The Northern Trust Company
50 South La Salle Street
Chicago, Illinois 60675
(312) 630-6000

Northern Trust

September 1, 2004

Submitted Electronically

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 5th Street NW
Washington D.C. 20549-0609

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

Dear Mr. Katz:

I am writing to you on behalf of The Northern Trust Company in response to the Commission's request for comment on its recently published proposed "Regulation B" which is intended to implement the bank exemptions from broker-dealer regulation provided for under Title II of the Gramm-Leach–Bliley Act ("GLBA").

The Northern Trust Company is an Illinois banking corporation which, through the trust departments of its subsidiaries and affiliates organized either as national associations, state chartered banks or federal savings banks (together, "NTC") provides trust, fiduciary and custodial services to its customers. At the present time NTC, through its various bank trust departments, has approximately 2.4 Trillion Dollars in assets under administration in its trust, agency and custodial accounts.

NTC appreciates the opportunity to provide comment on the terms of proposed Regulation B which it anticipates will have a substantial impact upon its business operations and the investment activities it undertakes on behalf of its customers.

NTC strongly endorses the comments and concerns regarding proposed Regulation B that are being raised in separate letters by the American Bankers Association, the Financial Services Roundtable, and the Groom Law Group (on behalf of a group of banks and trust companies including NTC). We believe that these letters make a number of compelling arguments that are deserving of the Commission's support. These arguments address issues that are critical to the financial services industry, its clients and customers, and we urge the Commission to give them its serious, thoughtful consideration.

That said, there are several issues in proposed Regulation B that are of particular concern to NTC and motivate us to file this more detailed letter. We therefore respectfully request that the Commission address the following issues in its revisions to Regulation B.

I. Proposed Rules § 720-§ 724 – Trust and Fiduciary Activities Exemption

NTC believes that the current proposal's classification of all 12b-1 and other payments for bank record-keeping and administrative services as "sales compensation" is contrary to Congress' intent to permit banks to continue to receive compensation for bona fide record-keeping and administrative services provided to mutual funds (or their transfer agents or other affiliates).

The Trust and Fiduciary Activities Exemption provided for under § 3(a)(4)(B)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") which was enacted under § 202 of the GLBA is of particular interest to NTC. This exemption permits a bank to continue to effect securities transaction in a trustee or fiduciary capacity without registration as a "broker" as that term is defined in the Exchange Act.[1]

An express condition of this exemption, however, is the requirement that a bank, in conducting securities transactions within its trust department, must be "chiefly compensated" for such activities in a manner "consistent with fiduciary principles".

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[1] Specifically, Section 3(a)(4)(B)(ii) provides that a bank need not register as a "broker" if:

> (ii) Trust Activities. The bank effects transactions in a trustee capacity, or effects transactions in a fiduciary capacity in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards, and--
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> I. is chiefly compensated for such transactions, consistent with fiduciary principles and standards, on the basis of an administration or annual fee (payable on a monthly, quarterly, or other basis), a percentage of assets under management, or 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 any combination of such fees; and
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> II. does not publicly solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising its other trust activities.

In §§ 242.720-22 of the current proposal Regulation B attempts to measure a bank's compliance with the "chiefly compensated" limitation by:

(1) First, dividing bank compensation into three categories, (i) relationship compensation, (ii) sales compensation and (iii) unrelated compensation (which is disregarded); and

(2) Next, applying percentage limitation tests on either an account by account basis (less than 50% sales compensation) or the new proposed line of business exemption (less than 11% sales compensation).

Under this methodology the receipt of any compensation deemed to be "sales compensation" will force a bank to identify and measure all individual components of its compensation to determine compliance with the percentage limitation tests.[2]

In response to these compliance burdens, many banks will (i) simply refuse to accept any compensation deemed to be "sales compensation" (with the result that the fees will escheat to the mutual fund distributor) or (ii) custody such assets with a broker who will receive the "sales compensation".[3] NTC believes that neither of these likely responses to the current proposal will be of any benefit to bank customers and, to the extent that such "sales compensation" will be paid to a registered broker affiliate of the bank, do nothing to address the conflict of interest issues which are at the heart of the methodology advanced by the current proposal. Furthermore, if a bank cannot be compensated for providing record-keeping and administrative services to mutual funds without an unreasonable administrative burden, the expense of providing such services will be passed on to trust customers (<u>to the benefit of the mutual funds</u>).

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2 In attempting to respond to comments received in response to similar tests set forth in the Interim Rules which indicated that that this testing would create an undue administrative burden on banks, the current proposal attempts to ease the compliance burden by (i) creating new exceptions, (ii) new tests, (iii) "grandfathering existing accounts" and (iv) expanding the definition of "relationship compensation" (thus increasing the denominator of the testing fraction). Unfortunately, none of these changes will significantly ease the compliance burden of most banks because, despite some helpful changes, under the current proposal most banks which wish to continue their existing fiduciary investment practices must still categorize and test their compensation ratios (and in the case of grandfathered accounts, maintain duplicative systems) to establish compliance with the trust and fiduciary activities exceptions.

3 If a bank receives no "sales compensation" (or no sales compensation within a particular line of business), it will automatically comply with the terms of the "chiefly compensated" condition and thus will need to make no changes to its operations or accounting systems to track compliance.

Finally, in the case of NTC, which intends to receive and retain only record-keeping and administrative service fees earned by the bank, the necessity of modifying systems to measure compliance with the current proposals may inhibit the development of innovative products[4] similar to the current E-Trade Program referenced in the current Release which customers may find attractive.

II. Expansion of Administrative Services Exemption – Personal Trust and Agency Accounts

In the view of NTC, the primary fault with the chiefly compensated test as presently structured is that it fails to exclude from the definition of "sales compensation" compensation for all legitimate services which a bank has traditionally received "consistent with fiduciary principles and standards" in the manner required by the GLBA.

A. Service Compensation is Universally Permitted by Existing State Fiduciary Law

Federal law recognizes that trust law is generally governed by state fiduciary standards. Blaney v. Florida Nat'l Bank, 357 F.2d. 27, 30 (5th Cir. 1966)("In our conclusions we are reinforced by a basic feeling that the law of trusts and estates, . . . is primarily a matter of state concern"); In re Fidelity Bank Trust Fee Litig., 839 F.Supp. 318, 325 (E.D. Pa. 1993), aff'd, 43 F.3d 1461 (3d Cir. 1994))("[T]he law of trusts is primarily an area which has been left to state law.").

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4 In the course of acquiring other banks and receiving existing trust assets in kind from new customers, NTC has become trustee of numerous accounts which hold mutual fund shares in unrelated funds which pay 12b-1 and other fees. For tax reasons (reluctance to realize capital gains) or because of co-fiduciary directions, NTC cannot sell such assets and, for business reasons, refuses to accept the 12b-1 or other similar fees. The result is that, at the present time, such "sales compensation" reverts to the benefit of the mutual fund distributor. NTC is considering undertaking a "fee recovery program" wherein such fees are collected and passed through to individual accounts which generate the fees. Unlike the E-Trade program, which remits only 50% of similar fee income, NTC intends to remit 100% of this fee income (less the pro-rata direct cost of software and additional personnel required to implement the fee recovery program). Under the proposed rules this project would actually increase the amount of "bad" sales compensation attributed to NTC because, (1) if it continues to refuse the fees it will have no "bad" compensation but (2) if it passes the fees through to customers and deducts its direct processing costs, the direct processing costs incurred will show up as "sales compensation" on Regulation B reports and require that NTC undertake the complicated analysis set forth in Regulation B. This is an anomalous result and NTC requests that, if the Final Rules do resolve this issue, a no-action resolution process be permitted to exempt specified activities.

The legislative history is emphatic that this federal policy was not intended to be changed by the GLBA.[5]

At common law a trustee, while not entitled to retain sales commissions, is entitled to receive reasonable compensation for legitimate services provided to a corporation in which the trust is invested. See *Restatement (Second) of Trusts* § 170 (1959) *cmt. b* (no commissions); *cmt. o* (reasonable service compensation permitted).

More specifically, banks are expressly permitted under the fiduciary conduct codes enacted by every state, to invest trust assets in shares of an investment company to which the bank provides services.[6]

The Texas statute, for example, is typical and provides that:

> (g) In addition to other investments authorized by law for the investment of funds held by a fiduciary or by the instrument governing the fiduciary

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5. The legislative history clearly states that: "The Committee does not believe that an extensive ''push-out'' of or restrictions on the conduct of traditional banking services is warranted. Banks have historically provided securities services largely through their trust departments, or as an accommodation to certain customers. Banks are uniquely qualified to provide these services and have done so without any problems for years. Banks provided trust services under the strict mandates of State trust and fiduciary law without problems long before Glass-Steagall was enacted; there is no compelling policy reason for changing Federal regulation of bank trust departments, solely because Glass-Steagall is being modified." S. Rep. No. 106-44 at 10 (November 2, 1990).

6 Ala. Code § 19-3-120.1; Alaska Stat. § 13.90.010; Ariz. Rev. Stat. Ann. § 6-246 (2003 Ariz. ALS 212); Ark. Code Ann. § 28-71-104; Cal. Fin. Code § 1561.1; Colo. Rev. Stat. Ann. § 11-106-106; Conn. Gen. Stat. § 45a-209; Del Code Tit 12 § 3312; D.C. Code Ann. § 21-1721; Fla. Stat. Ann. § 737.402(2)(e); 660.417(2).; Ga. Code § 53-12-287; Haw. Rev. Stat. § 412-8-400; Idaho Code § 68-404A; 760; Ill. Rev. Stat. Ann. § 5/5.2; Ind. Code Ann. § 28-1-12-3; Iowa Code Ann. § 633.123A; Kan. Stat. Ann. § 58a-24a18; Ky. Rev. Stat. Ann. § 386.020; La. Rev. Stat. § 9:208b; Me. Rev. Stat. Tit. 18-A § 7-408; Md. Code, Estates & Trusts § 15-106; Mass. Ann. Law, § 23-710(185); Minn. State. Ann. § 501B.151; Miss. Code § 81-5-33; Mo. Stat. § 362.550.11; Mont. Code Ann. § 32-1-420; Neb. Rev. Stat. § 30-3205 (2003 Neb. ALS 2003); Nev. Rev. Stat. § 662.097; N.H. Rev. Stat. § 384:65; N.J. Stat. §313:B14-23; N.M. Stat. § 46-2A-1; NY EPTL § 11-2.3(d); N.C. Gen. Stat. § 36A-66.2; N.D. Cent. Code § 6-03-02; Ohio Rev. Code. § 1113.1(H); Okla. Stat. Title 60 § 175.55; Or. Rev. Stat. § 709-175; 20 Pa. C.S. § 7209; R.I. Gen. Laws § 19-31-2; S.C. Code. Ann. § 62-7-302 (C)(5)(6); S.D. Codified Laws Ann. § 55-1a-9; Tenn. Code Ann. § 35-3-117; Tex. Property Code Ann. § 113.053; Utah Code Ann. § 75-7-402; Vt. Stat. Ann. Tit. 8 § 1361; Va. Code. Ann. § 26-441; Wash. Rev. Code Ann. § 11.100.035; W.Va. Code § 44-6-9; Wis. Stat. Ann. § 881.015; WY. Stat. Ann. § 2-3-301

> relationship, and notwithstanding any other provision of law and subject to the standard contained in Chapter 117, a bank or trust company acting as a fiduciary, agent, or otherwise, in the exercise of its investment discretion or at the direction of another person authorized to direct the investment of funds held by the bank or trust company as fiduciary, may invest and reinvest in the securities of an open-end or closed-end management investment company or investment trust registered under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 et seq.) if the portfolio of the investment company or investment trust consists substantially of investments that are not prohibited by the governing instrument. The fact that the bank or trust company or an affiliate of the bank or trust company provides services to the investment company or investment trust, such as those of an investment advisor, custodian, transfer agent, registrar, sponsor, distributor, manager, or otherwise, and receives compensation for those services does not preclude the bank or trust company from investing or reinvesting in the securities if the compensation is disclosed by prospectus, account statement, or otherwise. An executor or administrator of an estate under a dependent administration or a guardian of an estate shall not so invest or reinvest unless specifically authorized by the court in which such estate or guardianship is pending. (Emphasis added.)

Tex. Property Code Ann. § 113.053(g). See also: Vail v. First of America Trust Company, 722 N.E.2d 248, 252 (Ill. App. 1999).

Notably, unlike the unique and incongruent classification system established under the current Regulation B proposal (which will apply only to banks and not to brokers), existing (i) state fiduciary laws, (ii) OCC Interpretive Releases and (iii) Department of Labor ERISA interpretations do not attempt to identify permitted service compensation by its source, but instead (like the NASD Rules applicable to brokers) identify such compensation in terms of the services provided.[7]

B. Under the Current Proposal Certain Record-Keeping and Administrative Service Compensation Earned by NTC Will be Erroneously Classified as "Sales Compensation" Simply Because the Services Are Paid For Under A Rule 12b-1 Plan, by an Affiliate of the Mutual Fund or by a Custodial Broker.

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7 See State Statutes listed in Fn. 6. above; OCC Trust Interpretive Letter 722; ERISA Adv. Op. 97-16A (May 22, 1997) ("These payments are based on a percentage of Plan assets invested in each Unrelated Fund through the 401(k) Program, and are paid either as administrative expenses by an Unrelated Fund (or by a servicing agent, adviser, or distributor from which the Unrelated Fund obtains its administrative services), or pursuant to a written plan described in Securities and Exchange Commission (SEC) Rule 12b-1, 17 C.F.R. 270.12b-1 (a 12b-1 Plan).")

NTC is particularly concerned by proposed Regulation B's apparent classification of record-keeping and administrative service compensation (other than such compensation paid directly from a mutual fund outside of a Rule 12b-1 Plan) as "sales compensation." The

administrative and record-keeping services provided and fees at issue for NTC are precisely those described in proposed Regulation § 242.724(i)(6)(i)-(vii).[8]

At the present time under various administrative servicing agreements NTC may provide record-keeping and administrative services to mutual funds and to brokers which hold mutual funds for NTC in street name accounts. Under existing and proposed record-keeping and administrative services agreements, payment for such services may be made by:

(i) the mutual funds themselves,

(ii) a mutual funds' Rule 12b-1 Plan,

(iii) mutual fund affiliates (typically the transfer agent, the distributor, or the investment advisor),

(iv) brokers who hold accounts in street name or who participate in fund gateway arrangements, or

(v) by combinations of the above entities.

Remarkably, under the terms of § 724(i)(6) of the current proposal, it appears that fees which may be received by banks for seven enumerated administrative services are deemed to constitute unrelated compensation (and not "sales compensation"), <u>if, but only if</u>, the fees are <u>both</u>:

(i) paid directly by an investment company,

(ii) not paid pursuant to a plan of distribution adopted under Rule 12b-1.

<u>See</u> § 242.724(i)(6); <u>See</u> <u>also</u>; <u>Proposed Regulation B</u>, 69 FR 39682 at 39698, n.130 (Staff acknowledges that limitations are new and will require banks and mutual fund companies to restructure existing arrangements).[9]

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[8] The list of such services, and associated fees, ARE NOT deemed to be "service fees" (formerly "trailing fees") for purposes of NASD Rule 2830(b)(9); NASD Notice to Members 93-12 (1993)(Q&A 17-19).

[9] 69 FR 39682 at 39698, n. 130. The Release notes that compliance with the current proposal's source of payment restrictions could be achieved by restructuring current fee

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The record-keeping and administrative services which NTC currently provides and/or contemplates providing to mutual funds and brokers, would, in every case fall within the scope of the administrative and record-keeping services described in § 242.724(i)(6)(i)-(vii) (and thus not be considered "sales compensation") except for the fact that the source of payment for such services is not always the mutual fund itself but instead may be an affiliate of the mutual fund or the Fund's Rule 12b-1 plan.

NTC respectfully submits that this novel limitation relating to the source of administrative and record-keeping compensation be removed from Regulation B. If this limitation, relating solely to the source of such compensation, is removed, the ability of NTC and many other banks to economically comply with the terms of the current Regulation B proposal within its trust, agency and custody lines of business will be significantly enhanced.

Moreover, classifying all presently permitted and properly disclosed record-keeping and administrative fees earned by a bank regardless of the source of such fees as "unrelated compensation" rather than as "sales compensation" would:

(i) be congruent with the existing fiduciary compensation practices identified in the text of the GLBA because state statutory law universally permits a bank to receive and retain of legitimate service fees earned by a bank in connection with administrative and record-keeping services provided to a mutual fund (without limitation as to the source of such payments);

(ii) be consistent with the clear announced legislative intent that in implementing the provisions of the GLBA "the SEC will not disturb traditional bank trust activities under this provision" H.R. Conf. Rep. No. 106-434, 164 (1999); and

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arrangements to cause record-keeping and administrative fees to be paid solely by the mutual funds rather than by affiliates or from existing Rule 12b-1 plans. Other than enhancing disclosure of such fees in prospectuses NTC cannot see any benefit to its customers which would result from shifting these expenses from the fund service providers to the fund itself. To the contrary, it is likely that as a result fund expenses will increase and that there will be no corresponding reduction in the existing service fees charged to mutual funds by service providers. Also, as noted above, under existing state fiduciary codes Banks have an affirmative obligation to disclose the rates of their mutual fund service compensation to their customers, regardless of its source. It is also noted that if existing Rule 12b-1 service plans need to be restructured, the same obligations should be imposed on brokers as apply to banks.

(iii) significantly ease compliance burdens imposed on all banks by eliminating all legitimate service fees earned by banks from tracking and testing requirements.

Finally, in this request NTC is not asking that bank fund practices be given a preference over similar operations conducted by brokers. In this regard the receipt of record-keeping and administrative fees from multiple sources by brokers has long been expressly recognized as permissible by the Commission. See *Investment Co. Institute*, SEC Inquiry Let (Oct. 30, 1998); *Charles Schwab & Co. Inc.*, SEC No Act Ltr. (Available Aug. 6, 1992); *Linsco/Private Ledger Corp.*, SEC No Act Ltr. (Available Nov. 1, 1994); cf. *Shareholder Services Group Inc.*, SEC No Act Ltr. (Available August 12, 1992).

III. Proposed Rules § 760, § 762 – Administrative Service Compensation Received In Connection with Custody Accounts

Proposed Rules 760 and 762(f) extend the sales compensation definitions and related tests discussed above to custodial relationships. In this context it is important to note that the Texas statute quoted above which permits the receipt of administrative service compensation, applies to both traditional fiduciary and custodial arrangements. See also, Restatement of Agency, § 387 cmt b. ("[Agent's] duties of loyalty to the interests of his principal are the same as those of a trustee to his beneficiaries").

For the reasons set forth above NTC again requests that the Commission recognize that, in custodial relationships, existing state law standards applicable to agents do not restrict administrative service compensation based upon its source of payment and request proposed modifications to the Commission's definition of unrelated compensation (Rule 724(i)(c) to include all administrative service compensation also be reflected in Proposed Rule 724(f).

IV. Proposed Rule § 760 – Prohibition Against Executing Securities Orders Placed by Custodial Customers.

NTC is also greatly concerned by Proposed Rule 760, which would eliminate NTC's longstanding ability to forward securities orders from custodial customers to (1) brokers (in the case of listed securities) and (2) transfer agents or electronic fund transfer intermediaries such as NSCC (in the case of mutual funds). This restriction would force a radical change in the conduct of NTC's custody operations and place it at a severe disadvantage to competing brokers providing similar administrative services.

NTC's agency and custody customers currently place their trade orders for listed securities through registered broker/dealers. Through the Depository Trust Company (DTCC) automated custody settlement system ("IID") and straight through processing (STP), those trades automatically settle into the bank agency or custody account.

However, open end mutual funds are not available on the DTCC automated trade settlement platform. Instead, in order to settle and maintain open end mutual fund shares on behalf of agency and custody customer accounts, banks are required to:

(i) First accept the purchase or redemption orders directly from the custody client, and

(ii) Then place the orders directly with the mutual fund's transfer agent or through an electronic settlement system (FundSERV) operated by the NSCC.

The primary reason customers engage a bank, such as NTC, to act as a custodian is to consolidate the administrative and recordkeeping tasks associated with their investments with a single provider which can provide them with a single report or statement consolidating a number of securities holdings and mutual fund account holdings. Banks also provide custody and agency accounts with services not available through brokerage accounts. Those services include principal and income segregation and reporting (for those custody accounts which may be irrevocable trusts but NTC is not the trustee). Bank custody statements track tax cost for all security purchases and gain/loss information which clients use for tax return preparation. Banks also provide performance and risk analysis reporting to custody customers. Banks track, file proof of claims and collect class action proceeds on behalf of custody clients. These are just a few of the many services banks provide to agency and custody customers.

Forcing bank custodial customers to open accounts and place orders directly with each mutual fund will significantly increase the burdens of both customers and the custodial record-keeper. If this change is adopted each party will be required to maintain, track and reconcile transactions among numerous accounts.

For example, instead of one call to a custodian to sell ABC fund shares ($600) and to purchase XYZ fund shares ($400), if the proposed rules were adopted the customer would have to:

(1) contact fund ABC to redeem shares,
(2) deposit the $600 proceeds with the custodian,
(3) contact XYZ fund to purchase shares, and
(4) direct the custodian to send $400 to fund XYZ.

As stated above, banks will be unable to reflect mutual fund holdings in customer custody accounts. Therefore, customers would have to seek other alternatives in order to hold all of their assets in one account at one institution. Thus, a bank's ability to provide a comprehensive custody product to its customers is limited. Additionally, these custody and agency customers would have nowhere else to obtain some of the unique services (mentioned above) provided by bank agency and custody accounting.

NTC does not believe that Congress, in enacting the custodial exception, intended to effectively force banks to discontinue this activity. There is nothing in the legislative history to suggest that a change in the long established practice of forwarding securities orders (specifically mutual funds) was intended by Congress when it enacted the GLBA. To the contrary, the Federal Reserve, the FDIC and the OCC have previously jointly commented to the SEC that:

> The Interim Final Rules also are contrary to the statute and legislative history of the GLB Act's exemption for custody and safekeeping activities because they exclude order-taking activities that are part of customary banking activities. Bank custodians have a long-standing history of accommodating customers by accepting and transferring orders for securities to a registered broker-dealer. The GLB Act includes an exception for safekeeping and custody services to preserve the traditional role of banks in providing customary custodial services for their customers, which customarily included order-taking. In enacting this exemption, Congress expressed clear intent that traditional custodial, safekeeping and clearing activities, including custodial IRA relationships, be allowed to remain within the bank. Contrary to this statutory scheme and congressional intent, the Interim Final Rules do not include customary custodial order-taking services within the exemption. (footnote omitted)

See Banking Agencies Comment Letter On Interim Rules[10] For the reasons set forth above NTC, in the strongest possible terms, urges the Commission to revise or rescind Proposed Rule 760 so that banks such as NTC may continue to forward orders on behalf of their custodial customers.

For the reasons set forth above, NTC respectfully urges to commission

1. To reclassify trustees and custodians administrative services compensation, including such compensation paid from Rule 12b-1 plans and fund affiliates, as unrelated compensation, in the same manner as proposed for fees described in § 724(i)(6).

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[10] Joint Comment Letter of the Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency to Jonathan Katz dated June 29, 2001 at page 5.

2. Permit banks to continue to place mutual fund redemption and purchase transactions on behalf of their custodial clients.

Respectfully,

THE NORTHERN TRUST COMPANY

By /s/
Dale K. Nichols
Assistant General Counsel