U.S.TRUST

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September 3, 2004

Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549-0609.

Attention: Mr. Jonathan G. Katz
Secretary

Re: Proposed Regulation B (File No. S7-26-04)

Ladies and Gentlemen:

United States Trust Company of New York welcomes the opportunity to comment on proposed Regulation B as recently published by the Securities and Exchange Commission (the "Commission").[1] Regulation B would, *inter alia*, interpret the various clauses that exclude banks from the definition of *broker* in Section 3(a)(4) of Securities Exchange Act of 1934 (the "Exchange Act") as modified by the Gramm-Leach-Bliley Act of 1999 (the "GLB Act".) United States Trust Company of New York is submitting this letter on behalf of itself and its sister bank, U.S Trust Company, National Association (both banks being collectively referred to as ("U.S. Trust").[2]

[1] S.E.C. Release No. 34-49879, 69 Fed. Reg. 39682 (June 30, 2004).

[2] United States Trust Company of New York is a bank chartered under the laws of New York and a member bank of the Federal Reserve System. Accordingly, it is subject to the supervision of the New York Banking Department and Board of Governors of the Federal Reserve System. U.S Trust Company, National Association is a national bank chartered under the laws of the United States and is subject to the supervision of the Office of the Comptroller of Currency. Both banks are members of the Federal Deposit Insurance Corporation.

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U. S. Trust has provided wealth management services since 1853. Although it has a number of institutional clients, U. S. Trust's primary focus has been the needs of affluent individuals and families. To that end, U. S. Trust offers a broad range of services including financial and estate planning, investment management and consulting, trust services and private banking. The nature of U. S. Trust's business makes it particularly interested in proposed Regulation B.

I. General:

In the preamble to proposed Regulation B (the "Preamble"), the Commission describes the erosion to the barriers between the securities and banking industries that had been put in place during the 1930's. As the functions of the banking and securities industries overlapped, and as the separations dictated by the Glass-Steagall Act became increasingly anachronistic, Congress enacted the GLB Act. This was not the first time that Congress had considered the issue. There had been numerous statutory and regulatory initiatives advanced over a period of more than twenty years that had attempted to deal in whole or in part with the relation of the banking and securities industries.

When Congress enacted the GLB Act, it was not addressing a perceived a failure by the banking regulators to supervise adequately the securities activities of the banking industry. It was seeking to achieve a clear and economic delineation of the responsibilities of the Commission and the banking regulators. By avoiding overlapping responsibilities, the statute would avoid duplicative regulation. This would result in the efficient allocation of limited regulatory resources and avoid unnecessary expenses on the part of regulated entities.

Congress adopted the concept of "functional regulation" under which those activities involving securities that had traditionally been regulated by the Commission,

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Both banks are wholly-owned subsidiaries of U.S. Trust Corporation which, in turn, is a wholly-owned subsidiary of The Charles Schwab Corporation.

such as securities brokerage, would continue to be regulated by the Commission while those activities involving securities that had traditionally been regulated by the Federal and state banking regulators, such as trust and fiduciary activities, would continue to be regulated by the Federal and state banking regulators. “functional regulation” would as Sen. Gramm said allow consumer protection to be maintained at lower costs.[3]

In contrast, the Preamble appears to express the view that the jurisdiction of the Commission under revised Section 3(a)(4) is subject only to limited exceptions that are to be narrowly construed in the interest of consumer protection. This view, however, would not be consistent with either the wording or legislative history of the statute.

II. Other Comments:

U.S. Trust is aware that the American Bankers Association and the New York Clearing House are each submitting extensive comments on proposed Regulation B. U.S. Trust supports the thrust of those submissions. Still, because of the relevance of proposed Regulation B to its core business, U.S. Trust is addressing proposed Regulation B in its own right. However, in light of the extensive comments submitted by various trade associations, among others, U.S. Trust is confining this letter to the exclusions from the definition of broker that concern trust and fiduciary activities and custody and safekeeping and to the Commission’s discussions of bonus plans under the “networking” exception.

[3] 69 Fed. Reg. at 39684 n.12.

III. Bank Trust and Fiduciary Activities:

Regulation B would enervate the exclusion from the definition of "broker" of banks engaged in trust and fiduciary activities.[4] The following sets forth the most salient of U.S. Trust's concerns.

A. Chiefly Compensated:

To qualify for the exclusion for trust and fiduciary activities, a bank must be "chiefly compensated" for such activities by "relationship compensation"[5] In order to pass this "chiefly compensated" test, Proposed Regulation B would, generally, require that such a bank receive more "relationship compensation" than "sales compensation" from each fiduciary account.

U.S. Trust is particularly concerned with the manner in which proposed Regulation B would interpret the "chiefly compensated" test. The "account-by-account" method for measuring compliance with the "chiefly compensated" test is neither mandated nor supported by either the statutory language or legislative history of the GLB Act. The statute refers to "transactions in a trustee capacity, or . . . transactions in a fiduciary capacity in its trust department or other department . . . .'' The use of the plural is clearly a reference to "transactions" in the aggregate. There is no mention whatsoever of accounts – indeed, nothing on which an "account-by-account" test could be based.

Besides, the "account-by-account" method for measuring compliance is really not a viable option. The cost and difficulty entailed in testing each account would render that method a mere simulacrum and drive banks to the "line-of-business" method. This

[4] Section 3(a)(4)(B)(ii) of the Exchange Act.

[5] Section 3(a)(4)(B)(ii)(I) requires that a bank be "chiefly compensated" for its fiduciary activities:

> "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."

Proposed Regulation B characterizes this type of compensation as "relationship compensation." Prop. 17 C.F.R. § 242.724(h) *at* 69 Fed. Reg. 39735.

means that the alternate "line-of-business" method contained in Proposed Rule 721 would, in reality, be the standard method for measuring compliance with the "chiefly compensated" test. As long as more than half of its compensation is "relationship compensation," measured either by each of its lines-of-business or by its fiduciary activities in the aggregate, a bank is, in fact, "chiefly compensated" by such compensation, and therefore, should pass the "chiefly compensated" test. Accordingly, the one-to-nine ratio of "sales compensation" to "relationship compensation" that would be permitted under Proposed Rule 721(a)(2) would be inordinately low.

In proposing the one-to-nine ratio of "sales compensation" to "relationship compensation," the Commission appears to be trying to prescribe the narrowest possible exception that would allow banks to remain in the fiduciary business. This seems to be the reason that the Commission is seeking extensive quantitative information to determine "what ratio would be appropriate".[6] Congress did not intend that banks would have to shoehorn their trust and fiduciary activities into unwieldy constraints, establish expensive systems to assure compliance with an artificial ratio and forego sources of revenue to which they would otherwise be entitled.

Congress established the "chiefly compensated" test as one which banks would easily meet in order that "the SEC . . . not disturb traditional bank trust activities under this provision".[7] Instead, the Commission has proposed a "line-of-business" method that would cause banks to develop extensive or adapt data collection and processing systems to identify and track "sales compensation" and "relationship compensation." Then, banks would have to develop ongoing monitoring and compliance procedures to assure that the bank stayed within the artificial one-to-nine ratio. There would be a significant burden imposed, but no enhancement in investor protection.

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[6] 69 Fed. Reg. at 39696.

[7] Conf. Rep. 106-434, 106th Cong. 1st Sess. At 164 (1999), *reprinted in,* 1999 U.S. Code Cong. & Admin. News 245, 258.

B. Line of Business:

Proposed Rule 724(e) would require that a "line of business" be an "identifiable department, unit, or division of a bank organized and operated on an ongoing basis for business reasons . . ."[8] Unfortunately, Proposed Rule 724(e) would also impose the requirement that a line of business consist of "similar type of accounts … for which the bank acts in a similar type of fiduciary capacity".[9] This additional requirement is vague and unnecessary. The Release provides no guidance on what accounts are of a similar type or when a bank is acting in a similar type of fiduciary capacity. This additional requirement should be eliminated.

C. Flat or Capped Per Order Processing Fee:

The statute provides "relationship compensation" treatment for 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".[10] Proposed Rule 724(b) would limit such treatment to the "direct marginal cost of any resources of the bank that are used for transaction execution, comparison, or settlement".[11] The limitation to "direct marginal cost" is contrary to the clear language of the statute. Section 3(a)(4)(B)(ii)(I) expressly permits a bank charge a fee equal to the "cost incurred" – i.e., the total cost incurred and not just that portion of the "cost incurred" that is "direct" and "marginal."

Moreover, Proposed Rule 724(b) would condition a bank's ability to characterize the cost of certain resources as a part of a "flat or capped per order processing fee" on "the bank['s] mak[ing] a precise and verifiable allocation of these resources according to their use".[12] This condition would be particularly burdensome and would require banks to

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[8] Prop. 17 C.F.R. § 242.724(e) *at* 69 Fed. Reg. 39735.

[9] *Ibid.*

[10] Section 3(a)(4)(B)(ii)(I) of the Exchange Act.

[11] Prop. 17 C.F.R. § 242.724(b) *at* 69 Fed. Reg. 39735.

[12] *Ibid.*

make extensive investments to make measurements not required for any other purpose. The condition would clearly exceed the requirements of the statute and should be eliminated.

D. Other Department That Is Regularly Examined by Bank Examiners:

Section 3(a)(4)(B)(ii)(I) restricts a bank's reliance on the trust and fiduciary activities exception to those securities transactions effected in the bank's "trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards." The Preamble adds a requirement that "all aspects" of effecting securities transactions should be regularly examined by bank examiners. Indeed, according to the Preamble, "if some aspect of a securities transaction occurs outside of a bank, unless the securities-related activity in question is located within a registered broker-dealer, the bank would be unable to rely upon the trust and fiduciary activities exception for that transaction".[13]

U. S. Trust urges the Commission to clarify that the language cited above was not intended to prevent banks from outsourcing certain functions. The Federal banking agencies have on a number of occasions addressed the risk and benefits to banks from outsourcing.[14] The Commission should state that it does not override the supervision of these agencies in this area. Any outsourcing by a bank should be supervised by the bank regulators and not the Commission.

E. Review of Individual Accounts:

Under Proposed Rule 721(a)(3) and(4), a bank would be required to review each account and determine that is was likely to receive more *relationship compensation* than *sales compensation* at the opening of the account and whenever the bank increased the

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[13] 69 Fed. Reg. at 39704. The Preamble does indicate that "certain securities related activities [could] occur in a registered investment adviser." *Id.* at 39704 n. 201.

[14] E.g., Interagency Policy Statement on the Internal Audit Function and Its Outsourcing (March 17, 2003), *reprinted at*, 4 Fed. Banking L. Rep. ¶ 43-358; FFIEC: Risk Management of Outsourced Technology Services (November 28, 2000), *reprinted at*, 5 Fed. Banking L. Rep. ¶ 60-707.

proportion of *sales compensation* as compared to *relationship compensation*. These provisions should be deleted. They are essentially a reversion to an *account-by-account* method for measuring compliance. As was pointed out above, there is no statutory authority for testing on an *account-by-account* basis and no benefit to be gained from the extraordinary burden imposed.

F. Definition of Investment Adviser:

Section 3(a)(4)(D) of the Exchange Act defines the term “fiduciary capacity” to include a bank that acts as an “investment adviser if the bank receives a fee for its investment advice.” Without any authority in the statute, Proposed Rule 724 (d)(1) would mandate that such a bank owe the “customer a duty of loyalty, including an affirmative duty to make full and fair disclosure of all material facts and conflicts of interest”.[15] For guidance on complying with this requirement, the Preamble refers banks to the disclosure obligations imposed under the Investment Advisers Act of 1940 (the “Advisers Act”), the rules thereunder and Form ADV.[16]

Congress prescribed that the parameters of the “duty of loyalty” that are owed by a bank that is acting in a fiduciary capacity are to be determined by applicable fiduciary law and not by the Commission under the Securities laws. The Commission has no authority to implant in the definition of “investment adviser if the bank receives a fee . . .” a separate and additional “duty of loyalty.” Moreover, it has no authority to adopt a “quasi-brochure rule” for banks.

This inclusion of an additional “duty of loyalty” is an assault upon the concept of “functional regulation” adopted by Congress in the GLB Act. This attack is exacerbated by the cross reference to the Advisers Act and the rules promulgated thereunder. Unless it acts as investment adviser to a registered investment company, a bank is exempt from regulation under the Advisers Act. A bank need not prepare or file a Form ADV and it has no obligation to provide an “ADV brochure” to its clients. By explicitly including

[15] Prop. 17 C.F.R. § 242.724(d)(1) *at* 69 Fed. Reg. 39735.

[16] 69 Fed. Reg. at 39702-03.

"an investment adviser if the bank receives a fee for its investment advice" in the definition of "fiduciary capacity," Congress clearly specified that banks could continue to providing investment advice for a fee subject to applicable fiduciary law without complying with the Advisers Act or the rules adopted thereunder.

This imposition of a "duty of loyalty" and "quasi-brochure rule" would obviously entail duplicative regulation. Banks would have to adopt a second set of compliance policies and procedures and conduct extensive staff education so that the second set of rules would be followed. Although the goals of each set of rules might be identical, the second set would at times probably be confusingly similar but subtly different from the first, and at other times in actual conflict with the first. This extraordinary burden of duplicative regulation, which "functional regulation" was designed to avoid, would have a minimal beneficial effect, if any.

IV. Custody – Order-Taking Exemption:

Proposed Rules 760 and 762 would severely impede the ability of banks to rely on the exclusion from the definition of "broker" contained in Section 3(a)(4)(b)(viii) of the Exchange Act. U.S. Trust is particularly concerned (a) that the order-taking exclusion would be available only to limited class of customers, (b) that unnecessary restrictions would be imposed on other areas of a bank and (c) that the definition of "account for which the bank acts as custodian" would impose a new and unneeded layer of regulation.

A. Scope of the Order-Taking Exemption:

Proposed Rule 760(a) would limit the availability of the custody order-taking exemption to "qualified investors"[17] and pre-existing customers.[18]

The term "custody and safekeeping" has traditionally been understood to include order-taking.[19] The GLB Act did not change this aspect of custody and safekeeping and

[17] *Qualified investor* is defined at Section 3(a)(54) of the Exchange Act. In the case of natural person, a *qualified investor* must own and invest on a discretionary basis not less than $25,000,000.

[18] I.e., persons "with an account that was opened before July 30, 2004."

continues to permit custodial order-taking.[20] Preventing bank custodians from carrying out orders to purchase and sell securities from all but a few customers would diminish the utility of custody accounts. This assault on the traditional custodial activities of banks would be contrary to the clear language, as well as the intent, of the GLB Act.

The Commission appears to have two concerns with the order-taking exemption. The Preamble indicates that the Commission believes such exemption should be available only to those "entities [who] do not require the comprehensive protections of the federal securities laws" because of their "special circumstances".[21] The other concern is that a custody accounts would be used as a substitute for a brokerage account.

First, there is no indication that customers who have placed orders to purchase or sell securities through their bank's custody department have suffered harm. In this regard, banks in the custodial business do not solicit trading activity; they merely follow instructions. They have no incentive to recommend unsuitable securities and no opportunity for churning. Moreover, banking regulations require banks to establish securities trading policies and procedures including equitable trade allocation policies.[22]

Second, many customers find it advantageous to hold their securities at banks. Custodial accounts at banks serve many important functions for which brokerage accounts are not suitable. For example, customers may desire a centralized location to hold and settle their assets irrespective of where transactions are executed. In the case of unlisted securities like bonds, such customers can more easily seek bids from multiple brokers before making a trade.

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[19] "The principal duties of a custodian are (1) to receive, issue receipts for, and safely keep securities; . . . (8) to *buy, sell, receive, or deliver securities on specific directions of the customer*." I. A. Scott, The Law of Trusts § 8.1 (3rd Ed. 1967), citing a publication of the American Institute of Banking (Trust Business I, 315 (1944)) [*Emphasis added*.]

[20] The letter being submitted on proposed Regulation B by the American Bankers Association explains in extensive detail that order-taking is, and has been, a traditional and integral part of a bank's custody and safekeeping activities. Moreover that letter points that Section 3(a)(4)(b)(viii) was added by the GLB Act with the specific intent that such activity continue unimpeded.

[21] 69 Fed. Reg. at 39709.

[22] *See, e.g.*, 12 CFR §12.7(a)(2).

Other customers may believe there is additional security in having their assets held by a bank. Securities Investor Protection Corporation and private insurance protect customers of brokers. Still, customers would rather have their securities available at a solvent institution when they want them than have an insurance claim. In light of the capital requirements imposed on banks and the restrictions placed on their activities, such customers may have greater confidence in the stability of a bank.

Some customers may seek to enhance their returns through securities lending. When securities are held in a margin account at broker, they are usually subject to being on-lent by the broker. Securities held in bank custodial accounts are not. Instead, customers may enter into a separate agreement with their custodial bank under which the bank lends securities as agent for the customer. The agreement would also specify the collateral that would secure the return of the borrowed securities.

Other customers may hold assets of a type (such as real estate or certain privately held securities) that a broker-dealer will not or cannot hold in custody.

Limiting the scope of the order-taking exemption would adversely affect customers. This limitation would require the additional costs of duplicative accounts (bank and brokerage) for those (non-grandfathered) customers that did not meet the definition of "qualified investor." Accordingly, Proposed Rule 760(a) should be amended to extend the scope of the order-taking exemption to all custody customers. At a minimum, the order taking exception should be available to those clients that are "accredited investors".[23] The exemption should also be available for accounts managed either by a registered investment adviser or by a trustee that qualifies as an accredited investor. Finally, the final rule should allow orders for purchases or redemptions of mutual fund shares from any custody account.

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

B. Solicitation of Securities Transactions:

The Preamble indicates that under the rubric of preventing "solicitation" departments throughout a bank (other than the custody department) would be precluded from providing:

> "lists of recommended securities, watch lists, research reports, or other publications highlighting particular securities or groups of securities, [or] . . . provide investment advice".[24]

Reasonable restrictions on a custody department's ability to solicit order-taking would address the Commission's concern that custodial arrangements could be transmuted into a surrogate for a brokerage account. Such restrictions should not, however, preclude the solicitation of the purchase or redemption of shares of money market mutual funds. Bank custody department customers need to be able to invest their excess cash, and permitting the solicitation of transactions in money market funds should not raise any investor protection issues.

On the other hand, the restrictions on solicitation if applied to other departments of a bank would be unwarranted and intrusive. For example, bank trust departments must be able to continue the normal marketing of their fiduciary services. Such restrictions on the ability of non-custody bank departments to market their services would severely compromise the practical benefit of the custody and safekeeping exemption.

C. Definition of "Account for Which the Bank Acts as a Custodian":

Proposed Rule 762(a) would define the term "account for which the bank acts as a custodian." with extraordinary specificity. A custody account (other than an individual retirement account) would have to be established by a:

> "written agreement . . . which at a minimum provides for the terms that will govern the fees payable, rights, and obligations of the bank regarding:

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[24] 69 Fed. Reg. at 39710.

(1)(i) Safekeeping of securities;

(ii) Settling trades;

(iii) Investing cash balances as directed;

(iv) Collecting income;

(v) Processing corporate actions;

(vi) Pricing securities positions; and

(vii) Providing recordkeeping and reporting services . . ."[25]

This definition would effectively cause the Commission to regulate the custody activities of banks in violation of concept of "functional regulation" adopted by the GLB Act. Moreover, in the absence of a demonstrated need to address or remedy a particular harm risk or abuse, U. S Trust would raise concerns if such specificity were proposed to be adopted by a banking regulator.

V. Bonus Plans:

U. S. Trust is particularly concerned about the discussion of bonus plans in that portion of the Preamble[26] that describes the so-called "networking" exception.[27] Essentially, the "networking" exception allows unregistered bank employees to be paid a nominal fee for referring a customer to a broker-dealer. This discussion of bonus plans appears to go well beyond the issue of referral fees and would effectively result in the Commission's regulating bank and holding company bonus and other compensation plans.

When confronted by earlier comments that "argued that only bonus plans used as a conduit to pay brokerage-related compensation to unregistered employees under the exception [should be] prohibited,"[28] the Commission replied: "We do not agree. Any

[25] Prop. 17 C.F.R. § 242.762(a) *at* 69 Fed. Reg. 39737.

[26] 69 Fed. Reg. at 39689-90.

[27] Section 3(a)(4)(ii)(I) of the Exchange Act.

[28] 69 Fed. Reg. at 39689-90.

bonus or other incentive compensation that is payable based in part, directly or indirectly, on a referral for which the employee has already received a referral fee, would violate the exception's requirement that brokerage-related incentive compensation paid to unregistered employees under the exception be limited to 'one-time' referral fees."[29]

The Preamble would allow bonuses based on the overall profitability of the bank or the bank's parent holding company.[30] This, however, would provide little comfort. Very few, if any, bonus plans are based solely on the stand-alone profitability of a bank or of a bank holding company. Bonus plans not solely a function of overall profitability might include plans based in part on the performance of the employer's stock, on year-to-year changes in financial measures, on assets under management, or any of a number of other customer metrics not based or dependent on individual referrals or brokerage transactions.

We do not believe Congress intended the term "incentive compensation for any brokerage transaction" to grant the Commission extensive jurisdiction over normal company and division bonus plans. If such a plan were an indirect conduit for paying impermissible referral fees to unregistered bank employees, the Commission would have a legitimate interest in preventing such circumvention. Otherwise, it would have no authority under the GLB Act to regulate the internal personnel practices of banks.

In conclusion, U. S. Trust appreciates the opportunity to express its views on proposed Regulation B and hopes the comments contained in this letter are helpful. If you have any questions on the above, please contact the undersigned or John B. Sullivan by telephone at (212) 852-1367 or by E-mail at john_sullivan@ustrust.com.

Very truly yours,

John B. Sullivan

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[29] *Id*. at 39690.

[30] *Ibid*..