September 1, 2004

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

Re: Regulation B Proposal Governing Broker Exceptions for Banks
(File Number S7-26-04)

Thank you for the opportunity to comment in response to the Regulation B proposal implementing broker exceptions to the Securities Exchange Commission Act (Exchange Act), as required by the Gramm-Leach-Bliley Act (GLB) of 1999. The SEC is responding to the "push-out" provisions contained in Title II of GLB designed to terminate the blanket exemption from the definition of "broker" in the Exchange Act. Title II was intended to shift much of the brokerage activity currently taking place in banks to broker-dealers (subject to a broad range of rules enforced by state and federal securities regulators) *unless* the bank's activities fall within statutory exceptions interpreted by the SEC. To allow banks to prepare for the changes associated with the proposal, the SEC would extend the blanket exception until January 1, 2006.

Background

The SEC has identified three new exemptions from the application of the proposed rule: (1) Transactions in money market funds would not be subject to the Regulation B proposed rules when the bank is acting for *qualified investors*, when it acts in a fiduciary capacity, or when the banks acts as an escrow agent, collateral agent or paying agent; (2) Transactions in mutual fund shares in designated tax-deferred plans (such as 401k plans) when the bank is acting as trustee or custodian would also not be subject to the proposed rules; and (3) Transactions that banks conduct outside the US for foreign persons, subject to existing rules (e.g., Regulation S) also fall outside the scope of the Proposed rules.

While these exceptions appear to be measures to balance the application of changes required by GLB against concerns expressed by the banking industry, the proposal also imposes challenging administrative hurdles that banks must comply with in order to retain exceptions from the definition of "broker." Such hurdles are particularly evident in language contained in the proposed rule governing trust and fiduciary activities and the payment of referral fees to bank employees that recommend customers to broker-dealers with whom the bank has a "networking" arrangement.

The Conference of State Bank Supervisors[1] (CSBS) will address these issues and offer broader policy suggestions for SEC officials to consider as the Agency works to fulfill the spirit and letter of Title II through the proposal. The analysis and comments contained in the proposal

[1] CSBS is the professional association of the nation's state banking agencies that charter and supervise approximately 6,000 state chartered banks and related financial institutions.

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reflect a disciplined evaluation of GLB requirements and a thorough analysis of practical concerns members of the banking industry raised in response to key provisions of the interim final rules issued in 2001. Our goal is to facilitate the SEC's evaluation of these issues, particularly relating to the "networking exception", the "trust and fiduciary exception" and how functional and coordinated supervision might be used to address important issues contained in the proposed rule.

<u>Exceptions to the Definition of "Broker"</u>

Networking Exception
Bankers that qualify for a "networking exception" may continue arrangements with broker-dealers and receive compensation from brokerage transactions carried out by the broker-dealer, typically on the bank's premises without triggering the definition and corresponding oversight associated with "brokers." The proposed rule allows banks to pay an employee (who is not associated directly with the broker-dealer) only a nominal fee (not contingent upon an actual transaction) of a fixed dollar amount for a referral of a bank customer to the broker-dealer.

Notably for bankers, the proposed rule if adopted will ease constraints on referral fees by removing a limit contained in the interim final rules of one hour of the referring employee's wages. Instead, the proposed rules would allow banks to pay either the referring employee's base hourly pay rate (allowing for a straight forward calculation) or a flat fee of $15 adjusted for inflation, currently amounting to $17, or a flat fee of $25. Also noteworthy is the inclusion of language in the proposed rules that would allow bankers to pay employees the referral fee only if the bank customer meets background requirements for the bank's broker-dealer program (e.g., a net worth threshold) and only if the referred customer actually keeps his or her appointment with the broker-dealer.

The proposed rule has the effect of balancing these benefits by adding new constraints, based apparently on bank practices that triggered concerns among SEC staff. As a consequence, the proposed rules clarify that bankers can pay the referral fee "one time" only per customer. The proposed rules also identify additional changes that tighten the rules governing compensation that bankers can provide through employee bonus programs based on points awarded for referrals. The points must now have a readily ascertainable cash value, points awarded for broker-dealer referrals may not exceed points awarded for non-securities related activities, and in addition to the requirement that the bonus program cover a broad range of products including non-securities related products, the proposed rules require that such programs must reward employees primarily on *non*-securities-related activities. These added constraints suggest that the SEC is seeking to affirmatively limit bankers' involvement with securities transactions given the exemption from the definition of "broker." Many banks will likely need to restructure their referral programs in order to be in compliance if the proposed rule is finalized in its current form.

CSBS suggests that if the impetus for the language governing referral programs under the networking exception is the result of concerns that SEC staff have regarding certain practices in some banking organizations, coordination between the SEC and state and federal banking agencies may provide an effective solution without the impact of adding additional layers of regulatory compliance on all banks. Such coordination could result in regulatory guidance governing certain practices developed collaboratively by federal and state securities regulators and the bank's primary bank supervisors.

Trust & Fiduciary Exception
Bankers also are exempt from the definition of "broker" if they meet exceptions outlined and interpreted by the SEC in the proposed rule relating to trust and fiduciary activities. This exception is arguably the one valued the most by the banking industry and was the focus of considerable attention in response to the initial proposal issued by the SEC that resulted in the interim final rules.

The proposed rule sets forward fairly complex criteria for banks to follow in order to qualify for the exception based upon whether the bank is "chiefly compensated" by its clients for trust related securities transactions on the basis of administrative or annual fees, fees based upon the percentage of trust assets the bank manages and flat or capped per order processing fees that do not exceed the bank's actual costs associated with executing a securities transaction for the trust client. Such fees paid directly by a bank's trust clients are considered "relationship compensation."

"Sales compensation" includes fees a bank receives in connection with its trust and fiduciary activities from other sources such as payments broker-dealers remit for finder's fees and service fees from mutual funds. Under the proposed rules, a bank maintains its "broker" exception if the bank satisfies the "chiefly compensated" threshold by earning "relationship compensation" that far exceeds "sales compensation."

The existing interim rules required banks to evaluate whether income earned from relationship compensation exceeded the amount earned from sales compensation on each and every trust account. The need to make such a determination on an account-by-account basis drew intense criticism largely due to the regulatory burden it would impose.

The proposed rule removes the account-by-account requirement *but only if* the bank's relationship compensation makes up at least 90% of the total fees earned in connection with its trust and fiduciary activities. Sales compensation can account for no more than 10 percent if the bank wishes to evaluate whether it meets the "chiefly compensated" standard (required to qualify for the trust and fiduciary exception) based on an evaluation of its trust and fiduciary business compensation in aggregate.

This approach indicates that the SEC is interpreting the definition of "chiefly compensated" very narrowly. A reading of Title II suggests that the 10% threshold is neither required by nor identified as a standard in Gramm-Leach-Bliley.

CSBS suggests that the SEC evaluate whether the 10% limit is essential in order to carry out the principles of Title II. The 10% threshold may limit a bank's ability to provide a range of services that are related to and support their clients' trust relationships with their institution. If the SEC has identified practices in the trust and fiduciary area within banks that have presented concerns, addressing such issues in coordination with state and federal banking agencies may prove to be an even more effective tool than the imposition of the 10% threshold.

CSBS applauds SEC officials for carefully evaluating the statutory language of GLB towards the goals of issuing implementation rules that reflect congressional intent, seek to provide sound and equitable standards for our nation's investors and attempt to simplify regulatory compliance concerns. Compliance with the proposed rule would require banks across the country to make significant changes. Additional regulatory requirements may take on increased significance in smaller institutions that frequently serve as a primary provider of a broad range of financial services products in their markets.

CSBS has attempted to identify areas for which enhanced coordination between state and federal banking and securities regulators could result in a reduced need for new regulatory requirements, while addressing issues or concerns that the SEC may have regarding certain practices. We hope our comments are helpful as the SEC continues to evaluate these important matters and CSBS stands ready to work with you during that process.

Best personal regards,

Neil Milner
President and CEO