer as long as four basic conditions are satisfied.[23] First, the bank can not publicly solicit brokerage business, other than by advertising that it effects transactions in securities as part of its overall advertising of its general trust business. Second, the bank's compensation for effecting transactions in securities must consist *chiefly* of an administration or annual fee; a percentage of assets under management; a flat or capped per order processing fee that does not exceed the cost of executing the securities transaction for trust or fiduciary customers, or a combination of such fees. Third, the bank would have to direct all trades of publicly traded domestic securities to a registered broker-dealer. And fourth, the bank must effect the transactions in a department that is regularly examined by bank examiners for compliance with fiduciary principles and standards.

The purpose of this exception is to allow banks to keep in the bank the types of trust and fiduciary activities they have engaged in for many, many years, even if a substantial portion of those activities generate fees that would otherwise trigger broker registration

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[21] *See* Release no. 34-49879, 69 Fed. Reg. at 39692.

[22] *See* Section 3(a)(4)(B)(i)(V) of the Exchange Act, 15 USC 78c(a)(4)(B)(i)(V).

[23] *See* Section 3(a)(4)(B)(ii) of the Exchange Act, 15 U.S. C. 78c(a)(4)(B)(ii).

requirements.[24] In providing this exception, the Congress recognized that where banks conduct securities transactions in their fiduciary capacity, they are subject to an entirely separate scheme of bank fiduciary regulation. In that context, where customers have alternative regulatory protections, the statute expressly recognizes that securities activities ought to be permissible in the bank even where there are significant amounts of transaction-based compensation. Of course, the "chiefly compensated" language, along with the requirements of separate broker-dealer execution of securities trades and the prohibition on brokerage advertising, ensures that the trust exception may not be used simply to transfer a full-scale securities brokerage operation into a trust department to evade Commission regulation.

On this last point, we understand that there is concern that broker-dealers may affiliate with banks and, in an attempt to evade Commission regulation, move brokerage accounts into the bank's trust and fiduciary department. We believe this concern is unjustified.

Prior to enactment of GLBA, many brokers were already affiliated with savings institutions regulated by the Office of Thrift Supervision. Many of these brokers could have moved brokerage accounts to the savings institutions but did not. Why? They did not for a couple of reasons. First, the brokerage customer generally did, and does not, want the services offered with a fiduciary account, such as principal and income accounting and tax lot reporting. Nor did that customer want to pay the increased fees associated with the extra services provided by fiduciary accounts.

Second, the risks associated with fiduciary accounts are great. A financial services firm would not run the risk that an account that properly resides in a brokerage firm will be treated in a court of law as a fiduciary account subject to strict fiduciary principles of law, including the prudent investor rule. That rule requires fiduciaries to invest assets in such a manner as a prudent person would in investing his or her own assets.[25]

The pricing of fiduciary accounts reflects the fiduciary risks assumed therein. No financial services firm would assume these risks without properly pricing for them. Nor would the bank regulators allow them. If the brokerage client doesn't want fiduciary services and won't pay for them, there is no incentive—indeed, there is great disincentive—for a brokerage firm to move accounts to a bank simply to evade Commission regulation.

A. A simple "chiefly compensated" test will significantly reduce the regulatory burdens associated with complying with Regulation B.

As the Commission is aware, the banking industry has, since the beginning of the Title II rulemaking process, been very concerned about the costs and complexities associated

[24] Conf. Rep. 106-434 at 164.

[25] Under the classic statement of the rule, a fiduciary "must conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent dispositions of their funds, considering the probable income, as well as probable safety of the capital to be invested." Harvard College v. Armory, 26 Mass. (9 Pick.) 446, 461 (1831).

with complying with the trust and fiduciary exception. And it was for that reason that ABA and ABASA argued that nothing in the statutory language creating the trust and fiduciary exception required calculations to be made on other than a line-of-business basis. We urged the Commission to allow banks to calculate "chiefly compensated" on that basis rather than on the account-by-account basis originally suggested by the Commission.[26] We believed, and still do, that the burdens associated with complying with an account-by-account analysis for over 25 million accounts would be great,[27] while a line-of-business calculation comports with current bank practices, systems capabilities, and regulatory reporting requirements.[28]

In the Interim Rules, the Commission did provide an exemption from calculating "chiefly compensated" on an account-by-account basis for those banks that could demonstrate that "sales" compensation for the trust department was less than 10% of the total amount of "relationship" compensation. At the time, our objections to the exemption were grounded on the fact that the exemption contained so many conditions and restrictions as to make it unworkable. For example, despite the fact that the exemption allowed compliance with the "chiefly compensated" test to be measured on a department-wide basis, the exemption, nevertheless, required that each account be analyzed at various points during the life of that account. Many of these conditions, to our thinking, made the exemption more illusory than real. We are, therefore, pleased that the Commission has taken steps to reduce some of the burdens associated with complying with the line-of-business exemption.[29]

We also appreciate that the Commission, mindful of the costs and complexities associated with the "chiefly compensated" test, has taken a number of other steps to reduce these burdens. For example, the definition of "relationship"

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[26] *See* Letter to Jonathan G. Katz, from ABA and ABASA, dated July 17, 2001 (hereinafter cited as "ABA/ABASA Letter").

[27] Federal Financial Institutions Examination Council ("FFIEC"), Consolidated Reports of Condition and Income (Quarterly Call Report) June 2004.

[28] In our letter to the Commission, we noted that banks and regulators use line-of-business in order to track fiduciary fees, manage fiduciary business lines, and report fiduciary business to bank regulators. *See* Schedule RC-T of the Quarterly Call Reports (Form FFIEC 041). We also noted that banks generally charge fees for fiduciary services according to fee schedules that vary from business line to business line and track revenues earned and expenses incurred on a line-of-business basis. *See* ABA/ABASA letter, *supra* n 26.

[29] We emphasize some as we continue to be troubled by the requirement in the line-of-business exemption to review compensation on an account-by-account basis at account opening. *See* proposed Rule 721(a)(3). This requirement undermines the efficiencies sought to be achieved by the "line-of-business" exemption. Clearly if a bank is to keep its sales compensation under some arbitrary number, it will actively police its accounts on its own accord to make sure that it does not violate the line-of-business exemption. Moreover, the need to police these accounts will become even more apparent to the bank if the bank ever avails itself of the safe harbor provisions provided. Finally, we have been informed by our members that the requirement to review compensation is unworkable for many institutions. Trust sales and investment management functions at banks are often kept separate. A trust account may be opened by a salesperson who has no knowledge of what type of investments the assets of the account may eventually be invested in or fees that those investments will generate. Investment decisions will be made by the trust investment officer sometime after the account is opened and funded. Thus, there is no way for the trust salesperson to know before opening or establishing an account whether "relationship" compensation will outweigh "sales" compensation.

compensation[30] has been expanded to include any assets under management fees charged, including fees assessed for managing oil and gas properties, limited partnerships, closely-held businesses, and real estate.[31] Unfortunately, as we discuss more fully below, the percentage level of "sales" [32] to "relationship" compensation when calculated on a line-of-business or department-wide basis has, under proposed Regulation B, increased imperceptibly from 10 to 11 percent, far short of the 25 to 49.99 percent the industry has advocated.[33]

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[30] Proposed Rule 724(h) defines "relationship compensation" to mean "any compensation a bank receives directly from a customer or beneficiary, or directly from the assets of an account for which the bank acts in a trustee or fiduciary within the scope of section 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 USC 78c(a)(4)(D)), that consists solely of:

(1) An administration or annual fee (payable on a monthly, quarterly, or other basis);

(2) A fee based on a percentage of assets under management;

(3) A flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers; or

(4) Any combination of such fees.

[31] Previously, the Commission had taken the position that assets under management fees could not be included within "relationship" compensation if the assets on which basis the fee was assessed were not securities. *See* Release No. 34-44291, 66 Fed. Reg. 27760, 27799 (May 18, 2001).

[32] Proposed Rule 724(i) defines "sales compensation" as "any compensation a bank receives in connection with activities for which it relies on an exception under section 3(a)(4)(B)(ii) of the Securities Exchange Act of 1934 (15 USC 78c(a)(4)(B)(ii)) that is:

(1) A fee for effecting a securities transaction that exceeds the fee defined in paragraph (b) of this section [flat or capped per order processing fee];

(2) Compensation that if paid to a broker or dealer would be payment for order flow, as defined in 17 CFR 240.10b-10;

(3) A finders' fee received in connection with a securities transaction or account, except a fee received pursuant to section 3(a)(4)(B)(i) of the Securities Exchange Act of 1934 (15 USC 78c(a)(4)(B)(i)) [referral fees permissible under the networking exception];

(4) A fee paid for an offering of securities that the bank does not receive directly from a customer or a beneficiary or directly from the assets of an account for which the bank acts in a trustee or fiduciary capacity, ….;

(5) A fee paid pursuant to a plan under 17 CFR 270.12b-1, ….;

(6) A fee paid by an investment company, other than pursuant to a plan under 17 CFR 270.12b-1, for personal service or the maintenance of shareholder accounts,…[but does not include shareholder administrative fees, *see* note 44 *infra*].

[33] We initially took the position that "chiefly compensated" meant that "relationship" compensation should outweigh "sales" compensation when measured on a line-of-business basis. *See* ABA/ABASA letter n. 26 *supra*. The industry revised its approach latterly in an attempt to move the discussions forward by suggesting that "sales" to "total" or, alternatively, "sales" to "relationship" when calculated on a line-of-business basis should not exceed 25 percent. Our approach was and continues to be a compromise as we believe the statute clearly allows banks to receive more than a 25% level of "sales" compensation.

We also recognize many of the other efforts the Commission has taken to reduce the regulatory burdens associated with complying with the "chiefly compensated" test. The grandfather for personal and charitable trusts,[34] the safe harbor provisions allowed when a bank fails to comply with the "chiefly compensated" test when calculated on either a line-of-business or an account-by-account basis,[35] and the ability to test for compliance for the current year based on the previous year's numbers were all taken with a view toward reducing compliance burdens.[36] Even the exemptions from the definition of "broker" for banks serving as indenture trustees[37] or employee benefit plan providers,[38] or banks investing fiduciary client assets in money market mutual funds[39] may assist some banks in complying with the "chiefly compensated" test. Despite these efforts, we nevertheless remain concerned about the costs and complexities trust banks will face under proposed Regulation B.

As we understand the system envisioned by the Commission, to come into compliance with the "chiefly compensated" test for its trust and fiduciary accounts, a bank will first be required to review its fiduciary book of business to determine which accounts and/or business lines are exempt from the definition of broker and, therefore, from the "chiefly compensated" test. This will require a review of the following accounts to determine which:

- Trustee and fiduciary accounts, escrow, collateral, depository, or paying agency accounts that are not invested in money market mutual funds or cannot satisfy the other requirements of proposed Rule 776.

- Personal trust accounts opened before July 30, 2004, that are not grandfathered under Rule 720.

- Personal and charitable trust accounts opened before July 30, 2004, that qualify for the grandfather but cannot meet the other conditions of Rule 720's grandfather.

- Non-qualified and governmental plans other than 403(b) and 457 plans, that are not exempt under Rule 770.

- Qualified, 403 (b) and 457 governmental plans that cannot meet the conditions of the Rule 770's exemption.

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[34] *See* proposed Rule 720 and discussion below.

[35] *See* proposed Rule 721(b) and 722(b).

[36] *See* definition of "Chiefly compensated" contained in proposed Rule 724(a).

[37] *See* proposed Rule 723.

[38] *See* proposed Rule 770 and discussion below.

[39] *See* proposed Rule 776.

- All other accounts not conditionally grandfathered or conditionally exempt.

Next, the bank would make a determination as to which "chiefly compensated" test—the line-of-business test or the account-by-account test—made the most business sense to employ.[40] Both exemptions require a comparison of "sales" compensation to "relationship" compensation with the line-of-business analysis effectively allowing a bank to collect up to 11% of its compensation from sales fees, whereas the account-by-account would allow a bank to collect just under 50% of its compensation from sales compensation. As the Commission is aware, the trade-off is that in order to collect just under 50% in "sales" compensation, the bank will have to perform the "chiefly compensated" analysis for each individual account.

Any bank opting to use the account-by-account exemption would need to invest in the necessary software and systems and expend significant company resources to make these programs operable in order to track compensation received from mutual funds and allocate that money to individual accounts. The proposal provides a formula to allow banks to allocate to individual accounts any Rule 12b-1 fees that are paid to the bank on an entity basis.[41] Another allocation formula is provided for revenue sharing and non-12b-1 compensation.[42] While intended to be helpful, these formulae increase the complexity of meeting the exemptions.

Should the bank opt to follow the line-of-business test, it would then be required to make sure that each line of business constituted "an identifiable department, unit, or division of a bank organized and operated on an ongoing basis for business reasons with similar types of accounts and for which the bank acts in a similar type of fiduciary capacity." As we discuss elsewhere, this requirement, in itself, poses quite a few obstacles for the banking industry.

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[40] We are oversimplifying the analysis here, as a "line-of-business" test may require compensation earned on some exempted accounts, e.g., employee benefit plans, to be brought back into the calculation. *See* discussion below in Section II. C.

[41] The formula provides that 12b-1 fees be allocated to each account by multiplying the number of shares of each class of a registered investment company's securities (or class of a series of an investment company's securities) held in each account on the last business day of the preceding year by the net asset value per share for that class of securities for such day by the annual Rule 12b-1 fee rate applicable to that class of securities. *See* proposed Rule 724(4)(i)(5).

The proposal would allow other methods of allocation that fairly and consistently measure the amount of sales compensation attributable to each account during the preceding year. *Id.*

[42] The formula provides that the fees are to be allocated to each account by dividing the number of shares of each class of an investment company's securities (or class of a series of an investment company's securities) held in each account on the last business day of the preceding year by the aggregate number of shares of the same class held by the bank in a trustee or fiduciary capacity on the same day, and then multiplying the resulting number by the aggregate dollar amount of fees the bank received in connection with that class during the preceding year. *See* proposed Rule 724(4)(i)(4) and (6).

The proposal would also allow a bank to use another method of allocation that fairly and consistently measured the amount of sales compensation attributable to each account during the preceding year. *Id.*

Finally, the bank would be required to analyze "sales" and "relationship" compensation. The definitions of "sales" and "relationship" compensation do not capture all bank trust department fees. For example, tax preparation fees[43] and administrative service fees received by banks from mutual funds[44] are classified as neither "sales" nor "relationship" compensation. Consequently, in order to determine the category to which various fees should properly be assigned, banks will be forced to peel apart all fees earned by trust departments on affected accounts or lines-of-business. Fees that satisfy neither definition will not be considered when calculating whether an account or a line-of-business satisfies the statute's "chiefly compensated" requirement. Clearly, the burdens associated with this analysis, when multiplied by the thousands of banks providing trust services for over 25 million accounts are great.[45]

Consequently, we would strongly encourage the Commission to reformulate the "chiefly compensated" test to allow for a much simpler and less costly approach. We believe that the "chiefly compensated" test should require "sales" compensation to be measured against total compensation. So long as its "sales compensation" is less than 50% of total compensation, measured on a department or line-of-business basis, the bank would satisfy the "chiefly compensated" requirement. This option, we believe, will reduce significantly the regulatory burdens associated with demonstrating that a bank is acting within the bounds of the law.[46] In this way, the Commission can be assured of complying with Congressional wishes that

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43 Under the Internal Revenue Code ("IRC"), generally the trustee is legally responsible for filing the trust's tax return. Why then are fees for services that are not only an integral part of, but legally mandated as, a trustee's duties not considered relationship compensation?

44 Administrative service fees include fees received from mutual funds for:

- Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;
- Aggregating and processing purchase and redemption orders for investment company shares;
- Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;
- Processing dividend payments for the investment company;
- Providing sub-accounting services to the investment company for shares held beneficially;
- Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or
- Receiving tabulating, and transmitting proxies executed by beneficial owners of investment company shares held beneficially.

45 According to Call Report (June 2004) banks and thrift Call Report data, there are over 2,500 institutions with trust powers.

46 While the vast majority of banks would be able to comply with this option for testing trust compensation, the Commission should be aware that there may be some banks that derive so much of their trust and fiduciary fee income from serving as trustee for municipal or corporate bondholders or as fiduciary for employee benefit plans that they may have difficulty satisfying this simple test. These institutions would still need exemptions to be crafted for these business lines. Should the Commission determine to limit the amount of "sales compensation" that a bank can receive to 11% of relationship compensation, the need for these exemptions would grow.

"the SEC…not disturb traditional bank trust activities under this [trust and fiduciary] provision."

B. The proposed 9:1 ratio of "relationship" to "sales" compensation will be difficult for many banks to meet.

The Commission has proposed to exempt a bank from the statute's "chiefly compensated" requirement if the bank "can demonstrate that during the preceding year its ratio of sales compensation to relationship compensation [for each line of business] was no more than one to nine." [47] A one to nine ratio of "sales" to "relationship" compensation expressed in percentages requires that "sales" compensation comprise no more than 11% of a bank's "relationship" compensation.[48]

As we said above, this is only a slight change from the Commission's earlier proposal which would have granted a safe harbor from the account-by-account "chiefly compensated" test for those trust banks that could demonstrate that their "sales" compensation was less than 10% of the their total "relationship" compensation. We have previously informed the staff that this 10% level is unworkable. We do not believe that the newly proposed 11% level will bring much in the way of regulatory relief for our members, particularly if employee benefit plans are required to be included in the calculation.

It is true that the Commission's determination to exempt from the definition of "broker" the bulk of indenture trustee business engaged in by bankers will have some impact on some banks' ability to comply with the proposed line-of-business exemption. As a result of negotiations with bond issuers, banks serving as trustee on corporate and municipal bond issuances are very frequently compensated through 12b-1 fees. Banks serving in these capacities would have been unable to comply with any measure of "chiefly compensated."

The Commission's very welcome action in this regard will, for the most part, exempt all banks engaged in the corporate and municipal bond trustee business from Title II compliance. This is because proposed Rule 723 would exempt all indenture trustees from the definition of broker when effecting transactions as an indenture trustee in a no-load money market mutual fund, while proposed Rule 776[49] would conditionally exempt banks

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[47] *See* proposed rule 721(a)(2).

[48] We are unclear whether the Commission would permit the "chiefly compensated" test to be calculated on a holding company basis when the holding company has several banking institutions that must comply with the trust and fiduciary exception. Several of our members have opined that it would be easier to calculate compliance on this basis.

[49] The Commission has requested comment on whether Proposed Rule 723 is still necessary given the exemption provided under Proposed Rule 726. *See* Release No. 34-48979, 69 Fed. Reg. at 39700. We agree with the Commission that the utility of the indenture trustee exemption in Proposed Rule 723 is lessened by the new general exemption for money market mutual funds provided in Proposed Rule 776. However, we believe Proposed Rule 723 should be retained. Proposed Rule 723 has significantly less conditions attached to it than does Proposed Rule 776. Some banks may prefer to claim an exception under proposed Rule 723.

effecting transactions in any money market mutual fund when acting as trustee or as escrow, collateral, depository or paying agent.[50]

Only those banks that invest proceeds of corporate or bond offerings in funds other than money market mutual funds would appear to be covered by Title II. Thus, we would urge the Commission to expand the exemption in proposed Rules 723 and 776 to include short-term bond funds and short-term U.S. Treasury funds.

Despite the positive nature of the Commission's action with respect to corporate trustees, it still remains that many banks cannot comply with a requirement to limit "sales" compensation to 10-11% of "relationship" compensation. This is true because many trust and fiduciary clients, such as employee benefit plan sponsors, often negotiate for bank trustees and fiduciaries to be compensated through the use of 12b-1, shareholder servicing and transaction fees. Often times, these fees are paid by mutual fund complexes in which plan assets are invested. Companies that sponsor employee benefit plans like these fee arrangements. For many employers, it is the only way they can afford to offer their employees access to 401(k) plans. Plus, plan sponsors prefer prices quoted on an all-in or NAV basis rather than on a separate line disclosure for trustee services provided.

In recognition of these compliance problems, the Commission has proposed to exempt certain qualified and governmental plans from the definition of "broker."[51] Unfortunately, as we discuss below, the exemption is unworkable. As a result, banks with significant employee benefit business will be unable to pass any "chiefly compensated" test, regardless of whether "sales" compensation is calculated at a 10-11% or at a 49.99% level.

Previously the industry had proposed to the staff that the Commission permit "chiefly compensated" to be calculated on a line-of-business basis so long as the percentage of "sales" to total compensation did not exceed 25%.[52] This proposal assumed that all corporate trust and employee benefit business would be exempt from the calculation. Many of our members indicated that they could manage their current business within the 25% level, even though many of them agreed that a literal reading of the statute would seem to suggest that it would be permissible for a trust institution to earn up to 49.99% of its total compensation in "sales" compensation. Nothing has happened to date that gives us any less confidence in our earlier proposal.

C. The line-of-business formulation raises significant and costly compliance issues.

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[50] We would request that "fiscal agent" be added to the list of capacities under proposed Rule 776. It is our understanding that banks doing business in California frequently serve in this capacity.

[51] *See* proposed Rule 770.

[52] Admittedly, the industry's proposal to set a line-of-business exemption at the 25% level is just as arbitrary as the Commission's suggested level of 11%, especially when the statute calls for a "chiefly" standard. Nevertheless, the industry is fairly comfortable that it can live with a 25% level. It does not share that same comfort level with the 11% proposed by the Commission.

Further difficulties with the proposal are presented by the Commission's definition of "line-of-business." Proposed Rule 724(e) defines "line-of-business" to mean "an identifiable department, unit, or division of a bank organized and operated on an ongoing basis for business reasons with similar types of accounts and for which the bank acts in a similar type of fiduciary capacity…"

The concept of "similar types of accounts . . . and for which the bank acts in a similar type of fiduciary capacity," could cause many banks to be in non-compliance. While it is true that many banks organize their fiduciary activities along business-lines, e.g., personal and employee benefits, they also operate these business lines without distinguishing between different types of accounts in that business line or the capacity in which the bank is acting.

For example, the employee benefit business will often include both qualified and non-qualified plans. In addition, the bank may serve in several different capacities with respect to these accounts, including serving as directed trustee, trustee with investment discretion or custodian. In this instance, it would appear that because the accounts are not similar and the bank does not function in the same capacity with respect to these accounts that the described employee benefit business does not satisfy the definition of line-of-business.

Further, for a bank that manages both qualified and non-qualified plans together to use the line-of business exemption, it may become necessary for the bank to reject using the employee benefit plan exemption proposed by the Commission. This is because, in order to argue that its employee benefit business is a line-of-business when the bank functions as trustee, the bank may be forced to give up the ability to exempt qualified plans under Proposed Rule 770.

The personal trust area also raises similar problems. Accounts for which the bank serves as discretionary trustee, directed trustee, executor, conservator, investment manager and investment adviser[53] are all managed within the personal trust department. It would appear that the personal trust department could not meet the line-of-business definition unless it reorganized according to the capacity in which the bank served with respect to these accounts.

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[53] We note that proposed Rule 724(d) has redefined the term "investment adviser if the bank receives a fee for its investment advice" to eliminate the earlier requirement that the advice be "continuous and regular." Instead, the adviser must now have "an ongoing responsibility to provide investment advice based upon the customer's individual needs …." We support this revision as it is a clear improvement over that contained in the Interim Final Rules. We continue, however, to be opposed to the addition of "a duty of loyalty" requirement as it narrows what the Congress had specifically required, namely that all fiduciary investment advisory activities are, without exception, protected by the trust and fiduciary exception. The requirement is also unnecessary. Banks acting in the fiduciary capacity of investment adviser are subject to range of fiduciary obligations including the duty of loyalty. That duty is derived from bank regulation, the Employee Retirement Income Security Act ("ERISA"), the Internal Revenue Code ("IRC"), state statutes, and common and case law. For example, under ERISA, the duty of loyalty has been subject to years of study and interpretation that banks and other employee benefit trustees rely upon. This duty emphasizes that trust assets are maintained for the exclusive benefit of beneficiaries. No need exists to place on bank fiduciaries yet another duty of loyalty emanating from the federal securities laws.

We would suggest that the Commission jettison the requirement that the business unit be organized along "similar types of accounts and for which the bank acts in a similar type of fiduciary capacity." Instead, line-of-business should be defined to include any type of fiduciary accounts that are administered within "an identifiable department, unit, or division organized and operated for business reasons."

D. The definition of "sales compensation" needs further clarification.

The Commission has proposed to define "sales" compensation as any compensation a bank receives in connection with effecting securities transactions that is: (1) a profit added onto a flat or capped per order processing fee equal to no more than the cost incurred by the bank in connection with executing a securities transaction; (2) compensation that if paid to a broker-dealer would be payment for order flow; (3) a finders' fee, but not a referral fee permitted under the networking exception; (4) revenue sharing; (5) a 12b-1 fee; or (6) a fee paid by an investment company, other than pursuant to a 12b-1 plan, for personal service or the maintenance of shareholder accounts.[54]

With respect to "compensation that if paid to a broker-dealer would be payment for order flow," we note that Rule 10b-10 defines "payment for order flow" to include remuneration, compensation, or consideration for "research." Bank trust departments receive soft-dollar research from broker-dealers and it is unclear how those dollars should be allocated, if at all, among trust and fiduciary accounts or lines-of-business. We do not believe that the Commission intended to require banks to allocate these dollars to individual accounts or lines-of-business but request clarification of this point.

Revenue sharing is also characterized as "sales" compensation.[55] Concerns have been raised that internal corporate reallocation of fees might be brought into the definition of sales compensation. It is not uncommon for bank-affiliated investment advisers to reallocate fees earned from advising mutual funds to the bank. These reallocation practices can be traced to the fact that bank investment advisory activities commenced in bank trust departments where bank trustees would often invest client assets in common and collective funds. As trust customers exhibited interest in being invested in mutual funds, bank investment advisory activities migrated out of the bank and into registered investment advisory firms. Reallocation recognizes that the customer invested in the mutual fund is, nevertheless, still the customer of the bank trust department.[56]

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[54] Administrative service fees are not included in the definition of "sales" compensation. *See* n. 32 and accompanying text, *supra.*

[55] "*Sales compensation* means any compensation a bank receives in connection with activities for which it relies on an exception under section 3(a)(4)(B)(ii)….that is…..(4) A fee paid for offering of securities that the bank does not receive directly from a customer or beneficiary, or directly from the assets of an account for which the bank acts in a trustee or fiduciary capacity,…." *See* propose Rule 724(i).

[56] The Department of Labor's PTE Exemption 77-4 recognizes just this fact as it permits bank fiduciaries to invest plan assets in affiliated mutual funds and receive compensation through investment advisory fees paid from fund assets. *See* PTE 77-4, 42 Fed. Reg. 18732 (April 8, 1977).

Because these fees are based on assets under management, the industry has always considered them to be more akin to "relationship" compensation. Transfer agency and custodial fees are similarly considered to be "relationship" compensation. We are concerned that the proposed rule may be read to require these monies to be interpreted to be included within "sales" compensation and request confirmation that they are not. In this connection, we would note that it is our belief that any data supplied to the Commission previously regarding "sales" to "relationship" or total compensation ratios would not have included revenue reallocations in any "sales" compensation estimate.

E. The exemption for certain living, testamentary, and charitable trust accounts is too narrow.

Proposed Rule 726 conditionally exempts banks from meeting the statute's "chiefly compensated" requirement to the extent that the trustee or fiduciary bank effects securities transactions for living, testamentary, or charitable trust accounts opened, or established before July 30, 2004. Any bank claiming this exemption would be required, among other things, to satisfy the statute's advertising requirements; to execute through a registered broker-dealer all domestic, publicly-traded securities trade orders, and not to individually negotiate with the accountholder or beneficiary to increase the proportion of sales compensation to relationship compensation after July 30, 2004.

This exemption is helpful in that it provides flexibility with respect to established personal trust accounts, however, it does not go far enough. Estates should be included within the exemption. Banks serve as executors, administrators or personal representatives with respect to estates. In addition, conservatorships and guardianships should be added. All of these capacities are fiduciary[57] and should be included within the exemption.

In addition, because some in the industry view the term "living trust" as more limited than what we believe the Commission intended, we would urge the Commission to make clear that all irrevocable and revocable trusts, whether inter vivos or testamentary, as well as charitable trusts and estates are included within the exemption. A revocable trust enables the settler to retain control over the trust assets by expressly reserving to him or herself in the trust instrument the power to amend, modify or revoke the trust. The laws of most states provide that a trust is irrevocable unless the power to revoke is reserved in the trust instrument.

An irrevocable trust account ordinarily cannot be amended, modified or revoked absent a court-ordered termination. Two principal reasons for the creation of an irrevocable trust are to provide a vehicle for completing a gift short of outright transfer of the property to the donee, and to produce a transfer tax savings as the result of the completed gift.

We would point out that the usefulness of this exemption is limited. Only those banks that opt to calculate "chiefly compensated" on an account-by-account basis would be able to use the exemption because the "line-of-business" exemption, as we discuss above, requires a unit of the bank to be "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…." No bank

[57] *See e.g.,* Section 3(a)(4)(D).

that we are aware of is likely to organize and operate its trust department in a manner that would permit grandfathered accounts to be managed separately from accounts not grandfathered, i.e., accounts opened before July 30, 2004 and accounts opened after date. Consequently, we do not believe any bank using the exemption could use the line-of-business exemption for non-grandfathered accounts.

Finally, we would request that the grandfather date be changed to be coterminous with the final effective date, currently proposed as January 1, 2006. One date for compliance and grandfathered accounts will reduce confusion.

F. A bank's business decision to outsource certain aspects of its trust and fiduciary business should not jeopardize its status under the exception.

Section 3(a)(4)(B)(ii) requires a bank to effect transactions in a trustee or fiduciary capacity in a trust department or other department that is "regularly examined by bank examiners for compliance with fiduciary principles and standards." The narrative portion of the release states that the Commission proposes to interpret this requirement to mean "all aspects" of effecting securities transactions in compliance with the trust and fiduciary activities exception "must be regularly examined by bank examiners for compliance with fiduciary principles and standards." Thus, it is the activities, rather than the department in which they are conducted, that would need to be regularly examined.[58]

In this connection, we request confirmation that a bank's trust and fiduciary exception would not be jeopardized if it were to outsource certain aspects of effecting a securities transaction for a fiduciary account to an affiliated or unaffiliated party. Banks may choose to outsource for any number of reasons, including gaining operational or financial efficiencies, increasing managements focus on core business functions, and obtaining specialized expertise. For example, it is not uncommon for a bank to use a registered investment advisory affiliate to place fiduciary orders. The Commission, not the bank regulators, is the functional regulator for the advisory firm and, consequently, the bank regulators would not examine the advisory affiliate for compliance with fiduciary principles and standards.

To be sure, however, the bank regulators will examine the bank to determine whether it has exercised the appropriate oversight and review of the outsourced activity.[59] For activities not otherwise subject to supervision by a functional regulator, the bank regulators have the authority to supervise all of the activities and records of the financial institution whether performed or maintained by the institution or by a third party on or off the premises of the financial institution.[60] We request confirmation that so long as the activity outsourced is subject to oversight by either the bank regulators or the Commission, as appropriate, a bank's status under the trust and fiduciary exception will not be jeopardized.

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[58] *See* Release no. 34-49879, 69 Fed. Reg. at 39703.

[59] *See, e.g.,* FFIEC, Outsourcing Technology Services , June 2004.

[60] Bank regulators supervise banks' use of third-party service providers under the Bank Service Company Act, 12 USC Section 1861, *et seq.*

III. SAFEKEEPING AND CUSTODY EXCEPTION

A. Order-taking is a traditional and customary bank custodial activity and, as such, is protected under Title II's custodial exception.

The Congress determined in the Gramm-Leach-Bliley Act that a bank engaging in safekeeping and custody activities in accordance with the conditions outlined in clause (viii) of subparagraph (B), will not be considered a broker within the meaning of Section 3(a)(4)(A) of the Exchange Act.[61] As demonstrated below, order-taking clearly comes within the ambit of "custody services" and is, thus, permitted under the statute.

It is clear that in enacting the various exceptions, the Congress intended to permit banks to engage in certain activities involving securities transactions, thereby allowing those activities deemed international banking activities to remain in the bank.[62] In this vein, order-taking or buying or selling securities at a customer's direction and as an adjunct to a custody relationship has long been a custody service provided by banks. Recognized authorities in trust and fiduciary law tell us that custody services include safekeeping of securities; collecting income; collecting matured or called principal; notifying the customer of subscription rights; and **buying, selling**, receiving and delivering of securities on specific directions from the customer (emphasis added).[63]

The specific language of the exception further supports the conclusion that Congress intended to include all traditional custodial services within the safekeeping and custody exception by referencing safekeeping and custody services as part of customary banking activities. Almost 30 years ago, both the Commission and the Department of Treasury noted that banks buy and sell securities at the direction of their custodial customers and

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[61] Clause (viii) provides that "[t]he bank, as part of customary banking activities—(aa) provides safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers; (bb) facilitates the transfer of funds or securities, as a custodian or clearing agency in connection with the clearance and settlement of its customers' transactions in securities, (cc) effects securities lending or borrowing transactions with or on behalf of customers as part of services provided to customers pursuant to division (aa) or (bb) or invests cash collateral pledged in connection with such transactions; (dd) holds securities pledged by a customer to another person or securities subject to purchase or resale agreements involving a customer, or facilitates the pledging or transfer of such securities by book entry or as otherwise provided under applicable law, if the bank maintains records separately identifying the securities and the customer; or (ee) serves as custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive or other similar benefit plan."

[62] *See* Conf. Rep. 106-434. at 163-64; S. Rep. No. 106-44, at 10 (April 28, 1999).

[63] *See* the definition of custodian in Banking Terminology (2nd edition), a publication of the American Institute of Banking; Section 8.1 of Scott on Trusts; FDIC Trust Examination Manual, Vol 1 (2001); Clarke, Zalaha, and Zinsser, The Trust Business at 67 (1988); Gregor, Trust Basics at 43 (1998); the discussion of the responsibilities of a custodian in Trust Business, published by the American Institute of Banking in 1934; the discussion of custodial accounts in Trust Audit Manual, (1976), a publication of the Bank Administration Institute; What a Trust Department Does at 34 (1940), a publication of Continental Illinois National Bank.

charge a fee for that service.[64] Importantly, even the Commission, in its 1977 Report to Congress, noted how prevalent order taking is in custodial accounts.[65] Clearly, the Congress understood this when approving the custody exception's "customary banking" language.

Indeed, the Commission itself advocated on behalf of a custody exception narrowed to customary banking activities. "The Commission staff is concerned that the broad language in this [the custody] exemption could be interpreted to include activities beyond *customary banking activities*."[66] Clearly, "customary banking activities"—a term specifically embraced by the Commission in the context of the safekeeping and custody exception—includes order-taking.

Other provisions of the exception also lend support regarding the Congress' clear understanding that bank custodians customarily take direction regarding the purchase and sale of securities from individual clients. Section 3(a)(4)(C) directs banks and trust companies conducting securities transactions under the auspices of the safekeeping and custody exception, as well as the trust and fiduciary and stock purchase plan exceptions, to transmit certain publicly-traded security buy or sell orders to a registered broker-dealer for execution. This requirement makes sense in the context of the trust and fiduciary and stock purchase plan exceptions, where banks do initiate securities transactions either at their own or their customer's direction. If banks were not taking orders from customers, however, there would be no need for any legislative requirement to direct the transaction to a registered broker-dealer, as the instruction would come from the customer's broker-dealer in the first instance. As order-takers for custody clients, the requirement to direct trades to a registered broker-dealer makes equally good sense.

We also note that division (ee) to the exception singles out one of the many types of accounts for which banks provide order-taking services, namely, individual retirement accounts or IRAs. Self-directed IRA custodial accounts were singled out for special treatment during the House and Senate conference process in order to make crystal clear that self-directed IRA activities involving securities would remain in the bank.[67] This action was viewed as necessary, despite the fact that the legislative history for both the 106th and 105th Congresses specifically addressed self-directed IRAs,[68] because the Commission's

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[64] Securities and Exchange Commission, Initial Report on Bank Securities Activities, at 77-89 (January 3, 1977); U.S. Department of the Treasury, Public Policy Aspects of Bank Securities Activities: An Issues Paper, at 5 (November 1975).

[65] Initial Report on Bank Securities Activities, at 77-78.

[66] Appendix to Testimony of Securities and Exchange Commission Chairman Arthur Levitt before the Subcommittee on Finance and Hazardous Materials of the House Committee on Commerce, July 17, 1997 (emphasis supplied).

[67] *See* Summary of Provisions of Chairmen's Mark and Chairmen's Mark of the Gramm-Leach-Bliley Act, dated October 12, 1999. ("The limited [Title II] exemptions would cover transactions in connection with the following bank activities:… self-directed IRAs …).

[68] S. Rep. 106-44, 106th Cong. 1st Sess. at 10 (1999); S. Rep. No. 105-336, 105th Cong. 2d Sess. at 10 (1998). An earlier Committee report issued by the House Commerce Committee during the 105th Congress had suggested that self-directed IRA accounts were not protected under the push-out provisions thereby

opposition to permitting banks to service self-directed IRA accounts was well known.[69] In addition, various articles appearing in the press at the time questioned whether self-directed IRA accounts were adequately protected under the push-out exceptions then included in the bills under consideration by both legislative bodies.[70] In response, division (ee) was added to reinforce the Congress' intention to protect self-directed IRAs.

Division (ee) recognizes that banks do take direction from bank customers. It does not contemplate that the bank as custodian or provider of services will become involved in the transaction only after the trade has been executed. Rather the self-directed IRA provision illustrates quite clearly that Congress understood and embraced the notion that banks would remain exempt from broker-dealer registration even if they took direction from an individual customer and transmitted that order to a broker-dealer for execution.

If the statute does not permit order-taking by custodians, then bank custodians would be prohibited from taking orders from 401(k) plan participants, self-directed IRA customers, registered investment advisers, and charitable organizations, just to name a few. Clearly, Congress could not have intended such a disruption to traditional and customary bank custodial activities.

The Commission need not be concerned that investor protection will suffer, as little opportunity for sales practice abuse and confusion exists. These transactions are initiated by the consumer. No trades are solicited and none can be initiated absent the customer's authorization. Investment advice is not sought and none is given. Further, consumer protection is provided by ERISA and banking regulations that require the bank to establish securities trading policies and procedures.[71] Subsumed within those trading practice procedures are requirements to establish equitable trade allocation policies. And because the transaction would be executed through a registered broker-dealer, compliance with best execution requirements imposed by the federal securities regulators is assured. In sum, current laws provide sufficient protection from abuses.

The Commission has chosen to provide two regulatory exemptions that would permit banks to engage in order-taking under certain limited circumstances. While we appreciate the need for these regulatory exemptions given the Commission's narrow reading of Title II, the issue remains that no need for these regulatory exemptions exist as order-taking is clearly permitted under the statute itself.[72]

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necessitating a rebuttal from the Senate Banking Committee during that same session of Congress. *See* H.R. Rep. No. 105-164, pt. 3, at 135 (1997).

[69] *See* Appendix to Testimony of SEC Chairman Arthur Levitt at 3-4.

[70] Melanie L. Fein, *Comment: Is Reform Bill a Menace to Bank Retirement Plans?,* The American Banker, June 1, 1999, at 12; Sarah A. Miller, *Comment: Reform Won't Affect Pension Services*, The American Banker, June 18, 1999, at 9; Lee A Pickard, *Comment: House Version of Trust Bill Goes Too Far*, The American Banker, July 9, 1999, at 6.

[71] *See, e.g.*, 12 CFR 12.7; Comptroller's Handbook on Conflicts of Interest, at 22 (June 2000); Comptroller's Handbook on Community Bank Fiduciary Activities Supervision, at 33 (December 1998).

[72] We are also concerned that a future Commission and staff, unaware of the legislative history behind the Gramm-Leach-Bliley Act, may choose to cut back significantly on or worse repeal these regulatory exemptions.

B. <u>The general custody exemption for order-taking will cause significant confusion among investors as it will force wide-scale revisions to current industry practices.</u>

Proposed Rule 760 would exempt a bank from the definition of "broker" to the extent that it accepts securities trade orders for those accounts for which the bank acts as a custodian so long as the account was opened before July 30, 2004, or the custodial customer is a "qualified investor."[73] As we outline above, this condition is most troubling and is one to which the ABA and ABASA are strongly opposed. All of our member banks, large and

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[73] Section 3(a)(54)(a) of the Exchange Act, 15 U.S.C. 78c(a)(54)(A)(vii) and (xi), defines "qualified investor" as:

(i) any investment company registered with the Commission under section 8 of the Investment Company Act of 1940;

(ii) any issuer eligible for an exclusion from the definition of investment company pursuant to section 3(c)(7) of the Investment Company Act of 1940;

(iii) any bank (as defined in paragraph (6) of this subsection), savings association (as defined in section 3(b) of the Federal Deposit Insurance Act), broker, dealer, insurance company (as defined in section 2(a)(13) of the Securities Act of 1933), or business development company (as defined in section 2(a)(48) of the Investment Company Act of 1940);

(iv) any small business investment company licensed by the United States Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958;

(v) any State sponsored employee benefit plan, any other employee benefit plan, within the meaning of the Employee Retirement Income Security Act of 1974, other than an individual retirement account, if the investment decisions are made by a plan fiduciary, as defined in section 3(21) of that Act, which is either a bank, savings and loan association, insurance company, or registered investment adviser;

(vi) any trust whose purchases of securities are directed by a person described in clauses (i) through (v) of this subparagraph;

(vii) any market intermediary exempt under section 3(c)(2)of the Investment Company Act of 1940;

(viii) any associated person of a broker or dealer other than a natural person;

(ix) any foreign bank (as defined in section 1(b)(7) of the International Banking Act of 1978;

(x) the government of any foreign country;

(xi) any corporation, company, or partnership that owns and invests on a discretionary basis, not less than $25,000,000 in investments;

(xii) any natural person who owns and invests on a discretionary basis, not less than $25,000,000 in investments;

(xiii) any government or political subdivision, agency, or instrumentality of a government who owns and invests on a discretionary basis not less than $50,000,000 in investments; or

(xiv) any multinational or supranational entity or any agency or instrumentality thereof.

small, accept orders from customers that cannot meet the definition of "qualified investor" because they do not have the requisite $25-$50 million investment portfolio.

For example, many banks serve as custodians for individuals, charitable organizations, non-profits, municipalities and insurance companies that do not satisfy the "qualified investor" definition. Often times, these entities hire an SEC-registered investment adviser to assist them in selecting appropriate investments. It is not uncommon for those investment decisions to be communicated by the registered investment adviser directly to the custodian. Alternatively, the client will communicate its order directly to the custodian bank. As required under GLBA and proposed Rule 775, the custodian then directs any order for debt or equity to a broker-dealer or, if it is a mutual fund, directly to the investment company or its agent.

Because registered investment advisers generally do not come within the definition of "qualified investor,"[74] bank custodians will no longer be able to accept orders even from entities that are subject to the Commission's jurisdiction if proposed Rule 760 were to become final. Instead, the registered investment adviser would have to hire a broker-dealer to communicate that order to the market. As we discuss below, this process denies consumer choice and is operationally unworkable with respect to investment company securities. In addition, it makes meaningless the Congress' direction to custodians to direct security trades to a registered broker-dealer.

Further examples of the disconnect between the Commission's proposal and current industry practices exist. Monies held in 401(k) plan accounts are frequently rolled-over to IRA accounts when an employee leaves his or her place of employment. The Commission's current interpretation that the statute's custody and safekeeping exception does not permit IRA account holders to place their security transaction orders with bank custodians, combined with the qualified investor limitations of proposed Rule 760 leave these account holders with little option other than to hire a registered broker-dealer to provide custodial services. As illustrated below, customers often seek bank custodial services because banks are able to offer a product that is markedly different than that offered by broker-dealers. By denying consumers the ability to select banks as their IRA custodians, the Commission has denied investors the ability to choose the products or services that make the most sense given their particular needs.

We would also note that under the Internal Revenue Code ("IRC") only banks are able to serve as IRA trustees and custodians without specific approval of the Treasury Secretary.[75] Further, Treasury does not distinguish between a custodial and a trust IRA account. "[A]

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[74] A registered investment adviser could only be considered "a qualified investor" if it had its own investment portfolio of $25 million or was affiliated with a broker-dealer. *See* Section 3(a)(54)(vii) and (xi) of the Exchange Act.

[75] *See* IRC Section 408(a)(2)(h), 26 USC Section 408(a)(2)(h). IRC Section 408(h) trustee or custodial qualification requirements are also applicable to Health Savings Accounts (*see* IRS Notice 2004-2, Q&A 9) and Coverdell Education Savings Accounts (*see* IRC Section 530(g)). For purposes of the broker registration exemption under proposed Rule 760, the Commission should expressly provide that all such accounts and successors to such accounts are included within the exemption.

custodial account shall be treated as a trust if the assets of such account are held by a bank….. [I]n the case of a custodial account treated as a trust, the custodian of such account shall be treated as a trustee thereof." If the Congress, Treasury and the Internal Revenue Service ("IRS") regard banks as the preferred provider of IRA services and impose upon IRA custodians, the same duties and responsibilities applicable to IRA trustees, why does the Commission take the contrary position that banks are not preferred providers of IRA services and that IRA trusts and IRA custodial accounts need to be treated differently under the federal securities laws?

Furthermore, if the Commission persists in its position that bank IRA custodians cannot accept orders for custodial IRAs, but that such orders must be placed with a broker, the ultimate effect of that position will be to eliminate bank custodial IRAs over time. Clearly, that could not have been the intent of Congress when it provided in the IRC that banks were the preferred providers of IRA services.

Most significant, however, is the havoc the Commission's proposal will wreak on employee benefit plans. As the Commission is aware, employee benefit plan sponsors often hire banks as custodians or non-fiduciary administrators. As such, the bank, among other things, takes investment orders from 401(k) and other defined contribution plan participants. Because plan participants do not satisfy the definition of "a qualified investor," proposed Rule 760 would effectively prevent plan participants from communicating their investment orders to any bank custodian properly hired by the plan sponsor.

Moreover, we note that even if it were theoretically possible for a plan participant to satisfy the "qualified investor" definition, proposed Rule 760(a)(5) makes clear that banks providing employee benefit plan services may NOT take advantage of the exemption provide by Rule 760. And as we outline in detail below, the exemption for employee benefit plans proposed to be provided by Rule 770, while well-intentioned, simply does not work. Consequently, the only meaningful alternative is for all employee benefit plan sponsors that currently employ banks as custodians or non-fiduciary administrators to hire registered broker-dealers to provide these services or to renegotiate their contracts with the banks, designating the banks as trustees or fiduciaries to the plan. Neither option is workable.

First, few broker-dealers have the necessary infrastructure to take daily plan participant direction and provide plan participant loan services—services that, for all practical purposes, are required when a entity serves as a custodian or non-fiduciary administrator to employee benefit plans. Broker-dealer systems also are not set up to handle Form 5500 reports.[76] This Form is in lieu of a trust tax return for qualified plans (and partially satisfies the tax filing requirements for other trusts, such as VEBAs, which are also required to file a Form 990). It is also a significant enforcement tool used by the Department of Labor ("DOL") and the IRS to protect plan participants.

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[76] Form 5500 provides the government with statistical and financial information about the plan and/or the plan sponsor. Bank systems report plan information in a format that complies with DOL's audit requirements and is efficient for outside auditors to use. *See* Section 103 of ERISA, 29 USC Section 1023; 29 CFR Section 2520.103-5.

Second, as we discuss previously, banks serving as trustees or fiduciaries to these plans cannot satisfy the trust and fiduciary activities "chiefly compensated" test, whether calculated on an account-by-account basis or on a line-of-business basis. Failure to satisfy the "chiefly compensated" test will require the activity to be pushed-out of the bank and into a broker-dealer—an entity that, we reiterate, generally does not have the necessary infrastructure to support employee benefit plan services.

C. The general custody exemption effectively denies consumer choice.

There are significant differences between custodial services offered by banks and those offered by broker-dealers and, depending on the needs of the consumer, it may be more appropriate for a client to pick one type of provider over another. For example, as part of their overall custodial fee, banks automatically provide their custodial clients with a range of services, including entering appearances in class actions, performance reporting, risk analysis, and tax-lot and gain and loss reporting. Broker-dealer clients generally do not need these types of services, nor do they want to pay for them. Consequently, broker-dealers do not typically offer these services.

Further, many bank custodial clients are individual trustees or executors or administrators of estates that seek principal and income accounting. For example, a trust agreement may call for separate and distinct use or distribution of the invested assets or principal on the one hand and the income or return derived from the use of the assets/principal on the other hand. It is not uncommon for a trust agreement to require mandatory distribution of income to the current beneficiaries and distribution of remaining principal to any remaindermen. Bank trust accounting systems can track receipt to and distribution from principal and income, thereby assisting the trustee in carrying out the terms of the trust agreement. Broker-dealers do not provide this service as again, their clients neither need nor want to pay for this service.

Other differences exist. Securities held in margin accounts at broker-dealers are, as a matter of course, subject to being lent or hypothecated. Securities held in bank custodial accounts are not. Rather, banks enter into a separate agreement with their custodial clients whereby the client authorizes the bank to lend securities held in the account in order to generate a larger return for the account. Some institutions engage in securities lending with the assistance of a registered investment advisory affiliate. The agreement further specifies, among other things, that the account will receive cash or Treasury securities as collateral equal to 102 percent or more of the market value of the borrowed securities and that the income earned on the transactions, whether it is a fee received from the borrower or income earned on the invested collateral, is shared between the account and the bank and/or an affiliate.[77]

Most importantly, banks are not limited in the types of assets they can hold in custodial accounts, whereas brokers are. For example, it is not uncommon to find deposit

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[77] We assume this fee, if earned by a bank functioning not in a custodial capacity but a trustee or fiduciary, e.g., as securities lending agent would be considered "relationship compensation under the trust and fiduciary exemptions as it is compensation earned on assets under management.

instruments, promissory notes, restricted stock, real estate, physical assets, mineral interests, as well as securities, held in bank custodial accounts. Broker-dealers are either not permitted or do not want to hold many of these types of assets.

The popularity of bank custodial accounts should not be ignored. Demand for bank custodial accounts has grown by 50 percent since 2001, with banks holding 28.2 million accounts with assets in excess of $25 trillion as of June 2004.[78] Contributing to this demand is the fact that 88% of very wealthy investors with trusts prefer to self-trustee their trusts.[79]

By limiting the ability of banks to engage in order taking for their custodial clients, the Commission will force those consumers that want to engage in order taking and need the custodial services offered by banks to open and pay for two accounts. Specifically, proposed Rule 760 will force consumers to open an account with a broker-dealer that will take all security trade orders and communicate those orders to the market, while the account at the bank will hold the assets and perform all the services commonly associated with bank custodial accounts. Rather than give consumers the choice to pick the product provider that best suits their needs, the Commission has both denied them that choice and forced them to incur higher costs.

In this connection, we would also note that many broker-dealers affiliated with banks have expressed concern about assuming order execution responsibilities for bank custodial accounts. Potentially thousands of accounts would be opened at affiliated broker-dealers under individual customer account names. Records for these accounts would have to be established and maintained at the broker-dealer and broker-dealer compliance responsibilities would be expanded by adding these accounts to the broker's book. Yet no assets would be held in these accounts, as the actual assets would remain at the bank in custodial accounts.

Finally, we note that plan sponsors <u>want</u> banks to service their employee benefit plans for a number of reasons, not the least of which is that any bank deposits held in these accounts are insured on a "pass-through" or per-participant basis.[80] Insurance provided by the Securities Investor Protection Corporation for broker-dealers is not quite so robust. Forcing those employee benefit plans for which the bank provides order-taking services out of the bank and into a broker-dealer will be against clients' wishes.

D. <u>Proposed Rule 760 is operationally unworkable.</u>

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[78] FFIEC Report, n. 27, *supra.*based on July 2004 Call Report Data.

[79] *See* Walper and McBreen, <u>Updating, *Bank Trust Operations*, American Banker</u>, at 10 (August 27, 2004).

[80] *See* 12 CFR 330.14 (….[A]ny deposits of an employee benefit plan or of any eligible deferred compensation plan described in section 457 of the Internal Revenue Code …in an insured depository institution shall be insured on a "pass-through" basis, in the amount of up to $100,000 for the non-contingent interest of each plan participant,….).

As we understand it, the Commission envisions that all security trade orders for custodial accounts not exempt under proposed Rules 760 and 761[81] will be communicated by the client to a registered broker-dealer for execution. While the process envisioned might work for listed and over-the-counter securities, it does not work for mutual fund transactions. Clearly, the potential disruptions to the market are huge and provide no benefits to the investor.

Stocks and bonds are generally depository eligible. Transactions in depository eligible securities for bank custodial clients can be effectuated by broker-dealers and denominated as a DVP payment account. These accounts recognize banks' role in the clearance and settlement of securities and allow bank custodians to get confirmations regarding transactions effected by brokers on behalf of the bank's custodial client.

Mutual fund shares are not depository eligible. Shares in mutual funds are held at the mutual fund's transfer agent in book entry format. Currently, banks that effect custodial clients' mutual fund orders are recognized on the account as custodian or agent for the specific client. If banks were prohibited from effecting these orders and a broker-dealer were required to effect a mutual fund transaction on behalf of a bank custodial client, the shares held at the fund would be denominated as held in the broker's name either as agent for a specific beneficial owner or on an omnibus basis. In this environment, the records of the fund's transfer agent reflect the fact that the broker-dealer is the record holder of the position. The transfer agent would not have the ability to recognize the bank as custodian, only as an interested party. In this situation, bank custodians would be unable to get the necessary documentation needed from the fund to perform its custodial duties.

To remedy the situation and to allow the bank to take custody of fund assets, the individual client will need to send a letter to the mutual fund requesting that the fund's transfer agent transfer the assets on its book back to the custodian bank's name. This process would need to be repeated on a per transaction basis, creating more transactions and more expense to clients. In addition, this process would severely impact the timeliness of these transactions. Clearly, it would be an understatement to claim that the costs, burdens and confusion to the mutual fund marketplace will be enormous, with no added benefit to the investor, if the Commission's proposal to prohibit custodian banks from taking all custodial clients trade orders becomes final. Alternatively, the proposal could have the unintended consequence of causing custodial clients to redirect their investments from mutual funds to exchange traded funds.

E. Other provisions of the general custody exemption need further clarification.

The Interim Rules would have prohibited a bank from receiving any compensation in connection with accepting customer trade orders. The Commission has now determined to allow banks to receive compensation for effecting these transactions for all grandfathered custody accounts or custody accounts for qualified investors. We believe the requirement that the fee charged for effectuating the order does not vary depending on whether the order

[81] Proposed Rule 761 exempts small banks engaged in order-taking on behalf of their custodial customers from the definition of broker under certain circumstances. *See* discussion *infra* at pp. 33.

was communicated to the custodian bank directly from the custody account holder or through a broker-dealer comports with industry practice.

The narrative portion of the release states that the Commission is not proposing to amend the exemption to permit banks to be compensated for accepting securities orders through revenue sharing arrangements.[82] We request clarification on this point as it was our understanding that the staff had informally taken the position during discussions with the industry that compensation received from a mutual fund's investment adviser, including revenue sharing or revenue reallocation, was not prohibited. Nor were fees received from a mutual fund for providing mutual fund custodial or transfer agency services prohibited. Our understanding appears to conflict with the prohibition on revenue sharing arrangements.

We request confirmation on two other points. First, in connection with explaining proposed Rule 760's prohibition on using the exemption for trust and fiduciary accounts for which the bank also serves as custodian, the Commission states that "[t]ransactions for trust and fiduciary activity accounts would need to be effected in compliance with the trust and fiduciary exception in Exchange Act Section 3(a)(4)(B)(ii). This statement should not be read to suggest that a bank acting in a fiduciary capacity is precluded from using any of the other Title II exceptions, including the permissible securities transaction, sweep transaction and custody and safekeeping exceptions, or the regulatory exemptions proposed to be provided by rules 770 and 776.

Second, in connection with its discussion of proposed Rule 760's solicitation restrictions the narrative portion of the release discusses lists of recommended securities, watch lists, research reports, or other publications highlighting particular securities or groups of securities that may provide investment advice. We request confirmation that nothing in this language should be read as limiting a bank's ability to solicit trust and fiduciary business under Section 3(a)(4)(B)(ii)(II). Bank trust departments often generate research reports that may be shared with their current and prospective clients.

F. <u>Proposed Rule 760 can be revised to address many of the issues raised.</u>

We strongly believe that the statute on its own permits banks to accept trade orders from custodial customers. Nevertheless, should the Commission disagree with our position, we believe that some of our concerns might be best resolved if the Commission were to:

- Exempt, as we more fully discuss below, all employee benefit plans, including IRAs, from operation of Regulation B;
- Absent an operational fix with respect to mutual fund orders, allow custodial clients to place mutual fund orders directly with bank custodians or non-fiduciary administrators;

[82] *See e.g.,* Release No. 34-49879, 39710

- Reduce the complexity of the grandfather for existing accounts by making the grandfather date for Rule 760 and the compliance date coterminous, i.e., January 1, 2006, and

- Provide that banks can provide, on a going forward basis, custodial services for "accredited investors,"[83] and other entities registered either with the Commission or state authorities.

G. The proposed small bank custody exemption is a significant improvement over the earlier proposal.

Proposed Rule 761 would allow small banks to be conditionally exempt from the definition of broker to the extent they enter security trade orders for custodial accounts. "Small bank" is defined as a bank that has less that $500 million in assets for the prior two calendar years and is not affiliated with a holding company with consolidated assets in excess of $1 billion.

We heartily endorse the Commission's action of raising the asset threshold for small banks from the original $100 million in assets to $500 million. By doing so, we believe proposed Rule 761 will become a much more attractive exemption for many of our small bank members. We believe the exemption could potentially exempt 1,254 banks, thrifts and trust companies from the trust and fiduciary and custodial provisions of Regulation B.

We take this opportunity to request that the Commission consider raising the asset size for institutions that can take advantage of this small bank custody exemption. Specifically, we would suggest that the asset size be raised from $500 million to $1 billion. That is the definition of a small savings institution used by the OTS under its Community Reinvestment Act ("CRA") regulations and proposed to be similarly used by the Federal Deposit Insurance Corporation.[84]

In this connection, the Commission should be aware that we are strongly opposed to any efforts to reduce the number of trust companies that can take advantage of the exemption. Many of our trust company members strongly support proposed Rule 761 as it would completely exempt their trust, fiduciary and custodial accounts from Regulation B. These institutions have not focused on the many difficulties associated with complying with the trust and fiduciary, general custodial and employee benefit exemptions and the potential impact those exemptions will have on their current business. We are troubled by the idea that if the Commission were to change the definition of "small bank" at the adoption stage so as to effectively reduce the number of trust companies that would be exempt from

[83] An "accredited investor" is defined, under the federal securities laws, to include banks, savings and loan associations, registered brokers or dealers, insurance companies, registered investment companies; business development companies; small business investment companies; state or local government employee benefit plans with total plan assets in excess of $5 million; natural persons with a net worth of $1 million; natural persons with income in excess of $200,000 for the past two years or joint income with their spouse in excess of $300,000 for the past two years; and trusts with assets in excess of $5 million. *See* Rule 501(a) of Regulation D, 15 CFR 230.501.

[84] See 12 CFR Part 563e, 69 Fed. Reg. 51155 (August 18, 2004); 69 Fed. Reg. 51611 (Aug. 20, 2004).

Regulation B, it will not have had the benefit of the effected trust companies' comments. We urge the Commission NOT to revise the definition of "small bank" in any manner that would reduce the number of trust companies that could take advantage of proposed Rule 761.

Finally, one of the conditions to the small bank custody exemption provides that the bank does not pay its employees any incentive compensation related to any brokerage transactions effected under the exemption except as permitted under the networking exception.[85] We assume that this limitation does not impact the ability of banks to pay bonuses to their employees based on the dollar value of the custody business generated when the bank does not pay any referral fees for such business.

IV. EMPLOYEE BENEFIT PLAN EXEMPTION

Proposed Rule 770 would provide a conditional exemption for banks from the definition of broker to the extent that a bank, acting in a trustee, custodial or a non-fiduciary administrative capacity,[86] effects transactions in mutual funds for certain employee benefit plans. Several conditions are attached to the exemption, including requirements that any compensation received from mutual funds must be offset against all fees and expenses owed to the bank by the plan; that plan sponsors be provided certain disclosures; that investments other than those generally offered through the plan be offered through a registered broker-dealer, and that compensation paid to non-qualified natural persons be limited.

The Commission correctly recognizes that an exemption from broker registration for banks that service employee benefit plans is absolutely imperative. Banks do not typically charge plan participants directly for the total cost of plan administration in daily valued participant-directed plans, but, rather, are often partially or fully compensated through 12b-1 and other fees the Commission proposes to define as being included within "sales compensation." As a consequence, banks that administer retirement accounts often cannot meet the "chiefly compensated" requirement necessary to the trust and fiduciary activities exception.

Similarly, banks that serve in a custodial capacity or non-fiduciary administrative capacity for those employee benefit plans that permit participants, including 401(k) plan participants, to place securities orders directly with the bank will not be exempt from registration under the statutory safekeeping and custodial exception, as proposed to be interpreted by the Commission.[87] Should the Commission's statutory interpretation hold, then an exemption

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[85] *See* proposed rule 761(e).

[86] We note that the narrative portion of the release states that proposed Rule 770 will exempt from broker registration "bank trustees and non-fiduciary administrators," yet the actual text of the Rule suggests that the exemption will only apply to banks that act as "a trustee or a custodian." *See* proposed Rule 770(a). Because the statute discusses banks acting in a trust or fiduciary capacity and as "custodian or provider of other related administrative services," we assume that the exemption will cover bank trustees, custodians and non-fiduciary administrators but request confirmation of our understanding.

[87] Clearly, under the Commission's view, banks can use the statute's safekeeping and custody exception when serving as custodian or provider of related administrative services to employee benefit plans that does not offer order taking services to their clients.

would be absolutely necessary to allow these investors to continue to save for their retirement through bank service providers. Unfortunately, the employee benefit plan exemption, as proposed, does not work for the reasons we discuss below.

A. <u>The scope of the exemption is too narrow.</u>

The exemption is limited to plans that are qualified under section 401(a) of the IRC (26 U.S.C. 401(a)) or a plan described in sections 403(b) or 457 of the IRC (26 U.S.C 403(b) or 26 U.S.C. 457). Plans that would come within the exemption include defined benefit plans, such as traditional pension and cash balance plans, and defined contribution plans, including 401(k) plans, profit sharing plans, money purchase plans, employee stock bonus plans, and employee stock ownership plans.

No rational reason exists for the exemption to be so limited. The statute, places no limit on the types of plans for which bank can provide custody and safekeeping services. Nor should the Commission.[88] The exemption should be expanded to include all qualified and non-qualified types of employee benefit plans. Church plans, governmental plans authorized under section 414 of the IRC, rabbi trusts, deferred compensation plans, and supplemental or mirror plans, multi-employer plans,[89] and voluntary employee benefit association plans or VEBAs,[90] SUBs,[91]as well as IRAs, health savings accounts and Coverdell education savings accounts, and successors to these employee benefit plans should be included within the exemption.

The vast majority of these plans must comply with certain fiduciary standards of operation and administration as dictated by ERISA and/or the IRC, including the requirement that plan fiduciaries must act prudently and solely in the interest of plan participants and beneficiaries. Those plans not subject to ERISA, such as government plans and church plans, are generally subject, by applicable state and local law or contract to ERISA-like fiduciary responsibilities

The proposal itself would seem to support the notion that all employee benefit plans should be treated similarly. For example, under proposed Rule 721, banks are exempt from the "chiefly compensated" requirement of the statute's trust and fiduciary exception if the bank performs certain calculations on a "line of business" basis. Proposed Rule 724(e) defines "line of business" to mean "an identifiable department, unit, or division of a bank *organized and operated on an ongoing basis for business reasons with similar types of accounts and for which the bank*

[88] Title II provides that a bank may serve "as a custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings incentive or other similar benefit plan." *See* Section 3 (a) (4) (B) (VIII) (ee) of the Exchange Act, 15 USC 78c(a)(4)(B)(viii)(ee).

[89] A multi-employer or Taft-Hartley plan is maintained pursuant to a collective bargaining agreement. *See* Section 302(c)(5) of the Taft-Hartley Act, 29 USC Section 1002.

[90] VEBAs are used to fund welfare plans which provide medical, death, disability, or other "welfare" benefits, 29 USC Section 1002, and are exempt from tax under 26 USC Section 501(c)(9).

[91] SUBs are supplemental unemployment benefit plans subject to ERISA, 29 USC Section 1102, and are exempt from tax under 26 USC Section 501(c)(17).

acts in a similar types of fiduciary capacity….” (emphasis added). Many banks organize and operate their employee benefit business without distinction as to whether the plans are or are not qualified. The proposed employee benefit plan exemption should similarly not distinguish between qualified and non-qualified plans.

The confusion posed by the interplay between the employee benefit plan exemption, the trust and fiduciary exemptions provided by Rules 721 and 722, and the general custody exemption exemplifies the need to exempt <u>all</u> employee benefit plans, whether or not they are qualified, from operation of Regulation B. For example, under the general custody exemption, non-qualified plan accounts opened after July 30, 2004, can only satisfy "the qualified investor" definition if the plans' investment decisions are made by a plan fiduciary that is a bank, savings and loan, insurance company or registered investment adviser or the plan is a pension trust, where the bank or certain other entities exercise investment discretion. Yet, because the general custody exemption is not available to banks acting in a fiduciary capacity which includes investment discretion or investment advice for a fee, only those non-qualified plans whose investment decisions are made by corporate entities other than banks would be able to use the general custody exemption. And as we discuss above, employee benefit plans, whether or not qualified, cannot satisfy either the account-by-account or the line-of-business "chiefly compensated" tests.

What happens to non-qualified plans for which the bank serves as custodian but are managed by plan sponsors or beneficiaries that are not qualified investors? Many non-qualified plans mirror qualified plans.[92] It seems nonsensical to permit banks to accept plan participant trade orders when serving as custodian for qualified plans but not for virtually identical non-qualified plans. The result, it seems, whether intended or otherwise, is that all non-qualified plan accounts opened after July 30, 2004, that require banks to accept securities trade orders must be pushed-out to a broker-dealer.

Even qualified plans cannot escape this confusion. Many, if not most, qualified employee benefit plans cannot meet the conditions of the employee benefit exemption (see discussion below). Yet Rule 760(a)(5) provides that the general custody exemption is only available to those accounts that do not come within the scope of Rule 770's employee benefit plan exemption. What happens to these plans when the bank serves in a custodial or non-fiduciary administrative capacity? Are even qualified plans required to be pushed-out to a broker-dealer?

Most significantly, the employee benefit plan exemption is limited to those situations where the bank effects transactions in investment company securities or there is a participant-directed brokerage window.. It is not uncommon, however, for employee benefit plans, particularly defined benefit plans and, of course, employee stock ownership plans or ESOPs, to invest in securities other than mutual funds at the direction of the plan sponsor or investment adviser. It appears that these plans do not come within the ambit of the

[92] Non-qualified and qualified plans may require the same operational and administrative tasks, such as recordkeeping, daily valuation, and tax filings.

exemption.[93] Indeed, for a plan that is invested in mutual funds and individual securities (at the direction of the plan sponsor), is the account exempt under proposed Rule 770 only with respect to that portion of the plan assets held in mutual funds? Assuming the bank is functioning in a trust or fiduciary capacity, is the "chiefly compensated" test then applied to the individual securities in the account?

Because of the confusion regarding the scope of the employee benefit plan exemption and its interplay with the trust and fiduciary and general custody exemptions, we strongly urge the Commission to exempt all qualified and non-qualified employee benefit plans, regardless of the types of securities in which plan assets are invested, from operation of Regulation B. Such an exemption will comport with corollary provisions in Title II and, at the same time, reduce the regulatory burdens associated with complying with Regulation B for banks that serve as trustees, custodians or non-fiduciary administrators to employee benefit plans.

B. The Exemption's dollar-for-dollar offset or credit requirement is unworkable.

The exemption is unworkable due to the requirement[94] to offset or credit any compensation[95] that the bank 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 (hereinafter referred to as "dollar-for-dollar offsets or credits"). Dollar-for-dollar offsets or credits do not comport with current industry practices, as permitted under ERISA. As the Commission notes, the DOL, the Cabinet-level office charged with administering ERISA, has opined on this issue on several occasions.[96]

Dollar-for-dollar offsets or credits are required under ERISA only when the bank exercises discretionary authority or control over plan investments in mutual funds that pay a fee or

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93 The 'brokerage window" option discussed below does not solve this problem, as the option only applies when participants choose to invest in securities other than mutual funds. The option does not encompass those situations where the plan's investment fiduciary, whether the plan sponsor, a bank or some other non-participant entity, is charged with investment selection responsibilities.

94 Proposed Rule 770(a)(1) requires that "[t]he 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."

95 We also note that the dollar-for-dollar offset or credit requirement speaks in terms of compensation. We assume the Commission intended only to include those fees received from mutual funds that would fall under the definition of "sales compensation" as defined by proposed Rule 724(i). Without such a limitation, Rule 770 could be read to require a dollar-for-dollar offset of all fees received from mutual funds including investment advisory fees, transfer agent fees, and fees received for providing shareholder administrative fees such as those defined in proposed Rule 724(i)(6)(i)-(vii). Banks do take these fees consistent with the fiduciary principles required under ERISA.

96 *See e.g.,* ERISA Advisory Opinion 2003-09A (available at *htpp://www.dol.gov/ebsa/regs/aos/ao2003-09a.html);* ERISA Advisory Opinion 97-16A (the "Aetna Letter") (available at *http://www.dol.gov/ebsa/programs/ori/advisory97/97-16a.htm);* ERISA Advisory Opinion 97-15A (the "Frost Letter") (available at *http://www.dol.gov/ebsa/programs/ori/advisory97/97-15a.htm);* Information Letter from Bette J. Briggs, PWBA, DOL to Judith A McCormick, American Bankers Association, dated August 20, 1997 (hereinafter referred to as the "McCormick Letter.")

other compensation to the bank.[97] In Frost (the letter the Commission cites for authority to require dollar-for-dollar offsets or credits), the bank was not a directed trustee, as the Commission claims, but a discretionary trustee. Accordingly, the DOL took the position that when a bank exercises its discretionary authority or control over the choice of investments available to plans, dollar-for-dollar offsets or credits were required in order for the bank not to be in violation of ERISA's self-dealing prohibitions.[98] The DOL simultaneously clarified in the Aetna Letter that when a directed trustee or plan recordkeeper does not exercise investment authority or control over plan investments, no dollar-for-dollar offset or credit is required.[99]

Thus, whether or not a bank acts as employee benefit plan investment fiduciary will dictate whether the bank follows the guidance laid out by the DOL in the Frost or Aetna Letters. We are quite confident in saying that the vast majority of bank trustees, custodians and non-fiduciary administrators have designed their participant-directed plan products to come within the factual setting of the Aetna Letter, rather than the Frost Letter, i.e., they operate without discretion. Thus, the proposed exemption is, for the most part, inconsistent with current practice and of little use to the industry.

We would respectfully suggest that the Commission eliminate this requirement from the proposed rule. The Commission can be assured that the DOL, as the primary regulator of fiduciary responsibility and prohibited transactions under ERISA, takes its responsibilities quite seriously. For example, even though dollar-for-dollar offsets or credits were not required under the facts of the Aetna Letter, the DOL reaffirmed in that letter that ERISA requires plan fiduciaries to assess the reasonableness of all fees and other compensation received by banks, regardless of source, in connection with the investment of plan assets.

Specifically, ERISA's general standards of fiduciary conduct require plan fiduciaries to act prudently and solely in the interest of plan participants and beneficiaries both in deciding whether to enter into, or continue, any arrangement with a directed trustee, custodian, or non-fiduciary administrator.[100] Thus, according to the DOL, plan sponsors, as fiduciaries, must assure that the compensation paid directly or indirectly by the plan to any directed trustee, custodian, or non-fiduciary administrator is reasonable, taking into account the services provided to the plan as well as any other fees or compensation received by the bank in connection with the investment of plan assets. In order to exercise that responsibility, plan sponsors and other fiduciaries must obtain sufficient information regarding all fees or other compensation that a bank receives, directly or indirectly, with respect to the plan's

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[97] *See* the Frost Letter and McCormick Letter, *supra* note 96.

[98] *See* ERISA Sections 406(b)(1) and (b)(3), 29 USC. Sections 1106(b)(1) and (b)(3). Section 406(b)(1) prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in its own interest or for its own account. Section 406(b)(3) prohibits a fiduciary with respect to a plan from receiving any consideration for its personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.

[99] *See* Aetna Letter and McCormick Letter, *supra* note 96.

[100] *See* Section 404(a)(1) of ERISA, 29 USC Section 1104(a)(1).

investment in each fund in order to make an informed decision on whether the bank's compensation for services is reasonable.

C. The Exemption's fee disclosure requirements pose the potential for significant conflicts with existing fiduciary disclosure requirements.

As noted above, ERISA, as interpreted by the DOL, already requires disclosure to plan sponsors or their designated fiduciaries of all fees and expenses charged for services provided to the plan, as well as compensation received from the mutual funds in which plan assets are invested, in order for the plan sponsor to determine the reasonableness of the fees and compensation received. Proposed Rule 770 would condition the exemption on similar, but not exact, disclosures being made.[101]

We see no need for the Commission to dictate either the content of the disclosure or the manner in which that disclosure is made. Banks are required to provide plan sponsors with information sufficient to determine whether the overall fees and compensation received, directly or indirectly, by bank service providers is reasonable. Some banks do so by providing plan sponsors with full and detailed written disclosure of investment advisory and other fees charged to or paid by the plan and the mutual fund, along with fund prospectus disclosures. Plan participants are also provided fund prospectuses containing fee disclosures. In addition, all marketing and other materials provided to plan fiduciaries contain robust fee disclosures. Finally, the DOL has recently taken steps, through its Fiduciary Education Campaign, to remind plan sponsors of their fiduciary responsibilities to understand plan fees and expenses. To this end, the DOL has encouraged plan sponsors to utilize a fee expense form posted on the DOL's web site.

We believe the potential for conflicts in the manner and content of disclosures required by the DOL and the Commission, should proposed Rule 770's current disclosure requirements be adopted, exists. For example, no requirement currently exists for the bank service provider to provide information sufficient for the plan sponsor to determine whether a dollar-for-dollar offset has occurred when the bank is not serving in any investment fiduciary capacity, yet this is precisely what proposed Rule 770 would require. Proposed Rule 770 should not address disclosure issues. Instead, the Commission should take comfort from, and rely on, the fact that banks must comply with ERISA and the DOL's guidance on disclosure.

D. The Exemption's brokerage window condition does not reflect current industry practice.

The exemption permits the bank to offer plan participants a participant-directed brokerage account to invest in securities and funds beyond those offered in the particular plan's

101 Proposed Rule 770(a)(2) requires "[t]he bank [to] provide…a clear and conspicuous disclosure to the plan sponsor or its designated fiduciary, if any, that includes all fees and expenses assessed for services provided to the plan and all compensation received or to be received from a fund complex in a manner that permits the plan sponsor or its designated fiduciary, if any, to determine that the bank has offset or credited any compensation received from a fund complex related to securities in which plan assets are invested or to be invested against the fees and expenses that the plan owes to the bank."

investment menu. This type of arrangement is often referred to as a participant-directed brokerage account or brokerage window.

While it is quite appropriate for the exemption to recognize the directed brokerage or brokerage window features of plans, the Commission is, unfortunately, laboring under the misimpression that when plan participants are offered this option, it is always offered through separate brokerage accounts established for each participant with a broker-dealer. Many directed brokerage or brokerage windows are, in fact, offered through investment advisory desks housed within the bank. Participant orders are bundled together and placed on an omnibus basis with either broker-dealers for debt and equity trades or Fund/Serv or mutual fund transfer agents for mutual funds as required under the statute[102] or proposed Rule 775.[103] Because the exemption requires directed brokerage/brokerage windows to be conducted on a fully disclosed basis, many banks serving plans with this feature would be unable to take advantage of the exemption. We would submit that it should be irrelevant whether or not directed brokerage/brokerage windows are conducted on a fully disclosed basis.

As we mentioned earlier, the networking exception is the only Title II provision where the Congress chose to address employee compensation. Nevertheless, the Commission proposes to condition the employee benefit plan exemption on bank employees not receiving incentive compensation that differs based on the value of a security or the type of security purchased or sold by an account or a person who exercises control over the assets of such account.[104]

While we continue to remain unalterably opposed to the Commission's interference with bank compensation plans, we request confirmation that this condition will not preclude the award of compensation based on the dollar value of the assets gathered. It is not uncommon for bank employees to receive compensation for attracting new employee benefit business to the bank.

[102] *See* Section 3(a)(4)(C) of the Exchange Act, 15 U.S.C. 78c(a)(4)(C).

[103] Section 3(a)(4)C) of the Exchange Act requires that banks relying on the trust and fiduciary, stock purchase plan, and safekeeping and custody exceptions of GLBA direct trades in any security that is a domestic publicly traded security to a registered broker-dealer. Because there is no secondary market for mutual fund shares, the Commission provided in the Interim Rules to permit banks to effect mutual fund trades though NSCC's Mutual Fund Services. The Commission now proposes to exempt banks from this GLBA requirement so long as the transactions are effected either through NSCC or directly with the mutual fund's transfer agent. We are pleased that the Commission has recognized that not all mutual funds are on the NSCC platform or that all banks use NSCC to effect securities transactions in all funds. We are, however, strongly opposed to the several conditions the Commission has put on transfer agent compensation. Specifically, the transfer agent is prohibited from accepting 12b-1 or revenue sharing compensation. The transfer agent is the mutual fund's agent. How is the bank expected to police the transfer agent to ensure that the bank's exemption from registration is not jeopardized by the transfer agent's receipt of compensation? This is just one more example of the Commission adding unnecessary and burdensome conditions to these exceptions.

[104] *See* proposed Rule 770(a)(4).

V. SWEEP EXCEPTION

A. Congress intended to preserve the ability of banks to sweep deposit accounts into money market mutual funds that do not charge sales loads.

Title II provides an exception from broker registration for those banks that sweep demand deposit balances out of the bank and into a no-load money market mutual fund. These "sweep accounts" offer bank customers the ability to make cash deposits productive, while, at the same time, allow banks offering these services to compete against financial services providers offering corporate cash management accounts that look and feel like checking accounts, but pay market rates of interest. Banks are legally prohibited from paying interest on demand deposit accounts.[105]

Interest in these sweep services is particularly strong with small business customers. To accommodate these customers, banks generally sweep customers' funds into bank deposit instruments, commercial paper, U.S. government securities[106] and money market mutual funds. Because money market mutual funds are securities, Congress determined that an exception from broker registration is necessary.[107]

Sweep services are also important to bank trust, fiduciary and custody departments. As fiduciaries, banks are required to invest all available cash held in these accounts. To enable them to do so, a trust institution will open an omnibus account with the commercial side of the institution in the trust department's name. Cash from all trust and fiduciary accounts is then swept on a daily basis into investments, including money market mutual funds. We understand that these services could be exempt under either the sweep exception, the trust and fiduciary exception, the custody exception or the money market mutual fund exemption provided by proposed Rule 776.

With regard to the sweep exception specifically, the Commission continues to adhere to the position that a "no-load" money market mutual fund is a fund that is not subject to either a front-end or a back-end load and the fund's total charges against net assets do not exceed 25 basis points.[108] While the Commission's proposed definition of no-load does not include fees paid for administrative services,[109] it also does not comport with Congressional intent.

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[105] *See* Section 19(i) of the Federal Reserve Act. Legislation has been introduced in the Congress that would allow banks to pay interest on corporate accounts. This legislation, H.R. 1375, was approved by 392-25 margin in the House. No comparable bill has yet been introduced in the Senate.

[106] Sweep account services involving commercial paper and U.S. government securities would be excepted from registration under the exception for permissible securities transactions. *See* Section 3(a)(4)(B)(iii) of the Exchange Act.

[107] *See* Section 3(a)(4)(B)(v), 15 USC 78c(a)(4)(B)(v).

[108] *See* proposed rule 740(c).

[109] *See* proposed rule 740(c)(2)

Ample evidence exists that the Congress intended that "no-load" be defined only as subject to no front-end or back-end load and we strongly urge the Commission to define the term similarly for purposes of this exception.

Specifically, two of the primary legislators responsible for the passage of GLBA indicated in letters to Chairman Levitt that the intent of the Congress was that bank sweep activities should remain in the bank. Rep. Leach (R-IA), Chairman of the House Banking Committee at the time GLBA was enacted, indicated that "….it was the intent [of the Congress] that such term [no-load] be construed to ensure that existing bank sweep activities not be disturbed by the law."[110] The same notion of not changing or limiting existing bank activities was echoed by Senator Gramm (R-TX), Chairman of the Senate Banking Committee at the time GLBA was enacted.[111] The Commission should follow this guidance and ensure that bank sweep activities remain in the bank.

B. <u>Additional steps can be taken to ensure that bank money market sweep services remain exempt from broker registration.</u>

We recognize that proposed Regulation B, through a combination of interpretations and exemptions, may allow some bank sweep programs to continue. Specifically, those banks that have "qualified investor" customers will be able to offer a sweep product that pays in excess of 25 basis points through proposed Rule 776. We are quite concerned, however, about the impact the proposed regulation will have on many existing programs offered by our members to customers that are not "qualified." We would urge the Commission to take further steps to minimize the impact of Regulation B.

Large banks that make their affiliated mutual funds available to their clients seeking sweep services will probably be able to comply with the proposed definition of "no-load" by restructuring applicable sweep agreements to make clear that the bank is providing the fund with administrative services as permitted under proposed Rule 740. In addition, any banks serving clients that meet the definition of "qualified investor", under proposed Rule 776,[112] should also be exempt regardless of whether the fund into which cash deposits are being swept is a load or no-load fund. Intuitively, we know this exemption will benefit larger institutions as they are most likely to service the larger net worth clients and corporations required under proposed Rule 776. Smaller institutions that do not offer proprietary mutual funds nor have the market power to force unaffiliated mutual funds to restructure their sweep agreement with the bank will not be so fortunate. We strongly encourage the Commission to take certain additional steps to allow smaller institutions to offer sweep services to their clientele.

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110 *See* Letter from Chairman James A. Leach to Arthur Levitt, Chairman of the Securities and Exchange Commission, dated January 2, 2001. *See also* H.R. Rep. No. 106-74, at 167.

111 *See* Letter from Chairman Phil Gramm to Arthur Levitt, Chairman of the Securities and Exchange Commission, dated February 6, 2001. ("At the time Congress enacted the Title II broker-dealer exemptions, Congress did not intend that rules, definitions, or interpretations would be changed in a way that would limit the current activities preserved by the exemptions.")

112 *See* n. 49 *supra.*

Amending the definition of "qualified investor" in proposed Rule 776, as we advocate elsewhere in this letter, will enable more banks to offer more clients access to both load and no-load money market mutual fund sweep products. Additionally, the Commission could add sweep services to proposed Rule 761, the small bank custody exemption, to allow money market mutual fund sweep services to be offered without condition.

Finally, the Commission requests comment on whether rate spread or retained yield fees should be counted as sales charges. As the narrative portion of the release indicates, the industry first raised these fees in the interest of full disclosure and a spirit of cooperation with the staff in connection with responding to staff inquiries regarding bank sweep products. We are hard pressed to understand why a fee charged by a bank to a customer would ever enter into an analysis of whether or not a fund is "no-load" and would most definitely not support such a position.

VI. THRIFT EXCLUSION

Previously, we strongly supported the Commission's effort to grant savings associations and savings banks (hereinafter referred to as "savings institutions") parity with commercial banks.[113] The Commission has now determined that, with respect to exemptions from broker registration, these institutions should no longer be granted complete parity with commercial banks. Specifically, the Commission has determined that the general custody exemption in proposed rule 760, the employee benefit plan exemption in proposed Rule 770, and the Regulation S exemption in proposed Rule 771, discussed below, should not apply to savings institutions. The Commission bases its decision to treat these organizations differently on its inability to determine whether thrifts directly engage in the types of securities activities covered by these proposed exemptions.

We can assure the Commission that savings institutions are very much engaged in all of these activities. For example, almost 200 savings institutions are authorized to engage in trust and fiduciary activities. Seventy-two savings institutions offer custody services. Those institutions hold more than $220 billion and $370 billion in trust and custody assets, respectively. With respect to employee benefit plans, savings institutions serve as trustee or custodian for over 15% of all employee benefit plans serviced by insured depository institutions. This amounts to approximately 130,000 plans, which collectively hold plan assets in excess of $225 billion.[114]

The Regulation S exemption provides a safe harbor from broker registration for transactions occurring outside the US. Allowing savings associations to take full advantage of this exemption would give them the flexibility to sell the full range of Regulation S securities as their current - and future - private banking customers demand.

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[113] *See* ABA/ABASA Letter.

[114] Federal Deposit Insurance Call Report, December 2003.

We strongly urge the Commission to give savings institutions full parity under Regulation B with commercial banks. Failing to extend the exemptions to savings associations is inconsistent with functional regulation principles, and would create regulatory disparity between banks and savings associations offering these same services.

The rationale for applying this exemption to banks is that "non-US persons will not be relying on the protection of US securities laws when purchasing Regulations S securities from US banks." This same logic holds true for foreign customers of US savings associations, who unless savings associations are given the same treatment, would be forced to purchase securities from either US banks that benefit from this exemption or foreign banks. This would clearly put US savings associations at a clear competitive disadvantage.[115]

VII. REGULATION S EXEMPTION

The Commission has proposed a conditional exemption from broker and dealer registration for banks effecting transactions in securities issued pursuant to Regulation S.[116] The exemption would permit banks to effect transactions involving Regulation S securities with offshore, non-US persons on an agency or riskless principal basis.

We support the exemption as it will allow our members to compete for foreign clients with banks located outside of the U.S. who are not subject to the Commission's broker-dealer registration requirements. As the Commission notes, non-U.S. investors able to choose to buy these securities from either U.S. banks and banks located outside the U.S. are not likely to rely on the protections of U.S. securities laws.

We urge the Commission, however, to revise the conditions that restrict eligible Regulation S securities sold under this exemption to those not sold from the inventory of a bank or an affiliate of the bank and those not being underwritten by the bank or an affiliate.[117] Conditions such as these that require banks to seek out other financial service providers in order to obtain securities that they could more easily obtain from an affiliate adds inefficiencies and costs to these transactions. So long as the affiliate is a U.S. registered

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[115] We note that the Commission has proposed in Rule 774 to exempt federal and state-chartered credit unions to the same extent banks are exempt from broker registration under the GLBA networking and sweep exceptions, Sections 3(a)(4)B(i) and (v) of the Exchange Act, 15 USC 78c(a)(4)(B)(i) and (v). In addition, the Commission has proposed to exempt these same credit unions on the same terms from dealer registration under the investment, trust and fiduciary transaction exception of Section 3(a)(5)(C)(ii), 15 USC 78c(a)(5)(C)(ii). In this regard, we continue to note ABA's very strong opposition to giving credit unions full parity with commercial banks without the concomitant responsibility for paying taxes.

[116] Regulation S specifies the requirements for an offer or sale of securities to be deemed to occur outside of the United States and therefore not subject to the registration requirements of Section 5 of the Securities Act of 1933, 15 USC Section 77e. *See* 17 CFR 230.901, *et seq.*

[117] In recognition of the fact that there may be instances when a customer wants to purchase a security that is being underwritten by a bank or its affiliate, proposed Rule 771 would allow the bank to acquire the security from an unaffiliated distributor that did not purchase the security from the bank or an affiliate of the bank. *See* proposed Rule 771(b)(ii).

broker-dealer subject to U.S. securities laws and the securities are sold on an agency or riskless principal basis, little, if any, potential for conflicts of interest exists.

CONCLUSION

In conclusion, the ABA and ABASA appreciate the opportunity to offer their views on proposed Regulation B. We strongly urge the Commission to revise the proposal to ensure that it fairly meets with Congressional intent and to reduce the significant regulatory burdens associated with the proposed Regulation. In addition, we continue to urge the Commission to provide the industry with a sufficient amount of time in which to come into compliance. The one-year compliance period currently contemplated by the Commission is essential.

As we said at the outset, we do appreciate all the time and effort the Commission and its staff have taken in crafting Regulation B. We pledge to work further with the staff on these very complicated issues. We believe that with revisions we have suggested here the Regulation will be significantly improved.

Sincerely yours,

Sarah A. Miller
Director
Center for Securities, Trust and Investment
American Bankers Association
and
General Counsel
ABA Securities Association

cc: Chairman Donaldson
Commissioner Glassman
Commissioner Goldschmid
Commissioner Atkins
Commissioner Campos
Annette Nazareth
Robert L. D. Colby
Catherine McGuire
Lourdes Gonzales
Linda Stamp Sundberg