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# FirstMerit Corporation, N.A.

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OFFICE OF THE SECRETARY

Monday, August 23, 2004

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Regulation B, File No. S7-26-04 (69 Federal Register 39682; June 30, 2004)

Dear Mr. Katz:

This letter is in response to the SEC's invitation to comment on Regulation B, the proposed broker "push out" rules. FirstMerit Bank, N.A. (FirstMerit) has $10.4 billion in assets, with $4.2 billion in trust assets as of June 30, 2004.

FirstMerit has been a national bank since 1947 (formerly First National Bank). Since that time, FirstMerit has had all of its trustee, fiduciary, investment management, agency, custody, safekeeping, sweep, networking and compensation activities and functions continually scrutinized by regulators. Our policies, procedures and operating practices have been developed to protect our clients from any conflicts of interest, self dealing, unethical practices and violations of legislation, regulations and local law. This would include maintaining strict control of traditional fiduciary activities such that any 'free wheeling' in broker-dealer functions would not occur.

Therefore, FirstMerit strongly opposes the Regulation B proposal put forth on June 17, 2004. In our view, the proposal, as currently written, is unworkable, and unduly disruptive to our business - in some instances it will force our institution out of specific business lines. Moreover, several aspects of the proposal are anti-competitive in that they create new rules and regulations ***for banks only*** – putting them at a significant disadvantage against other non-bank, financial services firms. In addition, the proposal is not in the interest of consumers. It will result in fewer clients having knowledge of the availability of resources necessary to assist them with college planning or retirement, and force some customers to have two accounts – one with a bank and one with a broker. FirstMerit does not believe this is what Congress intended when it passed the Gramm-Leach-Bliley Act in 1999.

First, FirstMerit is most concerned that the proposal will force our bank out of the custody business, as the vast majority of our clients do not satisfy the qualified investor definition. Further, we will not be able to offer new custody clients the ability to place orders through the bank. Rollovers from 401(k) accounts and IRA accounts, which do not fall under the qualified investor definition, are a very important part of our business strategy. Custodial assets comprise more than 20% of our total asset base and would represent a significant loss of revenue (about 6%).

Proposed Regulation B appears to disregard the fundamental function that bank trust departments perform in custodial relationships. In additional to our standard administration, income posting, reporting and accounting activities; these relationships are, by definition, form and function, nondiscretionary directed accounts. Trades are not initiated nor executed by the custodian; the custodian directs them to a registered broker-dealer. The over riding issue of protecting the investor and their assets while maintaining traditional banking services is not being achieved by the proposed Regulation B custody exception. An investor is afforded no more 'protection' by placing a trade directly with a broker-dealer as the custodian acts only as a conduit and forwards the trade to a registered broker-dealer who executes the trade

There is clear demand for bank custody services. FirstMerit is able to take custody of all types of investment products including real estate and restricted securities, while brokers cannot. If a client's custody account includes investments that

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broker-dealers are unable to hold, what other alternative is available to our customers? Must the customer deal with two account opening processes, doubling the time and paperwork merely to find institutions able hold a mix of assets? We currently maintain custody accounts and forward all directed trades to a nonaffiliated broker dealer for execution. Under proposed Regulation B, we would have to 'push out' the order taking function. But, if we retained the assets and had the client call the broker dealer directly to place trade requests, FirstMerit would still run afoul of the 'carrying broker' prohibition.

With regard to 'carrying brokers', we believe it would be prudent to clearly define the distinction between a bank acting as a carrying broker and a bank acting as a custodian. For the eight factors listed in Regulation B, item (2) covering a bank extending credit to broker-dealer customers needs additional clarification. Specifically, differentiate between margin credit versus a separate bank line of credit or loan product provided to the customer based on normal bank lending practices. For item (5), the bank would have no control over a customer who sets up a custody account with the bank and then directs all of their trade activity through a specific broker-dealer (they would essentially be a broker-dealer customer).

Second, there is a significant problem with the proposal's "chiefly compensated" test required under the trust and fiduciary exception. In our view, the account-by-account test is far too costly for a bank of our size to undertake. Moreover, FirstMerit does not believe it can satisfy the 9-to-1 ratio of relationship to sales compensation, especially since the employee benefit plan exemption is not at all workable.[1] If FirstMerit were to use the line-of-business test with regard to the 'chiefly compensated' condition; and furthermore, if Employee Benefit accounts were defined as one of our business lines, FirstMerit would not meet the 'chiefly compensated' condition. Data for year ending 2002 shows over $312,000 in mutual fund fee income for Employee Benefit accounts and about $2.5 million in total Employee Benefit income for a ratio of 8:1. This ratio is due to our practice of negotiating, at the time of account opening, to retain the mutual fund income and in return we would reduce the cost of the client's relationship compensation to FirstMerit. ***This is a very important part of our business strategy.*** Additionally, we receive mutual fund fee income only for nonsales services even though it is received via a 12(b)(1) contract.

The proposed test is overly complex and burdensome, particularly given the exemption for some, but not all, personal and charitable trust accounts. Even with corrections to the employee benefit plan which might permit us to fall within the 9-to-1 ratio, the penalties and exposure of having our bank deemed to be an unregistered broker-dealer are so great, and the procedural rules so complex, that FirstMerit will still have to invest in technology and systems to track transaction compensation.

FirstMerit suggests that it would be far better for the SEC to examine "chiefly compensated" by looking at sales compensation, as compared to total trust department compensation, provided that sales compensation is less than 50 percent of total compensation. Alternatively, relationship compensation could be compared to total trust operation compensation. Again, so long as relationship compensation is more than 50 percent of total compensation the bank's trust and fiduciary operations would be in compliance, and able to remain within the bank. A general review of how the trust operation earns it revenue in a given year should be more than satisfactory to determine that our bank is not engaging in the brokerage business.

Additionally, FirstMerit does not receive sales compensation in any form from Investment Companies formed pursuant to the Investment Company Act of 1940. FirstMerit only receives fees for performing transfer agent, order aggregating and processing, statement of account, income processing, sub-accounting, forwarding Investment Company communications and proxy services. However, the current proposal would require counting these fees as 'sales compensation' since many Investment Companies use a one-size-fits-all 12(b)(1) contract to provide fees for these services as well as for providing sales compensation. The SEC needs to recognize that all 12(b)(1) fees are not for sales compensation. Failing that, perhaps

[1] Our bank follows the DOL guidance outlined in the AETNA letter, not the Frost letter as described in the SEC's employee benefit plan exemption.

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Investment Companies could be required to have a minimum of two fee contracts - one for sales compensation and the other for nonsales compensation.

Third, FirstMerit finds the sweep exception very troubling. Our bank sweeps asset and deposit accounts into money market mutual funds, for which we receive income, in some instances, greater than 25 basis points. ***This is fully disclosed to our clients.*** Under the proposal, we would no longer be able to offer most of our customers the ability to have their deposit account assets swept into these funds, taking away a popular product that consumers demand. This would put our institution at a disadvantage against broker-dealers offering a cash management account - which from the consumer's perspective looks identical to a checking account – because broker dealers can receive fees from mutual funds in excess of 25 basis points.

This also raises the issue of application of a consistent regulatory standard. If 12(b)(1) fees in excess of 25 basis points are not appropriate for banks to accept, why is it appropriate for broker-dealers to receive them?

Finally, the SEC should refrain from regulating bank compensation programs. All companies, across all industries set performance goals for their employees - banks are no different. It makes good business sense to do so, yet the proposal would prevent banks from implementing these types of programs unless their employees are licensed, registered representatives. Why can't the bank set yearly performance goals for its employees in terms of sales of products offered by the bank and its affiliate? It is most anti-competitive for banks to be precluded from doing so, but broker-dealers are not.

FirstMerit also strenuously objects to the notion that either base hourly wages, $15 in 1999 dollars or $25 dollars, is an appropriate referral fee for non-retail referrals.

In a time when consumer debt has risen, banks should be encouraged to train and manage associates to educate consumers about the need for saving and investing for college and retirement. By unnecessarily regulating bonus plans and creating such uncertainty around how brokerage might be deemed to directly or indirectly taint a bonus plan, regulations will thwart our ability to serve our customers needs. The SEC can best protect the individual consumer by regulating the registered individuals and brokerage companies to whom the bank directs the customer.

On a positive note, the proposal gives banks sufficient time to comply. When the final rule is adopted, hopefully with changes made to exorcise the proposed Regulation B shortcomings identified in this letter, the SEC will retain a minimum compliance period of one year.

Sincerely,

William A. Nappi, CTCP
Trust Compliance Officer

cc: John D. Hawke, Jr.
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