Federal Deposit Insurance Corporation
Board of Governors of the Federal Reserve System
Office of the Comptroller of the Currency

October 8, 2004

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

Re: Proposed Regulation B, File No. S7-26-04 (“Proposed Rules")

Dear Mr. Katz:

The Federal Reserve Board, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (the “Banking Agencies”) appreciate this opportunity to provide the Securities and Exchange Commission (the “Commission” or “SEC”) formal comments on the Proposed Rules. The Proposed Rules would implement the exceptions for banks from the definition of “broker” in the Securities Exchange Act of 1934 (“Exchange Act”) that Congress adopted in the Gramm-Leach-Bliley Act (“GLB Act”) and would replace the interim final rules initially published by the Commission in May 2001.[1]

The GLB Act was one of the most significant pieces of banking legislation enacted in a generation and a special focus of the Banking Agencies. The GLB Act repealed much of the longstanding Glass-Steagall Act and, for the first time since 1933, allowed the affiliation of banks and full-service securities firms. Because of the Act’s importance to the structure, functioning and regulation of banking organizations, and our expertise in examining and regulating the activities of banks, including the securities activities of banks, our Agencies were intimately involved in the development and negotiation of the statutory provisions underlying the Proposed Rules. Our Agencies also have primary responsibility for examining the activities affected by the Proposed Rules as well as for designing the recordkeeping requirements that will be used to monitor compliance with the Proposed Rules.[2] We appreciate the time and effort that the Commission and its staff have devoted to the “broker” exceptions for banks in the GLB Act, as well as the opportunities Commission staff have provided our staffs to discuss development of the Proposed Rules and the existing securities activities of banks.

After carefully reviewing the Proposed Rules, we believe that the Proposed Rules reflect a profound misinterpretation of the language and purposes of the “broker” exceptions in the GLB Act. The Proposed Rules would require banks to make substantial changes in the way they conduct well established and already highly regulated lines of banking business and would impose a new, SEC-created regime of extraordinarily complex

requirements and restrictions on longstanding banking functions and relationships—a regime that, in some areas, conflicts with the existing regulatory requirements already applicable to banks, such as the Department of Labor's rules under the Employee Retirement Income Security Act ("ERISA"). Far from implementing the "exceptions" for banks adopted by Congress, the Proposed Rules would insert the Commission to an unprecedented and unforeseen degree in the management of banks' internal operations. The track record of how banks conduct the activities covered by the GLB Act's exceptions does not warrant this response, the language of the GLB Act does not require it and the legislative history of the GLB Act indicates that Congress did not want or intend it.[3]

For decades, banks have provided securities transaction services as an integral part of their trust, fiduciary, custodial and other normal bank functions without generating significant securities-related concerns. In light of these facts, Congress determined that maintaining the existing regulatory structure for these activities was both consistent with the principles of functional regulation and customer protection.[4] Accordingly, the "broker" exceptions for banks in the GLB Act were designed and intended to permit banks to continue to provide securities transaction services without disruption to customers as part of their trust, fiduciary, custodial and other banking functions. Moreover, these exceptions were drafted broadly to accommodate the diverse manner in which banks provide these services to their customers.

The framework and restrictions embodied in the Proposed Rules do not give effect to this congressional purpose or the statutory language. Rather, the Proposed Rules would significantly disrupt the normal banking functions and customer relationships that Congress sought to protect and would impose new, complex and burdensome regulatory requirements on longstanding banking functions. In addition, the Proposed Rules would impose additional costs on bank customers and limit customer choice by preventing or discouraging banks from providing certain services that customers have come to expect and demand from their banking institution.

Of greatest concern is the overall approach that the Commission has taken to implementing the critically important exceptions for bank trust, fiduciary and custodial activities. This approach combines overly narrow interpretations of the statutory exceptions for bank trust, fiduciary and custodial activities with new SEC-granted administrative exemptions that do not fully comport with the existing operations and customer relationships of banks. The fact that administrative exemptions would be needed to allow banks to continue to engage in normal trust, fiduciary and custodial activities shows, by itself, that the Commission has not faithfully interpreted the statutory exceptions. Moreover, the Commission's approach creates precisely the results that Congress sought to avoid in the GLB Act—the unnecessary disruption of normal bank functions and services and the imposition of additional regulatory burdens on bank activities that already are effectively regulated and supervised. In addition, because the Commission's administrative exemptions may be withdrawn or modified at any time, this approach creates uncertainty as to whether, or under what conditions, banks may be able to perform these normal banking functions in the future. Importantly, these results would not occur if the Commission interpreted the exceptions for bank trust, fiduciary

and custodial activities in a way that gives meaningful effect to the language and purposes of the statutory provisions.

Our most significant concerns with the Proposed Rules are summarized below. The Appendix to this letter sets forth the Banking Agencies' views on the Proposed Rules in detail.

I. Trust and Fiduciary Activities

Trust and fiduciary services are core banking functions and ones that banks were authorized to conduct well before enactment of the Glass-Steagall Act and the Exchange Act. Banks also have long effected securities transactions for customers as part of their trust and fiduciary services and these securities transaction services are an integral part of the asset management, advisory and administration services that banks provide to their trust and fiduciary customers.

The trust and fiduciary services that banks provide their customers are governed by well-developed principles of trust and fiduciary laws. In addition, these activities have been effectively supervised by the federal and state banking authorities for many years. Together, these existing laws and principles and regular Agency examinations have effectively protected the trust and fiduciary customers of banks from abusive practices for the decades prior to the GLB Act and the five years since its passage.

It was in light of this existing and effective regulatory framework that Congress adopted the trust and fiduciary exception for banks in the GLB Act.[5] The statute's legislative history makes clear that this exception was designed and intended to allow banks to continue to effect securities transactions as part of their trust and fiduciary activities without disruption.[6] In essence, Congress concluded that there was no compelling reason to force banks to restructure their trust and fiduciary operations or subject these activities to regulation under the Federal securities laws.[7] To help ensure that this intent was carried out, the Conference Committee explicitly directed that the Commission "not disturb traditional bank trust activities."[8]

Based on our knowledge and experience supervising the trust and fiduciary operations of banks, we have no question that the Proposed Rules would significantly disrupt those activities. Moreover, the restrictions and burdens the Proposed Rules would impose on those activities are not found in the GLB Act nor are they necessary to achieve the purposes of that Act. For example, the statute's plain language provides that a bank may continue to provide securities brokerage services as part of its trust and fiduciary activities so long as the bank is "chiefly compensated" for such transactions based on a comparison of the relationship compensation to total compensation that the bank receives from its trust and fiduciary accounts in the aggregate. The Proposed Rules, however, interpret the statute's "chiefly compensated" test in a manner that does not comport with the language and purposes of the statute or the existing trust and fiduciary activities of banks.

The Proposed Rules generally would require that banks comply with the statute's "chiefly compensated" standard on an account-by-account basis. They also would require that banks classify the fees that they receive from each trust or fiduciary account into three different categories—relationship compensation, sales compensation and other compensation—in order to determine whether they meet the Act's chiefly compensated test. The definition of these categories proposed by the SEC would impose significant burdens on banks without faithfully implementing the purposes and wording of the GLB Act. For example, the Proposed Rules define permissible relationship compensation in a way that excludes certain types of compensation, such as Rule 12b-1 and service fees from mutual funds, that would appear to qualify as relationship compensation under the plain language of the statute and are legitimate, long-recognized forms of fiduciary compensation. In addition, the proposed definitions are not consistent with the systems banks currently maintain or with the regulatory reports that banks currently file with the Banking Agencies concerning their fiduciary activities.

In light of these provisions, the Commission's interpretation of the chiefly compensated test simply would *not* work for a wide variety of the trust and fiduciary accounts of banks, including essentially all of the corporate trust and employee benefit plan trust and fiduciary relationships of banks. Thus, the Commission's interpretation, if implemented, would force banks to either cease providing securities transaction services to many corporate and employee benefit plan customers or significantly restructure their trust and fiduciary operations in these areas. We do not believe that Congress established a "chiefly compensated" test that would not work for some of the most important trust and fiduciary business lines of banks.

Moreover, the Commission's interpretation would require banks to develop, implement and maintain new and costly information systems that will have the effect of discouraging many banks, including small banks in particular, from continuing to provide the very trust and fiduciary services Congress was attempting to protect. We note that the concern expressed by the Commission as justification for its interpretation—the fear that a bank may conduct a retail securities brokerage business in the bank under the guise of a trust and fiduciary business—is far more effectively addressed by the statutory prohibition on a bank advertising that it conducts securities brokerage services and by the bank examination process than by the onerous account-by-account review process.

We recognize that the Proposed Rules include several new administrative exemptions that are designed to mitigate, at least partially, the adverse effects that the Commission's proposed interpretation of the chiefly compensated test would have on banks and their customers. The fact that administrative exemptions would be needed to allow banks to continue to engage in some of their most fundamental trust activities, however, demonstrates why the Commission's interpretation of the statute's chiefly compensated standard is flawed.

Moreover, as discussed more fully in the Appendix, these administrative exemptions are subject to a variety of conditions that are not contained in the statute, create a

formidably complex and burdensome regulatory framework for banks and their customers, and conflict in several important respects with the normal trust and fiduciary operations of banks. For example, the SEC's proposal to grant an exemption that essentially treats a bank as being "chiefly compensated" by sales compensation if the sales compensation the bank receives from its trust and fiduciary accounts exceeds *11 percent* of the "relationship compensation" the bank receives from these accounts simply cannot be squared with the language or purposes of the GLB Act.[9] In addition, although the Proposed Rules include an administrative exemption for certain employee benefit plan relationships of banks, this exemption does not cover the full range of employee benefit plans that currently receive securities transactions services from banks and includes compensation restrictions that are inconsistent with both existing industry practice and guidance issued by the Department of Labor under ERISA.

II. Custodial and Safekeeping Activities

Custodial and safekeeping activities—like trust and fiduciary activities—are core banking functions and ones that historically have involved certain securities services. For example, bank custodians have a long-standing history of accommodating their custodial customers by accepting and transferring, on an unsolicited basis, orders for securities to a registered broker-dealer. This customer-driven service provides custody clients a costeffective and convenient way to make occasional trades in their custody accounts, which may hold real estate and other non-securities assets, without having to establish a second account at a broker-dealer.

Banks also for many years have provided custodial or administrative services to 401(k) and other retirement and employee benefit plans and, as part of these services, accepted and processed orders from the plan, the plan's fiduciary, or the plan's participants for the investment of new contributions, the re-allocation of existing contributions or the liquidation of holdings. These bank-offered services allow plan administrators to obtain securities transaction and other administrative services in a costeffective manner, thereby reducing plan expenses and benefiting plan beneficiaries. In addition, banks are key providers of self-directed IRA accounts. Bank-offered custodial IRAs provide customers throughout the United States a convenient and economical way to invest for retirement on a tax-deferred basis.

The custodial and safekeeping exception in the GLB Act was intended to preserve the customary custodial services of banks, including the order-taking and other securities related aspects of these traditional custodial services.[10] In fact, language specifically was added to the custodial and safekeeping exception by the Conference Committee to ensure that banks could continue to provide securities services to custodial IRAs and other pension, retirement and benefit plans that receive custodial or other administrative services from banks.

In the Proposed Rules, however, the Commission asserts that the statutory exception for bank custodial and safekeeping activities does *not* permit banks to accept securities orders from their custodial IRA customers, for 401(k) and employee benefit plans that receive custodial and administrative services from the bank, or as an accommodation to

other types of custodial customers. This interpretation is not consistent with the Act, its legislative history, or the purposes of the Custody and Safekeeping Exception. In addition, this interpretation is flatly at odds with the customary practices and customer relationships of banks and, if implemented, would force banks and their customers to radically restructure their long-standing custodial relationships and force bank customers to incur additional and unnecessary burdens and expenses to effect occasional trades related to their custodial assets.

While the Commission has again attempted to address the consequences of its narrow interpretation of the statute through the grant of administrative exemptions, these exemptions themselves conflict with the current custodial practices of banks and limit the ability of banks to provide traditional custodial services in the future. For example, these exemptions would not permit many banks to provide securities transaction services to future IRA or other custodial customers that do not meet new and restrictive qualifications established by the SEC. Accordingly, the Proposed Rules would disrupt the normal custodial activities and customer relationships of banks, deprive many customers of their preferred provider of services, and impose additional and unnecessary costs on custodial customers.

III. Networking Arrangements

The GLB Act permits banks to establish and maintain “networking” arrangements with a broker-dealer under which bank customers may be referred to the broker-dealer for securities services. Consistent with the longstanding guidance of both the Banking Agencies and SEC staff, the Act permits bank employees to receive a nominal fee for these types of referrals. The Proposed Rules would establish a new, highly complex, restrictive and inflexible definition of what constitutes a nominal cash referral fee rather than allowing examiners, as they do today, to review these fees in light of the geographic location of the bank involved and other relevant factors during the supervisory and examination process. We believe that setting, by regulation, an inflexible and restrictive definition is ill-advised because what is “nominal” depends on the marketplace and the circumstances.

The Proposed Rules also would impose new limits on non-cash referral programs that are unworkable and inconsistent with current practice. In addition, we are concerned about the potential breadth of certain language in the release accompanying the Proposed Rules that could be read as suggesting that the Commission intends to assert broad jurisdiction over the employee compensation programs of banks and bank holding companies, even where these programs are not used as a conduit for the payment of referral fees. We see no basis in the GLB Act for the Commission to assert such broad jurisdiction over the internal operations of banks and bank holding companies.

IV. Other Matters

Our Agencies also continue to have concerns with the provisions of the Proposed Rules that would implement the statutory exception for the deposit “sweep” activities of banks.

In addition, we continue to believe that it is important for the Commission and the NASD to clarify, before any rules implementing the “broker” exceptions for banks are finalized, that NASD Rule 3040 does not apply to bank employees that also are associated persons of a broker-dealer when they engage in bank-permissible securities activities in their role as bank employees.

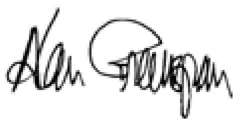
IV. Conclusion

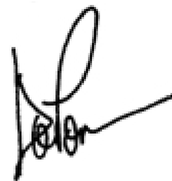
We believe that the Commission must follow a fundamentally different approach to make its rules comport with the language and purposes of the “broker” exceptions adopted by Congress in the GLB Act. Such an approach should focus on faithfully implementing the statutory exceptions that Congress designed to cover the diverse nature of normal bank activities, rather than developing administrative exemptions that conflict with the statute and Congress’ intent.

Because proper implementation of the GLB Act’s “broker” exceptions is critically important to ensuring that banks may continue to provide their customers traditional banking services, we urge the Commission to take the time necessary to get these rules right. Banks have provided the services covered by the statutory exceptions for th e decades prior to the GLB Act, and for the five years since its passage, under the effective supervision of the Banking Agencies and without creating significant securities-related concerns . Accordingly, we strongly believe the Commission should further delay th e effectiveness of the statute's "broker" exceptions in order to continue working to develop regulations that properly implement the statute .

In addition, the Commission should provide banks at least a one-year transition period after final rules are published to bring their operations into compliance with thos e rules. A longer transition period may well be needed if the final rules remain as complex and burdensome as the Proposed Rules . Of course, our Agencies remain committed to working with the Commission an d its staff to implement the important "broker" exceptions for banks .

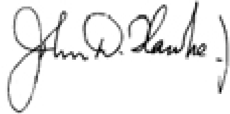
Sincerely,





Alan Greenspan, Chairman
Board of Governors of the Federal Reserve System

Donald E. Powell, Chairman
Federal Deposit Insurance Corporation



J. D. Hawke, Jr.
Comptroller of the Currency

[1] See 66 Federal Register 27,760 (May 18, 2001) ("Initial Rules").
[2] See 12 U.S.C. § 1828(t).
[3] See S. Rep. No. 106-44 at 10 (1999) ("Senate Report"); H.R. Rep. No. 106-74, Pt. 3 at 101 (1999) ("House Commerce Committee Report").
[4] See H.R. Rep. No. 106-434 at 163-64 (1999) ("Conference Report"); Senate Report at 10.
[5] 15 U.S.C. § 78c(a)(4)(B)(ii).
[6] See Conference Report at 164; House Commerce Committee Report at 164.
[7] Senate Report at 10; see also S. Rep. No. 105-336 at 10 (1998); House Commerce Committee Report at 101 and 114.
[8] Conference Report at 164.
[9] See Proposed Rule 242.721.
[10] 15 U.S.C. § 78c(a)(4)(B)(viii).