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September 23, 2004

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

Re: Proposed Regulation B (File Number S7-26-04)

Members of the Commission:

On behalf of the Committee on Banking Law and the Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association (the "Committees"), we are writing to express our views with respect to proposed Regulation B, issued by the Securities and Exchange Commission ("Commission") under Title II of the Gramm-Leach-Bliley Act of 1999 ("GLB Act").[1] This letter was drafted by a task force of members of the Committees whose names are set forth below, and the members are available to discuss the matters discussed herein with the Commission and its staff.[2] The comments expressed in this letter represent a broad consensus of the members of the Committees only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, they do not represent the position of the ABA Section of Business Law, nor do they necessarily reflect the views of all members of the Committees on every comment herein.

We wish to preface our comments by noting that we endorse the concept of functional regulation, and we recognize that the amendments made by the GLB Act to Sections 3(a)(4) and (5) of the Securities Exchange Act of 1934 ("Exchange Act") will require interpretation by the Commission, in consultation with the banking industry and regulators, to be implemented effectively and in a manner that protects investors. Indeed, many of us have participated in ongoing, informal discussions with the Commission staff with respect to these matters since the

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[1] Exchange Act Release No. 49,879 (June 17, 2004), 69 Fed. Reg. 39,682 (June 30, 2004) ("Proposing Release").

[2] Each of the members of the task force is in private practice, and although many of the concerns expressed in our comments are shared by many of our clients -- state- and federally-chartered banks, trust companies, thrifts, credit unions, and their affiliated securities firms -- we have sought to provide an independent perspective on the issues raised by Regulation B.

enactment of the GLB Act. We have greatly appreciated the Commission staff's willingness to engage in this meaningful dialogue, particularly since the publication of the "Interim Final Rules" in 2001 and during the adoption of the bank/dealer rules in 2003.

Although we believe that proposed Regulation B is, in some respects, more practical and strikes a better balance between important investor protection principles and the needs of banks[3] than the Interim Final Rules, we have some of the same reservations about the nature and scope of Regulation B that we had with respect to the Interim Final Rules. In brief, we believe that Regulation B (and the substantial compliance burden that its implementation portends) conflicts, in many respects, with the clear Congressional intent in the GLB Act not to disturb traditional bank trust and fiduciary, custody and safekeeping and other customary banking products and services.[4] We recommend that the Commission reconsider whether it is in the public interest and the protection of investors for Regulation B to address in great detail so many issues that are similar to "status" issues raised under other statutes that the Commission administers, such as the Securities Act of 1933, the Investment Company Act of 1940 ("Investment Company Act"), and the Investment Advisers Act of 1940 ("Advisers Act"), where the Commission has historically chosen to regulate in a more general manner.[5]

In this letter we will highlight some of our concerns with specific provisions of proposed Regulation B. While we hope that the Commission will address each of these concerns, we again stress that doing so will not fully resolve the pervasive conflict noted immediately above.

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[3] For convenience, we will refer to all depository institutions collectively as "banks." In so doing, we do not intend to suggest that the treatment of thrifts and credit unions under the Exchange Act are not issues of importance. Rather, we assume that representatives of specific types of depository institutions will give their comments to the Commission based on their unique regulatory perspectives.

[4] For a fuller analysis of Congressional intent in this context, *see* Letter dated June 29, 2001, from Alan Greenspan, Board of Governors of the Federal Reserve System, Donna Tanoue, Federal Deposit Insurance Corporation, and John D. Hawke, Office of the Comptroller of the Currency to Jonathan G. Katz, Commission (commenting on the Interim Final Rules).

[5] For example, there are thirteen exclusions from the definition of "investment company" in Section 3(c) of the Investment Company Act, each of which is arguably as complicated as the exceptions to the definitions of "broker" and "dealer" added to the Exchange Act by the GLB Act, yet the Commission has adopted very few definitional rules under Section 3(c) of the Investment Company Act during the past 65 years and has added a number of exemptive rules to address issues raised by new investment vehicles. We are not persuaded that the Commission must adopt comprehensive and specific regulations in this one instance in sharp contrast to its usual administrative preference of dealing with issues as they arise and becoming educated as a consequence of those experiences.

Moreover, we did not see in the Proposing Release, nor in any post-GLB Act releases by the Commission to date, a discussion of, or recognition that, changes to the definitions of "broker" and "dealer" at the federal level will have far-reaching consequences for how banks and broker-dealers will ultimately be treated under the laws of the various states.[6]

Finally, we understand that the Commission staff has indicated that there is a strong interest in adopting Regulation B by the end of this calendar year. With respect, getting Regulation B "right" is much more important than adopting it quickly or adhering to an artificial deadline. After all, it has already been almost five years since the GLB Act was passed by Congress and signed by President Clinton. We urge the Commission and its staff to take all the time necessary to consider every comment carefully.

Comments of the Committees

I. <u>Third Party Brokerage Arrangements Exception</u>

We understand that, when improperly arranged and administered, a referral fee may create an incentive for unlicensed bank employees to begin the securities sale process. However, we submit that Regulation B, like the Interim Final Rules, is unduly burdensome and does not properly reflect how banks currently compensate non-licensed employees who refer customers to broker-dealers. We believe that the jurisprudence jointly developed by the Commission and the NASD regarding the payment of referral fees to non-licensed persons is not the proper benchmark for comparison since the purpose of those rules and regulations was to cause a non-

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[6] In this connection, we note, by way of example, that the Connecticut Uniform Securities Act defines the term "broker-dealer" as meaning "any person engaged in the business of effecting transactions in securities for the account of others or for such person's own account." *See* Conn. Gen. Stat. Section 36b-3(5). A "bank" is, by definition, not a broker-dealer, but only "when conducting activities that would except it from the definitions of 'broker' or 'dealer' under Sections 3(a)(4) or 3(a)(5) of the [Exchange Act]." *Id.* By order of the Commissioner of Banking, a bank is currently excluded from the definition of "broker-dealer" under Section 36b-3(5) until "the effective date of any final rule or rules issued by the SEC defining the terms in, and providing specific exemptions from, the definitions of 'broker' and 'dealer' under Sections 3(a)(4) and 3(a)(5) of the Exchange Act." *See* Administrative Order of the Connecticut Commissioner of Banking dated September 26, 2001. Consequently, when Regulation B becomes effective, all state and national banks (and not just a division thereof) will be required to register as broker-dealers in Connecticut if they engage in Connecticut in the business of effecting transactions in securities for the account of others outside of the an exemption under, or pursuant to a push-out exception as interpreted by, Regulation B. In addition, any employee of banks triggering the broker-dealer registration requirements will have to register as an "agent" of such bank if he or she represents the bank in effecting or attempting to effect purchases or sales of securities. *See* Conn. Gen. Stat. Section 36b-3(1).

licensed referring person to become a registered representative of a broker-dealer, and thus to become subject to the NASD's rules and regulations. By contrast, a non-licensed referring bank employee is already fully subject to the jurisdiction of a federal banking agency charged with responsibility for insuring the safety and soundness of the bank. Without suggesting that the regulations administered by the federal banking agencies are investor protection statutes in the same sense as the statutes administered by the Commission, the fact that they exist and are actively administered by a federal banking agency ought to be taken into account by the Commission when shaping and evaluating the nature and scope of investor protections being imposed on banks and non-licensed bank employees.

Under the Interim Final Rules, the Commission would have effectively limited referral fees to one hour of the gross cash wages of an unregistered bank employee.[7] Proposed Rule 710(b) of Regulation B will slightly change the types of acceptable referral fees by amending the definition of "nominal one-time cash fee of a fixed dollar amount" to mean a fee that does not exceed the greatest of three alternative measures: (1) an employee's base hour rate of pay, (2) $25, or (3) a dollar amount equal to $15 in 1999 plus an adjustment for inflation. While this amendment better addresses payments to salaried employees by removing the requirement that the fee be based on one hour of gross cash wages, we continue to believe that this level of detail in interpreting the GLB Act is unwarranted and excessively rigid.

The revised rule would require banks to review the base hour rate of pay for each individual and monitor these salaries as they change (seemingly an unnecessary administrative burden) or adopt a flat fee that does not adequately fit existing banking concepts of "nominal" during the ten years since the adoption of the Interagency Statement on Retail Sales of Nondeposit Investment Products. We understand that, under existing guidance from federal bank regulators, banks generally pay referral fees in the range of $10 to $100 based on a variety of factors, including the local competitive market.

Furthermore, we believe that establishing fixed amounts for defining "nominal" in connection with referral fees may work as a perverse incentive for unlicensed bank employees to make judgments that they are not trained to make. For instance, a bank employee may refer a customer to an insurance agency or an investment adviser or the trust department, instead of to the broker-dealer, because he or she may be paid a potentially higher referral fee for that activity. That potential conflict of interest is not merely hypothetical, and may be beyond the reach of functional regulators other than a federal bank agency.

We recommend that the Commission not attempt to establish an appropriate amount for referral fees and instead rely on the other prophylactic safeguards proposed in the regulation, such as natural constraints created by the definitions of "referral" and "contingent on whether the referral results in a transaction" in paragraphs (c) and (a) of Rule 710 of Regulation B. If the

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[7] Exchange Act Rule 3b-17(g)(1).

Commission believes it is compelled to impose limiting amounts, we ask that it make the definition of "nominal" a safe harbor, not an absolute ceiling.

The proposal also permits a referral fee to be paid only to the non-licensed employee who makes the referral and not other employees, such as a branch manager or other bank supervisors.[8] We urge the Commission to reconsider whether a referral fee may be allocated in part to a supervisor of an employee making the actual referral. Supervisors are often compensated in part on the basis of revenue generated by those whom they supervise; an exception need not and should not be made for referral fees. In addition, other bank personnel may have developed banking relationships with the customer before the actual referral is even made. We suggest that the Commission amend the proposed rule to allow a bank to have the discretion to provide at least a portion of the referral fee to all non-licensed bank employees that directly or indirectly assist with the referral. Such allocations are unlikely to create an undue "salesman's stake" in bank personnel.

We support the recognition by the Commission in the commentary that "one-time" as defined in proposed Rule 710 does not preclude payment by a financial institution of bonuses based on the overall profitability of the organization, including securities activities.[9] We would find it useful if that recognition were set forth in the Rule so that attorneys who are asked to render opinions on bonus plans may rely on the Rule, not a comment in a notice of proposed rulemaking. We ask, however, that there be only the two qualifications recognized in the commentary: that the plan not be a substitute for a referral fee program by counting referrals as a predicate for the bonus; and that it not weight profits from securities activities differently from other profits.

Finally, we commend the Commission for creating two exceptions from the definition in Rule 710(a) of the term "contingent on whether the referral results in a transaction." These exceptions contained in Rule 710(a)(1)-(2) permit referral fees to be contingent on whether (1)

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[8] The Commission notes that this is apparently consistent with "existing networking practices and banking agency guidance." Proposing Release at 39,691. We believe that this is an overstatement -- neither existing self-regulatory guidance (*e.g.*, NASD Rule 2350) nor banking guidance prohibits payments of referral fees to supervisors. Indeed, the Interagency Statement on Retail Sales of Nondeposit Investment Products only limits the payment of incentive compensation to audit and compliance personnel; we understand that banks generally interpret this provision to allow supervisory personnel to be allocated part of any nominal, one-time referral fee.

[9] On this point, we do not believe that the GLB Act either directs or entitles the Commission to regulate the bonus plans of banks (or their holding companies) solely to eliminate one aspect (that might arguably improperly incent a non-licensed person) of a comprehensive bonus plan. The principle of functional regulation that is embodied in the GLB Act must be respected.

the customer contacts or keeps an appointment with a broker or dealer as a result of the referral and (2) the bank customer has assets, a net worth, or income meeting any minimum requirement that the registered broker-dealer, or the bank, may have established generally for referrals for securities brokerage accounts. Both of these exceptions give banks appropriate flexibility in deciding to award referral fees. We would support other contingencies allowing banks to condition the payment of referral fees on other customer criteria, such as aspects of the customer's financial profile, including federal and state income tax bracket.

II. Trust and Fiduciary Activities Exception

A. The Proposed "Line of Business" Test Should Be Modified

We applaud the Commission's attempt to give banks flexibility by creating a "line of business" alternative for determining whether a bank is "chiefly compensated" on the basis of appropriate relationship compensation under Rule 721(a) of Regulation B. Nevertheless, we note that Section 3(a)(4)(B)(ii) of the Exchange Act does not expressly require or support the imposition of an "account-by-account" test. We respectfully recommend that the Commission reconsider the basis and need for an "account-by-account" approach generally and, if such approach is retained, we urge the Commission to make changes to expand the availability and practicality of the "line of business" test for a larger number of institutions that operate their trust activities in a manner consistent with existing banking regulation.

First, we recommend that the Commission reevaluate the required one-to-nine ratio of sales compensation to relationship compensation.[10] The proposed ratio will make it difficult for many banks to use this approach and therefore will lead the majority of institutions to use the account-by-account method for calculating compensation. As suggested in comments to Interim Final Rules, the account-by-account approach is widely considered to be unworkable in light of the multi-faceted trust and fiduciary activities that are typical of banks' trust operations. That approach is not consistent with the way banks track fiduciary fees, manage fiduciary lines of business, and report on fiduciary business to bank regulators. To switch to an account-by-account approach would require banks to make substantial expenditures in software and systems, expenditures that would not serve a commensurately useful purpose.

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[10] In the Proposing Release, the Commission states that "any fee a bank receives that is not related to effecting securities transactions is considered 'unrelated compensation' and, except [in certain circumstances], is not included in the definition of 'relationship compensation.'" Proposing Release at 39,693 n.96. As we develop more fully below with respect to fees from Rule 12b-1 Plans, this presumption is arbitrary, and is certainly not based on the facts and circumstances that attend the receipt of the compensation by a bank. We recommend this and all similar presumptions about the nature of the compensation received as a result of a bank's activities be abandoned in favor of a general "facts and circumstances" test.

The Commission explained in the Proposing Release that it has chosen the one-to-nine ratio because it believes many banks will be able to qualify for the exemption at this level.[11] We are not aware of empirical data supporting that belief, and we caution that this level will make the exception unattainable for many banks. Like the Commission, we hope that commenters provide data to better establish the appropriate tipping point for this provision. In any event, we believe the Commission could establish a lower ratio of sales compensation to relationship compensation while still maintaining consistency with the "chiefly compensated" requirement. The Commission's own analysis concludes that the GLB Act requires only that relationship compensation exceed sales compensation. To require that relationship compensation exceed sales compensation by nine times to take advantage of the "line of business" approach seems unnecessary.

B. Fees from Rule 12b-1 Plans Need Not Automatically be Classified as Sales Compensation

In Rule 724 of Regulation B, the Commission has proposed changes to the definitions of relationship compensation and sales compensation to more closely reflect the statute's intention to require that banks be "chiefly compensated" for their trust and fiduciary activities on the basis of certain types of fees. In particular, we commend the Commission for expanding the definition of relationship compensation to include fees generated by all types of assets rather than limiting such compensation to only fees generated by securities activities.

Our drafting committee members have two different views on this topic. The majority of the members respectfully recommend that the Commission consider further modifications to Rule 724 to better capture the distinctions between what is fiduciary compensation and what is not. We describe these views first, below.

The Commission proposes to include all fees from Rule 12b-1 Plans in the definition of "sales compensation."[12] The Commission's approach, therefore, will characterize as "sales compensation" some fees from Rule 12b-1 Plans that we believe are better characterized as "relationship compensation."

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[11] *See* Proposing Release at 39,695 n.112.

[12] The Commission has proposed to add a formula to the definition of "sales compensation" allowing banks to estimate the amount an individual account bears annually in fees from Rule 12b-1 Plans that are paid on an entity basis. The option to use this method would help banks that provide trust services to the beneficiaries of omnibus accounts by not requiring that such fees be allocated on an account-by-account basis, but it does not solve the other problems that would be presented if all fees from Rule 12b-1 Plans were considered sales compensation.

The Commission's discussion of fees from Rule 12b-1 Plans does not appear to reflect how fees from Rule 12b-1 Plans are used and how Rule 12b-1 Plans operate in this context. The decision to adopt a Rule 12b-1 Plan is made by the board of trustees of the investment company, based on its (the payor's) subjective intent. The bank that may receive payments under the plan does not design the plan. Rule 12b-1 under the Investment Company Act requires that the board of trustees of an investment company adopt a Rule 12b-1 Plan where the board of trustees is persuaded that payments to be made are "primarily intended" to be for distribution of the investment company's shares.

But "primarily intended" for distribution does not mean "used solely" for distribution. A board of trustees may adopt a Rule 12b-1 Plan even though up to 49% of the payments being made pursuant to that Plan may be intended for other purposes, which may include payments that would not properly be characterized as sales compensation. For example, the proposed rule would deem 100% of the payments a bank receives pursuant to a Rule 12b-1 Plan to be sales compensation, even though many of the activities that bank engages in to justify receipt of the payments might equally properly be characterized as sub-transfer agent, sub-administrator, sub-custodian, or shareholder servicing functions. These other functions do not appear to raise the same inference as to the nature of the bank's involvement in the investment company's distribution system. For example, we believe a bank's performance of administrative services for the beneficiaries of a trust account that owns shares of an investment company cannot reasonably be characterized as being part of the investment company's distribution system absent some affirmative showing that the bank is actually engaging in sales activities. We believe that characterizing 100% of these payments as sales compensation would be going too far.

In addition, although it is clear that fees from Rule 12b-1 Plans are not brokerage commissions,[13] the Commission seems to be suggesting that a fee paid *to a bank* from a Rule 12b-1 Plan is in the nature of a brokerage commission. Yet, the Commission is applying a different standard *to other recipients* of fees from Rule 12b-1 Plans, such as investment advisers, transfer agents, and third party administrators, who do not face the same consequences. It would be unfair for the Commission to deem all fees to banks from Rule 12b-1 Plans to be 100% sales compensation -- notwithstanding (i) what the banks are actually doing for the investment company to earn that compensation and (ii) the existence of significant federal bank regulations that apply to the recipients -- while ignoring others who receive fees from Rule 12b-1 Plans, many of whom are not subject to any kind of substantive regulation (federal or state) with respect to the receipt of compensation.

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[13] Indeed, fees from Rule 12b-1 Plans have never been disclosed in Rule 10b-10 confirmations at any time during the 25 years since Rule 12b-1 was adopted for the very reasons that the Commission explained in its *amicus curiae* brief in the *Quick & Reilly* case. *See Press v. Quick & Reilly, Inc.*, 218 F.3d 121 (2d Cir. 2000) (citing the Commission's brief, which notes that disclosure of such fees in funds' prospectuses obviates the need for additional confirmation disclosure).

The Commission states in the proposing release that fees from Rule 12b-1 Plans, because they often vary from investment company to investment company, can create conflicts of interest between banks and investors. The Commission then explains that a policy goal of minimizing conflicts of interest instructs much of broker-dealer regulation.[14] But the Commission does not explain why it takes the view that, in designing the investor protections that ought to apply in this area, it appears to have given no weight to the traditional oversight of trust and fiduciary activities by bank regulators regarding potential or actual conflicts of interest, particularly in light of long-standing regulations administered by the Office of the Comptroller of the Currency ("OCC") that specifically address self-dealing and conflicts of interest.[15]

We recommend that the Commission develop a "facts and circumstances" standard that permits banks (and others) to distinguish between relationship compensation and sales compensation based on the activities engaged in by the entity receiving the payments. Under such a standard, banks could properly receive compensation in the form of fees from a Rule 12b-1 Plan that is either required by law (*e.g.*, under ERISA) or in return for services that are administrative in nature without fear that the business line receiving such fees must be "pushed out" to a broker-dealer. (It is important to keep in mind with respect to this exception that many trust and fiduciary activities cannot be "pushed out" of a bank.) We understand that one possible response to this recommendation is that a bank can always eschew taking fees from a Rule 12b-1 Plan or use its influence with the payor investment companies to cause the investment companies to pay the bank in some other manner that would not be characterized as a fee from a Rule 12b-1 Plan. As a practical matter, however, we are not aware of any bank that is in a position to force the board of trustees of an investment company to change the way it structures the compensation paid by the investment company, much less to force a change on the entire mutual fund industry, and we would suggest that such a board of trustees may well have important legal reasons of its own for how and why the investment company enters into relationships and makes payments.

More generally, the Commission proposes to maintain the requirement that relationship compensation be paid directly to the bank by the customer or beneficiary. This requirement does not properly reflect the circumstances under which banks are paid for rendering trustee and fiduciary services. In particular, companies that sponsor Section 401(k) plans often compensate the bank that serves as trustee for their pension plan through the use of fees from Rule 12b-1 Plans, shareholder servicing fees, sub-transfer agent fees, finders fees and/or referral fees that are paid by the investment company complexes in which the plan assets are invested. Under the definition proposed by the Commission, such fees would not be considered relationship

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[14] *See* Proposing Release at 39,699.

[15] *See* 12 C.F.R. § 9.12 (2004). Bank regulations specifically require banks to have policies and procedures that include "methods for preventing self-dealing and conflicts of interest." 12 C.F.R. § 9.5(c) (2004).

compensation. In making this distinction, Regulation B would exclude certain types of trust activities from any possibility of being considered relationship compensation. However, the Commission fails to take into account the fact that the Section 401(k) plan sponsors prefer this type of compensation and have strong views on the manner in which these payment arrangements are structured; banks cannot easily renegotiate fee structures to adapt to the Commission's proposed definition here any more than they can with respect to the Rule 12b-1 Plans adopted by the mutual fund industry.

As noted, this section of the letter has described the view of the majority of the drafting committee. One member of the committee instead believes that, because Rule 12b-1 payments from fund assets must be "primarily intended" for distribution of the investment company's shares, and because funds can pay for non-distribution charges outside the context of Rule 12b-1 plans, proposed Rule 724 provides sufficient flexibility for both distribution and non-distribution services payments to occur.

C. Clarification of "Account by Account" Safe Harbors

Rule 722 of Regulation B proposes safe harbors intended to provide greater flexibility to banks using the account-by-account approach in case of inadvertent failures to satisfy the "chiefly compensated" condition in one or more accounts during the previous year. We commend the Commission for proposing this avenue for relief, but we believe the primary safe harbor rule in paragraph (a) of this rule is not entirely clear. We are concerned that the lack of clarity promises uncertainty regarding the rule's application and makes difficult full evaluation of the secondary safe harbors.

Under this provision, a bank would be exempt from the "chiefly compensated" test with respect to an account during any calendar year if, among other conditions, the bank has satisfied the "chiefly compensated" condition with respect to the account during the preceding year. For example, a bank would be exempt from the "chiefly compensated" condition with respect to Account XYZ in calendar year 2007 if, among other conditions, the bank had satisfied the "chiefly compensated" condition with respect to Account XYZ in calendar year 2006. But, by definition under Regulation B, a bank satisfies the "chiefly compensated" condition for a particular account in a particular year by having received more relationship compensation than sales compensation from the account *during the preceding year*. Thus, in our example, a bank determines that it has satisfied the conditions for the safe harbor in 2007 by looking back to whether Account XYZ met the "chiefly compensated" condition in 2006, which in turn requires the bank to look back to the compensation received with respect to Account XYZ in 2005. In other words, when the Commission proposes to require that a bank satisfy the "chiefly compensated" condition for an account during the preceding year in Rule 722(a)(2), it is proposing to require that the bank have satisfied the "chiefly compensated" condition for the account during the calendar year *before* that immediately preceding year.

We think this literal reading is the correct one and recommend that the Commission confirm it. If the Commission, however, intends the requirement of Rule 722(a)(2) to be that the bank have satisfied the "chiefly compensated" condition of the safe harbor by examining compensation received with respect to a particular account during the preceding year (*i.e.*, in our example by examining compensation from 2006 for compliance in 2007), it should clarify its intention. We suggest, however, that such a requirement would render this exemption redundant; a bank that has received more relationship compensation than sales compensation in an account during the preceding year satisfies the "chiefly compensated" definition and does not need a safe harbor.

D. Proposed Rules 722 (b) and 722(c)

If the Commission confirms the interpretive position we recommend concerning Rule 722(a), proposed Rules 722(b) and 722(c) will augment Rule 722(a) as intended. First, under Rule 722(b) a bank with an account that exceeds the "chiefly compensated" requirement may still rely on the fiduciary exception in the next year for that account if (i) the bank has not relied on this safe harbor for the account during the five preceding years,[16] and (ii) the bank's accounts that do not satisfy the "chiefly compensated" condition represent 10% or less of the bank's total number of trust or fiduciary accounts. Second, even if a bank with an account that exceeds the "chiefly compensated" requirement has relied on the subsection (b) safe harbor for the account during the five preceding years, Rule 722(c) will allow the bank to continue to rely on the fiduciary exception if the bank (i) can document why the account is out of compliance and link the reason to its exercise of fiduciary responsibility, and (ii) has no more than the lesser of 500 accounts or 1% of its total trust or fiduciary accounts for which the bank has relied on this safe harbor during the five preceding years.

E. Expansion of the Grandfathering Exemption

Under proposed Rule 720, living, testamentary, or charitable trust accounts opened or established before July 30, 2004, would be excluded from the "chiefly compensated" test if the bank does not individually negotiate with the accountholder or beneficiary of the account to increase the proportion of "sales compensation" as compared to "relationship compensation" after the grandfathering date.[17] The Commission explains that it has proposed this exemption in response to concerns of commenters that banks need greater flexibility with respect to established personal trust accounts that have terms that cannot readily be changed without

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[16] As a technical comment, the "five preceding years" language in Rule 722(b)(2) is ambiguous -- this language can be read to suggest either the five years inclusive of the current year (making the safe harbor available once every five years) or the five years prior to and including the current year (making the safe harbor available once every *six* years).

[17] In addition, we urge the Commission to move the grandfathering date forward to the time at which a final or adopting release for Regulation B is issued.

consequences to the bank and trust beneficiaries.[18] We do not believe that the Commission has adequately explained why this safe harbor should not be available to all personal and charitable trust accounts.

F. Definition of "Investment Advice for a Fee" Should Not Require a Duty of Loyalty

Regulation B would eliminate the requirement from the Interim Final Rules that a bank must communicate continuously and regularly with customers. Proposed Rule 724 provides that a bank must have an ongoing responsibility to review, select, or recommend specific securities, and that it must have a duty of loyalty to its customers that includes an affirmative duty to fully and fairly disclose all material facts and conflicts of interest. However, our view is that the duty of loyalty requirement imposed by this proposal is not necessary. As commenters on the Interim Final Rules previously explained, the duty of loyalty may arise as a consequence of a bank or other entity acting as an investment adviser, but it is not a precondition to acting as an investment adviser. A duty of loyalty is already imposed on banks under federal bank regulation, ERISA, the Internal Revenue Code, state statutes, and case law. The Commission has not adequately explained why it needs to place an additional duty of loyalty on bank fiduciaries in the context of Regulation B, rather than in the context of rulemaking under the Advisers Act.

G. Clarify that Examinations for Compliance with Fiduciary Principles Extend to Certain Outsourced Activities

We urge the Commission to make clear that outsourced trust operations, including acting as liaison between fiduciary customers and a trust officer, can meet the requirement that the trust department or other department must be "regularly examined by bank examiners for compliance with fiduciary principles and standards."[19] Bank regulators have issued guidance that provides bank examiners with a comprehensive approach for ensuring that a bank's outsourced operations are subject to the same risk management and other regulatory oversight as operations conducted within the bank itself.[20] Supervision of outsourced trust operations is properly covered by bank regulators within this scheme.

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[18] *See* Proposing Release at 39,696.

[19] *See* Exchange Act Section 3(a)(4)(B)(ii).

[20] *See, e.g.*, OCC Bulletin 2001-47, "Third-Party Relationships Risk Management Principles" (Nov. 1, 2001) (the OCC "supports and encourages national banks' use of third parties to take advantage of the many legitimate and safe opportunities to enhance product offerings, improve earnings, and diversify assets and revenues.").

The Commission should not create any barriers that unnecessarily impede banks' ability to obtain these benefits for trust and fiduciary activities. In the Proposing Release, the Commission recognizes that the bank regulators distinguish between core and ancillary bank fiduciary activities, but instructs banks that they must rely on their regulators to ensure that activities that constitute effecting securities transactions are subject to regular examination.[21] However, banks would benefit if the Commission provided assurance that it would consider certain outsourced activities to be subject to banking regulation.

III. <u>Sweep Accounts Exception</u>

A. Recommended Changes to the Definition of "No-Load"

Section 3(a)(4)(B)(v) of the Exchange Act allows banks to sweep deposit funds into "no-load" money market mutual funds. Proposed Rule 740(c) states that an investment company or securities issued by an investment company is "no-load" if (1) it is not subject to a sales load or deferred sales load and (2) total charges against net assets of that class or services of the investment company's securities for (a) sales-related expenses; (b) personal service, including fees from Rule 12b-1 Plans; or (c) the maintenance of shareholder accounts do not exceed 25 basis points. This new provision also amends the definition of no-load to refer to loads applicable to a class or series of investment company securities, rather than to securities of an investment company in general.

As in the case of Rule 12b-1 Plan fees, our drafting committee members have two different views on this topic. The majority of the members respectfully suggest that that the definition of "no-load" in Regulation B -- like its predecessor, Exchange Act Rule 3b-17(f) -- is flawed. We describe these views first, below.

Although the Proposing Release suggests that Commission's proposed definition of "no-load" is consistent with widespread interpretation of the term during the drafting of the GLB Act,[22] this interpretation is derived from NASD Rule 2830(d)(4), which is intended to address the circumstances in which investment companies can be *advertised* as "no-load."[23] We believe that the term is meant to be used differently in the sweep activities exception than in the NASD's advertising prohibition. Importantly, subparagraphs (1)-(2) [*not* subparagraph (4)] of Rule 2830(d) address investment company sales charges with and without an asset-based charge, and Rule 12b-1 Plan fees are both treated as a sales charge for this purpose and capped at 75 basis

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[21] *See* Proposing Release at 39,704.

[22] *Id.* at 39,705 n.221.

[23] *See* Exchange Act Release No. 30,897 (July 7, 1992), 57 Fed. Reg. 30,985 (July 13, 1992) (adopting the NASD's interpretation of "no-load" effective July 7, 1993).

points. If Congress had intended to regulate the amount of compensation that a bank could lawfully earn on a sweep account from a money market fund's Rule 12b-1 Plan, surely it would have referenced the sales charge limits in subparagraph (2) and not the restriction on advertising in subparagraph (4); and if had intended to impose an earnings ceiling of 25 basis points on *all* services associated with sweep accounts, it surely would have said so instead of using a phrase that has one meaning (75 basis points) in a sales load context and another meaning (25 basis points) in an advertising context.

Importantly, legislative and regulatory versions of the sweep exception that pre-date the GLB Act included the term "no-load" before the NASD adopted its interpretation.[24] Thus, we believe that it is inappropriate to interpret the term "no-load" to exclude money market funds that impose asset-based sales *and other charges* in excess of 25 basis points. Instead, the definition should be interpreted to mean only that a money market fund is not subject to any front-end or deferred sales charges.

We believe the proposed interpretation will prevent many banks from continuing to operate sweep programs as they are currently configured. The conditions on the sweep exception will require many banks to modify sweep arrangements involving money market funds that impose more than minimal charges against the money market fund's assets. Some banks also will need to begin charging customers directly for sweep services in order to receive fees equivalent to what they currently may receive in the form of fees from Rule 12b-1 Plans and shareholder servicing fees.

As noted, this section of the letter has described the view of the majority of the drafting committee. One member of the committee instead believes that, instead, the Commission's proposal would appropriately require all funds carrying a "no-load" label to pay no more than 25 basis points for distribution fees and notes that charging investors directly for sweep services would be more transparent than including those charges in an asset-based fee paid at the fund level.

B. Exemption for Transactions for Certain Investors in Money Market Funds

We commend the Commission for proposing an additional exemption for transactions for certain investors in money market funds. Proposed Rule 776 allows a bank to effect transactions in money market securities for a customer if: (1) the customer has obtained other non-securities products from the bank and the customer is a "qualified investor"[25] or a person that directs the purchase of securities from any cash flows that relate to an asset-backed security that has a

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[24] *See, e.g.*, Proxmire Financial Modernization Act of 1988, S. 1886, 100th Cong. § 301 (1988) and now-defunct Exchange Act Rule 3b-9.

[25] As defined in Section 3(a)(54)(A) of the Exchange Act.

minimum original asset amount of $25 million; (2) the bank effects the transaction in a trustee or fiduciary capacity; or (3) the bank effects the transactions as an escrow agent, collateral agent, depository agent, or paying agent.

We believe that this new exemption will give banks the flexibility to offer a wider range of cash management services, including sweeps into money market funds that do not qualify as "no-load," and we support the Commission for permitting this exception where the bank acts in a trust or fiduciary capacity, or as an escrow, collateral, depository, or paying agent. That being said, this exemption would be more useful if it was broadened beyond requiring the customer to be a qualified investor or placing a $25 million floor on cash flows relating to asset-backed securities. Because of the limitations on sweep accounts, we contend that this exemption could be more useful if these services could be provided by banks to a broader set of customers.

IV. Safekeeping and Custodial Activities Exception

A. Order Taking Activities Are Overly Restricted

The Commission continues to express the view that customary banking activities do *not* include accepting orders from customers to purchase or sell securities. Order-taking was strictly limited under the Interim Final Rules, and those restrictions are largely carried forward in Regulation B. We strongly disagree with the Commission's underlying premise. Indeed, bank custodians have a long-standing history -- before and after passage of the Glass-Steagall Act -- of accommodating customers by accepting and transferring orders for securities to a registered broker-dealer. Section 3(a)(4)(B)(viii) of the amended Exchange Act is designed to preserve such customary banking activities.

It is important not to lose sight of the fact that these statutory exceptions are exceptions from the definition of "broker." They are intended to permit order-taking; that is perhaps their chief purpose. Like the Interim Final Rules, Regulation B includes highly limited order-taking exemptions that would not be needed if the Commission recognized and acknowledged that the GLB Act permits banks to offer order-taking services to custodial customers.

Under Rule 760 of Regulation B, banks may accept customer orders from two categories of customers: (1) grandfathered customers who have a custodial account with the bank on or before July 30, 2004,[26] and (2) qualified investors. For both types of excepted customers, the bank may not receive compensation that directly or indirectly varies based on whether the bank accepts an order to purchase or sell a security, except for a fee from a Rule 12b-1 Plan or personal service fee paid by a registered investment company. In addition, banks may not be compensated for accepting securities orders through revenue sharing arrangements because of

[26] As with the grandfathering provision under the trust and fiduciary activities exception, we urge that the Commission move the grandfathering date in this part of Regulation B forward to the time at which a final or adopting release for Regulation B is issued.

the conflicts that these payments create. While this exemption is more flexible than that of Exchange Act Rule 3a4-5 in that it does not create an outright prohibition on receipt of compensation for order-taking activities, we believe that even these more liberal restrictions are unnecessary. Nothing in the GLB Act or its legislative history supports the creation of these types of conditions on compensation in particular, or order-taking in general.

We understand that the Commission is concerned that order-taking activities[27] by a custodian not be a vehicle through which banks may engage in full-scale brokerage business. We believe, however, that the requirement that transactions be either crossed or executed through a broker-dealer adequately assures all the important protections of the Exchange Act to custody customers and their counterparties. Moreover, Regulation B includes other protections, such as delineating what is a true custody relationship, that further minimize the possibility that a bank will be able to offer full service brokerage activities in the guise of custodial activities.[28]

B. Raising the Asset Test for Small Banks

The current "small bank" exemption under Exchange Act Rule 3a4-4 would be replaced by Rule 761 of Regulation B. Under this proposed rule, a small bank may receive transaction-based compensation for effecting transactions in *any* type of security (not just shares of investment companies) held in a custodial account. "Small bank" is defined in Rule 762(h) of Regulation B to be a bank that (1) has less than $500 million in assets, (2) is not a part of a bank holding company with more than $1 billion in assets, and (3) is not affiliated with a broker-dealer (though it may have a networking arrangement with a broker-dealer).

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[27] As we discussed above in the context of fees from Rule 12b-1 Plans, we continue to believe that the Commission's position is discriminatory because the Commission appears to be using a different standard, at least in an enforcement context, with respect to investment advisers, transfer agents, third-party administrators, and a number of "service organizations" that engage in order-taking activities without registration as broker-dealers.

[28] For example, Rule 762(a) of Regulation B defines a custodial account is one "established by a written agreement between the bank and the customer, which, at a minimum, provides for the terms that will govern the fees payable, rights, and obligations of the bank regarding the safekeeping of securities, settling of trades, investing cash balances as directed, collecting of income, processing of corporate actions, pricing securities positions, and providing of recordkeeping and reporting services." Under proposed Rule 760(a)(4) of Regulation B, bank activities with respect to a trust/fiduciary account must be viewed in light of the trust/fiduciary push-out exception, whereas activities with respect to a non-trust/fiduciary, custodial account should be examined in light of the push-out exception for custody and safekeeping activities. Also, Regulation B makes clear that the custodial exception is not available for banks to effect transactions in securities for an employee benefit plan account; Regulation B provides a separate exemption for such activities.

Assuming the Commission continues generally to restrict order-taking activities of custodial banks thus necessitating this exemption, we recommend amending the definition of "small bank" in line with recent changes to this term under federal banking law. For purposes of examinations under the Community Reinvestment Act, the Office of Thrift Supervision recently raised, and the Federal Deposit Insurance Corporation recently proposed raising, their respective minimum asset tests for small banks from $250 million to $1 billion. We understand that the Commission considered the original tests when crafting the definition of "small bank" in Regulation B.[29]

V. <u>Support of New Exemptions Not Tied Directly to a Particular Push-Out Exception</u>

While we are concerned about the added complexity and would support a less-is-more approach to drafting, we generally support the new exemptions not tied to a particular push-out exception (*e.g.*, the exemption in proposed Rule 771 of Regulation B for transactions in securities issued under Regulation S).[30] We also endorse the concept of making the exceptions and exemptions of Regulation B available fully to thrifts and credit unions.

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[29] *See* Proposing Release at 39,713.

[30] *But see* comments on the money market fund exemption under proposed Rule 776 of Regulation B above in Section III.B.

Once again, we wish to thank you for this opportunity to comment on proposed Regulation B. We look forward to working with the Commission as this rulemaking process moves forward. Members of the Committees are available to discuss these comments. If you believe that such discussions would be helpful, please contact either of the undersigned.

Respectfully submitted,

Committee on Federal Regulation of Securities

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