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By US Mail

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

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

Dear Mr. Katz:

Thank you for this opportunity to comment on proposed Regulation B, which was issued by the Securities and Exchange Commission (the "Commission") on June 17, 2004.[1] Proposed Regulation B relates to amendments to section 3(a)(4) of the Securities and Exchange Act of 1934 (the "Exchange Act") made by the Gramm-Leach-Bliley Act of 1999 (the "GLBA"), which replaced a blanket exemption for banks from the Exchange Act definition of "broker" with a series of more limited functional exemptions. This letter comments on issues affecting services that banks provide to employee benefit plans, including the employee benefit plan exemption proposed under Rule 770, on behalf of ten banks and trust companies that provide services to employee benefit plans: Bank of Oklahoma, The Bank of New York, Marshall & Ilsley Corporation, Mellon Bank, N.A., The Northern Trust Company, PNC Bank, N.A., SEI Private Trust Company, State Street Bank & Trust Company, Union Bank of California, N.A., and Wachovia Bank, N.A. (the "Banks").[2]

[1] See 69 Fed. Reg. 39682 (published June 30, 2004).

[2] This letter addresses certain issues under proposed Regulation B and provisions under Exchange Act section 3(a)(4) relating to services the Banks provide to employee benefit plans, which are of common concern to the Banks. Many of the Banks are

I. Introduction and Summary

As trustees or custodians for a significant portion of the $4 trillion in assets held by employee benefit plans maintained in the United States, banks play a critical role in the management and administration of employee benefit plans (including traditional "defined benefit" plans, participant-directed 401(k) and similar plans, and welfare plans providing health, disability and other benefits). The employee benefit plan services industry is an extremely competitive industry. To meet the complex legal requirements[3] and other special needs of employee benefit plans, banks have developed highly specialized services and systems designed to serve the various types of plans. New regulation that unnecessarily increases the complexity and cost of providing employee benefit plan services, requires banks to restructure service arrangements, or reduces industry competition by forcing banks to leave the business will not benefit employee benefit plans or American workers participating in these plans.

Therefore, although the Banks commend the Commission for recognizing that bank services to employee benefit plans require special treatment by proposing Rule 770, the Banks respectfully submit that, as proposed, Regulation B does not accomplish the Commission's objective of accommodating banks' current business practices under conditions designed to protect investors.[4] Rather, proposed Rule 770 and other Regulation B provisions affecting services to employee benefit plans will completely disrupt the provision of services by banks to employee benefit plans (an outcome Congress specifically intended to avoid when it passed the GLBA[5]). As discussed in more detail herein, banks attempting to comply with proposed Rule 770 and other provisions under Regulation B will be forced to restructure most if not all of their compensation and service arrangements with plans simply to accommodate the new rules. Further disruption will result from the increased costs of bank-provided services and the

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commenting separately on these and other issues under proposed Regulation B and Exchange Act section 3(a)(4).

[3] Banks assist plans in providing benefits in accordance with complex plan terms and in meeting legal requirements under the Internal Revenue Code of 1986, as amended (the "Code"), the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), or, where ERISA does not apply, state laws.

[4] See 69 Fed. Reg. at 39685.

[5] Congress intended that the GLBA's revisions to section 3(a)(4) of the Exchange Act should not change banks' traditional securities activities provided through bank trust departments and other customary banking activities. See Conf. Rep. 106-434 at 163-164 (Nov. 2, 1999).

decreased convenience of these services. Plans will likely be required to engage and compensate broker-dealers to provide some of the services that banks currently provide, resulting in plans paying more for services they now receive more efficiently. The changes will put banks at a significant competitive disadvantage relative to mutual fund complexes and broker-dealers. These issues will cause some banks to stop providing plan services, reducing industry competition by limiting participation by an entire segment of plan service providers.

Therefore, the Banks urge the Commission to consider adopting a rule that would grant banks a complete exemption from the definition of the term "broker" to the extent that banks effect transactions for employee benefit plans. This broad exemption would be appropriate given the substantial regulations already provided by the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and similar laws, and Congress' stated intent that the GLBA's amendments to Exchange Act section 3(a)(4) should not change banks' customary banking activities.[6] If this broad exemption is not adopted, the Banks believe that the Commission should at least make the following changes to Rule 770.

- The proposed Rule 770(a)(1) condition requiring banks to offset or credit compensation received from mutual fund complexes against other plan fees on a dollar for dollar basis should be deleted. It is inconsistent with industry standard "bundled service" arrangements, through which banks are compensated for plan services indirectly through mutual funds in which plan assets are invested. Plans prefer these fee arrangements because they simplify payment of plan administrative costs and make it easier to evaluate investment return after considering plan administrative costs. An offset/credit requirement will force banks to restructure these arrangements, renegotiate their compensation arrangements, and increase service fees. In fact, the Banks believe that plan sponsors and plan participants may have more difficulty understanding fees and expenses associated with plans under an offset/credit structure. Moreover, the condition is unnecessary in light of guidance issued by the U.S. Department of Labor ("Labor Department") under ERISA, which generally would permit banks to receive payments from mutual fund complexes as compensation for plan services without such an offset under certain conditions

[6] In particular, the Banks believe that Congress clearly demonstrated its intent to allow banks to provide services to employee benefit plans without disruption by including a specific exception for banks providing plan services under Exchange Act § 3(a)(4)(B)(viii)(ee).

(including specific disclosure requirements).[7] Finally, an offset/credit condition would significantly disadvantage banks in competing with registered broker-dealers, mutual fund complexes and other plan service providers that will be able to continue to provide the same plan services without a complex offset fee structure.

- Proposed Rule 770 should be available where banks provide services to (in addition to the types of plans already identified by the rule): church plans described by section 414(e) of the Internal Revenue Code of 1986, as amended (the "Code"), governmental plans as described by Code section 414(d), "voluntary employee benefit associations" ("VEBAs") established under Code section 501(c)(9), and non-qualified deferred compensation plans. These types of plans receive the same services from the same departments or business units of the Banks as the Code section 401(a), 403(b) and 457 plans identified in proposed Rule 770; imposing different regulatory requirements would require the Banks to restructure services to support the different requirements. As a result, plan services will be disrupted and Banks may be forced to stop providing services to some types of plans.

- In addition to allowing Banks to effect transactions in mutual funds, proposed Rule 770 should be expanded to allow banks to effect plan transactions in other securities, including securities issued by the employer sponsoring an employee benefit plan ("employer securities"). In particular, plan investments in employer securities are common, and plan sponsors and other plan fiduciaries expect bank trustees and custodians to provide transaction services for securities owned by plans, especially in the case of the employer securities owned by plans.

- Conditions for participant-directed brokerage accounts under Rule 770 should be revised to permit banks to hold custody of securities purchased for participant-directed brokerage accounts and also provide clearance and settlement services in connection with securities transactions for participant-directed brokerage accounts. This change is needed to conform to current practices of some Banks. So long as participants must place their orders for securities transactions for their participant-directed brokerage accounts with a registered broker-dealer, the customer protections that flow from broker-dealer registration will be available to the participants.

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[7] See DOL Adv. Ops. 2003-09A (June 25, 2003), 1997-16A (May 22, 1997), and 1997-15A (May 22, 1997). These advisory opinions and other applicable Labor Department guidance are discussed, infra.

- The prohibition against banks paying incentive compensation to employees in connection with employee benefit plan services should be deleted. ERISA and other similar laws already regulate the activities of these employees and would impose substantial liability on banks for misconduct of their employees. If not deleted, the condition should be modified to clarify that banks are not prohibited from paying incentive compensation to unregistered employees based upon the total asset size of any new employee benefit account or the total revenue anticipated or actually received for a new account irrespective of whether the revenue is received directly from the plan or indirectly from other sources, and also to permit compensation arrangements meeting conditions under the networking exception under Exchange Act section 3(a)(4)(B)(i).

- The disclosure condition under proposed Rule 770(a)(2) should be deleted because banks already are required to disclose their compensation from mutual fund complexes under detailed guidance issued by the Labor Department. Additional disclosure requirements imposed by Commission rules would provide little or no benefit, but would require banks to comply with different, possibly contradictory disclosure standards.

The Banks also respectfully request that the Commission clarify certain issues in connection with certain of the statutory functional exceptions under Exchange Act section 3(a)(4). First, the Banks request confirmation that the statutory exception for safekeeping and custody services under Exchange Act section 3(a)(4)(B)(viii)(I) permits banks acting as "directed" trustees or custodians of plans to provide securities transaction clearance and settlement services and receive fees from plans for these services, so long as the bank is not engaging in "order-taking." Where Banks would rely on section 3(a)(4)(B)(viii)(I), a plan sponsor or investment manager or other plan fiduciary (other than the directed trustee or custodian bank) retains control of broker-dealer selection and negotiates the terms of plan securities transactions with registered broker-dealers.

In addition to issues under proposed Rule 770, there are additional issues under proposed Regulation B that should be addressed. Specifically, the Banks request that the Commission clarify that, in performing calculations for purposes of the "chiefly compensated" test under the statutory trust and fiduciary activities exception under section 3(a)(4)(B)(ii) (and proposed Rules 721, 722 and 724), fees or other compensation received by Banks in performing services covered by another exception or exemption under Exchange Act section 3(a)(4)(B) or proposed

Regulation B may be treated as "relationship compensation." For example, the following should be treated as "relationship compensation" —

- compensation from mutual fund complexes, fees for effecting transactions in other securities, including employer securities, and plan fees for self-directed brokerage services, to the extent that the bank receives the compensation or fees in accordance with proposed Rule 770;
- fees paid by plans for clearance and settlement services as permitted under Exchange Act section 3(a)(4)(B)(viii)(I); and
- compensation received from a broker-dealer in connection with a "networking" arrangement meeting conditions under Exchange Act section 3(a)(4)(B)(i).

The Banks believe that all of these types of compensation should be treated as "relationship compensation" for purposes of the "chiefly compensated" test because the compensation is for services banks provide to plans, which are services banks have always provided to all trust and custody customers, including employee benefit plans. In particular, with respect to amounts received from mutual funds under bundled service arrangements in accordance with proposed Rule 770, banks could provide the same plan trust, custody, recordkeeping, and other services for fees paid directly from plans. Banks should not be penalized because plan sponsors and other plan fiduciaries prefer that their plan service costs are paid from mutual fund complexes, since plans would otherwise have to pay directly. In other words, the source of the payment should not impede a bank's ability to provide services under the trust and fiduciary activities exception.

Section II of this letter responds to the Commission's questions in proposing Regulation B by providing a detailed description of the services Banks provide to employee benefit plans, including the types of plans and how Banks are compensated for their services. Following this description, Section III and IV of this letter discuss the Banks' comments and concerns about proposed Rule 770 and other issues relating to employee benefit plans under proposed Regulation B.

II. Background

The Banks act as trustees, custodians, or other service providers to a variety of different types of employee benefit plans, providing a broad range of services. These services are usually governed by ERISA. Among other things, ERISA generally requires that all plan assets be held "in trust" by a trustee[8] and imposes certain duties on plan "fiduciaries," including the plan sponsor or other "named fiduciary" of the plan, the plan trustee, the plan's investment managers, and any other persons that exercise discretionary authority or control with respect to the management or investment of plan assets or provide investment advice with respect to plan assets.[9] If ERISA does not apply, e.g., in the case of a governmental plan (described below), state or local laws governing the plan typically include fiduciary responsibility provisions that impose requirements similar to the fiduciary provisions under ERISA.

Certain ERISA requirements are responsible at least in part for the special role that banks play for employee benefit plans. In particular, because ERISA section 403(a) generally requires plan assets to be held "in trust" with a trustee, it is typical for banks to serve as trustees.[10] (As discussed below, this trustee role may be "discretionary" or "directed.") Also, the "limited scope audit" exception under Labor Department regulations encourages the appointment of banks to hold custody of plan assets. Under this regulation, plan auditors are not required to extend their audit reports to financial statements prepared and certified by a bank.[11] This substantially reduces the cost of plan audits. In addition, banks providing plan services are specifically required by ERISA and Labor Department regulations to provide information required to complete annual Form 5500 filings.[12] To comply with these obligations, Banks have developed specialized trust accounting and reporting systems that prepare plan financial information in

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8 See ERISA § 403(a).

9 ERISA section 3(21) defines the persons who are plan "fiduciaries." ERISA section 402 requires every plan to provide for one or more "named fiduciaries" who have authority (jointly or severally) to control and manage the operation and administration of the plan. Among other things, ERISA section 404 requires fiduciaries to act prudently, solely in the interest of plan participants and beneficiaries and according to governing plan documents. Prohibited transaction provisions under ERISA section 406 (and parallel prohibited transaction excise tax provisions under Code section 4975, which apply to all tax-qualified retirement plans) generally prohibit fiduciaries from causing plans to engage in certain "prohibited transactions" between plans and parties in interest and transactions that may involve fiduciary self-dealing, conflicts of interest or "kickbacks" to a plan fiduciary, unless there is an applicable statutory or administrative exemption.

10 ERISA section 403(b) provides certain exceptions, including an exception for assets held by an insurance company or under an insurance contract.

11 See 29 C.F.R. § 2520.103-8.

12 See ERISA § 103(b)(3)(G) and 29 C.F.R.§ 2520.103-5.

formats necessary to meet Form 5500 reporting requirements. In contrast, financial statements prepared by registered broker-dealers are not eligible for the limited scope audit exception.[13] Broker-dealers are not required by ERISA to provide financial information to plans for purposes of Form 5500 reporting and generally have not adopted accounting and reporting systems that would provide financial statements in formats appropriate for Form 5500 reporting purposes.[14]

More generally, requirements under ERISA (or similar state laws) govern all aspects of the services that the Banks provide to employee benefit plans, including conditions under which services are provided and the types of fees and other compensation that Banks may receive for these services. In addition to these ERISA (or state law) requirements, a variety of other circumstances impact the services that the Banks provide to plans and the Banks' compensation for these services, such as the type of plan, plan size and features, the types of investments plans may make, the capacity in which the Bank acts, and the range of services needed to manage and administer the plan and plan assets. Following is a general discussion of these various factors.[15]

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[13] See AUDITS OF EMPLOYEE BENEFIT PLANS § 5.02 at 64 (AICPA Audit and Accounting Guide, March 1, 2003).

[14] Labor Department guidance issued under ERISA section 403(a) further suggests that entrusting plan assets to broker-dealers is not preferred. In this regard, while Labor Department regulations allow securities owned by a plan to be held in street or nominee name by a broker-dealer, see 29 C.F.R. § 2550.403a-1(b), the Labor Department has cautioned that plan trustees must ensure that any arrangement for holding plan assets in fact provides the trustee with authority and control over plan securities. In the case of securities held in nominee or street name by a broker-dealer, relevant factors would include the financial stability of a broker-dealer, safeguards for holding securities, whether there is adequate insurance and the feasibility of alternative methods of holding the securities. See 47 Fed. Reg. 21241 n.20 (May 18, 1982). In addition, the regulation only permits broker-dealers to hold securities and does not address the holding of cash and other plan assets. Therefore, broker-dealers generally do not serve as plan custodians instead of a bank.

[15] This discussion summarizes and consolidates information received from the Banks. All of the Banks engage in some or all of the plan related activities that are described. However, individually, each Bank may provide services to some types of plans more than to others or may specialize in certain services.

For example, several Banks specialize in providing services to 401(k) and other participant-directed retirement plans. One of these provides services as directed trustee or custodian to about 1500 such plans, ranging in size from "small plans" (e.g., 100 participants and about $3 million in assets) to "large plans" (over 20,000 participants and more than $1 billion in assets), with the average plan size being between $5 and $200 million in assets. Another provides services to about 550 such plans, with average assets of about $7.5 million and an average of about 250 participants per plan. One Bank provides services to

A. Types of Plans Banks may provide services to a wide variety of employee benefit plans and related entities, including the following.[16]

1. Tax-Qualified Retirement Plans These include stock bonus, pension and profit-sharing plans meeting requirements for qualification under Code section 401(a), plans described by Code section 403(b), governmental plans as defined by Code section 414(d) (including governmental plans described by Code section 457), and "church plans" described by Code section 414(e). Some tax-qualified retirement plans are collectively bargained multi-employer plans jointly managed by a board of employer and union trustees ("Taft-Hartley" plans).[17] Unless a tax-qualified retirement plan is a governmental plan[18] or a church plan,[19] the operation and administration of the plan is governed by ERISA.

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about 125 "large" defined contribution plans with assets exceeding $100 million. The Banks also provide trust or custodial services to employers offering non-qualified deferred compensation plans and provide administrative services to non-qualified plans alongside tax-qualified defined contribution plans.

Other Banks focus on defined benefit retirement plans and other plans (e.g., VEBAs) that are not participant-directed. For example, one Bank provides services to about 2000 such plans, of varying sizes. Another Bank provides services to over 200 such plans with an average size of $50 to $220 million. A third Bank provides directed trust or custody services to more than 900 ERISA-covered plans (some of which are participant-directed), with an average plan size of $500 million, and to another 250 governmental plans, which have an average plan size of $5 billion.

Some of the Banks provide services to a broad range of plans. One Bank reports that it provides services to defined benefit plans with assets in aggregate exceeding $1.29 trillion, to defined contribution plans with assets in aggregate exceeding $362 billion and to VEBAs with assets in aggregate exceeding $36 billion. Another bank reports that it provides services to about 4,500 defined contribution and defined benefit plans with $60 billion in assets and about 1.2 million participants. A third Bank administers over $13 billion in plan assets, including 8430 defined contribution accounts, 2036 defined benefit accounts and 2260 other retirement accounts.

[16] In addition to the types of plans listed, the Banks also provide services to individual retirement accounts ("IRAs"), including salary deferral IRAs, which may be "plans" under ERISA, as well as IRAs that are not part of an employee benefit plan.

[17] Collectively bargained plans managed by a joint board of employer and union trustees are called "Taft-Hartley" plans after the Labor Management Relations Act, 29 U.S.C. § 186 (1947), which is also known as the Taft-Hartley Act.

[18] Section 3(32) of ERISA defines the term "governmental plan," in pertinent part, as "a plan established or maintained for its employees by the Government of the United States, by the government of any State

Tax-qualified retirement plans may be divided into two general types.

- "Defined benefit" plans are plans under which participants receive a fixed or determinable benefit based on a formula set forth by the plan. Assets of these plans are typically managed by one or more plan fiduciaries, including a plan trustee, employer or other named fiduciary of the plan, an investment manager, or a combination of these. The assets may be invested in any type of securities or other property, including (among other things) interests in collective trust funds maintained by a bank for the collective investment of assets of tax-qualified plans ("bank collective trust funds") and employer securities.

- "Defined contribution" plans, including 401(k) and similar plans, provide participants a benefit that depends on the value of contributions made to the plan by or on behalf of the participant to the participant's individual account maintained under the plan and earnings based on the investment success of the plan. Defined contribution plan assets (like assets of the defined benefit plans) may be under the management and control of one or more plan fiduciaries (e.g., the trustee, employer or named fiduciary, or investment managers.) Alternatively, some or all of the plan's assets may be "participant-directed" — that is, plan participants may elect how to invest the assets of their individual participant accounts under the plan among various plan investment options.

  Whether or not the plan is participant-directed, the plan's assets may be invested in any type of securities or other property, including (among other things), employer securities. However, if the plan is participant-directed, the plan sponsor or other named fiduciary typically selects a range of plan investment options. These options usually are mutual funds, but may also include employer securities, bank collective trust funds, a "separate account" consisting of assets under management by a trustee, plan fiduciary or investment manager, "participant-

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of political subdivision thereof, or by any agency or instrumentality of any of the foregoing." ERISA section 4(b)(1) exempts governmental plans from ERISA requirements.

[19] Section 3(33) of ERISA defines the term "church plan," in pertinent part, as "a plan established and maintained … for its employees (or their beneficiaries) by a church or by a convention or association of churches which is exempt from tax under section 501 of the Internal Revenue Code of 1986." ERISA section 4(b)(2) exempts church plans from ERISA requirements unless they elect otherwise.

directed brokerage accounts" or "mutual fund windows" (as further described below), or a combination of these.

2. Voluntary Employee Benefit Associations ("VEBAs") VEBAs are entities created pursuant to Code section 501(c)(9) to serve as funding vehicles for "welfare" plans providing medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, death, or other "welfare" benefits.[20] If a VEBA is maintained in connection with any ERISA-covered welfare plan, the trust requirement under ERISA section 403 and ERISA's other requirements apply to the management and administration of the VEBA. Therefore, VEBAs typically are structured as trusts. Some VEBAs are maintained in connection with Taft-Hartley plans established pursuant to collective bargaining agreements and are jointly-managed by a board of employer trustees and union trustees. Like retirement plans, the assets of VEBAs generally may be invested in a range of securities or other property, including (among other things) insurance contracts and employer securities.

3. Non-Qualified Deferred Compensation Plans Employers may establish these plans to provide benefits to a group of management or highly compensated employees. Non-qualified deferred compensation plans generally are "unfunded," which means that participants only have an unsecured contractual promise from the employer that plan benefits will be paid when due under plan terms. Unfunded non-qualified deferred compensation plans typically are exempt from most of the substantive requirements under ERISA.[21]

Although non-qualified deferred compensation plans are designed to be "unfunded," in practice, employers maintain separate bookkeeping accounts to reflect deferred amounts. In addition, employers often establish separate trust, custody or similar accounts and purchase securities with the deferred amounts to assist them in meeting their future benefit payment obligations under the non-qualified plans. In some cases, these funds are set aside in a "rabbi trust" or other trust or custodial account arrangement.[22]

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[20] See ERISA § 3(1). ERISA generally does not require employers to "fund" welfare plans, but in practice many employers may use VEBAs to fund future benefit obligations under welfare plans.

[21] See ERISA §§ 201(2), 301(a)(3), 401(a)(1).

[22] The plan remains "unfunded" so long as the assets of any such bank account, trust or custodial account are available to the employer's creditors in the event of insolvency. Even if the employer makes benefit payments on a "pay as you go" basis, the employer may still invest deferred amounts in securities.

Non-qualified deferred compensation plans are often structured to provide participants with an "account balance" equal to the amounts deferred with an earnings credit. The earnings credit may be determined based on one or more hypothetical investment choices from which participants may select under the plan. In this regard, many employers offer so-called "mirror" plans, which allow participants to elect among hypothetical investments that are similar or identical to the investment options available under the employer's participant-directed 401(k) or other tax-qualified defined contribution plan. If an employer maintains a "mirror" plan, amounts contributed to a rabbi trust or other informal funding account set up by the employer to support liabilities under the non-qualified plan may be invested in the same investments that are made under the employer's tax-qualified defined contribution 401(k) plan. "Mirror" plans typically are administered similarly to the employer's 401(k) plan, usually by the same service provider.[23]

B. Capacities in Which Banks Serve/Services Provided With respect to all types of plans, the Banks may serve as trustee, custodian, and/or provide other services, as follows.

1. Discretionary Trustee The Banks may act as a "discretionary trustee" of plans with discretionary investment management or investment advisory responsibilities. Acting as discretionary trustee, Banks are responsible for receiving plan contributions and other assets, the custody and safekeeping of plan assets and also for investment management of the assets. Banks may invest plan assets in any type of securities subject to investment guidelines provided by the employer or other plan fiduciary. Only a small portion of plans receiving services from the Banks receive "discretionary trustee" services.[24]

A Bank may act as a discretionary trustee for tax-qualified defined benefit retirement plans, VEBAs and also for tax-qualified defined contribution retirement plans. In some cases, the Bank may have discretionary trustee responsibilities for only a portion of the plan's assets and act as a "directed trustee" with respect to the remainder of the plan's assets. For example, in the case of a defined benefit plan, the Bank may be engaged to provide management services for

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[23] In some cases, these "mirror" plans are also "wrap-around" plans, which are designed to permit the non-qualified plan to hold deferrals that cannot be made to a tax-qualified 401(k) or similar plan after complex compliance testing with respect to certain contribution limitations under the Code is performed. Careful coordination of the two plans is required to satisfy requirements under the Code. Therefore, employers generally seek administrative services for both plans from the same service provider.

[24] One Bank explained that, of its 1,650 employee benefit plan clients, it provides discretionary trustee services to only 169. Most (but not all) of these are defined benefit retirement plans.

one "portfolio" of the overall trust fund, such as where the Bank has special expertise in managing an asset class or managing assets according to a particular strategy. In the case of a tax-qualified defined contribution retirement plan that is participant-directed, the Bank might have investment management responsibility for a portion of plan assets in a "separate account" offered as an investment option to the plan's participants, or the Bank may manage the portion of the plan's assets representing the employer's "matching" or "profit-sharing" contributions, or the Bank may have investment management responsibility only for plan assets invested in employer securities.

A Bank serving as a discretionary trustee may provide other services, such as cash management, securities lending, services with respect to employer securities, and plan distributions, as further described by B.3, below.

2. Directed Trustee/Custodian Banks may act as a "directed trustee" so that the plan meets the "trust requirement" under ERISA section 403(a). A Bank acting as a directed trustee is responsible for receiving plan contributions and other assets and the custody and safekeeping of plan assets. Generally, a directed trustee has no investment authority, and instead is solely responsible for implementing investment directions provided by other plan fiduciaries (e.g., an investment manager or the plan's named fiduciary) or, in the case of participant-directed plans, instructions from plan participants. However, a Bank serving as a directed trustee may sometimes contract to provide additional services, such as informational investment reporting to the plan sponsor or other named fiduciary selecting plan investment options, or participant education services. In some cases, Banks may also contract to provide investment consulting services to the plan sponsor or other named fiduciary selecting plan investment options, or to provide participant advice. Banks contracting to provide such services are "fiduciaries" for ERISA purposes to the extent they perform functions that are fiduciary in nature under ERISA.

Alternatively, Banks may serve as "custodian" because another person or entity is appointed as plan trustee. For example, in the case of Taft-Hartley plans (including some tax-qualified retirement plans and some VEBAs), a joint board of trustees is established and the Bank is engaged as custodian by these trustees to be responsible for custody and safekeeping of the plan's assets. Laws establishing certain governmental plans may provide for a trustee committee responsible for the management and control of plan assets, and that committee may engage a Bank to be custodian for the plan's assets. Some private-sector employers appoint one or more officers or other individuals to serve as plan trustee to meet the ERISA section 403(a) trust requirement, and Banks also serve as custodians to these plans. Banks serving as custodian also may contract with a plan to provide investment consulting or participant advice services.

The Labor Department's view is that the position of "directed trustee" is fiduciary in nature for ERISA purposes, whereas, typically, a bank custodian is not viewed as an ERISA fiduciary unless the bank undertakes to perform functions that may be fiduciary in nature (such as plan investment consulting or participant advice services).[25] However, in practice, a Bank has similar responsibilities whether it acts as a directed trustee or custodian. In this regard, like a directed trustee, a bank acting as custodian is responsible for receiving and holding plan assets, for the custody and safekeeping of the plan assets, and for accounting and reporting with respect to the plan assets. Moreover, when acting as custodian to the assets of governmental plans and Taft-Hartley plans, Banks are often required to accept and acknowledge as a contractual condition of the arrangement that the Bank is a "fiduciary" with respect to the plan (under state law or ERISA, as applicable) in performing services under a custodial agreement.

The services Banks provide as directed trustee or custodian are likely to differ, however, depending upon whether or not the plan is participant-directed.

a. Participant-Directed Plans Where a Bank provides services as directed trustee or custodian to a participant-directed plan (including tax-qualified defined contribution plans that are participant-directed and non-qualified plans that allow

[25] Under ERISA section 403(a), a plan trustee has exclusive responsibility and discretion to manage and control plan assets, except to the extent that the trustee acts in accordance with the proper directions or instructions of a named fiduciary or is directed by a properly appointed investment manager. According to the Labor Department, ERISA section 403(a) imposes on directed trustees a "residual" responsibility to refuse certain instructions that are not "proper" and accordingly, directed trustees are fiduciaries for ERISA purposes. See 29 C.F.R. § 2509.75-8, D-3 (trustee of a plan is a fiduciary by very nature of his position); DOL Adv. Op. 92-23A (Oct. 27, 1992). Courts are split on this question. See In re Enron Corp. Securities, Derivative & ERISA Litig., 284 F.Supp.2d 511 (S.D. Tex. 2003) (reviewing cases finding non-discretionary trustee to be a fiduciary); In re WorldCom, Inc., 263 F.Supp.2d 745, 762 (S.D.N.Y. 2003) ("the directed trustee is not relieved of the obligations 'to conform to the prudent man standard of care, to attempt to remedy known breaches of duty by other fiduciaries, and to avoid prohibited transactions'"); but see Maniace v. Commerce Bank of Kansas City, 40 F.3d 264 (8th Cir. 1994) (directed trustee that is required to act only upon direction of the plan's fiduciaries was not a fiduciary); Bradshaw v. Jenkins, 5 Employee Benefits Cas. 2754, 2755-56 (W.D. Wash. 1984) (bank trustee having no discretionary control over investment of plan assets or plan administration not a fiduciary). A bank acting as custodian to an ERISA-covered plan is not subject to section 403(a) and generally is not viewed as a fiduciary solely by virtue of holding custody of plan assets. See e.g., Arizona State Carpenters Pension Trust Fund v. Citibank (Arizona), 125 F.3d 715 (9th Cir. 1997).

participants to elect among hypothetical investments), the Bank may effect the plan's investment transactions in the plan's investment options (including mutual funds, bank collective trust funds, employer securities or other plan investment options) based on the investment instructions of plan participants. The Bank may receive these instructions from a plan recordkeeper independent of the Bank, or the Bank (or its affiliate) may be the recordkeeper and directly receive participants' investment instructions.

When acting as directed trustee or custodian to participant-directed plans, Banks may provide additional services, including plan administration and recordkeeping, plan distributions, cash management, services with respect to employer securities, or other services, as further described by B.3, below.

b. "Fiduciary-Managed" Plans The assets of these plans are managed by the plan sponsor (or other named fiduciary of the plan) or an investment manager (which must be a bank, insurance company or registered investment adviser[26]). These "fiduciary-managed plans" could be any type of plan, including tax-qualified defined benefit plans, defined contribution plans, VEBAs or other plans. Further, even if a defined contribution plan is participant-directed, a portion of the plan's assets may still be managed by a plan fiduciary rather than by participants. For example, the assets of a "separate account" under a participant-directed plan may be managed by an investment manager, or a plan sponsor may engage an investment manager to manage employer "matching" or "profit sharing" contributions, or a plan fiduciary or investment manager may be responsible for managing a portion of plan assets invested in employer securities.

Where plan investment transactions are directed by an investment manager, the investment manager almost always arranges the plan's securities transactions, by selecting the broker-dealer and negotiating the terms of the transaction (e.g., price, commission charged, etc.).[27] The Bank is responsible for clearing and settling the investment transactions executed by the broker-dealer. Clearance and settlement services include a variety of administrative services, such as preparing and processing documentation relating to the transaction, transferring funds and securities to settle the transaction, and accounting and reporting services relating to transaction clearance and

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[26] See ERISA § 3(38).

[27] One Bank estimates that for approximately 99% of its fiduciary-managed directed trustee and custody clients, it does not arrange for the execution of any securities transactions.

> settlement. Clearance and settlement services are an important component of the services that Banks provide to fiduciary-managed plans.
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> Although transactions for fiduciary-managed plans are usually placed with a broker-dealer, employers or investment managers may ask Banks to arrange for purchases or sales of certain securities. In particular, a plan sponsor or other plan fiduciary responsible for managing employer securities owned by a plan may direct the plan to purchase or sell shares of the employer securities. If plan assets are invested in mutual funds, a plan sponsor or investment manager may request the Bank to effect purchases and redemptions of shares of the mutual funds. Banks may also arrange for the purchase or sale of investments in certain private placements at the request of a plan sponsor or investment manager.
>
> In addition to these investment, clearance and settlement services, Banks acting as directed trustees or custodians to fiduciary-managed plans may provide other services, such as cash management, plan distributions, securities lending and other services, as described in B.3, below.

Importantly, a Bank department or business unit responsible for providing directed trustee services to plans nearly always also provides custodial services. For example, the Banks commonly maintain one business unit or department that provides services to participant-directed plans and another that provides services to the "fiduciary-managed" plans. Since services provided as directed trustee and custodian are similar, the business unit or department providing services to participant-directed plans may act as either a directed trustee or custodian. Similarly, the business unit or department providing services to "fiduciary-managed" plans also would provide custodian and directed trustee services. Other Banks may provide services to groups of plans maintained by a plan sponsor on a "relationship" basis. For example, a plan sponsor may engage the Bank to act as directed trustee or custodian to a defined benefit plan, a defined contribution plan, one or more VEBAs, a non-qualified deferred compensation plan, and to provide corporate cash services. To facilitate this relationship, the Bank may assign one "relationship" manager, and the same business unit or department would provide services to all of the related plans, even though the Bank may act in different capacities with respect to the different plans.

3. Other Services Banks provide a variety of other services to plans. Generally, these are provided together with trustee or custody services, but could be provided separately from trust or custody services.

a. <u>Plan recordkeeping services</u> Banks often act as recordkeeper to participant-directed tax-qualified retirement plans and to non-qualified deferred compensation plans. As recordkeeper for a tax-qualified retirement plans, a Bank may provide a wide range of services, including —

- providing prototype plan and trust documents, summary plan descriptions, sample plan forms and other written plan materials;
- assisting employers with plan set up, employee enrollments and employee education (including providing enrollment forms and participant education materials);
- maintaining and updating on a daily basis participant accounts;
- taking investment instructions from plan participants using multiple systems (including by written instructions, by automated telephone voice response and live operator telephone services, and internet-based services);
- processing participant investment instructions, including allocating participant contributions and processing participant exchange requests among multiple plan investment options (such as mutual funds, bank collective trust funds, employer securities and other options);
- processing other plan transactions, such as participant loan requests, withdrawal requests and other plan distributions;
- providing compliance testing and other services required to maintain the plan's tax-qualified status; and
- preparing and delivering periodic participant statements and other participant communications materials and drafting the annual Form 5500 report.

These recordkeeping and administrative services for participant-directed plans are very complex, require specialized expertise, and are expensive to provide. With respect to non-qualified deferred compensation plans, Banks provide many of these same services.

Banks also may provide "unitization services" in connection with participant-directed plans. This is a recordkeeping activity performed by Banks to facilitate participant exchanges among plan investment options if a daily net asset value is not otherwise available. For example, the investment managers of mutual funds and bank collective trust funds typically determine a daily net asset value for purchases and redemptions of shares or interests in the funds. By unitizing, the Bank similarly calculates a daily net asset value for an employer securities investment option (which would include a liquidity component) or an investment option funded by a separate account managed for a plan by an investment manager.[28] Usually, a small portion of cash is maintained in the unitized fund to facilitate daily purchases or redemptions of "units" by participants. In providing unitization services, a Bank may perform a solely ministerial recordkeeping service where the Bank's services are limited to making arithmetic calculations necessary for the unitization. In some cases, the Bank may also have responsibility for making sales and purchases of securities from the unitized fund to provide liquidity or to reinvest the fund if participants make additional purchases. The Bank may have investment discretion in making these purchases or sales, or the Bank may follow standing instructions that allow the Bank little or no discretion in effecting the purchase or sale transactions.

b. Plan administrative consulting services Banks may provide a range of administrative consulting services, including assistance with plan design, plan mergers, terminations and divestitures, review of qualified domestic relations orders ("QDROs"), drafting plan committee minutes, etc. Generally, these services are not "fiduciary" in nature (although, in some cases, a Bank with responsibility for deciding QDROs claims may be performing a fiduciary function for ERISA purposes).

c. Plan investment consulting services Banks may provide investment consulting or advisory services to plans. In the case of participant-directed plans, this may include any of the following: assisting plan sponsors or other plan fiduciaries by providing detailed information about available plan investment options to allow them to make decisions about plan investment options, providing advice about selecting the investment options to be offered to plan participants under the plan, and/or assisting plan sponsors or other plan fiduciaries on an ongoing basis in monitoring the investment options. For plans that are not participant-directed, investment consulting services might include making recommendations with respect to plan investment policy or the allocation of plan assets among various types of investments. Banks may provide these services acting as discretionary trustee or as a directed trustee or custodian, or the services might be provided separately from trust or custody services. These services may or may not be fiduciary in nature under ERISA.

[28] Unitization may also sometimes be used to strike a net asset value for a plan investment option in order to take accrued plan expenses into account.

d. Investment management services Banks may provide services to plans as an investment manager (as defined by section 3(38) of ERISA), even if the Bank is not a discretionary trustee. In providing investment management services to ERISA-covered plans (either as a discretionary trustee or as investment manager if the bank is not a trustee), ERISA's prohibited transaction provisions generally prohibit a bank from causing a plan to invest in "proprietary" investment products, such as mutual funds advised by the bank or an affiliate, unless a statutory or administrative exemption is available. In this regard, Prohibited Transaction Class Exemption 77-4 ("PTE 77-4"), allows a bank with investment management responsibility for plan assets to cause the plan to invest in a mutual fund advised by the bank or its affiliate, if (among other conditions) the investment is approved by an independent plan fiduciary (e.g., the plan sponsor or other named fiduciary of the plan) and the bank does not receive "double" fees for investment management. To meet the "no double fee" condition, a bank may waive its plan account fees to the extent that the plan invests in proprietary mutual funds, or the bank may offset or credit against the plan account fees the portion of the bank's investment management fees paid from the proprietary mutual funds in connection with the plan's investment.[29]

e. Employer securities services Many employee benefit plans include investments in employer securities. Defined benefit plans and VEBAs generally may purchase or acquire employer securities so long as no more than 10% of plan assets (measured at the time of acquisition) is invested in employer securities.[30] Employers sometimes fund these plans in part by contributions of employer securities.

Defined contribution plans also may invest in employer securities, if required by the terms of the plan, if directed to invest in employer securities by a plan fiduciary, or as a result of participant investment elections where plan terms allow participants to elect to invest in employer securities. In this regard, defined contribution plans holding employer securities include participant-directed 401(k) plans, employee stock ownership plans, stock bonus and similar plans. ERISA provisions allow up to 100% of the assets of certain defined contribution plans to be invested in employer securities (subject to some conditions).[31] Plan sponsors may contribute employer securities as a "matching"

[29] See PTE 77-4, 42 Fed. Reg. 18732 (April 18, 1977).

[30] See ERISA § 407(a).

[31] See ERISA § 407(b).

contribution or may allow participants to invest in an employer securities investment option. An employer securities investment option offered to participants may be a "unitized fund" as described above, or the plan may use a "share accounting" method under which a specific number of shares is allocated to each participant's account.

The plan sponsor or other named fiduciary of an employee benefit plan with assets invested in employer securities is often responsible for determining whether and when the plan will purchase additional employer securities or sell the employer securities. Typically, the plan fiduciary directs the Bank to effect the transactions in employer securities. If the plan's investments in employer securities are participant-directed, the Bank may receive and process participant instructions with respect to the employer securities and execute the necessary transactions. Banks may effect transactions involving employer securities through a broker-dealer designated by the plan sponsor or other plan fiduciary, or through the Bank's trust department trading desk. In some cases, employer securities purchases and sales may be effected between the plan and the employer issuing the securities, or an affiliate of the employer. Such transactions are subject to conditions under ERISA sections 406(a)(1)(E), 407, and 408(e).

Plan investments in employer securities comprise a significant portion of many plans' investment assets. For example, one Bank reported that about 14% of plan assets held by the Bank as directed trustee or custodian are invested in employer securities.

f. Participant-directed brokerage accounts Some plans may offer participants investment options (in addition to the "core" options selected by the plan sponsor or other named fiduciary), through a "participant-directed brokerage account" or "mutual fund window." These plan features are available only if the plan sponsor includes the feature in designing the plan, or if the plan sponsor or other plan fiduciary concludes that it is appropriate for plan participants to have the opportunity to elect additional investment choices. Plan sponsors (or another named fiduciary of a plan) also may place limits on participants' access to these features, e.g., by requiring that at least some portion of participants' accounts must remain in core investment options.

A mutual fund window allows plan participants to select to invest among mutual funds in addition to the mutual funds or other investment options that the employer selects as "core" plan investment options.[32] Usually (but not in all cases), the Bank takes orders from participants that elect to invest in one or more of the additional mutual funds and executes the transactions together with all other plan transactions in mutual funds.

A participant-directed brokerage account allows participants to invest in securities through a registered broker-dealer. These arrangements may be structured in at least two ways.

- The employer (or other appropriate named fiduciary of a plan) may designate a registered broker-dealer to provide the participant-directed brokerage services. Participants open a brokerage account with the designated broker-dealer, place their orders for purchases or sales of securities with that broker-dealer, and the broker-dealer holds custody of the securities purchased by the participant through the participant-directed brokerage account. The Bank is responsible for transferring funds to the broker-dealer as required to fund participant purchases of securities through the broker-dealer and, upon the participant's direction, the broker-dealer may transfer the proceeds of sales back to the Bank for allocation to the portion of the participant's individual account under the plan maintained by the Bank. To comply with the ERISA section 403(a) requirement that all plan assets must be held "in trust" under the control of a plan trustee, the Bank (as trustee or custodian) must enter into a "sub-custody" or similar agreement with the broker-dealer, under which the broker-dealer recognizes that the Bank as the plan's trustee or custodian is legal owner of the assets in the participant-directed brokerage accounts.

- Alternatively, the Bank may provide clearance and settlement services and hold custody of securities purchased for participant-directed brokerage accounts, but participants still must place orders for securities with a broker-dealer designated for the plan by the employer or (where the plan permits) the participant. In this situation, the clearance and settlement services provided by the Bank are similar to the services a Bank provides when acting as directed trustee or custodian with respect to a fiduciary-managed account.

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[32] Mutual fund windows vary from plan to plan. Some may only offer 50-60 additional mutual fund investment options, others may add more than one thousand additional mutual fund choices.

> This second arrangement allows the participant to receive a single statement showing all of the investments in the participant's plan account, and allows the Bank more control in the safekeeping of the plan assets. (In contrast, where a broker-dealer maintains custody of assets in participant-directed brokerage accounts, the Bank must rely on the broker-dealer's report of assets and manually "shadow" the broker-dealer reports, or participants may receive two different statements − one from the Bank and one from the broker-dealer − in order to review all of the investments in his or her plan account.[33])

Finally, some Banks offer participants the opportunity to direct trades for participant-directed brokerage accounts to a broker-dealer through the Bank. For example, one Bank allows participants access to on-line trading services through the Bank's trust system, but the orders are still executed by a registered broker-dealer.

g. Cash management services Banks may provide cash management services to plans, including sweep services. Sweeps may be directed to mutual funds (including proprietary mutual funds managed by a bank or its affiliate and non-proprietary funds) or to a bank collective trust fund, or other bank investment product (e.g., deposits, repurchase agreements, etc.). In providing sweep services, a Bank typically is directed and does not have investment management authority or other discretion to affect the amount and timing of the sweep.

h. Plan distributions Banks may process and make benefit payments (e.g., lump sum payments or monthly annuity payments from defined benefit plans, or withdrawals, distributions and loans from defined contribution plans, or pay insurance premiums or other benefits from VEBA assets). If the plan holds employer securities, the distribution may be made "in-kind" in employer securities. In all cases, Banks process and make benefit payments as directed by a plan administrator or other plan fiduciaries. Services provided in connection with plan distributions may include tax withholding and reporting services.

i. Securities lending services Banks may perform these services if separately authorized by the employer or another appropriate plan fiduciary (other than

[33] In addition, as noted, the assets held by a broker-dealer are not eligible for the "limited scope audit" exception under 29 C.F.R. § 2520.103-8, which may increase a plan's audit costs.

the Bank). If the plan is covered by ERISA, the services must meet conditions under Prohibited Transaction Class Exemptions 81-6 and 82-63 ("PTE 81-6" and "PTE 82-63"), which permit plans to lend securities to banks and registered broker-dealers who are parties in interest to the plans and receive compensation for these services.[34]

j. Proxy voting and other "shareholder" services Some of the Banks vote proxies for employee benefit plan accounts. Usually, however, the plan sponsor or an investment manager, or sometimes, plan participants, have responsibility for voting plan proxies. In that event, if a Bank holds securities on behalf of employee benefit plans in an "omnibus" account, the Bank provides notice of a proxy or other action to the plan sponsor or other named fiduciary of each plan holding securities the omnibus account. In addition, Banks may agree to distribute prospectuses, proxies and other shareholder materials to plan sponsors or other plan fiduciaries, or to investment managers, or to participants if the plan permits participants to vote proxies or respond to other corporate actions. A Bank also may provide tabulation services for participants' responses to proxies and provide the result to the issuer or its agent.

k. Financial reporting and accounting services Banks may provide various financial reporting and other services to plans, including performance measurement services, income tax reporting, and providing information necessary to prepare Form 5500s. As noted, the Banks have developed trust accounting and reporting systems that are specifically designed to meet plans' needs for Form 5500 reporting.

C. Compensation For Plan Services Banks receive a variety of fees and other compensation in connection with services provided to employee benefit plans.[35] The fees and other compensation may vary based on a variety of factors, including the type of plan, the plan's investments, the complexity of required (or requested) plan services, and the level of customization (i.e., where changes to standard plan service procedures are requested or required to support the plan), the number of participants and average account balance, and the type and frequency of services. Plans may pay this compensation directly, but (particularly in the case of "bundled service" arrangements described in more detail below) the cost of services may also be paid by the plan indirectly through payments made from mutual fund complexes. As discussed

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[34] See PTE 81-6, 46 Fed. Reg. 7527 (Jan. 23, 1981), as corrected at 46 Fed. Reg. 10570 (Feb. 3, 1981); PTE 82-63, 46 Fed. Reg. 14804 (Apr. 6, 1982), as corrected at 47 Fed. Reg. 16437 (Apr. 16, 1982).

[35] In practice, plan fees may be paid from plan assets or a plan sponsor may pay the fees. Where fees are described herein as paid by a plan, this includes the possibility that the plan sponsor may pay.

below, where plans invest primarily in mutual funds, plan sponsors prefer, if not demand, that banks derive and limit their compensation to the amounts available from mutual fund complexes.

To the extent that Banks receive compensation from mutual fund complexes in connection with plan investments, the compensation may be variously described as paid for shareholder sub-accounting and similar administrative services, for shareholder services, or for distribution services the Bank provides to plans or to the mutual funds. The payments may be from administrative fees of mutual funds, from so-called 12b-1 plans and shareholder service plans adopted by mutual funds, or under "revenue-sharing" agreements with managers of the mutual funds. Generally, the compensation is "asset-based" — that is, the Bank receives compensation determined as a percentage of the plan's average balance invested in mutual funds.[36] In some cases, mutual fund complexes may compensate Banks for shareholder sub-accounting or other administrative services with a "per head" fee rather than an asset-based fee.[37] Sometimes mutual fund complexes pay "finder's fees" on new accounts with a mutual fund, based upon a percentage of new investments for a particular period. In addition, a "proprietary" mutual fund (i.e., a fund managed by the Bank or its affiliate) pays asset-based compensation to a Bank (or its affiliate) for investment management services.[38]

The amount that the Banks may receive from a mutual fund complex depends on a number of factors, such as the selected mutual fund and mutual fund share class, including, in particular, whether the plan has engaged service providers other than the Bank. For example, a registered broker-dealer providing services to a plan, or a plan recordkeeper, may already be receiving compensation for services from the mutual fund complex. In that event, the Bank may receive less compensation from the mutual fund complex or no compensation at all and would charge its fees to the plan directly. Alternatively, if the Bank provides the plan recordkeeping and administrative services, the Bank may receive the compensation that mutual funds would

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[36] For example, in the case of shareholder administrative service fees, Banks may receive between .20% and .25% of plans' average account balances with the fund annually. In addition, under revenue-sharing arrangements with mutual fund complexes, the Bank may receive asset-based fees from the fund investment manager, so that total asset-based fees received by Banks for mutual fund complexes may exceed 25% of plans' average account balance. Banks disclose compensation received under revenue sharing agreements in the same manner as any other compensation the Banks receive from mutual funds.

[37] For example, a fund may pay a Bank an annual fixed fee (e.g., $7) for shareholder sub-accounting services for each participant having an account balance with the fund. (These per head charges have been mostly replaced with asset-based compensation in recent years.)

[38] Banks may also receive fees from proprietary funds for custodial, administrative and transfer agency services to the funds. Fees for administrative and transfer agency services may be asset-based or based on a fixed fee for services schedule or a combination of these.

otherwise pay to a recordkeeping firm for plan recordkeeping and other administrative services. All compensation received from mutual funds by the Banks is plainly disclosed to the plan sponsor or other named fiduciary, as described in more detail below.

Under ERISA (or state laws if applicable), an independent plan fiduciary must determine that the Bank's services and fee arrangements are reasonable, and that the Bank receives no more than "reasonable compensation" for its services.[39] In addition, regulations and prohibited transaction exemptions issued under ERISA provide specific requirements governing certain types of plan services, including the type and nature of fees Banks or other plan service providers receive. The Banks believe that these legal requirements result in substantial protections to plans and participants. In addition, because of these already existing legal requirements, additional regulation by the Commission would be burdensome and could subject banks to duplicate or competing conditions with respect to plan service arrangements.

Following is a general discussion of how Banks may be compensated for the variety of services they provide to plans. One important factor in distinguishing among different plan service and fee arrangements is whether the plan receives services under a "bundled service" arrangement, or the plan's fees are not "bundled." Bundled service arrangements are discussed first, followed by a discussion of arrangements that are not bundled.

1. <u>Bundled arrangements</u> Bundled service arrangements are widely offered throughout the defined contribution retirement plan industry by banks, mutual fund complexes and broker-dealers, and are also sometimes used for defined benefit plans that invest primarily in mutual funds. Under a bundled service arrangement, the plan receives a bundled package of plan services, including trust, custody, plan recordkeeping and administration and other services. The plan sponsor or other independent plan fiduciary agrees that the bank will be compensated for most or all of these services indirectly through amounts that will be paid by mutual fund complexes in connection with the plan's investments. Therefore, the plan account or participant accounts under a plan typically are not billed or invoiced for plan services or only for nominal amounts. Plan sponsors and other plan fiduciaries generally prefer these arrangements for a variety of reasons, but primarily because they substantially simplify plan fee and service arrangements for these fiduciaries and for participants. Plan sponsors or other plan fiduciaries selecting plan fee and service arrangements often demand bundled arrangements in negotiating

[39] <u>See</u> ERISA § 408(b)(2). DOL regulations provide that an arrangement is "reasonable" only if the services provided are necessary and appropriate to the plan, the arrangement is terminable without penalty on reasonably short notice, and the plan pays no more than "reasonable compensation." 29 C.F.R. § 2550.408b-2(a). "Necessary services" are services that are "appropriate and helpful to the plan" in carrying out the purposes for which a plan is established or maintained. 29 C.F.R. § 2550.408b-2(b).

service arrangements with banks and force banks to agree to limit their compensation to the fees that are available from mutual fund complexes.

Under bundled service arrangements, the Banks rarely offset or credit payments from mutual fund complexes against fees plans are otherwise obligated to pay to the Bank. (Indeed, because plans are not obligated to pay any direct costs for services under a bundled arrangement other than fees paid indirectly in connection with their investments in mutual fund investment options, there are no other plan fees to offset.) In this regard, the Banks generally structure their bundled service arrangements to comply with Labor Department guidance that allows plan service providers, including banks, to receive and retain payments from mutual fund complexes as their compensation for plan services so long as —

- the bank is not acting in a "fiduciary" capacity as defined by ERISA with respect to the plan's investment in mutual funds, by virtue of either exercising discretionary authority or control with respect to the investment of plan assets or providing investment advice (as defined by ERISA section 3(21) and regulations thereunder), and
- the bank provides a plan sponsor or other independent plan fiduciary with sufficient information to allow the sponsor or other fiduciary to make informed decisions about the bank's compensation, including fees received from mutual funds.[40]

Thus, typically, Banks do not exercise investment discretion or provide investment advice to plans in connection with bundled service arrangements and the plan sponsor or another independent plan fiduciary approves the entire arrangement, including the fact that the Bank will be compensated for providing plan services from amounts paid from mutual fund complexes in which the plan will invest.[41]

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[40] See DOL Adv. Ops. 2003-07A (June 25, 2003); 1997-16A (May 22, 1997) and 1997-15A (May 22, 1997). These advisory opinions are discussed in more detail below. Where ERISA does not apply, state trust and agency laws may apply and impose limitations on the amount and type of fees a trustee or custodian may receive from mutual funds that are as restrictive (or even more restrictive) than ERISA requirements and also may require detailed disclosure of compensation received. See, e.g., Ariz. Rev. Stat. Ann. § 6-246; Cal. Fin. Code § 1561.1; Fla. Stat. Ann. §§ 660.417, 737.402(2)(e); 760 Ill. Comp. Stat. Ann. 5/5.2; Tex. Prop. Code Ann. § 113.053(g).

[41] See, e.g., DOL Adv. Op. 2003-09A (June 25, 2003), which describes a typical bundled services arrangement offered by a bank. DOL Adv. Op. 2001-09A (Dec. 14, 2001) describes another bundled

The Banks may offset or credit compensation from mutual funds on occasion.[42] For example, if a Bank provides plan investment consulting services, and accordingly provides "investment advice" that makes the Bank a fiduciary for ERISA purposes in connection with plan investment transactions, a dollar for dollar offset may be required.[43] Also, a few plan sponsors negotiate to require the Bank to credit or offset compensation the Bank receives from mutual funds against other plan fees. Typically, this only occurs when the plan's assets are substantial, e.g., over $50 million. All of the Banks report that, if such a dollar for dollar offset is implemented, the offset or credit must be performed in a "manual" process. It would be very costly and burdensome from an administrative perspective to perform this type of calculation for all of a Bank's plan clients.

2. Other arrangements If plan services are not provided under a bundled service arrangement, Banks generally charge plans fees for the different services provided to each plan. These fees may be asset-based or fixed fees for services. The fee structures vary widely among the Banks and depend on the type of client and nature of services provided. However, if the plan is subject to ERISA, the fee arrangements must comply with ERISA's fiduciary responsibility provisions, including guidance issued by the Labor Department. Following is a general discussion of the fees plans may pay for different types of services.

a. Trust/custody fees For trust or custody services, Banks may charge fees based on the market value of the trust or custodial account assets. Fee

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service arrangement, where a bank arranged for participant advisory services, but still was not required to offset compensation from mutual funds on a dollar for dollar basis.

[42] One Bank that specializes in providing bundled service arrangements to participant-directed plans reported that it performs a dollar for dollar offset for no more than ten of the more than 4000 plans to which it provides services. Another Banks reports that it performs a dollar for dollar offset for no more than 11 of over 1100 plans clients.

[43] See, e.g., DOL Adv. Op. 1997-15A (May 22, 1997) (bank advised on the selection of plan investment options and could substitute options at its discretion). However, authority under ERISA allows a bank to provide investment advice to plans and receive compensation from mutual funds under certain conditions. For example, as noted, PTE 77-4, 42 Fed. Reg. 18732 (Apr. 8, 1977), allows a bank that is a mutual fund investment adviser to provide investment advice or exercise investment discretion to cause the investment of plan assets in its "proprietary" mutual fund, and the bank can receive management fees and other compensation from the fund (other than 12b-1 fees or other sales compensation), provided that a "no double management" fee condition and certain other conditions are satisfied.

schedules may vary depending upon the plan size, whether the plan is one of several plans for which the plan sponsor has engaged the Bank, the type of investment assets and the number of ancillary services (such as reporting or other services) provided. There are also flat annual fees.

b. Management fees If the Bank provides investment management services, the Bank may charge a separate asset-based fee for management services or the fee may be included in a trustee fee if the Bank is a discretionary trustee. Fees may vary depending on the class of assets the Bank manages and investment strategy (among other factors).

c. Compensation from mutual funds If plans invest in mutual funds, Banks may receive compensation from the mutual fund complex (even if plan services are not provided under a bundled service arrangement). The types of compensation from mutual funds may depend on whether the mutual fund is a proprietary fund or other fund, the type of fund and share class, and whether other plan service providers (e.g., a registered broker-dealer or recordkeeper) also are collecting compensation from mutual funds in connection with the plan's investment transactions.

Banks receiving compensation from mutual funds in connection with plan investments outside of bundled service arrangements are subject to the same legal obligations under ERISA that apply to bundled service arrangements. Therefore, whether or not the Bank offsets compensation received from mutual funds against other plan fees depends on the facts and circumstances, including whether or not the Bank exercises investment discretion or provides investment advice with respect to the plan's investment transactions and the Bank's contractual arrangements negotiated with the plan sponsor or other independent plan fiduciary.

d. Clearance/settlement fees Some Banks provide clearance and settlement services and do not charge fees separate from the Bank's trustee or custody service fees. (For example, under a bundled service arrangement, the Bank would not charge separate fees for clearance and settlement services.)

Other Banks charge separate fees for securities transaction clearance and settlement services, especially where the Bank specializes in providing services to fiduciary-managed plan accounts requiring sophisticated clearance and settlement capabilities. Banks also charge fees for providing services with respect to proxies or other corporate actions. These separate fees compensate Banks for transaction settlement, recording, accounting, and reconciliation, and may include certain "pass-through" charges from depositories, sub-custodians, and settlement agents. The fees take into account the Banks' costs in providing technology resources (e.g., accounting and custody systems), their obligation to reconcile the transactions with plan investment managers, human resource costs (e.g., operational expertise and account administration), and overhead and infrastructure necessary to support clearance and settlement services (including, e.g., a global settlement network).

The Banks report that these fees may currently range from $6 to $35 per transaction depending on a variety of factors, including the type of security and whether there are any special documentation or other requirements (e.g., settling private placements and foreign securities transactions generally costs more), the overall customer relationship, the level of automation for the trade (for example, straight-through-processing transactions are less expensive to administer than those that are communicated to a bank via a manual process) and documentation requirements (e.g., special documentation is required for transactions in certain overseas markets). The fee may be higher if manual processing is required (e.g., where a fax or other written instruction must be processed manually by bank employees) or if the transaction must be settled in foreign markets or with a foreign custodian, or in lesser-developed overseas markets.

In connection with providing clearance and settlement services, Banks may also provide certain overdraft services in connection with the necessity of rapid settlement of securities transactions. Fees for overdraft services must comply with Labor Department guidance in DOL Advisory Opinion 2003-02A (Feb. 10, 2003).

e. Employer securities services Banks may receive different fees depending on the services that the Banks provide with respect to employer securities. If the Bank has investment authority with respect to the employer securities, the Bank may receive a management fee. If the Bank only administers employer securities investments, e.g., in the case of a "unitized" employer stock fund offered as a plan investment option, the Bank may receive an asset-based fee or fixed fees for the administrative services. If the Bank takes plan fiduciary or participant orders for purchases or sales of the employer securities and places the order with a registered broker-dealer, the Bank may pass through to the plan the broker-dealer's commission and other transaction-related charges and also may charge the plan for clearance and settlement of the transactions.

f. Cash management fees For cash management services, Banks may charge a separate "sweep fee" based on the market value of assets invested in the cash management vehicle on a daily basis. Alternatively (or in addition), Banks may be compensated for sweep services from the cash management vehicle, such as an investment management fee if the cash management vehicle is a bank collective trust fund, or if the cash management vehicle is a money market mutual fund, the Bank may receive shareholder sub-accounting and administrative fees, shareholder service fees, investment management fees or other compensation that the fund complex may pay in connection with plan investments in the money market fund.

g. Plan distributions Fees for distribution services may be included in a Bank's overall fee for trust or custody services, or a Bank may charge separate fees for these services, such as fees for writing checks, making automatic deposits, and other charges for processing each distribution. Changes may also be applied to process "in-kind distributions" of employer securities to a plan participant. In addition, Banks may receive earnings on amounts held pending distribution from a plan. The Labor Department has issued specific guidance relating to such "float" compensation in Field Assistance Bulletin ("FAB") 2002-3 (Nov. 5, 2002).

h. Participant-directed brokerage account fees Participants pay commissions and other brokerage charges to the registered broker-dealer responsible for executing transactions through their participant-directed brokerage accounts from their plan account balances. In addition, Banks may charge for their services relating to these accounts (e.g., the accounting, reporting, and other services described above). For example, Banks may charge a one-time or annual fee for each participant-directed brokerage account established under a plan. An annual fee may be a fixed charge (e.g., $50 annually) or an asset-based charge.[44] If a Bank provides clearance and settlement services and holds custody of securities purchased through a participant-directed brokerage account, the Bank may charge clearance and settlement fees, as described above. If a participant selects mutual funds through a mutual fund window or

[44] In this regard, if the Bank is compensated under a bundled service arrangement based on compensation paid by mutual fund complexes, the Bank would not receive compensation from fund complexes to the extent that assets are invested in securities through a participant-directed brokerage account. In that event, participants investing in participant-directed brokerage accounts would not bear their share of the plan's overall administrative costs, unless an asset-based fee is charged on assets maintained in the participant-directed brokerage accounts.

participant-directed brokerage account, a Bank also might sometimes receive compensation from the mutual fund complex in connection with the transaction, but only if the broker-dealer is not otherwise collecting all of the compensation that is paid by the mutual fund complex.

i. Other services Banks may provide other services, including plan recordkeeping, administrative and investment consulting services, proxy voting and other services with respect to corporate actions, and financial reporting and accounting services for separate fees to be paid by the plan. Banks may also receive fees for securities lending services in accordance with conditions under PTEs 81-6 and 82-63.[45]

D. Fee Disclosure The Labor Department has explained that plan service providers, including banks acting as directed trustees or custodians, are required to disclose to plan customers sufficient information about their compensation so that their customers can reasonably approve plan service arrangements based on an understanding of the service provider's compensation. This concept of "full and fair" disclosure is intended to ensure that a plan service provider's compensation is determined and approved by a plan fiduciary independent of the service provider, so that prohibited self-dealing by the service provider is avoided.[46] Consistent with this guidance, the Banks provide detailed disclosure to the plan sponsor or other responsible plan fiduciary about the compensation and fees Banks receive for plan services.

Where Banks receive fees paid directly from plans, the fees are disclosed and approved in the applicable plan service agreements. If Banks receive compensation from mutual fund complexes, Banks generally disclose the compensation in accordance with guidance provided by the Labor Department in DOL Advisory Opinion 1997-16A (May 22, 1997), which requires plan service providers receiving compensation from mutual fund complexes in connection with plan investment transactions to disclose —

- the fact that the service provider receives compensation from fund complexes and the services provided to the funds and to the plan in connection with the compensation;
- the basis on which the compensation is determined, including the rate or range of rates at which the fees are determined; and

[45] See note 33, supra.

[46] See DOL Field Assistance Bulletin ("FAB") 2002-3 (Nov. 5, 2002).

- a statement that additional information is available on request, including an estimate of the compensation amounts and a point of contact for additional information.

This information is provided in materials provided to the plan sponsor or other plan fiduciary responsible for engaging the Bank at the outset of the engagement and any time that there is a change in the mutual funds or the fees paid by mutual funds in which the plan invests. The Banks generally do not rely solely on mutual fund prospectuses to provide this disclosure. For example, one Bank provides this disclosure on a standard Bank form listing each mutual fund, the types of compensation received from each fund, and the amount of that revenue expressed in terms of basis points. This Bank also provides plan clients with an annual plan review disclosing mutual fund fees received by the Bank in connection with the plan.

To the extent that a Bank offsets or credits compensation received from mutual funds against fees the plan is otherwise obligated to pay, the actual offset or credit amount typically is disclosed directly on the statement of fees due for services.

III. Comments on Proposed Rule 770

As discussed, banks play a critical role in the safekeeping and custody of the assets of employee benefit plans maintained for American workers, and, in this regard, various requirements under ERISA and Labor Department regulations encourage plan sponsors and other plan fiduciaries to rely on banks for the safekeeping and custody of plan assets. Accordingly, banks acting as trustee or custodian are responsible for the safekeeping of a substantial portion of the assets of America's employee benefit plans, and banks provide a wide range of specialized services required to manage and administer employee benefit plans.

Banks' ability to continue in this critical role as trustees and custodians to employee benefit plans is put at risk in connection with the implementation of the functional exceptions from broker registration under Exchange Act section 3(a)(4), as these provisions have been interpreted by the Commission in connection with proposed Regulation B. There are a number of issues relating to the services the Banks provide to employee benefit plans under proposed Regulation B. For example, the section 3(a)(4)(B)(ii) trust and fiduciary activities exception will not be available to the Banks when acting as custodians, and the Commission's narrow interpretation of the scope of the safekeeping and custody exception under section

3(a)(4)(B)(viii) would make that exception unavailable to the Banks in providing employee benefit plan services to the extent that Banks are performing any "order-taking" services.[47]

Even if a Bank is named as "trustee" and accordingly eligible to rely on the trust and fiduciary activities exception, the Bank probably cannot satisfy the "chiefly compensated" test under that exception if the plan services are provided under a bundled service arrangement, which are very commonly used in the benefit plan industry. In this regard, under proposed Rule 724, compensation received from mutual funds under bundled service arrangements would be either "sales compensation" or "neutral compensation" — the Banks would receive little if any compensation that would meet the definition of "relationship compensation" since plans generally pay directly little or no fees for services under these arrangements. In addition, a bank providing discretionary investment management services and investing plan assets in proprietary mutual funds would also likely fail the chiefly compensated test. In this regard, if the plan is subject to ERISA, the bank would be required to comply with PTE 77-4.[48] Under this exemption, a bank may waive plan-level fees in order to avoid receiving a "double" fee for investment management services from a plan and mutual fund. If plan account fees are waived, the bank will likely not receive sufficient "relationship compensation" to be compared against any "sales compensation" as required under the Commission's proposed approach to the chiefly compensated test.

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[47] See 69 Fed. Reg. 39707. As discussed above, the Banks commonly take and effect orders for plan securities transactions, especially for participant-directed plans, and for a variety of other plan securities transactions including transactions in employer securities. Accordingly, the Banks continue to object to the Commission's interpretation that "order taking" is not within the scope of the custody and safekeeping exemption under Exchange Act section 3(a)(4)(B)(viii), because this interpretation would prohibit the Banks from relying on the exception if they perform any order-taking as part of custody services. The Banks believe that this interpretation directly conflicts with this Congressional intent, as previously noted to the Commission in comments. See, e.g., Comments of the PNC Financial Services Group, Inc. on S7-12-01 (July 17, 2001); Comments of the American Bankers Association on S7-12-01 (July 17, 2001). To the extent that banks cannot offer order-taking as part of custody services, the Banks' plan customers will be required to open brokerage accounts with broker-dealers to effect plan securities transactions. This would be detrimental not only to banks, but to bank custody customers, including plans. Current practices are cost-effective for plans since they are able to place orders with custodians, allowing them to avoid the expense and burdens of establishing a separate account with a broker-dealer.

[48] See n.28, supra.

Moreover, as discussed in more detail in Section IV, below, there are additional issues with respect to the availability of the section 3(a)(4)(B)(viii) safekeeping and custody exception where the Banks provide clearance and settlement services to fiduciary-managed accounts. With respect to the application of the "chiefly compensated" test under the section 3(a)(4)(B)(ii) trust and fiduciary activities exception, it is unclear how the test applies where a bank provides a combination of services that would be covered by different functional exceptions under section 3(a)(4) and exemptions under proposed Regulation B. Because of the complexity and range of services that the Banks provide to plans, there may be a variety of situations in which the Banks could be forced to stop providing services if these issues are not resolved.

In this context, the Banks welcome the Commission's efforts to provide an exemptive rule to accommodate services the Banks provide to employee benefit plans by proposing Rule 770. Generally, proposed Rule 770 would exempt a bank from the definition of "broker" to the extent the bank serves as trustee or custodian of certain tax-qualified retirement plans and effects transactions in mutual funds, under certain conditions. Unfortunately, as proposed, Rule 770 will needlessly increase the complexity and cost of providing plan services, and cause substantial disruptions in the services banks provide to plans. It will force banks to restructure most if not all of their plan service and compensation arrangements, solely to accommodate conditions under proposed Rule 770. In some cases, banks may stop providing some services, or cease services to some types of plans. It also will put banks at a significant competitive disadvantage to competitors such as mutual fund complexes, broker-dealers and other non-bank plan service providers who will not be required to comply with proposed Rule 770's burdensome conditions and limitations. None of these consequences will benefit plans or participants. Moreover, the disruption of plan services that could be caused by conditions under proposed under Rule 770 are unnecessary in light of the extent to which banks are already regulated by ERISA and other laws in providing plan services.

Therefore, the Banks urge the Commission to consider adopting a broad exemption for banks providing services to employee benefit plans. Specifically, the Commission should modify Rule 770 to exempt banks from the definition of the term "broker" to the extent that banks effect transactions in any type of securities for any type of employee benefit plan, including a plan qualified under Code section 401(a), a plan described by Code section 403(b), a church plan described by Code section 414(e), a governmental plan described by Code section 414(d) (including governmental plans described by Code section 457), any VEBA established under Code section 501(c)(9), or any non-qualified deferred compensation plan. This would accommodate Banks' current business practices. Further, given the substantial regulation of services provided to employee benefit plans under ERISA or other applicable laws, conditions are already in place to protect plans and plan participants as investors. A broad exemption also would be consistent with Congressional intent that the GLBA's Exchange Act amendments should not disturb traditional trust and fiduciary activities and customary banking activities of banks.[49] In this regard, banks have provided trust, custody, and other services to employee benefit plans without any problems since before ERISA was enacted in 1974.

However, if the Commission concludes that proposed Rule 770 should not be so broad, the Banks respectfully request that the Commission consider a number of specific changes to Rule 770. As discussed below, these changes are needed to prevent substantial disruption in the services Banks currently provide to employee benefit plans.

A. The Offset/Credit Condition Should be Eliminated Proposed Rule 770 would provide that a bank must offset or credit any "compensation"[50] that it receives from a fund complex related to securities in which plan assets are invested against fees and expenses that the plan owes to the bank. The Commission suggests two reasons for this condition. One rationale is that banks "advised the Commission staff that they offset or credit any compensation received from mutual funds against plan expenses."[51] However, as discussed above, the Banks only rarely perform a dollar for dollar offset of compensation received from fund complexes against plan fees. At least one of the Banks communicated this fact to the Commission in comments.[52]

Second, the Commission explained that the dollar-for-dollar offset would "address the conflict of interest that banks would otherwise have when choosing particular funds to offer to plan sponsors." The Banks do not agree that this rationale supports a dollar for dollar offset condition, in light of relevant guidance issued by the Labor Department. Moreover, the imposition of a dollar for dollar offset would be administratively burdensome and would disadvantage banks in competing with registered brokers-dealers not required to perform the

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[49] See S. Rep. No. 106-44 at 10 (Apr. 28, 1999) and Conf. Rep. 106-434 at 163-164 (Nov. 2, 1999).

[50] Although the term "compensation" in proposed Rule 770 is not defined, it appears to include any form of compensation, whether for distribution, shareholder services, or administrative, sub-transfer agency or other services, received from the mutual fund or fund complex. However, even if the term only means "sales compensation," as that term is defined in proposed Rule 724, the Banks would still object to the offset or credit requirement for all of the reasons outlined in this letter.

[51] 69 Fed. Reg. 39718.

[52] See Comments of First Union National Bank on S7-12-01 (July 13, 2001).

offset or credit when providing identical services to plans. For these reasons, discussed in more detail below, the offset/credit condition should be eliminated from proposed Rule 770.

1. Labor Department Guidance In proposing Rule 770, the Commission recognizes that a bank's receipt of compensation from mutual funds in connection with services the bank provides to plans investing in the mutual funds is governed by Labor Department guidance, including DOL Advisory Opinion 1997-15A (May 22, 1997) (the "Frost Letter") and DOL Advisory Opinion 1997-16A (May 22, 1997) (the "Aetna Letter"). These opinions have been more recently supplemented by DOL Advisory Opinion 2003-09A (June 25, 2003) ("ABN AMRO Letter"), which provides similar guidance.

As noted above, the framework established by DOL — under the Frost Letter, the Aetna Letter, and the ABN AMRO Letter — generally provides that, whether a bank may retain compensation from mutual funds in connection with plan investments, or the bank must provide an offset or credit against plan fees, depends upon —

- whether the bank is or is not acting in a fiduciary capacity, either by virtue of its exercise of discretionary authority or control over plan assets or by virtue of providing investment advice, and
- whether the bank provides an independent plan fiduciary with sufficient information to allow the independent fiduciary to make informed decisions about the bank's compensation, including compensation received from mutual fund complexes.

For example, in the Frost Letter, a bank assisted plans in selecting the mutual funds that would be plan investment options, and reserved the right to add, delete and substitute the mutual funds selected to be plan investment options. The Labor Department concluded that this bank would have or exercise authority as a plan "fiduciary" in providing these services. Accordingly, the bank could receive compensation from mutual fund complexes in connection with the plan investment transactions only if the bank offset all compensation received from the mutual fund complexes on a dollar for dollar basis against other plan fees.[53]

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[53] Specifically, the Labor Department explained that, under the circumstances described, the bank would exercise authority or control with respect to plan investments that would make the bank a "fiduciary" for ERISA purposes by assisting plans in selecting plan investment options and reserving the right to add, delete or substitute mutual fund used as plan investment options. As noted, prohibited transaction rules under ERISA section 406 generally prohibit any person acting as a plan fiduciary from self-dealing, acting where the fiduciary has conflict of interest, or receiving "kickbacks." However, the Labor

In contrast, in the Aetna Letter, the Labor Department concluded that a plan recordkeeper could receive fees from mutual fund complexes without performing a dollar for dollar offset, where the recordkeeper offered a "menu" of mutual fund investment options from which a plan sponsor (or other independent plan fiduciary) would select plan investment options and the recordkeeper reserved the right to make changes to the menu. In this regard, after reviewing the services provided by the recordkeeper, including the recordkeeper's procedures for disclosing fees received from mutual funds and for making changes in the menu of mutual funds, the Labor Department concluded that the recordkeeper would not act as a plan "fiduciary" by exercising its right to add, delete or substitute funds on the menu. A key fact to this conclusion was that plan fiduciaries maintained full authority and control over the plan investments because the terms of the recordkeeper's compensation arrangements with the mutual fund complexes were disclosed, and the plan fiduciaries were free to decide whether to accept a fund deletion or substitution or take their business elsewhere.

Although the Aetna Letter focuses on the recordkeeper's rights to make changes in a mutual fund menu, it implies that the recordkeeper's decision-making about what investment options to include in the menu is not a "fiduciary" decision for ERISA purposes. The ABN AMRO Letter addresses the same issue more directly. Specifically, under ABN AMRO's bundled services program, ABN AMRO would be a directed trustee and would provide plans a menu of mutual fund investment options, including proprietary and non-proprietary mutual funds. ABN AMRO would require, as a condition of entering into a services arrangement, that a potential client plan select at least one proprietary mutual fund (from which ABN AMRO or its affiliate would receive compensation). The Labor Department still determined that ABN AMRO's receipt of compensation from mutual fund complexes without a dollar for dollar offset was permissible because the plan sponsor or other appropriate plan fiduciary would retain full authority and control over plan investments where the terms of the arrangement are fully disclosed, and the plan sponsor or other plan fiduciary was free to accept the terms or seek out a different service provider.

The Labor Department's analysis in the Frost, Aetna, and ABN AMRO Letters make it clear that the Labor Department has already reviewed and addressed the circumstances in which conflicts of interest could require banks to offset or credit compensation from mutual funds

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Department further agreed that violations of these provisions could be avoided if the bank offset or credit compensation received from mutual funds against the fees the plan was otherwise obligated to pay to the bank. See DOL Adv. Op. 1997-15A.

against other plan fees, including whether banks have a conflict of interest when choosing particular funds to offer to plans. Where banks comply with this Labor Department guidance, including the disclosure required by this guidance, additional regulation under Commission rules should not be necessary. In this regard, ERISA remedies and penalties for breach of fiduciary duties provide significant deterrents to breach of disclosure and other fiduciary obligations by banks.[54] (Indeed, as discussed, a bank's failure to provide sufficient information that enables a plan sponsor or other plan fiduciary to determine whether a bank's compensation is appropriate may be enough to cause a bank to violate the ERISA prohibition against self-dealing.[55])

2. Industry impact of dollar for dollar offset As a result of the Labor Department rulings described above, banks restructured their fee and service arrangements to reduce, and in most cases entirely eliminate, the amounts charged to and paid directly from plans under bundled service arrangements. Instead, fees for plan services are paid indirectly through amounts paid from mutual fund complexes, under conditions that comply with ERISA's fiduciary responsibility provisions. These arrangements have become the industry standard, particularly for participant-directed plans, for several reasons. Specifically, the fee arrangements are simpler in that there is no need to allocate and collect plan service charges from participant accounts. This also simplifies disclosures to participants about the fees paid for plan services. These arrangements also allow plan fiduciaries and participants to evaluate plan investment return on a basis that takes into account most, if not all, plan administrative costs.

Importantly, since the Banks provide plan sponsors (or another appropriate named fiduciary of a plan) information about the services provided and compensation that the Banks receive from mutual fund complexes, plan sponsors and other plan fiduciaries can evaluate whether the level of services the plan is receiving is commensurate with the compensation paid

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54 ERISA section 409 requires any fiduciary breaching a fiduciary duty to make the plan whole for any losses including lost investment earnings and to disgorge any profit (including excess compensation received by a fiduciary). Actions for breach of fiduciary duty may be brought by any plan fiduciary, plan participant, or the Labor Department. In addition, fiduciaries and other "disqualified persons" receiving excess compensation could violate prohibited transaction excise tax provisions under Code section 4975 (which are substantially similar to the prohibited transaction provisions under ERISA section 406). Any prohibited transaction must be corrected by, in the case of excess compensation, repaying the excess compensation to the plan. In addition, Code section 4975 imposes on the disqualified persons self-assessing excise taxes of 15% of the "amount involved" in a prohibited transaction each year until the prohibited transaction is corrected.

55 See FAB 2003-3, supra n. 45.

from mutual funds. The bundled service industry is highly competitive, with all providers, including the Banks, competing to provide state of the art services to plans and plan participants. The Banks believe that, given the high level of specialized plan recordkeeping, administrative and other services that are provided under bundled services arrangements, their compensation from mutual fund complexes for these services is appropriate and reasonable.

Therefore, the offset/credit condition under proposed Rule 770 would disrupt Banks in providing services to plans under bundled service arrangements by forcing Banks to change their existing plan fee and service arrangements, without providing any additional protection to plans and participants as investors. Instead, Banks would be forced to adopt a fee and service model that could prove harmful to plans and participants in several respects. First, the Banks do not currently have automated processes to implement a dollar for dollar offset. In the rare cases where Banks perform a dollar for dollar offset for a plan, they employ a complex manual process that cannot be used for more than a few plan clients. Therefore, automated systems and processes for administering the dollar for dollar offset would be essential given the large numbers of plans receiving services from Banks, the fact that each plan may invest in several different mutual funds, and the fact that plans may invest in different share classes that pay different levels of compensation. The fact that Banks typically hold custody of plan assets invested in mutual funds in "omnibus" level accounts, and receive compensation from mutual fund complexes based on value of these omnibus accounts rather than for particular plan balances, further complicates the administration of a dollar for dollar offset requirement. [56] Banks will also have to adopt new administrative processes for maintaining plan participant account records in order to collect fees from participants' accounts. This also will require additional communication to plan participants about fees charged to their participant accounts. Banks will incur costs to develop and implement automated systems and processes to administer a dollar for dollar offset and to communicate the extra fees to participants. Plans and plan participants will bear at least some of these costs.

Further, to implement a dollar for dollar offset, the Banks will be required to renegotiate their service and compensation agreements with plans. Thus, in requiring the offset/credit, the

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[56] Also, the mechanics of fee offset/credit arrangements are complicated and raise technical issues under ERISA's prohibited transaction rules. In this regard, compensation paid from mutual fund complexes can be delayed substantially after the time at which the plan is making investments in mutual funds and receiving the services. Thus, a bank that delays collecting plan service fees otherwise due to be paid by a plan may be extending credit to the plan. ERISA section 406(a)(1)(B) generally prohibits extensions of credit between plans and parties in interest, including plan service providers.

Commission is actually regulating the terms of contracts established between Banks and their plan customers. Under the new agreements that would be required if the credit/offset condition is imposed, plan level fees could increase to offset the costs of developing new tracking and reporting systems to support a dollar for dollar offset. Furthermore, under an offset/credit requirement, plans and plan participants (rather than a bank service provider) would bear the risk of whether compensation paid by mutual fund complexes will entirely offset plan service costs. If the compensation amount from fund complexes is not sufficient, plans and plan participants would be "stuck" with the remaining fees.

Renegotiation of plan service agreements, building new systems capabilities to administer the offset/credit requirement, and communicating new plan level fees to participants will increase Banks' costs in providing services to plans. These costs eventually will be borne by plans and participants. Moreover, the possibility of new plan level fees may discourage or prevent some plan sponsors (especially plan sponsors who are small-sized employers) from offering retirement savings opportunities to their employees.

The retirement plan services industry has already had substantial experience with the problems of dollar for dollar offset compensation arrangements. In fact, these various administrative issues were an important reason why the bundled service compensation model is so commonly offered to plans and typically requested by plan sponsors and plan fiduciaries. By imposing a dollar for dollar offset condition under proposed Rule 770, the Commission would be regulating the terms of contracts established between banks and their plan customers. Moreover, in regulating these contracts, the Commission would be forcing banks and plans to return to a service model that has been rejected by retirement plan service providers, and by plan sponsors and other plan fiduciaries that select plan fee and service arrangements, an outcome Congress surely did not intend.

3. <u>Competitive concerns</u> Banks already compete with broker-dealers, mutual fund complexes, and other non-bank service providers to offer bundled services to plans. Requiring banks to perform a dollar for dollar offset where broker-dealers and mutual fund complexes are not subject to the same requirements would put banks at a substantial competitive disadvantage. In this regard, while Congress intended to "level" the playing field between banks and broker-dealers where the bank exception from broker-dealer registration created competitive disparities, it does not appear that Congress intended to put banks at a competitive <u>disadvantage</u> to broker-dealers. In particular, one reason given by Congress for the functional exceptions provided by Exchange Act section 3(a)(4) is that conditions relating to excepted activities "are tailored to protect investors and to ensure the competitive fairness among different types of

financial services providers."[57] In the case of employee benefit plans, regulation under ERISA (or similar laws where ERISA does not apply) already ensures competitive fairness by imposing the same legal requirements on all plan service providers.[58]

According to the Commission, the offset/credit requirement would benefit plans and plan participants because, as investors, they need to know about the fees associated with their investments because these fees directly affect their investment returns and information about fees "should be transparent to purchasers of ERISA plans so that they can make 'apples to apples' comparisons."[59] However, imposing an offset/credit requirement only on banks does not allow plan sponsors and other plan fiduciaries to make these "apples to apples" comparisons. So long as banks' competitors, including broker-dealers and mutual fund complexes, may continue to offer bundled services arrangements and are not obligated to offset compensation that they

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[57] H.R. Rep. No. 106-74, pt. 4 at 162 (1999). The Commission cites this language in its discussion of proposed Regulation B. See 69 Fed. Reg. at 39684, n.16.

[58] In fact, certain prohibited transaction class exemptions issued by the Labor Department under ERISA already put broker-dealers and mutual fund complexes at an advantage as compared to banks in offering mutual funds to plans, by providing registered brokers-dealers and fund principal underwriters with flexibility to receive compensation from mutual fund complexes without a dollar for dollar offset, even if the broker-dealer is acting as a "fiduciary" with respect to plans by exercising investment discretion or providing investment advice. For example, Part II of Prohibited Transaction Class Exemption 75-1 ("PTE 75-1"), 40 Fed. Reg. 50845 (Oct. 31, 1975), generally permits registered broker-dealers and their affiliates to sell shares of mutual funds (other than funds affiliated to the broker-dealer) to plans and receive sales commissions from the mutual funds without a dollar for dollar offset against plan fees, or even any specific disclosure conditions. Prohibited Transaction Class Exemption 84-24 ("PTE 84-24"), 49 Fed. Reg. 13208 (Apr. 3, 1984), as corrected at 49 Fed. Reg. 24819 (June 15, 1984), generally allows (among other transactions) mutual fund principal underwriters and their affiliates to recommend plan investments in their proprietary mutual funds and retain commissions received in connection therewith if disclosure and other conditions are required. (A dollar for dollar offset is not a condition.) Banks are not eligible to rely on either of these exemptions, unless the Bank is an affiliate of a registered broker-dealer or principal underwriter, and plan investment transactions are effected through the affiliated broker-dealer or principal underwriter. Instead, Banks providing investment advice or exercising investment discretion must rely on the Labor Department's interpretation under the Frost Letter (DOL Adv. Op. 1997-15A), or PTE 77-4, both of which require dollar for dollar offsets of compensation received from mutual funds against plan fees.

[59] 69 Fed. Reg. at 39718.

receive from mutual funds against plan service fees on a dollar for dollar basis, plan sponsors and other plan fiduciaries would have to compare two entirely different fee structures.

Moreover, plan sponsors or other plan fiduciaries selecting plan fee and service arrangements expect and will demand bundled service arrangements offered by broker-dealers and mutual fund complexes instead of the dollar for dollar offset service model that proposed Rule 770 would force banks to offer. As noted, bundled service arrangements have become the industry standard because these arrangements simplify the payment of plan expenses, and plan sponsors and other plan fiduciaries and participants evaluate investment performance after most or all plan costs are taken into account. If forced to perform a dollar for dollar offset, banks would be forced to charge plans at least the same fees that plans currently pay indirectly through mutual funds, or more likely, additional fees to reflect their increased costs to implement and administer the dollar for dollar offset. Therefore, the offset/credit condition will likely result in plans paying more for plan services provided by banks.

Because of this, proposed Rule 770's offset or credit requirement would create new competitive disparities among banks, registered broker-dealers and mutual fund complexes. Broker-dealers and mutual fund complexes would not be required to offset mutual fund compensation against plan fees on a dollar for dollar basis, while banks would forced to do so. This result would be unfair to banks and could ultimately remove banks as effective competitors in the employee benefit plan services industry. This reduction in competition would be harmful to plans and plan participants, and could result in plans paying more rather than less for plan investment management and plan administrative services.

4. Absence of Abuse or Need for Additional Regulation The Banks are not aware of any reports of widespread abuse in connection with banks receiving compensation from mutual fund complexes that would suggest that there is a problem with current industry practices. Moreover, the protections generally afforded to individual investors by broker registration and regulatory supervision would appear unnecessary in the context of employee benefit plans, including participant-directed plans, where a plan sponsor or other independent plan fiduciary is responsible for reviewing and approving plan investment options and fees. In this regard, these fiduciaries typically are more sophisticated than retail customers and have legal duties under ERISA or other applicable laws to protect plan participants. Further, as discussed, guidance issued by the Labor Department already substantially regulates banks' receipt of compensation from mutual funds, including specific disclosure requirements.

In this context, and in light of industry disruption that would result from imposing the dollar for dollar offset condition, the Banks believe that the dollar for dollar offset condition will not offer any benefits that would outweigh its costs. Therefore, the condition should be eliminated from proposed Rule 770.[60]

B. Other Plans Should be Covered by Rule 770 Rule 770 as proposed would only apply when banks provide services to qualified plans under Code sections 401(a), 403(b), or 457. The Banks believe this would leave out a large swath of the Banks' employee benefit plan business. Therefore, the Banks request that Rule 770 be expanded to apply to other types of employee benefit plans.

First, the rule should be available where banks provide services to VEBAs, to church plans described by Code section 414(e), and to all governmental plans described by Code section 414(d). These plans are administered together with plans already covered by proposed Rule 770, using the same trust administration and recordkeeping systems and following the same procedures. These plans also are subject to ERISA or to similar regulatory schemes that protect the plans and participants. There is no reason to omit these plans from coverage by proposed Rule 770.

Second, Rule 770 should be available where banks provide services to non-qualified deferred compensation plan accounts set up and administered together with tax-qualified retirement plans, including but not limited to the non-qualified deferred compensation mirror plan accounts described above. The Banks believe it would be unduly burdensome to separate services provided with respect to non-qualified deferred compensation plan accounts from other plans. It also should not be necessary because assets administered by banks in connection with these plan accounts are in fact owned by employers, who are typically more sophisticated than retail investors.

Regulatory distinctions under proposed Rule 770 among these different types of plans will be extremely disruptive. Where some plans are subject to different regulatory requirements, Banks would be required to restructure their services to support special services for these plans, which would increase the complexity in providing services to all types of plans. For some types

[60] If the offset/credit condition is eliminated, the disclosure condition under proposed Rule 770(a) should (if not deleted altogether) be amended to reflect this change and to be consistent with Labor Department guidance. See infra section III.F for suggested amendment language.

of plans, the changes will be too costly and Banks may exit the service business for those types of plans.

C. Delete or Clarify Limits on Incentive Compensation Several of the Banks offer bonus or other incentive compensation programs to employees for obtaining new business for their trust and custody business units or departments. Typically, these arrangements are structured so that employees may receive compensation based on the total new revenue received for marketing trust and custody services and products. The "total revenue" considered for this purpose could include all fees that plan clients are expected to pay directly or indirectly to the Bank, including amounts that a Bank may receive for plan services through mutual fund complexes. Importantly, a number of facts and circumstances are critical to the "total revenue" calculation, including the type of plan, plan size and the types and level of services that will be provided. Any fees paid by the plan directly are treated the same as the compensation that Banks receive indirectly for providing plan services through mutual fund complexes.

Proposed rule 770(a)(4) would prohibit a bank from relying on Rule 770 unless the bank does not "pay any incentive compensation to a natural person that is not qualified pursuant to the rules of a self-regulatory organization that differs based on the value of a security purchased or sold by an account or a person who exercises control over the assets of such account."[61] The Commission's comments indicate that the intent of this condition is that unregistered employees of the bank should not have a "salesman's stake" with respect to securities transactions.[62]

The Banks believe that the prohibition on incentive compensation described by proposed Rule 770(a)(4) is ambiguously drafted and unnecessary. First, the use of the phrase "purchased or sold by an account or a person who exercises control over the assets of such account" is confusing. Second, by only addressing compensation paid to unregistered persons, the language is ambiguous about whether compensation in accordance with the section 3(a)(4)(B)(i) networking exception is permitted. However, given the specific conditions provided under the networking exception, there is no reason to bar banks from paying their employees pursuant to that exception where the applicable conditions are satisfied, or dually-registered employees from receiving compensation for brokerage transactions.

[61] 69 Fed. Reg. at 39737-39738.

[62] See 69 Fed. Reg. at 39719.

Moreover, the Banks object to the language of proposed Rule 770(a)(4) because it could prohibit the typical bank employee incentive compensation programs described above. These programs are not designed and do not operate to create a "salesman's stake" in plans' securities transactions. In fact, the fees that plans pay directly are given the same weight as amounts plans pay indirectly through mutual funds. Therefore, the programs only compensate employees for obtaining new clients, including employee benefit plan clients, that engage Banks to provide the trust, custody, and other plan products and services described above. The programs do not reward employees for recommending any particular securities or other investments, or any specific type or category of securities. Therefore, there is no reason for the Commission to interfere with these types of bank employee incentive programs.

Importantly, the reasonable compensation and other conditions that apply under ERISA and similar state laws in the context of employee benefit plan services provide banks substantial incentive to carefully supervise the activities of their employees. In this regard, if an employee provides "investment advice" for ERISA purposes in the sales process, the bank could be deemed to be an ERISA fiduciary in connection with the employee's activities. In that event, the bank itself could be providing fiduciary investment advice of the type that might trigger requirements under ERISA to perform a dollar for dollar offset of compensation received from mutual funds under Labor Department interpretations described above.[63] Further, any misconduct by the employee (including any "imprudent" investment advice) could subject the bank to liability for breach of fiduciary duty. In light of these potential liabilities, additional Commission restrictions on how banks compensate their employees are not necessary.

Therefore, the Banks respectfully request that the Commission delete the prohibition on incentive compensation under proposed Rule 770(a)(4) because it is ambiguous and unnecessary. However, if the condition is retained, it should be revised to clarify that it does not prohibit programs that provide employee bonuses or other compensation based on the total of fees or other compensation generated by new clients, or incentive compensation relating to brokerage transactions paid pursuant to a networking arrangement meeting conditions under section 3(a)(4)(B)(i). In this regard, proposed Rule 770(a)(4) should be revised to read as follows:

> The bank does not pay any incentive compensation that differs based on the value of a security or the type of security purchased or sold by a plan to any natural person that is

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[63] See the Frost Letter and other authorities discussed above in Section III.A.

not qualified pursuant to the rules of a self-regulatory organization, provided that this condition does not prohibit:

(i) a bank from paying its employees compensation under a bonus or other incentive program based on the bank's total compensation for services to one or more plans, including any such compensation received indirectly from plans through payments from mutual fund complexes, or

(ii) any compensation paid pursuant to a networking arrangement that meets the conditions of section 3(a)(4)(B)(i) of the Securities and Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(i); and

D. Relief for Other Securities Transactions, Including Employer Securities As proposed, Rule 770 only applies where banks effect transactions in mutual funds or offer plan participants participant-directed brokerage accounts. However, many plans, including those that invest primarily in mutual funds, also sometimes purchase other securities and may request Banks to effect these transactions. This is particularly true for plans that invest in employer securities. In this regard, employer securities in a plan may be managed by the plan sponsor or another plan fiduciary, or may be offered as a plan investment option to plan participants. Plan sponsors or other plan fiduciaries expect that Banks will be able to effect these transactions, usually through a broker-dealer that they designate.

As discussed, many plans (whether or not they are participant-directed) invest in employer securities and the assets held by plans in employer securities are significant. If Banks cannot provide services with respect to employer securities and other securities owned by plans, plan sponsors or other plan fiduciaries will be forced to open separate brokerage accounts with a broker-dealer to effect these plan transactions. This would increase plan expenses for effecting plan transactions in employer securities and create administrative issues.

Exchange Act section 3(a)(4)(B)(iv)(I) would allow a bank to effect transactions in issuer securities as part of any pension, retirement or other similar benefit plans maintained for employees of an issuer, but only "as part of its transfer agency activities." According to the Banks, it is rare that an employer who is an issuer of securities would select the same bank as both transfer agent for its securities and as trustee or custodian for its employee benefit plans. Therefore, Banks may not be able to provide services to plans with respect to employer securities, even though these services are an important component of the services that Banks acting as trustees and custodians have customarily provided to employee benefit plans.

Therefore, the Banks ask that the Commission expand Rule 770 to specifically permit banks to effect transactions in securities other than mutual funds, or at least in employer securities, for any pension, retirement or other benefit plans (including in connection with VEBAs and non-qualified deferred compensation plans) where the bank acts as trustee or custodian with respect to the plan, subject to the condition already provided by proposed Rule 770(a)(5) (i.e., the bank complies with Exchange Act section 3(a)(4)(C), which would generally require the bank to direct the trades to a registered broker-dealer for execution). This change would accommodate the Banks' current business practices, while still protecting plans as investors. Without this change, the Banks could be forced to stop providing services that plan sponsors and other plan fiduciaries expect to receive from their plan trustees and custodians, and plans will incur additional expense to obtain these services through a broker-dealer.

E. Allow Banks Custody of Participant-Directed Brokerage Account Assets As proposed, Rule 770(b)(3) requires that participant-directed brokerage accounts be "carried" by a broker-dealer. This suggests that the broker-dealer through which participant-directed brokerage accounts are made available to plan participants must hold custody of securities and settle transactions for the participant-directed brokerage accounts.[64] The Commission states that bank representatives advised that, when they offer brokerage windows to plan participants, they establish separate brokerage accounts for each participant with a broker-dealer.[65]

As discussed above, participants generally must place orders for participant-directed brokerage accounts with a registered broker-dealer. However, a number of the Banks still clear and settle the transactions for participant-directed brokerage accounts and hold custody of the securities purchased for a self-directed brokerage account. This arrangement provides some specific advantages to plans and participants — it allows the Bank more control in meeting its obligation as plan trustee or custodian to keep control of plan assets and allows participants to receive a single account statement showing all of the investments of the participants' individual account (rather than two statements). Further, this arrangement ensures that the customer protections associated with order entry through registered broker-dealers are available to plan participants in connection with a participant-directed brokerage account.

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[64] See 69 Fed. Reg. 39712, n.283 (brokers effecting securities transactions are required to hold the customer assets and settle the securities transactions).

[65] 69 Fed. Reg. at 39719.

Accordingly, the Banks request that the Commission modify Rule 770 to clarify that banks providing services with respect to participant-directed brokerage accounts may clear and settle securities transactions and hold securities for the participant-directed brokerage accounts, so long as participants enter their securities orders through a registered broker-dealer. Specifically, section (b)(3) of proposed Rule 770 should be revised to read:

> "*Participant-directed brokerage account"* means an account maintained in connection with a plan through which participants may initiate, request or direct the purchase and sale of securities through a registered broker-dealer.

F. Eliminate the Disclosure Condition As discussed, banks are already required to disclose the compensation they receive from mutual fund complexes under detailed guidance issued by the Labor Department. Therefore, the Banks believe that the disclosure condition under proposed Rule 770(a)(2) is unnecessary and should be deleted.

However, if it is retained, it should be modified because it is unclear. In this regard, the disclosure condition under proposed Rule 770(a)(2) requires disclosures to be made to "the plan sponsor, or its designated fiduciary." This term is not defined. As discussed above, ERISA generally requires that a plan "fiduciary" review plan services and fee arrangements and determine that the arrangement is appropriate and compensation is reasonable. This fiduciary may be the plan sponsor or may be another person designated under the plan's terms. Accordingly, the Banks suggest that the Commission clarify that the appropriate person to receive the disclosure is the "plan sponsor or other person designated to review and approve plan service arrangements."

To reflect this comment and the proposed deletion of the credit/offset condition under proposed Rule 770(a)(1), the disclosure condition under proposed Rule 770(a)(2) (if not deleted altogether) could be revised to read as follows:

> The bank provides a clear and conspicuous disclosure to the plan sponsor or other person designated to review and approve plan service arrangements that includes all fees and expenses assessed for services provided to the plan and all compensation received or to be received from a fund complex in respect of the plan's investments a manner that provides such person sufficient information to determine whether amounts paid by the plan for the bank's services are reasonable.

G. Clarify Rule 770 Definition of "Compensation" Proposed Rule 770 does not currently include any definition of "compensation." The Banks strongly urge the Commission to delete the compensation offset/condition under proposed Rule 770(a)(1) for the reasons discussed above. However, if the Commission does not eliminate this condition, the Banks urge the Commission to clarify that only "sales compensation" as defined by proposed Rule 724(i) must be offset or credited against plan fees. This change would exclude the following types of compensation paid from mutual funds from the offset/credit requirement: shareholder administrative service fees paid for certain administrative services (see proposed Rule 724(i)(6)((i) - (viii)), and investment management fees, transfer agency fees, and custodial fees paid by proprietary mutual funds to a bank or its affiliate for services provided to the proprietary mutual fund.

H. Clarification of Proposed Rule 770(a) In proposing Rule 770, the Commission explains that banks serving as "trustees and non-fiduciary administrators" may rely on the exemption.[66] Proposed Rule 770 is not consistent with this statement because it would only provide an exemption where a bank acts as "trustee or custodian, or offers participants a participant-directed brokerage account . . ."[67]

In addition, as noted, the Banks act in a variety of capacities with respect to plans, including (in addition to trustee or custodian) as investment manager or other administrative service provider. Therefore, the Banks request that the language of Rule 770 be revised to exempt banks acting in any of their capacities with respect to plans, i.e., as trustee, custodian, investment manager or other plan service provider.

The Banks also note that it is confusing for the rule to state that a bank "offers" plan participants participant-directed brokerage accounts, as indicated by language under proposed Rule 770(a) and 770(a)(3).[68] Rather, as discussed, the Banks provide services in connection with participant-directed brokerage accounts if the plan is designed to allow participants to direct investments for their individual employee benefit plan accounts through a participant-directed brokerage option under the plan or if the plan sponsor or other plan fiduciary concludes that it is

[66] 69 Fed. Reg. at 39718.

[67] 69 Fed. Reg. at 39737 (proposed Rule 770(a)).

[68] Because the definition of "participant-directed brokerage account" under proposed Rule 770(b)(3) would require transactions to be effected through a registered broker-dealer, section (a)(3) under proposed Rule 770 appears to be duplicative and could be deleted. If it is not deleted, it should be restated.

prudent to allow participants the opportunity to select additional investment options through a participant-directed brokerage option. Accordingly, the Banks propose that the Commission modify proposed Rule 770 to clarify that banks provide services in connection with participant-directed brokerage accounts but do not "offer" participant-directed brokerage accounts.

To reflect these comments and other comments above relating to the types of plans that should be covered and the need to cover employer securities, the Banks suggest that the language under proposed rule 770(a) should be revised and additional definitions added to the proposed rule. Specifically, the language of rule 770(a) could be revised, as follows:

> A bank is exempt from the definition of the term "broker" under section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) to the extent that it effects transactions in securities of an open-end company <u>or employer securities or provides services with respect to a participant-directed brokerage accounts </u>in an account for a plan ~~that is qualified under section 401(a) of the Internal Revenue Code of 1986 (26 U.S.C. 401(a)) or a plan described in sections 403(b) or 457 of the Internal Revenue Code of 1986 (26 U.S.C. 403(b) or 26 U.S.C. 457)~~ for which the bank acts as a trustee<u>,</u> ~~or a~~ custodian<u>, investment manager or other service provider</u>~~; or offers participants a participant-directed brokerage account~~, if:

In addition, the following new definitions could be added:

> *Employer securities* means a security issued by an employer of employees covered by a plan, or by an affiliate of such employer.
>
> *Plan* means (i) a plan that is qualified under section 401(a) of the Internal Revenue Code of 1986, as amended (the "Code"), (ii) a plan described in section 403(b) of such Code, (iii) a church plan described by section 414(e) of such Code, (iv) any governmental plan described by section 414(d) of such Code (including governmental plans described by section 457 of such Code), (v) any voluntary employee benefit association established under section 501(c)(9) of such Code and any other trust or fund maintained by an employer for purposes of funding a welfare benefit plan subject to title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA), and (vi) any account maintained by an employer in connection with an unfunded plan under which employees' receipt of certain compensation from the employer is deferred.

IV. Other Issues under the GLBA Functional Exceptions

A. Interpretation of the Custody and Safekeeping Exception Exchange Act section 3(a)(4)(B)(viii) provides an exception from broker-dealer registration with respect to certain securities-related safekeeping and custody services that banks perform for their customers. Clearance and settlement services have always been an important component of these safekeeping and custody services. As discussed, this is particularly true where banks act as directed trustees and custodians for plan accounts that are "fiduciary-managed." In the case of these fiduciary-managed plans, a plan fiduciary or investment manager typically arranges the plan's securities transactions with a registered broker-dealer, and is responsible for selecting the broker-dealer and negotiating the terms of the transaction. The Bank is responsible for clearing and settling the transactions and maintaining custody of the plan's securities and other assets.

Although these clearance and settlement activities are part of the customary banking activities performed by banks for directed trustee and plan custody customers, questions have been raised about whether the safekeeping and custody exception excepts banks from broker-dealer regulation in performing these clearance and settlement services. In particular, the Banks are concerned that the Commission's narrow interpretation of the scope of section 3(a)(4)(B)(viii) may be misinterpreted to prohibit a bank from receiving fees in connection with clearance and settlement activities. Therefore, the Banks request that the Commission confirm −

- Section 3(a)(4)(B)(viii) excepts banks from registering as brokers to the extent banks are performing clearance and settlement services, so long as the securities orders are arranged by a plan investment manager or other plan fiduciary with a registered broker-dealer.
- The exception under section 3(a)(4)(B)(viii) is available even if banks charge separate fees for their transaction and settlement services and the fees may be determined on a "per transaction" basis.
- The section 3(a)(4)(B)(viii) exception is available to banks acting as trustee or custodian to plans and providing the clearance and settlement services as described, without regard to the "carrying broker" condition under Exchange Act section 3(a)(4)(B)(viii)(II).[69]

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[69] The Banks note that this "carrying broker" condition raises a variety of complex issues, which have not yet been addressed by the Commission and are not addressed by this comment letter. The Banks only request at this point that the Commission clarify that the carrying broker condition under Exchange Act

The Banks believe that this is the correct result because, where securities transactions are arranged for a fiduciary-managed plan account by a plan investment manager or other plan fiduciary, a bank custodian does not engage in any "order taking" in providing custody services, including clearance and settlement services in connection with securities transactions.

B. Coordination of Functional Exceptions and Exemptions The description of services that Banks provide to employee benefit plans provided in this letter makes it clear that employee benefit plans require a complex array of specialized services, and banks may act in a variety of capacities even with respect to a single plan. As a result, in providing plan services, the Banks may provide some securities-related services that are covered by one GLBA functional exception or exemption and, at the same time, provide other services that are covered by different exceptions or exemptions. It is critical that Banks are able to combine the exceptions and exemptions in providing services to employee benefit plans — otherwise, banks will not be able to provide the full range of services required by plans, and plans will be forced to pay additional fees and expenses to engage additional non-bank service providers.

Therefore, the Banks believe that clarification is needed with respect to how the various exceptions and exemptions are coordinated, particularly with respect to the "chiefly compensated" test under the statutory trust and fiduciary activities exception (Exchange Act § 3(a)(4)(B)(ii)). In this regard, the Banks believe that banks should be able to receive compensation for effecting transactions or performing other services for a single employee benefit plan under a combination of statutory functional exceptions and or exemptive rules under proposed Regulation B (e.g., the networking exception under section 3(a)(4)(B)(i), the exception for sweep services under section 3(a)(4)(v), the custody and safekeeping exception under section 3(a)(4)(B)(viii), or the employee benefit plan exemption under proposed Rule 770). In addition, to the extent that a bank also relies on the trust and fiduciary activities exception under section 3(a)(4)(B)(ii), any compensation that the bank receives in performing services covered by one or more other functional exceptions or exemptions should be treated as "relationship compensation" for purposes of the chiefly compensated test. Following are two illustrations of this approach.

1. Participant-Directed Plan Example Suppose that a bank is a directed trustee to a participant-directed defined contribution plan offering the following combination of

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section 3(a)(4)(B)(viii)(II) would not limit the Banks in providing clearance and settlement services to plans as described by this letter.

investment options to plan participants — (a) mutual funds, (b) a unitized employer stock fund, and (c) a unitized separate account investment option managed by an investment manager independent of the bank (the manager is appointed by the plan sponsor). The bank may provide services relating to the plan's securities transactions under a combination of functional exceptions and exemptions as follows.

- As recordkeeper, the bank receives and processes plan investment transactions and provides other administrative services. The bank does not charge a separate fee for the recordkeeping and administrative services and waives it customary trustee fees.
- The bank effects mutual fund transactions for the plan in accordance with conditions under proposed Rule 770. The bank receives compensation from mutual fund complexes in connection with plan investments but (consistent with the Banks' request under this comment letter) the bank does not offset compensation received from mutual fund complexes against plan fees.
- The bank administers the employer stock fund and effects transactions in employer securities as part of this administration. The bank receives an asset-based fee for employer stock fund administration and also fees for effecting, clearing and settling the employer securities transactions. The effecting of transactions in the employer securities and the bank's receipt of fees in connection with these transactions is covered by Rule 770, as it is proposed to be modified in this comment letter.
- With respect to the separate account investment option, the bank administers the option as a unitized fund and receives a fee based on the fund market value for its unitization services. The bank also provides clearance and settlement services and receives fees for these services in connection with securities transactions arranged by the investment manager with a registered broker-dealer independent of the bank. The bank's provision of the clearance and settlement services and receipt of fees for clearance and settlement services would be covered by the safekeeping and custody exception under Exchange Act section 3(a)(4)(B)(viii).[70]
- From time to time, the investment manager may direct the bank to purchase or sell certain securities for the separate account investment option and, in that event, the bank effects the transactions through its trading desk and may charge a separate fee for effecting the transactions. (This might be necessary, for example, to provide liquidity for participant purchases or redemptions of units of the separate account.)

[70] Services would also be covered by proposed Rule 770, if it is modified to extend to transactions in all types of securities as discussed above in Section III.D.

> The bank is permitted to effect these securities transactions and receive compensation for effecting the transactions under the trust and fiduciary exception at Exchange Act section 3(a)(4)(B)(ii), if the chiefly compensated test and other conditions are met. (In this regard, a bank acting as a directed trustee to any ERISA-covered plan is a fiduciary for ERISA purposes, and accordingly would be acting in a trustee or fiduciary capacity for purposes of the section 3(a)(4)(B)(ii) exception.)

In performing the "chiefly compensated" test for this plan account under the statutory trust and fiduciary activities exception (or under the line of business test under proposed Rule 721) —

- the bank's "relationship compensation" (as defined by proposed Rule 724(h)) would include the fees received for unitized account administration of the employer stock fund and separate account investment option (as noted, the plan does not pay any fees to the trustee for trust or recordkeeping services);
- the bank's "relationship compensation" should also include (a) fees the bank is permitted to receive under Rule 770, including the bank's compensation from mutual fund complexes and the bank's fees for effecting transactions in employer securities, and (b) the banks' fees for performing clearance and settlement services for the separate account under section 3(a)(4)(B)(viii) (where the separate account investment manager arranges the securities transactions with a registered broker-dealer); and
- the bank's "sales compensation" should be limited to the fees the bank receives for effecting transactions directed by the separate account investment manager, to the extent that such fees exceed a flat or capped per order processing fee (as defined by proposed Rule 724(b)).

2. Fiduciary-Managed Defined Benefit Plan Example Assume that a bank is a custodian for a collectively bargained defined benefit plan, which is a Taft-Hartley plan managed by a joint board of employer and employees. The bank charges a fee based on the market value of the account assets for its custody services and fixed fees for other plan services, such as making plan distributions.

The plan's assets are allocated among several "managed portfolios" each of which is managed by an investment manager appointed by the trustees. The bank provides clearance and settlement services in connection with transactions placed by the investment managers with a registered broker-dealer selected by the investment manager and the investment managers are responsible for negotiating the terms of the securities transactions. The bank's clearance and settlement services and receipt of fees for these services would be covered by the safekeeping and custody exception under Exchange Act section 3(a)(4)(B)(viii).

From time to time, in connection with a transition between investment managers for one or more of the managed portfolios, the trustees may engage a registered broker-dealer affiliated with the bank to provide "transition management" services (specifically, the broker-dealer sells securities from the manager portfolio and buys additional securities for the portfolio to conform the portfolio to meet the requirements of the new investment manager). The bank's affiliated broker-dealer receives commissions and other fees for providing the services. The bank and its affiliated broker-dealer have entered into a "networking" agreement described by Exchange Act section 3(a)(4)(B)(i), and the bank receives from the registered broker-dealer compensation for referring the plan to the registered broker-dealer for the transition services, subject to the conditions under section 3(a)(4)(B)(i).

The trustees engage the bank as investment manager for one of the managed portfolios and the bank receives a fee for providing the investment management services based on the market value of the managed portfolio assets. Acting as investment manager, the bank effects purchases and sales of securities for this portfolio through the bank's trading desk. The bank does not charge fees other than a flat or capped per order processing fee (as described by proposed Rule 724(b)) in connection with these securities transactions. As investment manager to the plan, the bank is permitted to effect these securities transactions under the trust and fiduciary exception at Exchange Act section 3(a)(4)(B)(ii). For this purpose, the bank's compensation for plan services, including its fees for custody services, distribution services and its investment management fees, would be "relationship compensation" (as defined by proposed Rule 724(h)). In addition, amounts received by the bank for providing clearance and settlement services under section 3(a)(4)(B)(viii) or under a networking arrangement with its affiliated broker-dealer that meets conditions under section 3(a)(4)(B)(i) should also be treated as "relationship compensation" for purposes of the chiefly compensated test.

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The Banks appreciate this opportunity to comment on the impact that the Commission's interpretations under Exchange Act section 3(a)(4) and proposed Regulation B will have on services that the Banks provide to employee benefit plans and commend the Commission for recognizing that accommodations are needed to avoid disrupting the services that banks provide to employee benefit plans. Unfortunately, proposed Rule 770, and uncertainties about how the section 3(a)(4) functional exceptions will apply, will result in significant disruptions in the employee benefit plan services industry, by forcing banks to restructure their service arrangements with plans, renegotiate plan service agreements and possibly exit some or all of the plan services business. This will mean increased costs and disruption of services to employee benefit plans, which would hurt American workers participating in these plans.

Therefore, the Banks strongly urge the Commission to adopt a rule granting banks a complete exemption from the definition of the term "broker" to the extent that banks effect transactions for employee benefit plans (broadly defined as discussed above). If the Commission does not adopt this broad exemption, the Banks still urge the Commission to make some critical accommodations to provide some relief to banks and minimize the disruption of services to employee benefit plans. In particular, Rule 770 should be revised to (among other things) delete the condition that would require banks to offset or credit compensation received from mutual fund complexes against other plan fees. In addition, the Commission should clarify that the safekeeping as well as custody exception under section 3(a)(4)(B)(viii) permits banks to receive fees for performing clearance and settlement services when acting as trustee or custodian to employee benefit plan accounts.

Thank you for the opportunity to provide these comments. We are available to answer questions about these comments. Please feel free to call me at Groom Law Group (202-857-0620) if you have questions or comments.

Very truly yours,

/s/

Roberta J. Ufford

cc. The Honorable William H. Donaldson, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
Annette Nazareth, Director, Division of Market Regulation
Robert Colby, Deputy Director, Division of Market Regulation

Catherine McGuire, Chief Counsel, Division of Market Regulation
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