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THE CLEARING HOUSE
Advancing Payment Solutions Worldwide

September 1, 2004

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

Attention: Mr. Jonathan G. Katz
Secretary

Re: Release No. 34-49879 (File No. S7-26-04): Regulation B

Ladies and Gentlemen:

The member banks of The Clearing House Association L.L.C.[1] ("The Clearing House") are writing to comment on the various rules proposed to be adopted (the "Proposed Rules") by the Securities and Exchange Commission (the "SEC") under the Securities Exchange Act of 1934 (the "Exchange Act") as modified by the Gramm-Leach-Bliley Act (the "GLBA") and that are proposed to be contained in a new Regulation B. The Proposed Rules define the terms of certain statutory exceptions for banks from the definitions of broker in Section 3(a)(4) of the Exchange Act and provide additional regulatory exemptions to banks from the Exchange Act's broker-dealer registration requirements.

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1 The member banks of The Clearing House are: Bank of America, National Association; The Bank of New York; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank; LaSalle Bank National Association; U.S. Bank National Association; Wachovia Bank, National Association; and Wells Fargo Bank, National Association. In addition, a number of banks that are not members of The Clearing House have contributed to the preparation of this comment letter. Thus, this letter reflects the views of a broader group of banks than just the members of The Clearing House.

The Clearing House appreciates the SEC's solicitation of comments in the proposing release[2] (the "Release") and the opportunity to provide its comments on the Release and the Proposed Rules.

I. Introduction

The Clearing House recognizes that the SEC and its staff have expended considerable effort to work with the banking industry to implement Title II of the GLBA in a manner that carries out what the SEC believes is the language and purpose of the statute, while accommodating the business needs of the industry. We appreciate the fact that the SEC has repeatedly postponed the effectiveness of Title II during this period, and we appreciate the time and the effort the staff has devoted to meeting with industry representatives and to listening to the concerns of the industry.

Unfortunately, however, The Clearing House cannot support the Proposed Rules. Indeed The Clearing House strongly believes that the Proposed Rules are not supported by either the language or the legislative history of Title II of the GLBA, and that the SEC should reexamine the fundamental approach it has taken. It is of course correct that Title II was intended to eliminate the complete exclusion that banks previously had from the definitions of "broker" and "dealer" in the Exchange Act. Banks' traditional banking activities, however, include providing a number of products and services that might raise questions as to whether, in the absence of the statutory exclusions, banks would be required to register with the SEC as brokers or dealers. If Congress had simply repealed the statutory exclusions provided to banks, banks would have been faced with no other choice than to seek regulatory exemptions from the SEC to continue performing these traditional banking activities.

Congress recognized these facts and decided that banks should <u>not</u> be required to seek exemptions from the SEC in order to continue their customary banking activities. Instead,

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2 Release No. 34-49879, 69 Fed. Reg. 39,682 (June 30, 2004).

it adopted statutory exceptions to, in the words of the Conference Committee Report, "facilitate certain activities in which banks have traditionally engaged" (emphasis added).[3] Congress concluded that these activities did not require SEC regulation and its clear purpose in adopting these statutory exceptions was to allow banks to continue to conduct these traditional businesses without unnecessary burdens and without having to seek further regulatory exemptions from the SEC. As the Conference Committee Report further stated with respect to one type of customary banking activity, the "Conferees expect that the SEC will not disturb traditional bank trust activities under this provision."[4]

Congress also intended that oversight of the activities permitted by these statutory exceptions would follow the principle of functional regulation. Accordingly, banks' provision of these traditional banking services pursuant to these exceptions was to be regulated by the banking regulators. Indeed Section 204 of the GLBA instructed the banking agencies, not the SEC, to "establish recordkeeping requirements for banks relying on" the exceptions for banks from the definitions of broker and dealer. Only if banks engaged in brokerage or dealing activities that went beyond the securities activities authorized for banks by the GLBA were they to be regulated by the SEC.

The approach taken by the Proposed Rules and the Release is, in our view, inconsistent with both the language and the legislative history of the GLBA. The approach taken by the Proposed Rules reads ambiguity into clear statutory language, interprets that ambiguity in a manner that constrains traditional bank securities activities (or otherwise burdens banks' conduct of those activities), and then, in some but not all cases, offers exemptive rules that allow banks to continue to conduct those activities in whole or in part, but only subject to burdensome and unreasonable conditions. The absence of any history of harm to bank customers from the conduct of these traditional activities makes the additional burden all the more unjustifiable.

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3 H.R. Conf. Rep. No. 106-434 at 163 (1999).

4 Id. at 164.

There are numerous examples of this approach in the Proposed Rules. The statutory exception for one specific business addressed by the Conference Report – the trust and fiduciary business – has in effect been read out of the statute by, among other things, the SEC's decision to interpret the statute to require banks to comply with the statutory "chiefly compensated" test on an account-by-account basis.[5] In addition, even though the Release recognizes that Rule 12b-1[6] fees have been a principal component of the revenues received by bank indenture trustee businesses for many years prior to the enactment of the GLBA and that Rule 12b-1 fees are paid on the basis of the assets managed by the bank in an indenture trustee capacity that are invested in mutual funds as determined by the client, the Proposed Rules do not recognize Rule 12b-1 fees as "percentage of assets under management fees" and instead treat them as "sales compensation" subject to regulatory restrictions under the "chiefly compensated" test. The effect is that without an SEC exemption, banks could not continue to provide indenture trustee services in the manner that they have been.

After adopting these interpretations of the trust and fiduciary activities exception, the SEC has imposed burdensome and extra-statutory (and in some cases contra-statutory) requirements on banks that seek to qualify for exemptions the SEC indicates it is adopting for the purpose of allowing them to continue conducting their traditional trust and fiduciary businesses. Banks are required either to calculate the compensation received by their trust and fiduciary departments on an account-by-account basis, a method that even the SEC seems to recognize would be unduly burdensome, or to satisfy a requirement that 90% (not the statutorily mandated majority) of revenues come from the statutorily permitted types of compensation.

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5 The SEC adopted this interpretation notwithstanding that the statute speaks of banks being compensated for trust and fiduciary "transactions," not of banks being compensated for "each transaction" or for "each account."

6 In this letter, when we refer to Rule 12b-1 fees we mean to refer also, where appropriate, to fees paid by an investment company other than under Rule 12b-1 for personal service or the maintenance of shareholder accounts.

A second example of how the Proposed Rules and the Release impose requirements without legislative support is with respect to bank bonus plans. The GLBA provides an exception allowing banks to pay referral fees to unregistered bank employees, a right not permitted by the Exchange Act to any other organization. Yet somehow this statutory exception is turned into authority for the SEC to regulate banks' compensation programs and to prohibit all such programs other than programs in which the bonus is based solely on the profitability of the bank or its holding company, even, apparently, if the bank does not have a referral fee program and even if the bonus program does not cover employees who receive the referral fees.[7] Banks are not the only business organizations that own or may be affiliated with broker-dealers. Why should their bonus programs become subject to SEC regulation because of a statutory exception granted to them when other organizations are free from such regulation?

A third example is the SEC's interpretation of the statutory sweep exception. Congress adopted an exemption to allow banks to sweep funds from bank deposit accounts into "no-load" money market funds. Notwithstanding that the Chairmen of both the Senate and the House Banking Committees wrote letters to the SEC urging the SEC not to do so, the SEC has chosen to interpret this exception to incorporate as part of the definition of "no-load" an additional NASD restriction on advertising a fund as "no load," thereby prohibiting the use of certain money market funds into which banks have swept deposit funds. Again, the effect of the SEC's action is to prohibit banks from continuing long-established practices widely thought to be authorized by Congress when it adopted the GLBA.

A fourth example is the SEC's interpretation of the custody exception in the statute. In spite of the clear language of the statute allowing banks to continue to serve as custodians for, and to act as "provider[s] of other related administrative services to," individual retirement accounts ("IRAs") and to all types of benefit plans, activities that necessitate the

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7 One question raised by this is why such a limited menu of permissible bonus programs is available, but we believe that a more important question is why bank bonus programs should be subject to SEC regulation at all.

ability to take orders for the purchase and sale of securities, the SEC interprets the custody exception not to allow bank custodians to accept such orders. Again, the effect is to interpret the GLBA to require banks, unless the SEC grants exemptive relief, to "push out" traditional banking businesses Congress intended would stay within banks.

There are other examples, and we address them in the body of the letter.

We believe that the SEC needs to step back from the Proposed Rules and the Release and address some fundamental questions. How can it be that the SEC is interpreting Title II such that banks may continue to conduct the traditional activities authorized by the GLBA only by obtaining exemptive relief from the SEC? Where in the language or the legislative history of the GLBA does the SEC find support for the proposition that Congress intended to prohibit the traditional bank activities authorized by the statute unless banks convinced the SEC to grant them regulatory exemptions? The answer is that there is no support for such a proposition. Congress intended that banks conducting brokerage activities <u>outside</u> the statutory exceptions would have to "push out" those activities. It did not intend to prohibit or restrict the traditional bank activities protected by the statutory exceptions.

We recognize that many of the restrictions imposed on banks by the Proposed Rules evidence the SEC's concern that in the absence of such restrictions, banks will attempt to increase their brokerage activities by conducting a full-scale general brokerage business within the bank without being subject to SEC overview. This concern is misplaced. The whole trend in the banking industry prior to the enactment of the GLBA was for banks to establish broker-dealer affiliates and to transfer any true brokerage activities to those affiliates. The enactment of the GLBA made it even less likely that any bank would want to attempt to conduct a brokerage business inside the bank. But if a bank did attempt to do so, it is simply inconceivable that the bank would have the ability to conceal the brokerage business from the examination process conducted by the banking regulators. This fact is all the more clear when one considers that such brokerage operations could not be successfully established by a bank without advertising the general availability of brokerage services.

We believe that if the SEC reassesses its approach in the Proposed Rules in light of the language, legislative history, and purpose of Title II, the result would be a simpler regulatory regime and a less complex and burdensome set of rules, all without any detriment to the public interest or to the protection of investors. We therefore urge the SEC to do so. We propose specific ways to do so herein.

II. A Simpler Approach

A simpler approach to Title II is possible and would be consistent with the language and legislative history of, and public policy behind, the statute. We recognize that the Proposed Rules do not adopt this approach, but we suggest the following:

A. Networking

Section 3(a)(4)(B)(i) of the Exchange Act authorizes bank employees to receive "nominal" fees for referring customers to a broker-dealer. The Proposed Rules could have left the word "nominal" undefined (as it has been in the SEC's Chubb no-action letter[8] and in the federal banking agencies' Interagency Statement on Retail Sales of Nondeposit Investment Products (the "Interagency Statement"),[9] from which Section 3(a)(4)(B)(i) was derived). The federal banking agencies would continue to monitor bank practice in this area (although now in consultation with the SEC) and identify and (along with the SEC) deal with any abuses. Payment of referral fees to bank employees would continue to be limited in the way it has been limited pursuant to the Interagency Statement and pursuant to the provision in Section 3(a)(4)(B)(i)(VI) that prohibits conditioning payment of a referral fee "on whether the referral

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8 Chubb Securities Corporation, SEC No-Action Letter, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76829 (Nov. 24, 1993).

9 7 Fed. Banking L. Rep. (CCH) ¶ 70-101 (Feb. 15, 1994).

results in a transaction." Bank bonus plans would be left unaffected unless they were used as a mechanism for paying impermissible referral fees.

B. Trust and Fiduciary Activities

Banks engaged in trust and fiduciary activities would have to comply with the "chiefly compensated" requirement on the basis of the revenues of the trust and fiduciary department (or departments) as a whole. "Sales compensation" would be limited to less than half of total compensation received for trust and fiduciary services. Rule 12b-1 fees would not be treated as sales compensation in recognition of the fact that such fees are not commissions and instead are paid on the basis of percentage-of-assets-managed by the bank that are invested in particular mutual funds and the fact that, as trust and fiduciary assets have increasingly come to be invested in mutual funds, both banks and fiduciary customers have agreed to recognize banks' receipt of Rule 12b-1 fees in determining the direct fees that will be charged to fiduciary accounts by banks.

C. Custody

Bank custody departments would continue to be allowed to provide order-taking services pursuant to the custody exception, subject to the statutory requirement to effect any purchases or sales of securities that are publicly traded in the United States through a registered broker-dealer and to the requirement not to advertise or solicit their order-taking services.

Employee benefit plan administration services would continue to be carried out under the custody exception (except when a bank conducts this activity under the trust and fiduciary activities exception).

D. Sweeps

Banks would continue to be permitted to sweep funds from deposit accounts into money market mutual funds that are sold without a front end or deferred sales charge.

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Although we believe the foregoing approach is consistent with the intent of Congress in enacting the GLBA, we recognize that the SEC may be reluctant to accept it in totality. We have set forth this alternative approach because we wish to demonstrate that there are alternatives that will avoid the incredible complexity of the Proposed Rules and the major disruptions of traditional banking activities they entail and that will also satisfy Congress' and the SEC's goal of investor protection and consistency with the statute's language and legislative history. We believe that these alternatives should be given careful consideration.

III. Timing and Process Concerns

The Clearing House banks are particularly concerned about the process to be followed by the SEC hereafter. As discussed in general above, and more specifically below, we believe that the Proposed Rules (as interpreted and explained in the Release) raise significant issues for banks' ability to continue to conduct their traditional business activities. Whether or not the SEC accepts our suggestion to go back to first principles, we believe that it will be virtually impossible for final rules to be prepared that do not create significant and unreasonable burdens for the banking industry in time for effectiveness in November. We believe that it will be critical that the SEC provide the banking industry with the opportunity to comment on revisions to the Proposed Rules, either through a formal reproposal or through informal consultations.

In addition, as discussed in more detail in Section XII below, it is critical that the SEC and the NASD resolve the issues the banking industry has raised regarding NASD Rule 3040 as part of any resolution of final rules implementing Title II of the GLBA.

We therefore urge that the SEC postpone its schedule for adopting final rules in order to allow either a new formal notice and comment process or such an informal consultative process.

We turn to our comments on the specifics of the Proposed Rules.

IV. Bank Trust and Fiduciary Activities

The Clearing House has major specific concerns about the provisions in the Proposed Rules that relate to the exception from the definition of "broker" for banks engaged in trust and fiduciary activities.[10] Specifically, our comments are focused on (a) the way in which the Proposed Rules implement the "chiefly compensated" test, (b) the definition of "investment adviser if the bank receives a fee for its investment advice" and (c) the SEC's interpretation of the Exchange Act's requirement that a trust department or other department relying upon the exemption for trust activities be "regularly examined by bank examiners."

A. "Chiefly Compensated" Test

The Clearing House recognizes that, as compared to the Interim Final Rules, the Proposed Rules reflect an effort by the SEC to facilitate banks' compliance with the "chiefly compensated" test. Specifically, we believe that a number of changes from the SEC's Interim Final Rules implementing Section 3(a)(4)(B) of the Exchange Act[11] are steps in the right direction, such as: the expansion of the definition of "relationship compensation" to include revenues received for managing non-securities assets; the new safe harbors applicable in the case of an occasional failure to meet the requirements of the "chiefly compensated" test, whether under the line-of-business or the account-by-account method; and the recognition of the need to grandfather existing accounts.

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

11 Release No. 34-42291, 66 Fed. Reg. 27760 (May 18, 2001).

1. Proposed Line-of-Business Exemption – One-to-Nine Ratio of "Sales Compensation" to "Relationship Compensation" (Proposed Rule 721(a)(2))

We believe, however, that notwithstanding these and other improvements, the new line-of-business exemption contained in Proposed Rule 721 is still not workable. This issue is particularly critical to The Clearing House because a vast majority of member banks believe they need to rely on the line-of-business exemption because it would be too difficult and costly to monitor compliance with the "chiefly compensated" test on an account-by-account basis.

The Clearing House recognizes the request made by the SEC that comments criticizing the alternative to the account-by-account method of calculation as implemented by Proposed Rule 721 should be accompanied by specific quantitative data demonstrating the inadequacy of the new proposals.[12] We must stress, however, our belief that it would be exceedingly difficult if not impossible for banks to provide the SEC with the sort of precise data it is seeking, and that attempting to gather such data would require incurring substantial expense. Banks have never before been required to calculate the amount of "sales compensation" (however defined) earned by their trust and fiduciary departments, and do not have systems for tracking this information. To measure this number precisely, a bank would have to build data collection and processing systems and then employ those systems over a year period to determine the exact amount of "sales compensation" it earns during the year. It would be important to measure this information over a year, given the potential for seasonality effects and because discrete events could disproportionately affect the ratio of "sales" to "relationship compensation" over shorter periods of time.

The foregoing task alone would be an expensive task, but it would not be enough. The Proposed Rules require a bank to measure "sales compensation" not as a percentage of all

[12] 69 Fed. Reg. 39,695-39,696 (2004).

trust and fiduciary revenues but as a percentage of "relationship compensation," another figure that banks have never had any reason to measure and do not track.

The cost of creating data collection and processing systems to measure these two parameters would be significant. Certain banks have estimated that it would cost them approximately $1 million, while other banks' estimates are even higher.[13] We understand that Title II of the GLBA will require certain changes in the way banks conduct their businesses and we do not dispute the principle that banks will have to incur expenses to comply with the final SEC rules implementing these statutory provisions. Nevertheless, to require banks to build these systems now – when the rule is only a proposal – is burdensome and unfair. Yet realistically this is the practical effect of indicating that the SEC requires precise data before it will make adjustments to the Proposed Rule.

Merely spending the money to build these systems, however, would not enable banks to provide the requested data. As discussed below, the Proposed Rules contain ambiguities and raise interpretive issues that make it impossible for banks to know how to implement the test and to derive precise numbers.

The Clearing House is especially concerned with two aspects of Proposed Rule 721 in connection with which the SEC is requesting specific quantitative data: First, the proportion of "sales compensation" to "relationship compensation" that is allowed under the Proposed Rule, which we think is too low. Second, the exclusion of so-called "unrelated compensation" from the "chiefly compensated" computation.

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[13] These estimates are, of course, just of the costs to create the systems. There would be additional annual expenses of operating the systems.

a. One-To-Nine Ratio, i.e. 10% Limit (Proposed Rule 721(a)(2))

Banks are very concerned about how they comment on this proposed 10% limit. Revenues that the SEC considers in the Proposed Rules to be “sales compensation” constitute a principal component of the revenues of substantial bank fiduciary businesses, such as the indenture trustee business. As discussed below, banks have concerns that the exemptions the SEC has proposed for this and other businesses will not work. The SEC apparently intends that such businesses be outside the scope of the line-of-business test and the 10% limit. Yet if the exemptions are not corrected, all of the “sales compensation” banks receive from these lines of businesses must be counted as such under whatever limit the SEC adopts.

Even if these other exemptions are corrected, there are significant issues, discussed below, with how the line-of-business test works. These issues make it impossible to know how to calculate a bank’s percentage under the Proposed Rules. We therefore believe that the 10% limit on “sales compensation” as a percentage of the total of “sales” and “relationship compensation” permitted under Proposed Rule 721(a)(2) is too low. Indeed, such a low limit would put many banks at risk of violating the “chiefly compensated” test, considering that a number of banks have estimated that their current ratios of “sales” to “relationship compensation” are probably above the 10% limit, either on the basis of the bank as a whole or on the basis of a particular line of business.

The 10% limit, however, is not a problem only for banks that believe they exceed the limit, but for most other banks as well. Indeed, the Proposed Rule would not provide even banks that believe that they would not exceed the limit (assuming the above-noted other problems are resolved) with sufficient legal certainty that they are not in violation, because most banks believe that (on this basis) they are close to the 10% limit. As a result, most banks would have to set up and maintain burdensome compliance systems. By contrast, if the permitted proportion of “sales compensation” to the total of “sales” and “relationship compensation” were set at a more reasonable level, most banks would be in a position to pursue their traditional trust and fiduciary activities with reasonable certainty that they are not in violation. This would greatly limit the costs imposed on banks to comply with the "chiefly compensated" test.

b. Exclusion of "Unrelated Compensation"

Similarly, The Clearing House believes that the approach taken by the SEC whereby so-called "unrelated compensation" must be excluded from the "chiefly compensated" calculation is both unreasonable and unduly burdensome. We believe that "sales compensation" should be measured against all revenues received by a bank from its trust and fiduciary activities. This would simplify banks' task of complying with the "chiefly compensated" test in that only "sales compensation," rather than three different types of compensation, would have to be monitored. The Release acknowledges that bank representatives have previously informed the SEC that "it would be simpler and more cost effective if banks were permitted"[14] to monitor compliance with the "chiefly compensated" test in this manner. The SEC appears to take the position, however, that this request will be taken into consideration only if banks provide specific data evidencing the current proportions of "sales," "relationship" and "unrelated compensation" for accounts in their trust and fiduciary departments. This disregards the fact that, as mentioned above, requiring banks to undertake the burdensome process of gathering this quantitative information is unreasonable; indeed this is precisely what banks are trying to avoid when they argue that "sales compensation" should be measured against total compensation.

Moreover, we believe that all types of compensation a bank receives from its trust and fiduciary activities that may be at issue here really are and should be recognized as "relationship compensation." The kinds of compensation that may be at issue appear to be such fees as fees for preparation of personal income tax returns, statutory termination fees, fees for considering discretionary requests (e.g., fees for consideration of requests to invade principal) and other similar administrative fees. The statute refers to banks being "chiefly compensated"

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14 69 Fed. Reg. 39,696 (2004).

by, among other things, “an administration or annual fee.” These are clearly administration fees. To be clear, we are not requesting that revenues from deposit taking or lending activities be treated as “relationship compensation.”

Finally, we believe that many, if not most, of the estimates banks have previously provided the SEC of their compliance with the “chiefly compensated” test have been calculated using the above understanding that “relationship compensation” is total compensation for purposes of the denominator. We are concerned that there may have been misunderstandings about how these prior estimates have been calculated.

c. Conclusion

Although we believe such an interpretation is more restrictive than what is mandated by the GLBA, The Clearing House banks believe that SEC rules that contain the following elements would provide a manageable approach for implementing the trust and fiduciary activities exception:

i. For purposes of the line-of-business test, “sales compensation” could not exceed 25% of <u>total</u> compensation from trust and fiduciary activities.

ii. Rule 12b-1 fees would be treated as “sales compensation” but no other revenues from activities that qualify for a statutory exception or regulatory exemption would be treated as “sales compensation.”

iii. The other issues raised herein regarding the line-of-business test are resolved satisfactorily.

iv. The SEC adopts rules to exempt banks’ indenture trustee and employee benefit plan businesses in a manner that satisfactorily addresses the issues raised herein.

2. Line-of-Business Exemption – Other Definitional Issues

a. Definition of “Line-of-Business” (Proposed Rule 724(e))

The Clearing House is concerned with the definition of what constitutes a line of business. Proposed Rule 724(e) requires 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 . . ." The Proposed Rule does not stop there, however. Instead, it also imposes 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." These two additional requirements are unduly vague and do not seem to serve any particular public policy purpose. The Release provides no guidance on how banks are to assess whether accounts are of a similar type or whether a bank is acting in a similar type of fiduciary capacity. For example, if a department of a bank serves as executor of wills and trustee for minors and also provides investment advice for a fee, are the accounts of a "similar type" and are the fiduciary capacities "similar"?

To avoid undue disruption in the operation of banks' trust and fiduciary departments, banks need to be allowed to organize their lines of businesses under the exemption according to the way banks' lines of businesses are actually organized by banks' managements so as to implement sound and efficient business practices.

In addition, the Release explains that banks could monitor compliance with the "chiefly compensated" test by measuring the "sales" and "relationship compensation" for all accounts "within a particular line of business established <u>before</u> a single date certain" (emphasis added).[15] We see no reason why banks should not be permitted to adopt the line-of-business approach for all accounts within a particular line of business that are established <u>after</u> a single date. In fact, we believe that this approach would be consistent with the Proposed Rules. It would, for example, allow banks to use the line-of-business test for all non-grandfathered accounts in a line of business.[16]

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15 <u>Id</u>. at 39,695.

16 It follows from this example that The Clearing House believes that, consistent with the Proposed Rules, banks should be allowed to use the line-of-business exemption for some lines of businesses, and to use an account-by-account calculation for other lines of businesses, and that a bank should be allowed to choose

We understand that the SEC has concerns that the "line-of-business" test will be manipulated. We believe that those concerns are entirely unwarranted for a number of reasons. First, banks are subject to examination by the banking regulators, who would be able to detect and deal with any manipulation. Second, the other requirements of the line-of-business test prevent manipulation. Third, as discussed above, banking industry practice has been to conduct true brokerage business in a broker-dealer, not a bank. For these reasons we believe that these two requirements should be eliminated.

b. "Sales Compensation" and "Relationship Compensation" from "All Accounts" Must Be Used To Determine Compliance (Proposed Rule 721(c))

Proposed Rule 721(c) requires that "sales compensation" and "relationship compensation" "from all accounts…[be] used to determine whether the bank meets the requirement" that "sales compensation" not exceed 10% of the total of "sales" and "relationship compensation." Although the Rule itself is unclear, the Release seems to suggest that opting for the line-of-business exemption will require banks to treat as "sales compensation" revenues that come from activities exempted under other exemptions but that would otherwise be included within the definition of "sales compensation." This would have the effect of vitiating these other exemptions for banks that wish to use the line-of-business test. For example, one bank's indenture trustee activities are conducted in a department that also provides custody, escrow, investment management and other trustee services. As a result, the "line of business" would include indenture trustee activities, for which Rule 12b-1 fees have been a principal component of the bank's revenues. Thus, the bank would be required to combine the "sales compensation" it earns from indenture trustee activities with the "sales compensation" earned from other parts of the department, and would exceed the 10% limit.

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whether to opt for the line-of-business approach for particular accounts based on a cut-off date that the bank determines.

Because the exemptions for indenture trustees and grandfathered accounts, as well as other exemptions, are necessary for banks to avoid violating the "chiefly compensated" test, we believe it is critical that the SEC clarify that revenues from transactions that qualify for another exemptive rule should not be treated as "sales compensation."

c. Requirement to Review Accounts When the Bank Individually Negotiates With the Accountholder to Increase the Proportion of "Sales Compensation" (Proposed Rule 721(a)(4))

The Clearing House considers it an improvement that the Proposed Rules, unlike the Interim Final Rules, do not require a bank to review the compensation in an existing account whenever the compensation arrangement for the account changes. Nevertheless, we believe that problems will arise under the new standard of review contained in Proposed Rule 721(a)(4). Under this new standard, a bank would be required to review an account to examine the ratio in the account of "sales" to "relationship compensation" when the bank "individually negotiates with the accountholder or beneficiary of that account to increase the proportion of sales compensation as compared to relationship compensation."

The Release asks for comment on the impact of this condition on "waiving relationship compensation for a particular account," and asks whether there is an "alternative that will allow for waivers without allowing the bank to be continually compensated by a significant number of accounts entirely through sales compensation."[17]

Circumstances arise under which, as a practical business matter, banks must waive fees that qualify as "relationship compensation." Under the Proposed Rules, such a waiver would trigger the requirement to review the individual account that is affected (or accounts that are affected). We believe that the numerous statutory conditions on the trust and

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[17] 69 Fed. Reg. at 39,695 (2004).

fiduciary exception, as well as the conditions of the line-of-business test, make this entirely unnecessary. There is no need for, nor should there be, a requirement to review individual accounts because of bona fide waivers of "relationship compensation." We believe that Proposed Rule 721(a)(4) should be revised accordingly.

In addition, we presume that if, for fiduciary law reasons, a bank agrees to or is required to waive certain relationship compensation because the bank or its affiliate has received other compensation that the SEC considers to be "sales compensation" (such as Rule 12b-1 fees), that fact would not trigger any special requirement to review an account.

3. Definition of "Flat or Capped Per Order Processing Fee" (Proposed Rule 724(b))

The Interim Final Rules were unduly restrictive in considering that only the amount charged by the executing broker-dealer for executing a transaction plus the resources exclusively dedicated to transaction execution, comparison and settlement could qualify as a "flat or capped per order processing fee." Unfortunately, we believe that the Proposed Rule's revisions to the definition place restrictions on the inclusion of such fees in "relationship compensation" beyond what is authorized by the Exchange Act. The restriction in Proposed Rule 724(b) to the "direct marginal cost of any resources of the bank that are used for transaction execution, comparison, or settlement" is contrary to the clear language of the GLBA, which refers to such fees being "not more than the cost incurred by the bank in connection with executing securities transactions" and does not limit such fees to the "direct" or "marginal" cost of the service. Moreover, this definition fails to take into consideration the fact that such costs may vary depending on the nature of the transaction handled.

Furthermore, Proposed Rule 724(b) conditions banks' ability to include the cost of certain resources in measuring the permitted "flat or capped per order processing fee" to "the bank mak[ing] a precise and verifiable allocation of these resources according to their use." This condition was not in the Interim Final Rules, nor is it in the language of the GLBA, and the SEC does not provide justification for this new condition other than stating – in reference to the overall change to the definition of "flat or capped per order processing fee" – that "we believe this proposed change is consistent with the statutory requirement of cost recovery."[18] This condition is particularly burdensome and we do not believe that it is necessary. It should be eliminated.

We therefore suggest that the definition of "flat or capped per order processing fee" be amended so that a fee that a bank reasonably believes is not greater than either its average total cost for executing securities transaction for trust and fiduciary customers or its total cost for executing the particular securities transaction qualifies as a "flat or capped per order processing fee."

4. Definition of "Sales Compensation"

Proposed Rule 724(i)(2) defines "sales compensation" to include "compensation that if paid to a broker or dealer would be payment for order flow, as defined" in Rule 10b-10 under the Exchange Act.

We note that Rule 10b-10(d)(9) includes "research" in the definition of "payment for order flow." Bank trust departments receive research from broker-dealers and use research in making investment decisions for the customers for which they serve as trustee or fiduciary. We do not believe that Congress intended Title II of the GLBA to restrict a bank trust or fiduciary department's ability to receive soft dollar research, and we therefore believe that the provision of research by broker-dealers to bank trust departments should not be characterized as "sales compensation." We request that the Proposed Rules be revised accordingly.

In addition, (i) to the extent that fiduciary or other laws require relationship compensation to be waived, or (ii) in states where such waiver is not required, if a bank has

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[18] Id. at 39,699.

agreed with a customer that it will waive certain relationship compensation, when "sales" or other compensation is received by the bank or its affiliate, The Clearing House proposes that such "sales" or other compensation should be included as "relationship compensation" and not as "sales compensation."

We also note that the SEC has requested comment as to whether "sales compensation" should "include additional sales-related arrangements that may create conflicts of interest, such as sales or distribution-related payments to affiliates or employees of banks."[19] We object to any further expansion of the definition of "sales compensation" and note that the Exchange Act does not grant the SEC authority to regulate bank trust or fiduciary activities.

5. Definition of "Relationship Compensation" in Relation to Proposed Line-of-Business Exemption

Section 3(a)(4)(B)(ii)(I) of the Exchange Act lists the types of fees by which a bank must be "chiefly compensated" if it effects securities transactions in a trustee or fiduciary capacity. These fees are "an administration or annual fee…, a percentage of assets under management, or a flat or capped per order processing fee (…), or any combination thereof." Proposed Rule 724(h) refers to the same types of fees in its definition of "relationship compensation." In contrast to the statute, however, Proposed Rule 724(h) restricts the definition of "relationship compensation" to "compensation a bank receives directly from a customer or beneficiary, or directly from the assets of an account."

We note that the GLBA places no such restriction on the source of payment of the statutorily enumerated fees. Further, we see no reason why a fee that meets the statutory definition of what the SEC refers to as "relationship compensation" should not be permissible simply because it is paid by a third party.

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[19] Id.

Indeed, bank trust and fiduciary departments are occasionally called upon to set up compensation arrangements for trust or fiduciary accounts whereby fees that would otherwise qualify as “relationship compensation” may be paid by someone other than the customer or beneficiary of the account. For instance, the settlor of a trust account created for the benefit of a third party may elect to pay the annual or other fees for the account himself or herself, as opposed to the fees being charged to the account directly. Proposed Rule 724(h), however, arbitrarily excludes such compensation from the definition of “relationship compensation.” Not only is this contrary to the language of the GLBA, but we fail to see any investor protection or other public policy purpose that is served by the exclusion.

We are particularly opposed to this requirement for a separate and compelling reason. In order to satisfy this requirement, even when seeking to rely on the line-of-business exemption, a bank would have to review each trust or fiduciary account within the line of business to ensure that all compensation that will be counted as “relationship compensation” was in fact received from the customer, from the beneficiary or directly from the assets of an account. Because the definition of “relationship compensation” is the same whether or not a bank monitors compliance with the “chiefly compensated” test on an account-by-account basis, this obligation would essentially defeat the purpose of the line-of-business exemption by requiring even banks that use this method to review accounts on an account-by-account basis. We therefore urge the SEC to revise the definition of “relationship compensation” to exclude the requirement that compensation will qualify only if received “directly from a customer or beneficiary, or directly from the assets of an account.”

6. Indenture Trustee Exemption (Proposed Rule 723)

We urge the SEC to expand the indenture trustee exemption to cover the purchase and redemption of shares of money market funds that do not meet the definition of “no-load” set out in Proposed Rule 740(c)(1); shares of short-term bond funds; and shares of short-term U.S. Treasury funds. This would avoid disruption and inconvenience to customers in banks’ provision of cash management services for indenture trustee accounts. Customers of banks acting as indenture trustees currently use banks to execute purchases and redemptions of such securities, as they do to purchase and redeem shares of no-load money market mutual funds.[20] To ensure clear delineation of the type of mutual funds from which a bank acting as indenture trustee would be permitted to purchase or redeem shares pursuant to this broadened exemption, we suggest that the SEC define the term "short-term" in line with the SEC's Division of Investment Management's guidelines regarding use of this term.[21] Accordingly, the revised exemption would allow banks acting in an indenture trustee capacity to purchase or redeem shares of registered open-end investment companies that limit their holdings to bonds or U.S. Treasury securities provided such funds maintain a dollar-weighted average maturity of no more than three years.

Additionally, we seek clarification as to how the indenture trustee exemption is to work in practice. We presume that the SEC intends that banks will treat their indenture trustee businesses as separate lines of businesses and analyze such lines of business separately from other lines of business for purposes of the "chiefly compensated" test. As noted above, this is not necessarily the case.

Even if this is the case, however, the Proposed Rules seem to require that an indenture trustee line of business be monitored on an account-by-account basis, because the provisions of the line-of-business test would require that the Rule 12b-1 fees a bank earns as indenture trustee be included as "sales compensation" in the 10% test. This is burdensome and should not be required. The line-of-business test should be revised to permit a bank to treat its indenture trustee business as a line of business without the bank being required to treat Rule 12b-

[20] The Release seems to assume that bank indenture trustee businesses rely only on money market funds that meet the NASD's rules for advertising themselves as "no load". This is not the case.

[21] See Release No. IC-24828.

1 fees from money market and short-term bond and treasury funds as "sales compensation" for purposes of measuring the line of business's compliance with the "chiefly compensated" test.

We note that the Release requests comment on whether the indenture trustee exemption would be necessary if the SEC were to adopt Proposed Rule 776.[22] As explained above, we believe that Rule 12b-1 fees that are permitted to be received under Proposed Rules 723 and 776 should not count as "sales compensation" in measuring compensation under the line-of-business approach. Accordingly, our preliminary conclusion is that the indenture trustee exemption would appear to be necessary only if Rule 12b-1 fees received pursuant to this exemption do not count towards the limit on "sales compensation" in the line-of-business test <u>but</u> the Rule 12b-1 fees received pursuant to Proposed Rule 776 do. Because we believe that Rule 12b-1 fees received pursuant to <u>either</u> exemption should not count as "sales compensation" under the line-of-business exemption, if our understanding of how the Rules are intended to work is correct, we believe that Proposed Rule 723 would be unnecessary. Because of the complexity of the Proposed Rules and our uncertainty as to how the SEC intends them to work, however, we do not believe we can provide a definitive answer to this question at this time.

7. Safe Harbors

The Clearing House appreciates that, by creating safe harbors under both the line-of-business and the account-by-account methods,[23] the SEC acknowledges that banks need to be provided with legal certainty when measuring compliance with the "chiefly compensated" test. We note that Proposed Rules 721 and 722 allow banks to use either safe harbor only if they did not rely on these safe harbors "during any of the five preceding years." The (presumably) unintended effect is that these safe harbors would be available to banks once every <u>six</u> years. By contrast, in connection with Proposed Rule 722, the Release "request[s] comment on whether the general limit on using the exemption once every five years…would provide banks with sufficient

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[22] 69 Fed. Reg. 39,700 (2004).

[23] Proposed Rules 721 and 722.

flexibility."[24] Our understanding is that the SEC intended these safe harbors to be available to banks once every five years. We request that Proposed Rules 721 and 722 be revised accordingly.

8. Grandfathering

Although we support the concept of grandfathering, we believe the grandfather date should be the final effective date of the rules implementing the bank exceptions from the definition of "broker" in the Exchange Act. Given the complexity of the Proposed Rules, we do not understand why grandfathering would end on the date they were published in the Federal Register rather than on the effective date. Moreover, the scope of the grandfather exemption should be expected to cover estates.

B. Definition of "Investment Adviser if the Bank Receives a Fee for Its Investment Advice" (Proposed Rule 724 (d))

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." The Clearing House considers it an improvement that the Proposed Rules, unlike the Interim Final Rules, do not limit the scope of this definition to situations in which the bank provides "continuous and regular investment advice to the customer's account." Indeed, the Release notes that although "most banks conduct continuous and regular reviews of the accounts of customers to whom they provide investment advice for a fee, … they may not necessarily communicate with each customer on a continuous and regular basis."[25]

The Clearing House strongly reiterates, however, its objection to the inclusion in the Proposed Rules of an SEC-imposed requirement of a "duty of loyalty" in the definition of

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24 69 Fed. Reg. at 39,698 (2004).

25 Id. at 39,702.

"investment adviser if the bank receives a fee for its investment advice" in Proposed Rule 724(d). We believe that the duties of a bank acting in any fiduciary capacity are to be governed by applicable state or other laws, not by the Exchange Act. Creating a duty of loyalty under the Exchange Act beyond the duties that already exist is inconsistent with the functional regulation approach of the GLBA. The Release refers banks to the disclosure obligations imposed under the Investment Advisers Act of 1940 (the "Advisers Act"), the SEC rules thereunder and Form ADV for guidance on complying with this requirement.[26] Banks are exempt from the Advisers Act (unless a bank serves as investment adviser to a registered investment company) and thus are not subject to Form ADV. By explicitly including "an investment adviser if the bank receives a fee for its investment advice" in the definition of "fiduciary capacity" for purposes of the trust and fiduciary activities exception to the definition of "broker," the GLBA clearly intended to enable banks to continue their traditional function of providing investment advice for a fee subject to the requirements of applicable fiduciary laws, or other laws, such as ERISA, but not the Advisers Act. The Proposed Rules and Release, by including a requirement of an Exchange Act "duty of loyalty" in the definition of "investment adviser if the bank receives a fee for its investment advice" and by further directing banks to the rules applicable to a registered investment adviser as guidance for compliance with this requirement, are substantively regulating banks' trust and fiduciary activities. There is nothing in the GLBA that suggests that a bank's disclosure obligations when providing investment advice for a fee should be regulated by the SEC, as opposed to being regulated by state or other applicable law and by the banking regulators. This is clearly contrary to functional regulation. We therefore urge the SEC to eliminate the Exchange Act duty of loyalty in Proposed Rule 724(d).

We note that the Rule 724(d)(2) requires that banks make recommendations about "specific securities." Some banks provide investment advisory services by choosing subadvisors with expertise in one or more market segments, with the subadvisors recommending the specific securities. Banks that use a subadvisor have fiduciary duties in doing so. We presume that, so

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[26] Id. at 39,702-39,703.

long as a bank's subadvisor recommends specific securities, the requirements of Proposed Rule 724(d)(2) are met, but we request that the SEC confirm this understanding.

C. Other Department That Is Regularly Examined by Bank Examiners for Compliance With Fiduciary Principles and Standards

Section 3(a)(4)(B)(ii)(I) restricts banks' reliance on the trust and fiduciary activities exception to 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 Clearing House recognizes that the SEC took into consideration comments arguing that the interpretation of this requirement in the release accompanying the Interim Final Rules was overly broad in requiring that "all aspects" of securities transactions effected by a bank for its trust and fiduciary customers be conducted in a part of the bank regularly examined by bank examiners for compliance with fiduciary principles and standards.[27] We disagree, however, with certain implications of the new interpretation of this requirement articulated by the SEC whereby "all aspects" of effecting securities transactions must be regularly examined by bank examiners. According to the Release, "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."[28] The SEC also states that "certain securities related activities may occur in a registered investment adviser,"[29] which we understand to allow such practice to continue under the Proposed Rules. The SEC is apparently taking the position, however, that banks may no longer outsource certain functions other than to a registered broker-dealer or, apparently, a registered investment adviser.

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27 Id. at 39,703.

28 Id. at 39,704.

29 Id. (emphasis added).

There is nothing in the language or the legislative history of the GLBA that suggests that the SEC is authorized to regulate banks' reliance on third-party service providers to provide trust or fiduciary (or indeed any) products or services. Regulation of banks' use of third-party service providers is the province of the federal banking agencies, not the SEC, as is further evidenced by the fact that Congress has already addressed this issue through the Bank Service Company Act[30] and has delegated implementation of this statute to the banking regulators. Regulation of outsourcing by the SEC would therefore clearly contradict the principle of functional regulation, one of the key purposes of the GLBA.

Moreover, this would adversely affect the way in which banks currently conduct securities transactions for their trust and fiduciary customers.

We therefore urge the SEC to state that it does not intend to regulate outsourcing through its interpretation of the requirement that securities transactions effected in reliance on the trust and fiduciary activities exception be conducted in the bank's trust department or "other department that is regularly examined by bank examiners [for compliance with trust and fiduciary principles and standards]."[31]

D. Other Provisions

The Clearing House appreciates that the Proposed Rules have eliminated the Interim Final Rules' provision defining "trustee capacity" and that the Proposed Rules do "not specifically identify trustee capacities that would provide a basis for relying on the trust and fiduciary activities exception."[32]

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30 12 U.S.C. §§ 1861 to 1867.

31 Section 3(a)(4)(ii)(I) of the Exchange Act.

32 69 Fed. Reg. 39,700 (2004).

V. Employee Compensation for the Referral of a Customer to a Registered Broker or Dealer

A. Networking Exception: Referral Fees

1. Definition of "Nominal One-Time Cash Fee of a Fixed Dollar Amount"

a. Referral Fees Paid in Cash (Proposed Rule 710(b)(1))

The Clearing House disagrees with the Proposed Rules' definition of the "nominal one-time cash fee of a fixed dollar amount" that a bank may pay an unregistered bank employee for the referral of a customer to a broker-dealer under the networking exception.[33] Generally, we believe that the three alternative measures of what constitutes "nominal" under Proposed Rule 710(b) reflect an unduly restrictive view of that term.

The first prong of the definition of "nominal" in Proposed Rule 710(b)(1)(i) permits a referral fee that does not exceed "the employee's base hourly rate of pay." The Release requests comment on whether this proposed alternative "might lead to some highly compensated bank employees being given a salesman's stake in the securities activities of the bank's customers."[34] We believe that it is not conceivable that it would. In fact, we view this definition as too narrow. It does not take into consideration the fact that the general trend in business is to increase the percentage of employees' total compensation that comes from bonuses, as opposed to base salary. Also, we believe that the proposition that compensation received by an employee for more than one hour of work may not be deemed "nominal" is so restrictive as to seem almost arbitrary. Why, for instance, should not the compensation received for two or three hours of work be deemed to be "nominal"? Two hours of work represent only

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33 Section 3(a)(4)(B)(i) of the Exchange Act.

34 69 Fed. Reg. 39,688 (2004).

1/20th of the normal work week and 1/1000th of the normal work year. We therefore believe that this limitation is set too low.

Because the SEC believes that guidance on what constitutes a “nominal” referral fee is necessary, we propose that banks at least be permitted to pay referral fees based on the following formula. An unregistered employee would be eligible to receive referral fees not greater than 1/1000th of the total compensation received by that employee for either the current year or for the prior year. For example, an employee who received $130,000 in total compensation for the previous year would be eligible to receive referral fees of $130.

Similarly, The Clearing House views the $25 limit in the second prong of the definition of “nominal” in Proposed Rule 710(b)(1)(ii) as inadequate. As mentioned above, Proposed Rule 710(b)(1)(i) allows the amount of a referral fee to be based on the referring employee’s hourly rate of pay. By thus permitting the value of a referral fee to vary while still qualifying as “nominal,” the SEC recognizes that what amounts to a “nominal” fee may depend on the compensation of the employee making the referral. By contrast, the flat $25 limit in Proposed Rule 710(b)(1)(ii) does not take this factor into consideration. Because this flat fee approach to defining “nominal” is easier to administer for banks, and may therefore be preferred by some institutions that favor administrative simplicity over flexibility, we believe that Proposed Rule 710(b)(1)(ii) should be revised to be available to banks paying referral fees to various types of bank employees, whether tellers or higher-level employees. Although the $25 limit may be appropriate for tellers, it is insufficient for other retail personnel, who are more highly compensated and who receive greater responsibility. We therefore request that Proposed Rule 710(b)(1)(ii) be revised to provide for a three-tier limit on this flat fee prong of the definition of “nominal one-time cash fee of a fixed dollar amount.” The limit for referrals made by tellers would remain $25; for referrals by other retail personnel the limit would be $50; and for referrals by non-retail personnel the limit would be $50, except that in the case of referrals by non-retail personnel of customers that either (i) are not natural persons or (ii) are natural persons who are "accredited investors" as defined in Regulation D under the Securities Act of 1933, the limit would be $100.[35]

Further, we take issue with the fact that Proposed Rule 710(b)(1)(ii) provides for a flat amount – $25 – that may qualify as "nominal" but does not provide for this amount to be inflation-adjusted, while Proposed Rule 710(b)(1)(iii) provides for a lower flat amount – $15 – that is periodically adjusted to take inflation into consideration. We do not agree with the SEC's view that a fee amount is "nominal" at any point in the future only if that amount could have thus been characterized that way when the GLBA was enacted,[36] nor do we agree with the SEC's estimate that a "nominal" fee amounted to no more than $15 at that time.[37] A flat fee approach to the definition of "nominal" cannot provide banks with significant relief if banks cannot adjust the permitted limit to reflect inflation. We therefore urge the SEC to provide that <u>any</u> flat amount that the final rules will deem "nominal" is to be inflation-adjusted.

b. Referral Fees Paid Other than in Cash (Proposed Rule 710(b)(3))

The Clearing House considers the definition of "nominal one-time cash fee of a fixed dollar amount" as applicable to a referral fee paid other than in cash not to be workable.

Proposed Rule 710(b)(3)(i) requires that such referral fees have a "readily ascertainable cash equivalent." According to the Release, this means that the "value or potential value [of the referral fee] must have been known by the bank and the employee at the time of the referral."[38] This is not, however, something that banks or their employees can accurately assess

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35 This proposed change is not a substitute for our prior proposal for a separate exemption for referrals of certain corporate, institutional, governmental and not-for-profit customers. See Section V.C. below. If that proposal is not addressed we would request that the $100 limit referred to above be increased.

36 69 Fed. Reg. 39,688-39,689 (2004).

37 <u>Id</u>.

38 <u>Id</u>. at 39,688.

at that time, because points systems plans contain too many conditions and variables. Maintaining this requirement would in effect prevent banks from paying their employees referral fees other than in cash. We therefore propose that Proposed Rule 710(b)(3)(i) be amended so that such fees may be paid "in units of value that can be assigned a value equivalent to a nominal cash value through a formula or other means after the payment period has passed."

Moreover, we take issue with the requirement in Proposed Rule 710(b)(3)(iii) that referral fees paid other than in cash be paid "under an incentive program that covers a broad range of products and that is designed primarily to reward activities unrelated to securities" (emphasis added). This requirement is too vague, creating potential legal uncertainty for banks as to whether they will be in compliance. We therefore believe that Proposed Rule 710(b)(3)(iii) should be amended so that referral fees paid other than in cash may be paid under an incentive program that "covers a broad range of products and that is not designed to evade the restrictions on paying referral fees."

We note that the Release requested comment on whether the conditions in Rule 710(b)(3) would be sufficient to ensure that unregistered bank employees are not given incentives to promote a broker-dealer's business by engaging in more than the limited activities permitted. We believe that even as amended to reflect our comments above, the conditions will be sufficient.

c. Definition of "One-Time" (Proposed Rule 710(b)(2))

As mentioned above, Section 3(a)(4)(B)(i)(VI) of the Exchange Act authorizes payment of a referral fee if the fee is a "nominal one-time cash fee of a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction" (emphasis added). It is clear that the statute was referring to a limit of one referral fee per referral, not a lifetime limit of one referral fee per customer. The Clearing House therefore disagrees with the SEC's interpretation of the term "one-time." Proposed Rule 710(b)(2) provides that a bank employee may receive a referral fee "no more than one time for each customer referred by that employee." The Release explains this requirement further by stating that "a bank could not pay a particular employee more than one referral fee based on multiple referrals of the same customer, and an unregistered bank employee who referred a customer more than once could receive only one fee related to that customer."[39]

Applying this "one-time" requirement on a per customer, rather than per referral, basis also creates administrative difficulties and legal uncertainty as to compliance. Banks would have to create records tracking the identity of customers referred and the employee to whom each referral fee is paid. Because payment of a referral fee may not be contingent on whether the referral results in the referred customer opening an account at the broker-dealer, these records would necessarily be distinct from records of the broker-dealer that keep track of accounts opened through referrals by bank employees. The administrative burden and cost would be enormous, and the effect of a mistake would be that the bank should have been registered as a broker-dealer with the SEC.

Moreover, the SEC is silent as to the way in which banks will have to monitor compliance with this added restriction. For instance, there is no indication in the Proposed Rules as to the length of time that the prohibition on payment of a referral fee to an employee for referral of the same customer would last. Consider the following hypothetical. An employee refers a customer to an affiliated broker-dealer. The customer meets with the broker-dealer but does not open an account. Two years later, the same customer's economic circumstances have changed, and the employee again refers the customer to the broker-dealer. In situations such as this one, we firmly believe that it is not inconsistent with the "one-time" requirement in the GLBA to allow a bank to pay a second referral fee to the bank employee.

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[39] Id. at 39,689.

2. Definition of "Contingent on Whether the Referral Results in a Transaction" (Proposed Rule 710(a))

The Clearing House considers the SEC's new definition of "contingent on whether the referral results in a transaction" an improvement especially insofar as Proposed Rule 710(a) provides a safe harbor for basing the payment of a referral fee on whether a customer contacts or keeps an appointment with a broker-dealer as a result of the referral and on whether the referred customer meets certain generally established requirements regarding assets, income or net worth that the bank or broker-dealer may have established for payment of referral fees.

The Release asks whether "banks should be able to condition the payment of referral fees on other criteria relating to other aspects of a customer's financial profile, such as tax bracket."[40] We see no reason why they should not. Proposed Rule 710(a)(2) allows a referral fee to be contingent on whether the referred customer has income that meets a predetermined threshold. Because an individual's tax bracket is based on that individual's income, we interpret Proposed Rule 710(a)(2) to permit banks to condition payment of a referral fee on such a criterion. For the same reasons, banks should be permitted to condition the payment of referral fees on other aspects of a customer's financial profile.

3. Clerical or ministerial activities

We are concerned by the Release's discussion of what activities constitute "clerical and ministerial." The SEC's suggestion that "clerical and ministerial" means those activities that do not require specific qualifications or licensing by an employee of a broker-dealer[41] ignores the fact that the Congress provided that "bank employees may forward customer funds or securities and may describe in general terms the types of investment vehicles available

40 Id. at 39,692.

41 Id.

from the bank and the broker or dealer under the [networking] arrangement." *See* Section 3(a)(4)(B)(i)(V) of the Exchange Act.

4. Supervisory Personnel

We also disagree with the Release's approach of treating compensation paid to supervisory personnel as a result of referrals by employees they supervise as impermissible incentive compensation.[42] This is not what the statute says, and we do not understand why banks should be restricted in rewarding supervisory personnel for motivating their employees to make referrals that are perfectly legal and are indeed authorized by the Exchange Act.

B. Networking: Bonus Plans

The Clearing House is particularly concerned about the discussion in the Release regarding bonus plans. This discussion appears to go well beyond the issue of referral fees without any basis in the GLBA for doing so.

The release accompanying the Interim Final Rules stated that "by their very nature [bonus plans] are incentive compensation" and then went on to state that unregistered bank employees may not "receive incentive compensation for any brokerage-related activity" other than permissible referral fees.[43] According to that release, only bonus plans based on the overall profitability of the bank were permitted.

The Release acknowledges that "commenters argued that only bonus plans used as a conduit to pay brokerage-related compensation to unregistered employees under the exception are prohibited."[44] To this suggestion, the SEC replied: "We do not agree. Any bonus or other incentive compensation that is payable based in part, directly or indirectly, on a referral

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[42] Id. at 39,691.

[43] 66 Fed. Reg. 27,760, 27,766 (2001).

[44] 69 Fed. Reg. 39,689-39,690 (2004).

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."[45] We note that the only change made by the SEC on this point since the release accompanying the Interim Final Rules is to allow bonuses that are based not only on the overall profitability of the bank, but on the overall profitability of the bank holding company as well.

Few, if any, bonus plans are based solely on the stand-alone profitability of a bank or of a bank holding company, although that is a component of many plans. The Rule results in the SEC's taking jurisdiction over bank and holding company bonus and other compensation plans, a matter that we believe is outside its jurisdiction. We believe that the legislative history of the GLBA demonstrates that Congress did not intend the term "incentive compensation" to apply to normal company-wide bonus plans or indeed to more narrowly focused bonus plans, such as bonus plans for individual divisions, units or teams, provided that such a plan is not an indirect conduit for paying impermissible referral fees to unregistered bank employees.[46]

Although we understand the SEC's concern that unregistered employees not be compensated more than once for the referral of a customer, we believe that the language in the Release on bonus plans could have far-reaching consequences that go well beyond the networking exception. For example, the discussion in the Release and in the release accompanying the Interim Final Rules goes so far as to raise the question whether the chief executive officer of a bank holding company that has a broker-dealer subsidiary could receive a bonus that is based in part on the revenues generated by the broker-dealer.

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45 Id. at 39,690.

46 Among the types of bonus plans that would appear to be prohibited would be plans based in part on performance of the employer's stock, year-to-year changes in financial measures, household profitability, assets under management, or other customer metrics based on the unit or team that do not reflect success of individual referrals.

The Clearing House urges the SEC to reconsider its position on bonus plans. Namely, we reiterate our view that the SEC should take the position that bank bonus programs are outside of its jurisdiction, except when used as an indirect conduit for the payment to bank employees of specific transaction-related referral fees not covered by the networking exception. We believe this gives effect to the statutory limitation on "incentive compensation" without unduly interfering with bank operations.

If, however, the SEC is not intending to single out bank bonus plans for special regulation but asserts the authority to regulate any bonus plan (whether of a bank, insurance company, diversified financial services company, or other company) when the bonus pool that funds such bonus plan includes revenues from a broker-dealer, then the appropriate method of addressing this issue is in a notice of proposed rulemaking that addresses all such companies, rather than in a release accompanying proposed rules that apply only to banks.

C. Referral of Certain Corporate, Institutional, Governmental and Not-For-Profit Customers: Proposal by The Clearing House for Non-Nominal Referral Fees

The Clearing House wishes to reiterate its proposal, made to the SEC's Division of Market Regulation by letter dated April 16, 2004, for an exemption that would allow banks to pay referral fees that are higher than would be permitted under the SEC's definition of "nominal," under circumstances different from those permitted by the SEC pursuant to the networking exception under the statute, to unregistered bank employees for the referral of certain corporate, institutional, governmental and not-for-profit customers. For your convenience, we have attached to this letter the term sheet relating to this proposal. We believe that it adequately addresses any concern that the SEC may have regarding the issue of investor protection.

VI. Custody – Order-Taking Exemption

The Clearing House agrees with the removal from the order-taking exemption of certain restrictions contained in the Interim Final Rules that banks considered inappropriate and unnecessary, such as the prohibition on use of dually licensed employees to effect transactions pursuant to the exemption; the requirement that a bank employee effecting transactions in reliance on the exemption primarily perform duties for the bank other than effecting transactions in securities; the prohibition on custody employees receiving compensation for the amount of securities-related assets gathered; and the prohibition on bank employees receiving payment of referral fees pursuant to the networking exception[47] if they engage in order taking on behalf of custody customers.

The Clearing House is concerned, however, that Proposed Rules 760 and 762 still unduly restrict the ability of banks to rely on the exception from the definition of "broker" contained in Section 3(a)(4)(b)(viii) of the Exchange Act by (a) limiting the scope of the order-taking exemption contained in Proposed Rule 760 to certain customers, (b) placing overly strict conditions on the receipt by banks of Rule 12b-1 fees in connection with order taking, (c) imposing unnecessary limitations on the solicitation of securities transactions and (d) creating a burdensome definition for the term "account for which the bank acts as custodian."

A. Scope of the Order-Taking Exemption - General (Proposed Rule 760(a))

At the outset we note our firm view that the Proposed Rules should not limit the availability of the custody order-taking exemption to "qualified investors"[48] and to preexisting customers.[49] The term "custody and safekeeping" has traditionally been understood to include order taking.[50] The Clearing House believes that the GLBA was not intended to and did not

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47 Section 3(a)(4)(B)(i) of the Exchange Act.

48 Section 3(a)(54) of the Exchange Act.

49 I.e. "a person with an account that was opened before July 30, 2004" under Proposed Rule 760(a).

50 "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).

change this aspect of custody and safekeeping and continues to permit custodial order taking. This is demonstrated by the statute's reference to IRAs and other retirement accounts[51] and its requirement that custody trades be executed through a registered broker-dealer.[52] Preventing bank custody departments from carrying out orders to purchase and sell securities for such customers as 401(k) plan participants, self-directed IRAs, registered investment advisers and charitable organizations negates this key aspect of banks' traditional custodial activities and is therefore contrary to the clear language, as well as the intent, of the GLBA.

Moreover, the SEC provides no justification for limiting the scope of the exemption in this manner, other than stating that it is "limit[ing] this exemption on a going-forward basis to 'qualified investors' because their custody accounts have not typically been used extensively for execution purposes."[53] Nor does the SEC explain why the Interim Final Rules did not limit the scope of the order-taking exemption to certain types of customers, but the Proposed Rules do.

In the Release, the SEC "solicits comment on limiting th[e order-taking] exemption to 'qualified investors' on a going-forward basis" and asks which additional entities should be covered by the order-taking exemption.[54] The Release further asks commenters to "include the special circumstances that apply to these entities and why these entities do not require the comprehensive protections of the federal securities laws."[55] We understand that the

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"In one type of agency the trust institution undertakes to look after the securities of the depositor deposited with it. Its duties, though important, are ministerial rather than discretionary in character. As to matters involving discretion it acts only on the orders of the customer. In such a case it is commonly said to be a custodian." Id. at § 8.1.

51 Section 3(a)(4)(B)(viii)(I)(ee) of the Exchange Act.

52 Section 3(a)(4)(C) of the Exchange Act.

53 69 Fed. Reg. 39,709 (2004).

54 Id.

55 Id.

SEC is concerned that banks may offer custodial arrangements as a surrogate for a brokerage account. Custodial accounts, however, serve many important functions for which brokerage accounts are not suitable. For example, customers may choose to open a custodial account because they desire the safety of having their assets held by a bank, because they desire a centralized location to hold and settle their assets irrespective of where transactions are executed, or because they 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. By limiting the scope of the order-taking exemption, the Proposed Rules will adversely affect customers. The effect of this limitation will be to require duplicative accounts (bank and brokerage) for new customers that do not meet the definition of "qualified investor" and to prevent customers from exercising their choice as to which type of account is best for them.

Furthermore, there is no indication that customers who have traditionally placed orders to purchase or sell securities through their bank's custody department have suffered any harm as a result. Banks do not offer custodial services as a way to solicit trading activity; banks in the custodial business merely follow instructions. No salesman commissions may be paid for trades, so there is no incentive to encourage trading activity. Custodial accounts may generate Rule 12b-1 fees, but these are paid on the basis of assets held in custody rather than per-transaction, and therefore create no incentive to encourage trading.

For the foregoing reasons we believe that Proposed Rule 760(a) should be amended to extend the scope of the order-taking exemption to all custody customers.

If the SEC nevertheless refuses to concede this general point, we believe that the Proposed Rules should <u>at least</u> be revised to broaden the scope of the custody order-taking exemption to permit taking orders from any account managed by a registered investment advisor; any account of an "accredited investor," as that term is defined Regulation D under the Securities Act of 1933; IRAs (as discussed below); and any account managed by an "accredited investor," as well as to permit taking orders for purchases or redemption of mutual fund securities for any other custody account that wishes to hold mutual fund securities.

Registered investment advisors frequently use banks to provide custody services for the assets of clients they manage and need to be able to use a bank to execute securities transactions. Not all the customers of a registered advisor may be "qualified investors," or even "accredited investors."

We believe that the financial conditions that an investor must meet to be deemed an "accredited investor" are sufficient safeguards to eliminate any concern that the SEC may have regarding investor protection.

Banks need to be able to take orders for all custody customers who own mutual funds. Because mutual fund shares in the United States are typically uncertificated and not held in a central depositary, for a bank actually to hold mutual fund shares in its possession as custodian on behalf of a customer, the bank or its nominee must be registered as the owner of those shares on the mutual fund's books and records, which are maintained by the fund's transfer agent. When a bank does this as a custodian, the bank is a "securities intermediary" for its customer because the mutual fund shares are held in a "securities account" on the bank's books with the customer as the "entitlement holder." Customers that use a bank custodian to hold mutual fund shares must therefore go through the bank as their securities intermediary to purchase new shares or redeem owned shares. Interposing a broker-dealer will only create confusion, because all the broker could do is pass the order back to the bank.[56]

[56] See UCC §§ 8-102(a)(15) and 8-103(b) (definition of security and application to investment company securities); §§ 8-102(a)(7) and (14) (definitions of entitlement holder and securities intermediary); § 8-501(a) (definition of securities account); and § 8-507 (duties of securities intermediary to comply with entitlement order).

B. Custodial IRAs

Banks provided custodial IRA services, including order-taking, long before brokerage firms entered this business. Indeed, under §408(a)(2) of the Internal Revenue Code of 1986, as amended (the "IRC"), *only* banks are able to serve as IRA trustees and custodians without specific approval of the Treasury Secretary:

> "The trustee is a bank (as defined in Subsection (n)) or such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section."

Further, Subsection 408(h) provides:

> "For purposes of this section, a custodial account shall be treated as a trust if the assets of such account are held by a bank (as defined in subsection (n)) or another person who demonstrates, to the satisfaction of the Secretary, that the manner in which he will administer the account will be consistent with the requirements of this section, and if the custodial account would, except for the fact that it is not a trust, constitute an individual retirement account described in subsection (a) . For purposes of this title, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof."

In the 30 years since IRAs were first authorized under the IRC, banks have serviced custodial IRAs, including order-taking, without harm to custodial account holders.

The IRS model forms for trust and custody IRAs, 5305 and 5305-A, respectively, make no distinction between the duties of an IRA trustee and an IRA custodian. In fact, both forms are completely silent as to the duties of the trustee or custodian other than with respect to information filing requirements. Further, the IRS trust and custody forms are word-for-word identical, except that the trust document refers to "trustee" and "grantor" and the custody document refers to "custodian" and "depositor." We appreciate that the SEC has given up its attempt to define what constitutes a "trust" relationship in the Proposed Rules. Nonetheless the

SEC's position that a bank IRA trustee can take orders from the account holder under the trust and fiduciary exception but a bank IRA custodian cannot under the custody exception has no basis in the legal documentation that establishes these accounts and elevates form over substance.

Health savings accounts and Coverdell Education Savings Accounts are governed by the same bank trustee and custodial rules as IRAs under IRC 408(n).[57] Also, in August 2004 the IRS released model trust (Form 5305-B) and custodial (Form 5305-C) forms for health savings accounts that are similar to the model trust and custodial forms it provided for IRAs (except, of course, with respect to technical administrative differences due to the type of account involved). Likewise, IRS model trust (Form 5305-E) and custodial (Form 5305-EA) forms are available for Coverdell Education Savings Accounts. Therefore, the SEC should acknowledge in this rule that these accounts and any similar accounts will be regulated in the same manner as IRAs.

For the same reasons, the custody order-taking exemption should also cover all custodial accounts established under arrangements described in Sections 403(b)(7) and 408 of the IRC, including SEP-IRA and SIMPLE-IRA plans.

C. Bank Compensation (Proposed Rule 760(a)(1) and (8))

1. *Rule 12b-1 Fees and Other Shareholder Servicing Fees*

Unlike the Interim Final Rules, the Proposed Rules recognize the need for bank custody departments to continue to receive Rule 12b-1 fees from mutual funds the shares of which they have purchased for custody accounts. The Release correctly acknowledges that this

[57] IRS Notice 2004-2, Q&A 9 and IRC Section 530(g), respectively.

is something banks need "to avoid any unnecessary disruption"[58] of the order-taking function performed by bank custody departments.

Under Proposed Rule 760(a)(8), however, a bank can only receive such fees from a mutual fund if it accepts orders to effect transactions "on the same terms for any class or series of securities" of such mutual fund "that can reasonably be obtained by the bank for purchase or sale by bank customers." The Release explains that "this condition is designed to ensure that investors have a full range of choices available when they consider whether to pay custody costs directly or to offset some of these custody costs with Rule 12b-1 fees."

We are concerned that this requirement might suggest that banks have an obligation to recommend that a custody customer consider the purchase or redemption of a class or series of securities other than what the customer orders. We seek confirmation that the Proposed Rule does not contain any such requirement, and we request that the SEC clarify that this condition does not require a bank to promote or recommend any class or series of securities of a mutual fund.

The Release requests comment "regarding whether [the SEC] should adopt disclosure requirements similar to the proposed general disclosure requirements" in Proposed Rule 776 in connection with the receipt by banks of Rule 12b-1 fees under the bank custody order-taking exemption. As explained above, we view order taking by bank custody departments as a traditional banking activity. Accordingly, the principle of functional regulation mandates, in our view, that any such concern be addressed by the banking regulators, not by the SEC.

2. Revenue Sharing

In the Release, the SEC states that it will not allow "banks to be compensated for accepting securities orders through revenue sharing"[59] because such arrangements create

[58] 69 Fed. Reg. 39,710 (2004).

conflicts of interest and "are not generally disclosed to investors."[60] The Clearing House proposes that rather than simply banning revenue sharing the SEC address this concern by revising the Proposed Rules so that banks acting as custodians may continue to be compensated through revenue sharing arrangements so long as such arrangements are disclosed to customers, which is the way that the SEC has handled this issue in Proposed Rule 776.

D. Solicitation of Securities Transactions

As the SEC acknowledges in the Release, the Proposed Rules are "tighten[ing] the solicitation conditions"[61] relating to the general bank custody order-taking exemption. One notable aspect of these restrictions is that a bank would not be permitted "to solicit through another bank department securities activities in its custody department."[62]

According to the Release, the SEC "specifically invite[s] comment on whether these restrictions are too lax or too strict." The Clearing House firmly believes that they are too strict.

As noted above, we understand that the SEC is concerned that banks may offer custodial arrangements as a surrogate for a brokerage account. For this reason, we understand restrictions on a bank custody department's ability to solicit order taking, provided that those restrictions do not apply to solicitation of the purchase or redemption of shares of money market mutual funds as permitted by the sweep exception. Bank custody department customers need to be able to invest their excess cash in such funds, and we do not believe that permitting such solicitation should raise any investor protection issues.

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59 Id.

60 Id.

61 Id.

62 Id.

Given the SEC's broad views regarding what constitutes solicitation, we are also concerned about the restrictions on solicitation by other departments of the banks, which we regard as unnecessary and burdensome. For example, bank trust departments should be allowed to continue their normal marketing of their fiduciary services, including to custody customers. If a custody customer decides to purchase a security recommended by the trust department through the custody department, that fact should not cause the bank's custody order taking to make it an unregistered broker-dealer.

The restrictions on the ability of other bank departments to market their activities contained in this exemption raise serious questions for The Clearing House banks as to whether the exemption provides any practical benefit at all.

E. Restriction on Employee Benefit Plan Accounts

We believe that the custody order-taking exemption should be available for employee benefit plan accounts.

F. Definition of "Account for Which the Bank Acts as a Custodian" (Proposed Rule 762(a))

In contrast to the Interim Final Rules, the SEC is now proposing to define the term "account for which the bank acts as a custodian." Pursuant to this new definition as set out in Proposed Rule 762(a), a custody account would have to be established "by 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 various tasks performed by a bank acting as a custodian.

The Clearing House believes that this definition will require many banks to re-document their custody relationships with customers. We view the establishment of such a new obligation as contrary to the principle of functional regulation. Moreover, it would impose a new "account-by-account" requirement in the custody context, because a bank would have to review every custody account to ensure compliance. No explanation, moreover, is given for requiring banks to comply with this new provision other than the statement that the SEC "based this definition on [its] understanding of what custodians do."[63]

Considering that this will add further complication to the implementation by banks of the Proposed Rules and in the apparent absence of any investor protection need, we see no reason for this new definition and urge that Proposed Rule 762(a) be eliminated.

G. Definition of "Carrying Broker"

The Release solicits "comment on whether the SEC should adopt a rule setting forth specific factors to clarify the distinction between a bank acting as a carrying broker and a bank acting as a custodian."[64] The Clearing House does not believe that further elaboration on this issue is needed.

VII. Sweep Accounts

A. Restriction on Sweeps (Proposed Rule 740(c)(1))

Section 3(a)(4)(B)(v) of the Exchange Act permits banks to sweep deposit funds into "no-load" money market mutual funds. The Clearing House takes note of the fact that the Proposed Rules have maintained the approach taken in the Interim Final Rules in respect of the definition of "no-load." Under Proposed Rule 740(c)(1), a mutual fund satisfies this "no-load" requirement only if its charges for sales promotion expense and personal service or the maintenance of shareholder accounts do not exceed 25 basis points of average net assets.

Regardless of how the statutory term "no-load" is interpreted, however, it is clear that requiring banks to change their current practices with respect to sweep accounts goes against

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63 Id. at 39,711.

64 Id. at 39,713.

the intent of the GLBA, as demonstrated by its legislative history. The House Report on the GLBA states that the sweep exception "has the effect of permitting banks to continue investing depositors' funds into no-load money market funds."[65] Both Senator Gramm and Representative Leach, the Chairmen of the Senate and House Banking Committees, have also indicated in letters to the SEC that they did not intend this provision to change current practice.

The Release makes clear that a bank could charge a sweep fee directly to its customers and continue to rely on the "no-load" exemption. (The restriction would apply only if fees imbedded in a mutual fund exceed 25 basis points.) If a higher total fee is permissible when a portion of it is charged directly by a bank, we see no reason whatsoever why the same total fee could not be charged entirely against fund assets. Charging sweep fees at the account level instead of the mutual fund level would be administratively burdensome and would increase banks' costs of providing the sweep service. Those higher costs would have to be passed on to customers.

For the foregoing reasons, if the SEC is unwilling to revise the Proposed Rules' definition of "no-load," we urge the SEC to adopt an exemption whereby banks will be exempt from the definition of "broker" to the extent that they sweep funds into money market mutual funds without a front end or deferred sales charge (whether or not they meet the definition of "no-load" that the SEC is proposing).

We also note that the Release is soliciting comment on "whether rate spread or retained yield fees should be counted as sales charges in determining whether money market funds in a sweep account program involving such fees should be considered 'no-load' for purposes of the [sweeps] exception."[66] Given that the SEC has accepted that a bank may charge

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65 H.R. Rep. No. 106-74, pt. 3, p. 167 (emphasis added).

66 69 Fed. Reg. 39,706 (2004).

its customers a direct fee for sweeping deposit funds, and that these are fees that a bank charges its customers directly, we believe that they should clearly not be restricted.

B. Definition of "Program"

Under Section 3(a)(4)(B)(v) of the Exchange Act banks are allowed to effect transactions in money market mutual funds "as part of a program for the investment or reinvestment of deposit funds." Referring to the legislative history of the GLBA, the Release interprets the term "program" to limit the availability of the exception to "regular, automatic sweeps"[67] and to prohibit a bank from effecting sweep transactions for a customer of another bank.[68] The Release requests comment on this interpretation and "on whether the term program should be defined by a rule."[69]

We do not believe that a rule to define the term "program" is necessary. More important, we disagree with the SEC's interpretation of this term. The SEC's interpretation would preclude a customer from actively managing its participation in sweep programs, and thus would harm, rather than protect, bank customers. We see no public policy purpose for a rule that restricts bank customers in this way. The narrowness of the sweep exception makes it unnecessary to add additional non-statutory restrictions on bank sweep activities.

We also do not understand why the SEC takes the position a bank may not rely on the sweep exception to effect money market mutual fund transactions for another bank using deposits held at the other bank.[70] For many small banks the only cost-effective way to offer a sweep product is to outsource it to a larger bank. The SEC's position basically makes this impossible.

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[67] Id.

[68] Id.

[69] Id.

VIII. General Purpose Exemption for Investment In Money Market Funds (Proposed Rule 776)

The Clearing House supports the SEC's Proposed Rule 776 whereby a bank will be exempt from the definition of "broker" when it effects transactions in money market mutual funds under certain circumstances. As the Release notes, this exemption will be particularly helpful in "provid[ing] banks with greater flexibility to provide cash management services to their customers."[71]

To further this purpose while respecting the SEC's concern for investor protection, we propose that the scope of this exemption be broadened in two manners. First, we recommend that Proposed Rule 776(a) be revised to add short-term bond funds and short-term U.S. Treasury funds to the securities in which a bank may effect transactions pursuant to this general purpose exemption, for the same reasons that are outlined in Section II.A.6. above. Second, we recommend that the scope of Proposed Rule 776(a)(1)(i) be expanded from "qualified investors" to "accredited investors," as that term is defined Regulation D under the Securities Act of 1933. This would enable banks to use the exemption for a wider range of investors. We believe that the financial conditions that an investor must meet to be deemed an "accredited investor," coupled with the limited types of securities that could be purchased or sold pursuant to the exemption, are sufficient safeguards to eliminate any concern that the SEC may have regarding investor protection.

Moreover, we note the restriction in Proposed Rule 776(a)(1)(i) whereby a bank may purchase or redeem shares of a money market mutual fund only on behalf of a customer that "has obtained from the bank a financial product or service not involving securities." Although we do not interpret this provision as prohibiting banks from relying on this exemption to

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[70] Id.

[71] Id. at 39,716.

purchase or redeem shares of no-load money market mutual funds on behalf of custody customers, we nevertheless request that the SEC clarify this issue.

Finally, we urge that the SEC clarify the condition in subsection (a)(2)(ii)(B) that requires disclosure of "any payments the bank may receive in connection with the transactions from the complex to which the issuer of the securities belongs." This provision should be revised to make it clear that it does not require banks to disclose transfer agency fees, fees for servicing as administrator, and other fees a bank may earn as a service provider to a fund.

IX. Employee Benefit Plan Exemption

The Release recognizes that banks need to be allowed to effect securities transactions on behalf of employee benefit plans. As noted above, we believe that no regulatory exemption is required for them to do so. We are concerned with the burdensome and unnecessary conditions with which a bank must comply under Proposed Rule 770.

Proposed Rule 770(a)(1) requires a bank that purchases or redeems mutual fund shares for the account of an employee benefit plan to "offset or credit any compensation that it receives from a fund complex related to securities in which plan assets are invested against fees and expenses that the plan owes the bank." The SEC correctly points out that this approach is consistent with <u>one</u> of the Advisory Opinions of the Department of Labor (the "DOL") – the "Frost Letter" [72] – concerning receipt of Rule 12b-1 fees by banks acting as investment fiduciaries of employee benefit plans.[73] The Release also refers to a subsequent DOL Advisory Opinion – the "Aetna Letter"[74] – in which the DOL allowed an administrator of employee benefit plans that is not an investment fiduciary <u>not</u> to offset fees received from mutual funds pursuant to Rule 12b-1 against fees charged to employee benefit plans.

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72 ERISA Advisory Opinion 97-15A (the "Frost Letter").

73 69 Fed. Reg. 39,718 (2004).

To justify conforming the requirements of the employee benefit plan exemption to the Frost Letter as opposed to the Aetna Letter, the SEC states that "[b]anks advised the [SEC] staff that they do a dollar-for-dollar offset, or credit, of the compensation they receive from the funds that they offer to plans against the fees imposed on the plans themselves."[75] In rejecting the approach taken in the Aetna Letter, the Release states that "no bank has advised the [SEC] staff that it does not apply mutual fund fees for the benefit of the plans."[76]

The SEC is in error in believing that banks offset Rule 12b-1 fees against expenses charged to employee benefit plans. On the contrary, most banks <u>do</u> <u>not</u> offset Rule 12b-1 fees in this manner. We note that compliance with either of the previously mentioned DOL Advisory Opinions requires banks to adjust their operations to certain essential factors in these Opinions. In fact, subsequent to the issuance of the Frost Letter and the Aetna Letter, the DOL has issued the "ABN-AMRO Letter,"[77] which further explained the circumstances under which dollar-for-dollar offsets are not required. Institutional trustees have since carefully designed their participant-directed plan products to come within the factual settings of the Aetna Letter and the ABN-AMRO Letter, rather than the Frost Letter, precisely because they do not offset Rule 12b-1 fees.

In any event, The Clearing House believes that the SEC should not be deciding which of the approaches taken by the DOL is best. Indeed, the DOL is the primary regulator of fiduciary responsibility and prohibited transactions under ERISA and has made this responsibility one of its highest priorities. We believe that the SEC should not restate the DOL's interpretation of the fiduciary responsibility and prohibited transaction rules, thereby potentially creating an additional overlay of requirements for banks.

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[74] ERISA Advisory Opinion 97-16A (the "Aetna Letter").

[75] 69 Fed. Reg. 39718 (2004).

[76] <u>Id</u>.

Rather, The Clearing House believes that the SEC should defer to the DOL's guidance on these matters and revise Proposed Rule 770 accordingly. This could be done by providing that banks that render services to employee benefit plans subject to ERISA or to employee benefit plans concerning which the IRS has ceded authority to the DOL (which would include prohibited transactions related to IRAs) would not be considered "brokers" under the Exchange Act to the extent that the bank acts in accordance with ERISA, as interpreted by the DOL. This approach would incorporate the requirements of the Frost Letter, the Aetna Letter and the ABN-AMRO Letter, as well as future guidance the DOL may issue. In addition, this proposal would subject trust and custodial IRAs (and trust and custodial health savings accounts and Coverdell Education Savings Accounts as well as any successors to these accounts) to the same rules as employee benefit plans for which a bank serves as trustee or custodian.

We are also concerned with the fact that the scope of the exemption does not cover all types of employee benefit plans. Plans not covered by the exemption include governmental plans under Section 414 of the IRC, nonqualified deferred compensation arrangements funded by "rabbi" or "secular" trusts, voluntary employee benefit associations (VEBAs), supplemental unemployment benefit plans (SUB plans) and plans or accounts established under Sections 403(a) or 408 of the IRC. We note that these plans are generally administered in the same department of the bank as the plans listed in Proposed Rule 770(a) and that those plans not subject to ERISA, such as government plans, are generally subject to ERISA-like fiduciary responsibilities by applicable state and local law or by contract. We therefore see no reason why they should not be included in the scope of the proposed exemption and we suggest that Proposed Rule 770(a) be revised to include these plans.

Furthermore, we take issue with Proposed Rule 770(a)(2)'s fee disclosure requirements. ERISA, as interpreted by the DOL, already governs disclosure to plan fiduciaries regarding fees and expenses and regarding compensation received from mutual funds. We see a

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[77] ERISA Advisory Opinion 2003-09A (the "ABN-AMRO Letter").

potential for conflict between the disclosure requirements imposed by the DOL and those set forth in Proposed Rule 770, and we believe that it is not necessary for the Proposed Rules to address disclosure issues. Instead, our view is that the SEC should defer to the DOL's guidance on disclosure and that Proposed Rule 770 should be revised accordingly.

Moreover, we view the definition of "participant-directed brokerage account" in Proposed Rule 770(b)(3) as burdensome. The SEC is not correct in believing that accounts are always opened in the participant's name at a broker-dealer. Although orders from participants are typically executed by a broker-dealer, they are typically placed through a bank's omnibus account at the broker-dealer. Requiring that "each participant that receives any brokerage services is fully disclosed to the broker or dealer" prohibits this practice. This prohibition will generate administrative complexity and increase costs for customers, while providing them with no corresponding benefit. It should therefore not be a condition to the exemption.

X. Exemption for Transactions in Securities Issued Pursuant to Regulation S (Proposed Rule 771)

The Clearing House supports the new exemption contained in Proposed Rule 771 pursuant to which banks may continue to sell Regulation S securities to non-U.S. persons under certain circumstances. We believe, as the Release acknowledges, that this exemption is necessary to keep domestic banks from being at a competitive disadvantage with foreign banks with respect to transactions in Regulation S securities.

We view the definition of "eligible security" contained in Proposed Rule 771(b)(2), however, as overly restrictive. We understand that the SEC has a concern with the potential for conflicts of interests in transactions involving affiliates of the bank. Nevertheless, we believe that so long as the bank offers securities on an agency or riskless principal basis, the restrictions on transactions involving affiliates should not apply if the affiliate is a U.S.-registered broker-dealer. In such a situation, since the affiliate's dealings with the bank would effectively be subject to both the U.S. securities laws and to SEC regulation, the potential for conflict of interest would in our view be adequately controlled.

XI. Exemption for Transactions in Investment Company Securities (Proposed Rules 775)

Section 3(a)(4)(C) of the Exchange Act requires that banks relying upon the trust and fiduciary activities, stock purchase plan, and safekeeping and custody exceptions adopted by the GLBA effect trades pursuant to those exceptions in “any security that is a publicly traded security in the United States” through a registered broker-dealer (unless one of certain exceptions applies). In the Interim Final Rules the SEC took the position that trades in securities of “mutual funds” were subject to this requirement, but adopted an exemptive rule allowing a bank to effect trades in such securities through the National Securities Clearing Corporation’s Mutual Fund Services.

As discussed below, we have concerns about Proposed Rule 775, which is the revised version of the Interim Final Rule. We believe, however, that the Rule is unnecessary and should be withdrawn.

The statutory requirement to execute through a broker-dealer applies only to securities that are “publicly traded” in the United States. We believe that the statutory purpose of this requirement was to ensure that secondary-market transactions in securities are handled by experienced market participants who can seek best execution on behalf of investors.

Shares of mutual funds are not traded, publicly or otherwise. Mutual fund shares are not listed on securities exchanges, nor do any broker-dealers make markets in them. Thus there is no organized trading market. The only exception, exchange-traded funds, proves the point. Because such funds are traded, there is at least an arguable purpose served in requiring execution through a registered broker-dealer. By contrast, purchases by investors of a mutual fund’s shares are satisfied by the issuance of new shares by the fund. Shares are not ordinarily sold by investors, but instead are redeemed by the fund. Purchases and redemptions are effected at a fund's net asset value next determined after an order is received, with any sales charge specified in the fund's prospectus added or (in the case of a redemption) subtracted.

A mutual fund's net asset value is published daily. Because of this transparency of pricing there is no need to interpose a broker-dealer in the purchase and redemption process. The quality of execution would not be improved, and the price paid or received by investors would not change.

Moreover, we note that interpreting the term "publicly traded" to apply to shares of mutual funds is inconsistent with the way in which that term is used elsewhere in the Exchange Act. In fact, as the Release recognizes, the Release's definition of "publicly traded security" is contrary to the definition of the term "publicly traded security" in Section 13(h)(8)(B) of the Exchange Act, which provides:

> "The term 'publicly traded security' means any equity security (including an option on individual equity securities, and an option on a group or index of such securities) listed, or admitted to unlisted trading privileges, on a national securities exchange, or quoted in an automated interdealer quotation system."

We do not understand why the term "publicly traded security" should be interpreted in a different way here.

We therefore believe that the SEC should withdraw Rule 775 and clarify that shares of mutual funds are not "publicly traded."

If the SEC does not accept this view, however, it needs to amend Proposed Rule 775. Proposed Rule 775(2)(i) restricts its availability to transactions for which the fund's transfer agent does not accept compensation paid for the distribution of the securities, such as revenue sharing or Rule 12b-1 fees. Banks will not be in a position to know whether a fund's transfer agent receives compensation for the distribution of securities and will thus not be able to monitor compliance with this prohibition. Even if banks were to seek and obtain representations on these matters from transfer agents (which we do not believe should be banks' responsibility), the effect of the Proposed Rule is that a misrepresentation by the transfer agent would cause the bank to become a broker-dealer that should have been registered as such with the SEC. We believe that this is completely unreasonable.

XII. Dual Employees

Note 289 to the release accompanying the Interim Final Rules suggested that the SEC expects the NASD to use NASD Rule 3040 to cause bank-affiliated broker-dealers to become involved in overseeing, and keeping records regarding, the bank activities of registered personnel of broker-dealers, and in doing so for the NASD to become involved in overseeing such activities. This contradicts the theory of functional regulation that is fundamental to the GLBA, *i.e.*, that bank activities should be regulated by the banking regulators. It also requires unnecessary duplication of supervision and record-keeping between banks and broker-dealers because broker-dealers are required to approve and record transactions that are properly processed by bank systems. Of particular concern are dual employee arrangements involving bank fiduciary employees, where the effect of Rule 3040, among other things, would be to require that transactions be recorded on incompatible systems (the broker-dealer's system and the bank's trust system). There is simply no practical way to comply with Rule 3040 in the manner that the SEC is interpreting the Rule when such dual employee arrangements exist.

The intent of Rule 3040 was not to cause the NASD to examine the activities of banks. Rather, by requiring prior notice of "private securities transactions" by registered personnel, Rule 3040 seeks to prevent registered personnel from conducting unlawful unregulated activity "off the books." The prospect of regulation by the NASD will be a disincentive to banks to cause their employees to become registered with a broker-dealer. This is contrary to the clear intent of the GLBA.

To address this concern, The Clearing House requests the cooperation of the SEC in obtaining an amendment to NASD Rule 3040. The amendment should (a) allow a securities firm to give blanket consent to its employees to be dual employees with the bank[78] and (b) provide that bank activities may be supervised only by managers in the bank, subject to the broker-dealer's being informed if the employee engages in securities fraud in the bank.

We understand that the SEC staff believes that the issues raised by NASD Rule 3040 should be resolved after completion of final SEC rules implementing Title II of the GLBA. We strongly disagree. The effect of many provisions of the Proposed Rules would be to require more bank employees to become associated persons of a broker-dealer, potentially dramatically increasing the scope of the above-described Rule 3040 problems. Banks should not be asked to give final answers on the effect of the Proposed Rules on their business activities when they do not know whether or how Rule 3040 will be amended.

* * *

The Clearing House would be pleased to discuss any of the points made herein in more detail. If you have any questions, please contact Norman R. Nelson, General Counsel, at (212) 612-9205.

Sincerely yours,

78 Such a blanket consent should also be available to satisfy the notice requirements applicable to outside business activities of registered personnel in NASD Rule 3030 to the extent that such activities are subject to the regulation of a federal banking agency.

Attachment

April 16, 2004

Via Federal Express

Ms. Catherine McGuire
Chief Counsel, Division of Market Regulation
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549-1001

Re: Proposal for Bank Exemption for Referral Fees in the Corporate, Governmental, Not-For-Profit and Institutional Settings

Dear Ms. McGuire:

Following up on the meeting with you and your staff on January 12, 2004, I am enclosing a term sheet relating to a proposal for an exemption from the definitions of "broker" and "dealer" in the Securities Exchange Act of 1934 that would allow the payment of referral fees to unregistered bank employees for referring corporate, governmental, not-for-profit and institutional customers to affiliated broker-dealers.

We hope that the final rules implementing the statutory networking exception will contain an appropriately higher limit for referral fees for referrals of "accredited investors" who are not natural persons by bank employees other than tellers. If that fails to occur, the industry may wish to amend this proposal to address that issue.

We would be delighted to meet with you and your staff to discuss this proposal further. Please call Donald Toumey at Sullivan & Cromwell (212-558-4077) or me with any questions related to this proposal.

Very truly yours,

Norman R. Nelson

NRN: kp
Enclosure
cc: Donald J. Toumey
Lourdes Gonzalez

TERM SHEET FOR PROPOSED EXEMPTION FOR CORPORATE/INSTITUTIONAL REFERRAL FEES

I. Background

After effectiveness of the Gramm-Leach-Bliley Act, bank employees will not be able to receive success-driven compensation[1] (a “Referral Fee”) for the referral of customers that engage in securities transactions to a broker-dealer unless they are registered representatives or principals of a registered broker-dealer. The proposed exemption would enable unregistered bank employees to receive Referral Fees for the referral of corporate, governmental, not-for-profit and institutional customers that engage in securities transactions without having to be so registered and without the bank itself having to register as a broker-dealer.

II. Conditions to Proposed Exemption

A. Amount of Referral Fee

1. All Referral Fees received by all unregistered bank employees in respect of any specific securities transaction resulting from a referral may not exceed 15% of the revenues earned (or projected to be earned) by the broker-dealer from the transaction.

2. Referral Fees paid to an unregistered bank employee may not exceed $25,000 for each referral.

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[1] Success-driven compensation refers to an award that is for more than a nominal amount and that is contingent on such factors as whether the referral results in a transaction.

3. Total amount of Referral Fees received by an unregistered bank employee in respect of a calendar (or fiscal) year may not exceed 25% of the greater of such employee's total base and incentive compensation in respect of (a) that calendar (or fiscal) year or (b) the prior calendar (or fiscal) year.

B. Requirements regarding/restrictions on conduct of unregistered bank employees who receive a Referral Fee

1. General Principle

    a. Unregistered bank employees who receive Referral Fees for referring customers that engage in securities transactions would be required to limit their activities so that none of their activities other than the making of the referral and the receipt of the Referral Fee would otherwise cause the bank or the employee to be required to register as a broker or dealer.

2. Specific restrictions for all types of transactions

    a. Such unregistered bank employees must be predominantly engaged in banking activities.

    b. Unregistered bank employees could advise customers of the availability of the broker-dealer's services and of its capabilities generally (including by informing customers of the broker-dealer's ability to execute specific types of transactions), such as by referring orally to prior transactions handled by the broker-dealer or by providing customers with materials approved by the broker-dealer listing such prior transactions, but could not participate in the negotiation of the terms of, or the execution of, any securities transaction (other than participation by bank employees in the execution of securities transactions to the extent permitted under Exchange Act Section 3(a)(4)(B) or 3(a)(5)(C)). Except as permitted under such exceptions, the activities of unregistered bank employees will be restricted as follows:

i. Unregistered bank employees will refer all securities-related questions to registered representatives of the broker-dealer. See Chubb (Publicly Available Nov. 24, 1993).

ii. All telephone inquiries related to the broker-dealer will be answered solely by registered representatives of the broker-dealer. See Chubb (Publicly Available Nov. 24, 1993).

c. Unregistered bank employees receiving Referral Fees would not be permitted to participate in any advertisement, endorsement or general solicitation regarding any securities offered to referred customers. See Paul Anka (Publicly Available Jul. 24, 1991).

d. A broker-dealer paying Referral Fees to, or for the benefit of, unregistered bank employees who have referred customers that engage in securities transactions would have a duty not to involve such unregistered bank employees in the negotiation or the execution of securities transactions (other than participation by bank employees in the execution of securities transactions to the extent permitted under Exchange Act Section 3(a)(4)(B) or 3(a)(5)(C)).

3. Specific restrictions on payment of Referral Fees in respect of brokerage services (i.e., execution-only services and full service brokerage):

    a. Notwithstanding that unregistered bank employees are authorized to make recommendations regarding purchases or sales of securities without being required to register as brokers, dealers or investment advisors, an unregistered bank employee who makes a recommendation to purchase or sell specific securities to a customer and refers such customer to a broker-dealer for brokerage services could not receive a Referral Fee in respect of any brokerage services the broker-dealer provides to such customer.

C. Restrictions on size of corporate/institutional customer being referred

1. Brokerage services (i.e., execution-only services and full service brokerage)

    a. No Referral Fee may be received by unregistered bank employees in respect of such transactions unless the corporation/institution being referred is a "qualified investor" as defined by Exchange Act Section 3(a)(54)(A).

D. Restriction on who may be referred by an unregistered bank employee

1. The unregistered bank employee could only refer customers encountered in the ordinary course of the employee's banking business.

2. Unregistered bank employees could not call on customers solely for the purpose of making them aware of the products and services of the broker-dealer.

E. Requirements regarding/restrictions on who may decide about and who may pay Referral Fees:

1. The amount of any Referral Fee in respect of securities transactions by a customer referred to a broker-dealer must be determined by the broker-dealer itself, although the bank or its affiliate may pay the Referral Fee provided that it is clear that such payments are made on behalf of the broker-dealer from funds allocated by the broker-dealer for payment of Referral Fees, see Chubb (Publicly Available Nov. 24, 1993) (condition to payments made to registered employees); provided that the bank may decline to pay Referral Fees to unregistered bank employees if in the bank's judgment it would not be appropriate to pay such Referral Fees.

2. The bank must make available to the broker-dealer information sufficient to demonstrate compliance with the limits set forth in II.A.

F. Certain restrictions pertaining to Referral Fee programs generally

1. Referral Fees in respect of securities transactions by a customer referred to a broker-dealer would have to be governed by a contractual or other written arrangement between the broker-dealer and the bank. See Exchange Act Section 3(a)(4)(B)(i).

2. The broker-dealer would have to be clearly identified as performing the broker-dealer services. See Exchange Act Section 3(a)(4)(B)(i)(I).

3. Any materials used by the bank to advertise or promote the availability of the broker-dealer's services would have to clearly indicate that those services are being provided by the broker-dealer

and not the bank and such materials would have to be in compliance with the federal securities laws prior to distribution. See Exchange Act Sections 3(a)(4)(B)(i)(III) and (IV).

4. Broker-dealer services would have to be provided by the broker-dealer on a basis on which all customers that receive such services are fully disclosed to the broker-dealer. See Exchange Act Section 3(a)(4)(B)(i)(VII).

5. The bank may not carry a securities account for a customer except as permitted under the trust or custody exceptions. See Exchange Act Section 3(a)(4)(B)(i)(VIII).

6. Referral Fees could only be paid in respect of securities transactions by customers referred to affiliated broker-dealers.

G. Bank employees who may not receive Referral Fees

1. Unregistered bank employees subject to a "statutory disqualification" preventing them from being registered could not receive such Referral Fees. See Exchange Act Section 3(a)(39).

III. Public Interest and the Protection of Investors

1. Public interest

a. In adopting the Gramm-Leach-Bliley Act, Congress recognized the economic efficiency that results from allowing banks, broker-dealers, and other financial services companies to combine under a single holding company. Restricting an organization's ability to pay Referral Fees in the circumstances addressed would prevent one of the very efficiencies in the provision of financial services that the GLB Act sought to achieve.

2. The protection of investors

    a. The conditions set forth above impose strict limits on the circumstances under which Referral Fees would be permitted and are sufficient to protect investors.

    b. The exemption will only be available to banks, which are regulated entities that are subject to examination by banking regulators, further enhancing the protection of investors.

    c. Any actual non-exempt securities transactions will be executed by a registered broker-dealer.

IV. Compliance with NASD/NYSE Rules

[To be discussed.]