Appendix - Comments of the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency Regarding Proposed Regulation B

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I. Exception for Trust and Fiduciary Activities

The statutory exception for trust and fiduciary activities authorizes a bank, without registering as a broker-dealer, to effect securities transactions in a trustee capacity, or in a fiduciary capacity in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards, so long as the bank—

(1) is chiefly compensated for such transactions, consistent with fiduciary principles and standards, on the basis of an administration or annual fee (payable on a monthly, quarterly or other basis), a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for its trust and fiduciary customers, or any combination of such fees; and

(2) does not publicly solicit brokerage business (other than by advertising that it effects transactions in securities in conjunction with advertising its other trust activities).[1]

Importantly, securities transactions effected by a bank for its trust and fiduciary customers under the Exception generally must be transmitted to a registered broker-dealer for execution.[2]

In adopting the Trust and Fiduciary Exception, Congress recognized that banks have long effected securities transactions in the normal course of providing trust and fiduciary services to customers. Congress also recognized that the trust and fiduciary customers of banks already are protected by well developed principles of trust and fiduciary law, as well as by the special examination programs developed by the Banking Agencies that are designed to help ensure that banks comply with their fiduciary obligations to customers. Accordingly, Congress determined that there was no need to alter the regulation or supervision of bank trust and fiduciary activities or to disrupt the trust and fiduciary operations of banks. To help ensure that this intent was implemented properly, the Conference Committee specifically directed the Commission to "not disturb traditional bank trust activities."

A. Chiefly Compensated Test

1. Commission Proposal.

The Proposed Rules, however, establish a chiefly compensated test that does not work for the diverse trust and fiduciary businesses of banks, is overly complex and burdensome, and would significantly disrupt the trust and fiduciary operations of banks that the statutory exception was designed to protect. In so doing, the Proposed Rules fail to recognize that the statutory ban on advertising and the Banking Agencies' regular examination process already effectively prevent banks from circumventing the Trust and Fiduciary Exception and conducting a retail securities brokerage business in the bank.

There are three major problems with the Commission's interpretation of the statute's chiefly compensated standard. First, the Proposed Rules continue to interpret the statute as requiring that banks comply with the chiefly compensated test in the Trust and Fiduciary Exception on an **account-by-account** basis.[3] As we previously have indicated, this interpretation is not mandated by the Act and, in fact, the language and legislative history of the statute suggests that the chiefly compensated test should be applied on an aggregate basis to all of a bank's trust and fiduciary accounts.[4]

Second, the Proposed Rules establish an overly complex formula for determining whether a bank meets the chiefly compensated test. In this regard, the Proposed Rules provide that a bank meets the chiefly compensated standard with respect to an account if the bank received more relationship compensation than "sales compensation" from the account during the preceding year. In order to make this calculation, however, a bank actually must classify **each** of the fees it receives from every trust or fiduciary account into one of **three** categories—relationship compensation, sales compensation, and "other" compensation. The "other" compensation category arises because the definitions of "relationship compensation" and "sales compensation" in the Proposed Rules do **not** include some common forms of compensation that banks receive from their trust and fiduciary customers, *e.g.*, fees for tax preparation, bill payment, and real estate settlement services, and certain types of payments received from mutual funds for personal services or the maintenance of shareholder accounts. The plain language of the statute, however, provides that a bank's compliance with the chiefly compensated test should be determined by comparing the relationship compensation the bank receives from all of its trust and fiduciary accounts to the **total compensation** that it receives from these accounts.

Third, the Proposed Rules define relationship compensation in an overly restrictive manner to exclude certain types of compensation that are expressly permitted by the statute and that often constitute a significant portion of a bank's income from fiduciary activities. For example, the Proposed Rules continue to provide that certain fees explicitly permitted by the statute may be included in the bank's relationship compensation only if the bank receives the fees "directly from a customer or a beneficiary, or directly from the assets of an account for which the bank acts in a trustee or fiduciary capacity."[5] This source-of-fee limitation is not found in the statute and, as we previously have noted, unnecessarily impedes the normal operations of bank trust departments.[6]

In addition, while the statute expressly permits banks to receive administration fees and fees payable as a percentage of assets under management, the Proposed Rules continue to treat all compensation that a bank receives from a mutual fund under a Rule 12b-1 plan or for personal services or the maintenance of shareholder accounts to be sales compensation or "other" compensation. These fees, however, are paid based on a percentage of assets under management and, in the case of servicing

fees, are paid for administrative services provided by the bank. Banks have received these types of fees for many years subject to, and in accordance with, applicable trust and fiduciary principles. In fact, in some trust and fiduciary business lines—such as corporate and employee benefit plan services—these fees often represent the predominant form of a bank's compensation under existing business practices and customers often request that banks structure their compensation in this manner.[7]

In light of these interpretations, the Commission's chiefly compensated test simply would not work for many banks and many important and traditional trust and fiduciary business lines. In addition, the Commission's proposed interpretation would impose substantial costs on banks that seek to comply with its terms. For example, banks generally do not have the systems in place to track the compensation that they receive from **each** trust and fiduciary account, nor do banks generally have the systems in place that would allow them to classify the fees they receive from each trust and fiduciary account into one of the three categories required by the Proposed Rules (relationship compensation, sales compensation and other compensation).[8] This is especially true because the Proposed Rule's source-of-fee limitation may well require banks to individually review each of their trust or fiduciary accounts in order to determine what person or account is billed and pays for the bank's services.

Moreover, the account-by-account approach is inconsistent with the manner in which banks receive certain fees. For example, banks typically receive 12b-1 and service fees from mutual funds on an aggregate basis for all of the bank's accounts invested in the relevant fund. While the Commission itself has proposed a methodology that would allow banks to allocate the Rule 12b-1 and servicing fees that they receive to individual accounts, this methodology itself creates problems. For example, as the Commission has recognized, this methodology could result in a substantial and inappropriate amount of fees being allocated to a trust and fiduciary account that is opened late in a year, which could cause the account to fail the chiefly compensated test due to the Commission's account-by-account interpretation of this test.

We do not believe it is reasonable to interpret the statute's chiefly compensated standard in a way that would not work for major aspects of the trust and fiduciary operations of banks and that would significantly disrupt the normal trust and fiduciary operations of banks. While we appreciate the Commission's efforts to mitigate the disruptions that would be caused by its interpretation through the adoption of administrative exemptions, we believe these administrative exemptions would be unnecessary if the statute itself was properly implemented. Furthermore, as discussed below, the administrative exemptions proposed by the Commission are subject to a variety of SEC-imposed conditions that are not consistent with the diverse nature of bank trust and fiduciary operations and would create an overly

complex and burdensome regulatory framework that is well beyond what Congress contemplated or authorized.

2. Banking Agency Recommendation.

The Banking Agencies strongly urge the Commission to modify its interpretation of the statute's chiefly compensated standard in order to give effect to the language and purposes of the Trust and Fiduciary Exception and not disrupt the trust and fiduciary activities and customer relationships of banks. Specifically, the statute itself permits a bank to calculate its compliance with the chiefly compensated test on an aggregate, bank-wide basis for all of the bank's trust and fiduciary accounts. In addition, the statute provides that a bank meets the chiefly compensated test if the total relationship compensation the bank receives from all of its trust and fiduciary accounts exceeds 50 percent of the **total compensation** the bank receives from these accounts.[9] As noted above, banks already report the total compensation they receive from their trust and fiduciary accounts for bank supervisory purposes. Finally, relationship compensation should be defined to include **all** of the permissible fees set forth in the GLB Act, including Rule 12b-1 and servicing fees, regardless of whether the fee was received from the assets of the account, a beneficiary or another source (such as a mutual fund).

We believe this interpretation of the statute's chiefly compensated test is fully consistent with both the language and purposes of the GLB Act. In addition, because this approach is significantly less complicated than the approach embodied in the Proposed Rules, adoption of this interpretation would substantially reduce the costs and disruptions that would be imposed on both banks and their customers.

B. Definition of Trustee and Fiduciary Capacity

The GLB Act's Trust and Fiduciary Exception is available for any securities transaction that a bank effects "in a trustee capacity . . . or in a fiduciary capacity." The GLB Act also specifically provides that a bank is deemed to act in a "fiduciary capacity" for purposes of the Exception whenever the bank acts (i) as a trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gift to minor act, (ii) as an investment adviser if the bank receives a fee for its investment advice, (iii) in any capacity in which the bank possesses investment discretion on behalf of another, or (iv) in any other similar capacity.[10] This definition of "fiduciary capacity" purposefully was drawn from and based on Part 9 of the OCC's regulations (12 C.F.R. § 9.2(e)), which governs the trust and fiduciary operations of national banks.

1. Trustee Capacity.

We support the Commission's decision to withdraw the exemptions contained in the Initial Rules that purported to define certain types of trust relationships (i.e., indenture trustee, ERISA trustee, and IRA trustee) as being a "trustee

capacity" for purposes of the GLB Act. These exemptions created ambiguity concerning the scope of the term "trustee capacity" by suggesting some parties that act as trustees under Federal and state law would not qualify as trustees for purposes of the Trust and Fiduciary Exception. As indicated in our previous comment letter, we believe that the term "trustee capacity" is not ambiguous and that this term includes a bank when it is named as trustee by written documents that create a trust relationship under applicable law. The Commission's decision to withdraw these exemptions, as well as its statement that banks acting as a trustee may effect transactions under the Trust and Fiduciary Exception "even if they do not assume significant fiduciary responsibilities as trustee,"[11] should provide banks appropriate certainty concerning the status of their trust relationships under the GLB Act.

2. Investment Advice for a Fee.

The GLB Act itself provides that a bank acts in a "fiduciary capacity" whenever it "acts as an investment adviser [and] receives a fee for its investment advice." Accordingly, we support the Commission's decision to eliminate the provisions of the Initial Rules that would have required a bank to provide "continuous and regular" investment advice to a customer in order to be acting in a fiduciary capacity.

The Proposed Rules, however, continue to provide that a bank providing investment advice for a fee will be considered to be acting in a "fiduciary capacity" only if the bank "has a fiduciary relationship with the advised customer in which the bank . . . [o]wes the customer [a] duty of loyalty, including an affirmative duty to make full and fair disclosure of all material facts and conflicts of interest."[12] The adopting release for the proposed rules ("Adopting Release")[13] also indicates that a bank should look to the Investment Advisers Act of 1940 ("Advisers Act") and Form ADV issued by the Commission under the Advisers Act for guidance on the disclosure obligations a bank has under this duty of loyalty.[14]

It is well settled that banks that provide investment advice to customers owe their customers a duty of loyalty under established principles governing fiduciary duties. However, our Agencies do not believe that such a duty can or should be imposed on a bank under the Exchange Act. The plain language of the GLB Act provides that a bank is considered to be acting in a "fiduciary capacity" whenever the bank provides investment advice to a customer for a fee. Thus, Congress itself has declared that banks providing investment advice for a fee are fiduciaries for purposes of the Trust and Fiduciary Exception. We see no basis for the Commission to provide that a bank acts as an investment adviser for a fee, and thus is considered to be acting in a "fiduciary capacity," only if the bank "has a fiduciary relationship" with the customer pursuant to which the bank has a duty of loyalty to the customer. Indeed, the Commission's definition is circular given Congress' own definition of when a bank is deemed, by operation of law, to be acting in a fiduciary capacity.

Moreover, as the courts have long recognized, the duty of loyalty that a bank or other entity providing investment advice owes to its advisory customers arises from the fiduciary nature of the advisory relationship itself and exists **independently** from the Federal securities laws.[15] While Congress decided in 1940 to provide the Commission with the authority to enforce this duty under the Advisers Act with respect to registered investment advisers, Congress also specifically exempted banks from the definition of "investment adviser" in the Advisers Act.[16] Congress did so in recognition of the fact that banks providing investment advice for a fee already have a duty of loyalty under fiduciary law and that compliance by banks with this important duty already was effectively monitored and enforced by the Banking Agencies through the bank regulation and examination process.

The Proposed Rule's duty of loyalty requirement essentially circumvents Congress's decision to exempt banks from the Advisers Act. In this regard, the Proposed Rules would require those banks that provide customers investment advice for a fee and effect securities transactions for these customers to comply with a new, SEC-imposed duty of loyalty and, by cross-reference, the specific disclosure requirements applicable to SEC-registered investment advisers under the Advisers Act. We do not believe it is appropriate for the Commission to seek to obtain through an interpretation of the GLB Act's "broker" exceptions the type of regulatory jurisdiction over the advisory activities of banks that Congress has declined to provide the Commission by statute.[17]

3. Other Fiduciary and Similar Capacities.

As noted above, Congress purposefully based the definition of "fiduciary capacity" in the Exchange Act on the definition of that term in Part 9 of the OCC's regulations governing the trust and fiduciary activities of national banks. Thus, while the Adopting Release correctly points out that the same term does not necessarily have the same meaning when used in different statutes, we believe that the OCC's interpretations and rulings concerning when a bank acts in a "fiduciary capacity" for purposes of Part 9 should be given great weight in construing the same term in the Exchange Act. Indeed, because Congress intentionally incorporated the definition of Part 9 into the Exchange Act, construing these terms harmoniously would promote and further the intent of Congress.

C. Departments Regularly Examined For Compliance with Fiduciary Principles

The GLB Act requires that all securities transactions effected by a bank under the Trust and Fiduciary Exception be effected in the bank's trust department or in another department of the bank that is regularly examined by bank examiners for compliance with fiduciary principles and standards. The Adopting Release provides that, in order for a bank to rely on the Exception, "all aspects" of the securities transactions effected by the bank on behalf of trust and fiduciary accounts must be

regularly examined by bank examiners for compliance with fiduciary principles and standards.[18]

In the Adopting Release, the Commission also states that it will rely primarily on the Banking Agencies to ensure that banks meet the examination requirements of the Trust and Fiduciary Exception. The Adopting Release also provides that the Trust and Fiduciary Exception would not be available to a bank if one or more “aspects” of a securities transaction are done at an affiliated or unaffiliated service provider that is not a SEC-registered broker-dealer or, potentially, a SEC-registered investment adviser.[19]

We support the Commission’s decision to rely on the Banking Agencies to ensure that banks meet the statute’s examination requirements. The securities transactions that banks effect on behalf of their trust and fiduciary accounts currently are subject to regular examination by our Agencies for compliance with fiduciary principles and standards. In this regard, the Banking Agencies have established detailed and rigorous examination procedures for the trust and fiduciary activities of banks. In accordance with these procedures, our examiners, among other things, review the information reported by banks on a quarterly basis concerning their trust and fiduciary accounts, interview management and key employees responsible for trust and fiduciary activities to understand any material changes to the bank’s business, review the policies and procedures banks employ to help ensure that they meet their fiduciary obligations to customers and comply with applicable law, including the results of internal audit or other reviews assessing the effectiveness of these policies and procedures, and periodically engage in transaction testing involving individual account files and documents.

The examination procedures employed by our examiners, moreover, encompass the full scope of a bank’s relationship with its trust and fiduciary customers, including the securities transactions effected by a bank or by a third party service provider on behalf of the bank. For example, our examiners assess banks’ (i) efforts to develop new trust and fiduciary business, (ii) trust and fiduciary fee schedules to ensure that fees charged are consistent with banks’ fiduciary responsibilities, (iii) systems to ensure that investments on behalf of discretionary trust and fiduciary accounts are prudent and consistent with any direction of the underlying trust or agency instruments, (iv) trading activities, including whether banks obtain best execution on, and ensure the fair and equitable allocation of, securities transactions for trust and fiduciary accounts, (v) procedures for ensuring adequate custody of customer funds, including procedures for clearing and settling of securities transactions, and (vi) compliance with the Banking Agencies’ regulations governing securities activities, including the settlement of securities transactions, recordkeeping requirements, and preparing and sending confirmations of transactions.[20]

The Banking Agencies have adopted a risk-focused approach to examining banks, including their trust and fiduciary activities. Under this approach, our ongoing monitoring of a bank’s trust and fiduciary activities allows for strategic targeting of examiner resources. As a result, the frequency and scope of our examination of the trust and fiduciary activities of a particular bank varies based on the size and

complexity of the bank's trust and fiduciary activities and the risks such activities pose to the bank.[21] Of course, examiners' assessment of a bank's past performance in effecting securities transactions on behalf of trust and fiduciary customers is a key determinant considered in setting the timing and scope of the next trust and fiduciary examination.

In light of the foregoing, we believe that the Commission should affirmatively state that the Trust and Fiduciary Exception is available to banks whose trust and fiduciary activities are examined in accordance with the examination procedures employed by the Banking Agencies. We believe this would provide important certainty to banks concerning this aspect of the Trust and Fiduciary Exception.

We also believe that the Trust and Fiduciary Exception is available to a bank even if it uses a registered broker-dealer, investment adviser **or other entity** to assist it in effecting securities transactions on behalf of its trust and fiduciary accounts. If a bank uses a third party service provider to perform (on behalf of the bank) securities transaction services for the bank's trust and fiduciary customers, examiners review the bank's relationship with the service provider and the systems the bank has in place to ensure that the services being provided are consistent with the bank's fiduciary obligations to its customers. Moreover, if an examiner has concerns about the services being provided, the Banking Agencies have authority under the Federal banking laws to examine the service provider, subject to certain limits where the provider is a functionally regulated affiliate.[22] Accordingly, the services that a third party provides to a bank's trust and fiduciary customers on behalf of the bank are regularly examined for compliance with fiduciary principles.

Our supervisory experience suggests that many banks rely on affiliated and unaffiliated third parties to assist in various aspects of securities transactions. For example, banks often rely on affiliates to provide administrative services, such as preparing and sending confirmations of securities transactions, on behalf of their trust and fiduciary accounts. Accordingly, interpreting the Trust and Fiduciary Exception to be unavailable to banks that use third parties in some "aspects" of a securities transaction would disrupt the normal trust and fiduciary operations of banks.[23]

D. Flat or Capped Per Order Processing Fee

The GLB Act defines relationship compensation to include a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with effecting securities transactions for trustee and fiduciary customers. While the Commission would allow a per-order processing fee to include some of the costs associated with shared trading desks and other resources that are not "exclusively dedicated" to trust and fiduciary customers, the Proposed Rules, allow an authorized per-order processing fee to include only the direct **marginal** costs of shared resources (such as common trading desks or trading platforms) that are used for the execution, comparison and settlement of transactions for trust and fiduciary customers. In addition, the Proposed Rules allow a bank to include these direct

marginal costs only if the bank makes a “precise and verifiable” allocation of these resources according to their use.

Banks, of course, may incur both marginal **and** fixed costs in developing and maintaining shared systems for handling securities transactions for trust and fiduciary and other customers. Prohibiting banks from including a portion of the fixed costs associated with such shared systems in a per-order processing fee does not allow banks to recover the “cost incurred by the bank in connection with executing transactions for trustee and fiduciary customers.”[24] It is, therefore, an interpretation that is contrary to the language of the GLB Act. This is especially true if the bank incurred significant fixed costs to develop the shared resources (such as software) and these resources are used primarily (but not exclusively) to support the bank’s trust and fiduciary operations.

The “precise and verifiable” requirement also is not mandated by the statute, may be unjustifiably costly to implement, and reflects unnecessary micromanagement of bank systems. We are concerned that many banks may not be able to make a “precise and verifiable” allocation of their resources in the manner contemplated by the Proposed Rules. If this is the case, then the Rules’ accounting restrictions would essentially prevent banks from including the costs of **any** shared resources in a per-order processing fee. We believe that a bank should be permitted to include its average total cost for effecting securities transactions for trust and fiduciary and other customers in a per-order processing fee if the bank has reasonable procedures for determining its average total per transaction cost. We believe this approach would give effect to the statute without imposing unnecessary burdens on banks.

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[1] 15 U.S.C. § 78c(a)(4)(B)(ii) (“Trust and Fiduciary Exception”).

[2] See id. at § 78c(a)(4)(C).

[3] See Proposed Rule 242.724(a).

[4] See Letter from the Banking Agencies to Jonathan G. Katz, Secretary of the Commission, dated June 29, 2001 (“2001 Comment Letter”), at Appendix p. 6-7.

[5] See Proposed Rule 242.724(h). Because of the statute’s plain language, we support the Commission’s decision to treat an asset under management fee as relationship compensation even if the fee is separately charged on real estate or other non-securities assets.

[6] Bank trust departments frequently are called upon to develop complex and individualized solutions to multi-faceted estate, inheritance, business-transition, corporate transaction and other wealth-preservation issues involving several parties. In responding to these needs, banks may establish complex payment and account structures that allow for the fees related to a trust or fiduciary account to be paid by someone other than the customer or beneficiary or by a source other than the account itself.

[7] We recognize that the Commission has expressed special concerns regarding the prevalence and growth of Rule 12b-1 fees and other fees in the mutual fund industry and the conflicts that these fees may create for broker-dealers, investment advisers, banks and other entities that manage or handle customer investments. However, we believe that existing trust and fiduciary principles, combined with our Agencies' rigorous examination programs, adequately protect the trust and fiduciary customers of banks from these conflicts. To the extent that the Commission has more general concerns regarding the Rule 12b-1 and other fees currently being paid by mutual funds, we believe it would be more appropriate for the Commission to address these concerns through action under the Investment Company Act of 1940 that would apply equally to all financial intermediaries that receive these fees.

[8] Banks that engage in trust or fiduciary activities currently are required to file a quarterly report with the appropriate Banking Agency indicating the **total** income that they receive from (i) all of their trust and fiduciary accounts, and (ii) all of their trust and fiduciary accounts within five identified business lines. For reporting purposes, these business lines are defined as personal trust and agency accounts; retirement related trust and agency accounts; corporate trust and agency accounts; investment management agency accounts; and other fiduciary accounts. This information is reported on Schedule RC-T of a bank's call report (Forms FFIEC 031 and 041).

[9] Alternatively, a bank could establish that it met the chiefly compensated test by demonstrating that the total sales compensation it received from its trust and fiduciary accounts, in the aggregate, constituted less than 50 percent of the bank's total compensation from those accounts.

[10] See 15 U.S.C. § 78c(a)(4)(B)(ii).

[11] See Adopting Release at 39,700.

[12] See Proposed Rule 242.724(d).

[13] See 69 Federal Register 29,682, 39,733 (2004).

[14] Id.

[15] See, e.g., **SEC v. Capital Gains Research Bureau**, 375 U.S. 180, 194 (1963) (recognizing that investment advisers have a fiduciary relationship with their clients and that the courts, under the common law, have imposed on advisers an "affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts'".) (citation omitted); **Spear & Staff, Inc**., Investment Advisers Act Rel. No. 188 (1965) ("It was judicially recognized long prior to the [Advisers] Act that investment advisers stand in a fiduciary relation to their clients."); 2 Frankel, **The Regulation of Money Managers: Mutual Funds and Advisers** § 13.01[A] (2d ed. 2001).

[16] **See** 15 U.S.C. § 80b-2(a)(11)(A). In the GLB Act, Congress amended this exemption to provide that a bank would be considered an investment adviser for purposes of the Advisers Act to the extent it served as an investment adviser to a registered investment company.

[17] As a technical matter, we note that the Proposed Rules suggest that a bank acting as an investment adviser only has a responsibility to effect a securities transaction for a customer “if the customer accepts [the bank’s investment] selections or recommendations.” **See** Proposed Rule 242.724(d)(2). Banks typically have an obligation to execute securities transactions for their non-discretionary advisory customers whether or not the customer accepts the bank’s investment advice and the text of the Proposed Rule should be amended to reflect this fact.

[18] The Adopting Release elaborates that “all aspects” of a securities transaction include: (i) identifying potential purchasers of securities transactions; (ii) screening potential participants in a transaction for creditworthiness; (iii) soliciting securities transactions; (iv) routing or matching orders, or facilitating the execution of a securities transaction; (v) handling customer funds and securities; and (6) preparing and sending transaction confirmations. **See** Adopting Release at 39,703; Initial Rules at 27,772-73.

[19] Although the text is not entirely clear, the Adopting Release appears to suggest that a bank would not lose its ability to rely on the Trust and Fiduciary Exception if certain aspects of a securities transaction are done by a SEC-registered investment adviser. **See** Adopting Release at 39,704, n. 201. For purposes of this discussion, we have assumed that the Commission intended this result.

[20] 12 C.F.R. Part 12 (OCC); § 208.34 (Board); and Part 344 (FDIC).

[21] For example, the material fiduciary business lines of banks with large and complex trust and fiduciary operations are examined, at a minimum, over a one- to two-year period or examination cycle as part of the continuous supervision process. Smaller banks and those with less-diverse trust and fiduciary operations are examined for compliance with trust and fiduciary principles at least every other exam cycle.

[22] **See** 12 U.S.C. §§ 1867, 1844(c) and 1831v.

[23] Of course, we agree that an entity that provides securities transaction services to a bank cannot **itself** rely on the bank exceptions in section 3(a)(4) of the Exchange Act unless that entity is a bank.

[24] **See** 15 U.S.C. § 78c(a)(4(B)(ii)(I).

II. Administrative Exemptions Related to Trust and Fiduciary Activities

A. Proposed Rule 242.721: Administrative Exemption Allowing Banks to Calculate their Compliance with the Chiefly Compensated Standard on a Bank-Wide or Business-Line Basis

Proposed Rule 242.721 provides an administrative exemption that would allow banks, subject to certain conditions, to calculate their compliance with the statute's chiefly compensated standard on a bank-wide or business-line basis. As discussed above, we believe that the GLB Act itself permits banks to use a bank-wide approach in determining whether they meet the Act's chiefly compensated standard without the need of an administrative exemption. Accordingly, we do not believe that Proposed Rule 242.721 is necessary if the statute itself is properly interpreted. We also believe that the conditions contained in Rule 242.721 are unduly restrictive and that, because of these restrictions, the Rule would not fully or adequately address the problems caused by the Commission's interpretation of the statute's chiefly compensated standard.

1. 11-Percent Limit.

Most importantly, Proposed Rule 242.721 would allow a bank to use a bank-wide or business-line approach in calculating its compliance with the statute's chiefly compensated test only if, during the preceding year, the bank's ratio of sales compensation to relationship compensation from the relevant accounts was no more than 1 to 9 (approximately 11 percent when stated in terms of a percentage). The Proposed Rule would allow this ratio to increase to 1 to 7 (approximately 13 percent), but only once every 5 years.

As an initial matter, we believe that any percentage threshold established by the Commission through an administrative exemption must reflect the language and intent of the GLB Act. Therefore, it must give life to the term "chiefly compensated." Granting 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. In addition, any percentage threshold must be high enough to accommodate the diverse trust and fiduciary operations and business lines of the nation's banking institutions, and provide banks with meaningful "headroom" so that the trust and fiduciary businesses of banks are not threatened by natural fluctuations and developments in the business. These considerations played a significant role in the development of the statutory Trust and Fiduciary Exception, which itself permits banks to derive up to 49 percent of their total trust and fiduciary income from fees that do not qualify as relationship compensation under the statute.

Moreover, if any percentage threshold established in the Proposed Rule does not meaningfully accommodate the full range of trust and fiduciary operations of banks, then additional administrative exemptions must be developed for

the multitude of trust and fiduciary operations of banks that would be disrupted by the artificially low threshold established by the Commission. This approach, which is the approach followed in the Proposed Rules, creates an overly complex and burdensome regulatory regime for banks simply to continue their normal trust and fiduciary activities. The statutory Trust and Fiduciary Exception was structured to establish a straightforward chiefly compensated test that would work for the diverse nature of banks and their trust and fiduciary businesses, and a similar approach should guide the development of any administrative exemptions necessitated by the Commission's unduly restrictive interpretation of the statute.

With this background, and based on discussions with the banking industry, we believe the percentage limits included in the Proposed Rule are far too low and would not meaningfully accommodate the diverse trust and fiduciary operations of banks or the natural development of these activities.[25] The 11-percent threshold is well below the 49-percent level that the statute itself allows and that the Commission has determined applies if a bank seeks to comply with the chiefly compensated standard on an account-by-account basis. In addition, as the Commission appears to recognize, banks with significant corporate, municipal or employee benefit plan trust businesses likely could not operate within the percentage thresholds established by the Proposed Rules. Even if separate administrative exemptions were developed that fully accommodate these business lines, we understand that the percentage thresholds included in the Proposed Rules would not work for many banks, either on a bank-wide or a business-line basis. For these reasons, we believe any administrative exemption should allow banks to receive sales compensation up to the statutorily established limit (49 percent). A slightly lower percentage threshold could be established if the Commission determined that some "wiggle room" was needed to ensure banks did not exceed this statutory limit.

The percentage limit established by the Proposed Rule also is based on a comparison of sales compensation to relationship compensation. As discussed above, this type of comparison is unduly complex, conflicts with the type of straightforward comparison called for by the statute and, given the Commission's definitions of these terms, would require banks to classify and track their fees according to three categories (relationship compensation, sales compensation and "other" compensation) which do not conform to the systems they currently use. Accordingly, any percentage threshold established by the Commission by administrative action should be based on a comparison of relationship compensation (or, alternatively, sales compensation) to the **total compensation** that the bank receives from the relevant accounts.

The Adopting Release requests that any bank seeking modifications to the percentage thresholds included in the Proposed Rule provide the Commission with specific information concerning the bank's ratio of sales compensation to relationship compensation.[26] As previously noted, banks

currently are not required to classify and track the fees that they receive from their trust and fiduciary customers in the detailed and complex manner that would be required by the Proposed Rules. Accordingly, banks generally do not have the management information and other systems in place that would allow them to provide the Commission with specific and detailed information concerning their ratio of sales compensation to relationship compensation (as those terms are defined in the Proposed Rules).[27] Thus, it likely will be difficult and expensive for many banks to provide the Commission with the specific information it has requested.

2. Exemption may force banks to use an account-by-account approach or nullify the effect of other exemptions.

The Proposed Rule permits a bank to use the exemption (i) "for all accounts for which the bank acts in a trustee or fiduciary capacity on a bank-wide basis" or, (ii) for "one or more individual lines of business provided that the sales compensation and relationship compensation from all accounts . . . within a particular line of business is used to determine whether the bank meets" the percentage limitations imposed by the Rule. Although the intended effect of this language is not entirely clear, it appears that these provisions essentially would force many banks to calculate their compliance with the statute's chiefly compensated test on an account-by-account basis for a number of their accounts or nullify the benefits of other exemptions.

For example, as the Adopting Release appears to acknowledge, many banks may be forced to use the proposed exemptions for certain types of employee benefit plan accounts (Proposed Rule 242.770, the "Employee Benefit Plan Exemption") because the 11-percent limit in Proposed Rule 242.721 would not accommodate the existing business relationships of banks and their customers in the employee benefit area.[28] A bank that took advantage of the Employee Benefit Plan Exemption, however, would appear to be prohibited from using the bank-wide approach to calculate its compliance with the Proposed Rule's 11-percent sales compensation limit for all of the bank's other trust and fiduciary accounts not covered by that exemption. In addition, the Proposed Rule would appear to **either**—

> (i) prohibit the bank from using a business-line approach to calculate its compliance with the Rule's 11-percent limit for all of the bank's employee benefit plan accounts that are **not** covered by Employee Benefit Plan Exemption;[29] **or**
>
> (ii) require the bank, if it seeks to use the business-line approach to calculate its compliance with the 11-percent limit for the employee benefit plan accounts **not** covered by the Employee Benefit Plan Exemption, to **include** all of the sales compensation and relationship compensation that the bank receives from the accounts purportedly covered by the Employee Benefit Plan Exemption.

Similar results would appear to occur if the bank sought to use the proposed exemptions for indenture trustee relationships (Proposed Rule 242.723), for transactions involving money market mutual funds (Proposed Rule 242.776), or for certain living, testamentary and charitable accounts established before July 30, 2004 (Proposed Rule 242.720).

A bank should not be prevented from calculating its compliance with any given percentage limit on a bank-wide or business-line basis simply because the bank decides to avail itself of a separate administrative exemption granted by the Commission for a subset of the bank's trust and fiduciary accounts. Restrictions that require banks to make such a choice would not only force many banks to comply with the statute's chiefly compensated standard on an account-by-account basis (a result that is inconsistent with the GLB Act), but also would greatly increase the complexities and hardships that banks may face in attempting to comply with the Commission's Proposed Rules.

In addition, if a bank decides to avail itself of a separate administrative exemption provided by the Commission for a subset of the bank's trust and fiduciary accounts, the bank should not be forced to include the fees received from accounts covered by those exemptions for purposes of calculating its compliance with a percentage sales compensation limit. Such a requirement could negate the purpose of the targeted exemptions, **i.e.** to free these accounts from the Commission's unduly restrictive chiefly compensated standard.

3. Proposed Rule continues to require account-by-account reviews.

Finally, the Rule would not entirely free banks from conducting account-by-account reviews of their individual trust and fiduciary accounts. In this regard, the Proposed Rule allows a bank to use a bank-wide or department-wide approach to compliance only if the bank maintains procedures that are reasonably designed to ensure that the bank reviews **each** trust and fiduciary account both before the account is opened, and whenever the bank individually negotiates with the accountholder or beneficiary of the account to increase the proportion of sales compensation to relationship compensation. After conducting these reviews, the bank must determine that the bank is likely to receive more relationship compensation than sales compensation from the individual account.[30]

Our Agencies continue to believe that the account-review procedures contained in the Proposed Rules are unnecessary and inappropriate. Banks that meet the chiefly compensated test on a bank-wide or business-line basis should not be required also to predict the level and types of fees they might receive from individual accounts.

B. Proposed Rule 242.770: Administrative Exemption for Certain Types of Employee Benefit Plan Accounts

Proposed Rule 242.770 would permit banks, subject to certain conditions, to purchase and sell mutual fund shares for employee benefit plans that are qualified under section 401(a) or described in sections 403(b) or 457 of the Internal Revenue Code ("eligible plans") if the bank serves as trustee or custodian to the plan. In essence, the exemption would allow banks that act as a trustee, custodian or administrator for an eligible plan to buy and sell mutual fund shares for the plan without complying with the statute's chiefly compensated requirement.[31] There are several significant problems with this proposed exemption.

First, the exemption is available only for employee benefit plans that are qualified under section 401(a) or described in section 403(b) or 457 of the Internal Revenue Code ("Code"). Banks, however, currently act as trustee, fiduciary, administrator or custodian for a variety of other employee benefit plans, including Voluntary Employee Beneficiary Association Plans, governmental plans, church plans, multi-employer plans offered pursuant to a collective bargaining agreement, deferred compensation plans (including rabbi and secular trusts), supplemental or mirror plans, and supplemental unemployment benefit plans. The proposed administrative exemption would not allow banks to continue to provide securities transaction services to these types of customers. In addition, the proposed exemption would **not** cover other types of employee benefit plans that may be developed in the future in response to changes in the tax laws or developments in the marketplace and, thus, freezes the ability of banks to respond to the developing employee benefit plan needs of their customers.

Second, the Proposed Rule would allow banks to purchase and sell only shares of a registered mutual fund for an eligible plan. However, many benefit plans buy and sell, or allow their participants to buy and sell, other types of securities. For example, defined benefit plans frequently are invested in the securities of individual companies and employee stock option and employee stock ownership plans, of course, normally invest in the stock (or stock options) of the sponsoring company. Prohibiting banks from offering their employee benefit plan customers investment options other than mutual funds, therefore, is inconsistent with the current practice of banks and the nature of the employee benefit business.

Third, the Proposed Rule permits a bank to effect securities transactions for an eligible plan only if the bank "offsets or credits any compensation" that it receives from a mutual fund complex due to the investment of the plan's assets against other fees and expenses that the plan owes to the bank.[32] The Adopting Release indicates that this offset or credit requirement was based on information that some banks informally provided Commission staff concerning their current practice.[33] The compensation restrictions contained in the Proposed Rule, however, are not consistent with banking industry practice and conflict with the requirements of the Employee Retirement Income Security Act ("ERISA"), as implemented by the Department of Labor.

In this regard, sections 406(b)(1) and (3) of ERISA generally prohibit a bank or other person that is a "fiduciary" with respect to a plan from (i) dealing with the assets of the plan in his or her own interest or for his or her own account, or (ii) receiving any

consideration for his or her own account from any party dealing with the plan in connection with a transaction involving the assets of the plan.[34] The Department of Labor has issued advisory opinions concerning when the receipt of Rule 12b-1, shareholder servicing and sub-transfer fees from a mutual fund by a bank or other entity providing services to an employee benefit plan may implicate these conflict-of-interest provisions.[35]

As a general matter, these opinions from the Department of Labor provide that a bank or other entity that exercises authority or control over the investment of a plan's assets in a mutual fund may not receive Rule 12b-1, shareholder servicing or sub-transfer fees from the mutual fund **unless** the bank or other entity uses these fees as an offset or credit against the fees the plan would otherwise have to pay the bank or other entity. A bank, for example, would have to provide such an offset or credit if the bank acts as a trustee for a plan and, in this role, advises the plan sponsor concerning the mutual funds to be included as investment options in the plan.

However, the Department of Labor's opinions do **not** require a bank to perform such an offset or credit where the bank does not exercise any authority or control to cause a plan to invest in the relevant mutual fund. Thus, for example, ERISA allows a bank that serves as directed trustee for an employee benefit plan to receive and retain fees from a mutual fund in which the plan is invested if another plan fiduciary (e.g. the plan sponsor), and not the bank, has the authority to determine the mutual funds in which the plan's assets may be invested. Many banks that provide services to employee benefit plans currently receive and retain fees from mutual funds in accordance with these Department of Labor opinions. The compensation limitation contained in the Proposed Rule, however, would not allow this existing practice even where these relationships are structured to comply with the conflict-of-interest and other protections provided under ERISA.[36]

Moreover, ERISA already provides significant protections for employee benefit plans and their beneficiaries that apply equally to banks and other entities that provide services to employee benefit plans. For example, ERISA already requires the responsible fiduciary for a plan to determine that the compensation paid directly or indirectly by the plan to a service provider (including a bank) is reasonable in light of, among other things, the services provided to the plan and the other fees or compensation that the service provider may receive in connection with the investment of the plan's assets. In addition, under ERISA, the responsible fiduciaries for a plan must (i) obtain sufficient information concerning the fees a service provider (including a bank) may receive from a mutual fund due the investment of the plan's assets to determine that the entity's compensation is reasonable, and (ii) monitor a service provider to ensure that, where the entity is required to provide the plan with fee offsets or credits, such offsets and credits are properly calculated and applied.[37] Given all these existing safeguards, the need for the Commission to impose special compensation or disclosure requirements on banks in this area as a condition to their use of the bank exceptions in the GLB Act is not apparent.

Finally, the Proposed Rule would allow a bank to offer the participants in an eligible plan a participant-directed brokerage window only if each participant's account is carried by a registered broker-dealer on a fully disclosed basis.[38] Eligible plans often allow their participants the ability to purchase mutual funds or securities that are outside the normal investment options within the plan (*i.e.*, those selected by the plan sponsor or other fiduciary). Many banks currently offer this service, which is commonly referred to as a participant-directed brokerage window, to their employee benefit plan customers and, indirectly, to the participants in these plans. However, the resulting participant accounts often are carried by the bank itself (and not a separate broker-dealer), in which case the bank transmits the orders from participants to a broker-dealer (or, in the case of mutual fund securities, to Fund/Serve or the fund's transfer agent) on an omnibus basis. The "fully disclosed" requirement of the Proposed Rule conflicts with this practice and would require participants to move (or establish) their accounts at a broker-dealer. This, in turn, may result in higher fees for participants seeking this service.

C. Proposed Rule 242.720: Administrative exemption for certain living, testamentary and charitable trust accounts

Proposed Rule 242.720 would allow a bank, without complying with the statute's chiefly compensated requirement, to buy and sell securities for any living, testamentary or charitable trust account that was opened or established before July 30, 2004, provided that the bank, among other things, does not "individually negotiate with the accountholder or beneficiary of [the] account to increase the proportion of sales compensation as compared to relationship compensation after July 30, 2004."

We do not believe that this limited, administrative exemption would be necessary if the statute's Trust and Fiduciary Exception was implemented properly. Moreover, the Trust and Fiduciary Exception in GLB Act was designed to ensure that banks could continue to engage in their normal trust and fiduciary **activities** without significant disruption. The Act was not intended to allow banks to retain only those trust and fiduciary **accounts** that existed on a given date. Accordingly, we do not believe that this exemption, which "grandfathers" only those living, testamentary or charitable accounts that were opened or established as of July 30, 2004, properly reflects the intent of Congress or provides meaningful relief from the hardships caused by the Commission's unduly restrictive interpretation of the statute's chiefly compensated test.

The proposed "grandfather" also does not cover the full range of personal trust and fiduciary accounts that banks establish for their customers.[39] In addition, the exemption expires if a bank individually negotiates with the relevant accountholder or beneficiary in a manner that increases the proportion of sales compensation that the bank receives from a "grandfathered" account after July 30, 2004. These conditions would require banks to develop systems to identify and monitor their "grandfathered" personal trust accounts and handle accounts that lose their grandfathered status and, thus, increase the overall complexity and compliance burdens associated with the Proposed Rules. In addition, it is possible that an

account would lose its “grandfathered” status if a bank, through negotiation or voluntarily, reduced the relationship compensation it received from a “grandfathered” account, thereby *reducing* the overall fees the customer or beneficiary had to pay for the bank’s services.

D. Proposed Rule 242.722: Administrative Exemption for Banks Using an Account-By-Account Approach to Compliance

Proposed Rule 242.722 seeks to provide banks that attempt to comply with the chiefly compensated test on an account-by-account basis a “safe harbor” in case certain accounts do not meet this test in any given year. Proposed Rule 242.722(b) generally would allow an individual trust or fiduciary account of a bank to fail the Commission’s chiefly compensated test in a given year if (i) no more than 10 percent of the bank’s total trust and fiduciary accounts failed the chiefly compensated test within that same year, and (ii) the individual account in question did not rely on the safe harbor in the Proposed Rule in any of the preceding 5 years.[40] The Proposed Rule also appears to allow an individual trust or fiduciary account to fail the Commission’s chiefly compensated standard more than once every 5 years if (i) the bank documents the reasons why the account has not met the Commission’s chiefly compensated test and links that reason to the bank’s exercise of its fiduciary responsibilities, and (ii) no more than the lesser of 500 or 1 percent of the bank’s total trust and fiduciary accounts have failed to meet the Commission’s chiefly compensated test in more than one of the preceding 5 years.

As discussed earlier, we do not believe the statute’s chiefly compensated test was intended to be applied on an account-by-account basis. In addition, because banks generally do not have the systems to enable them to comply with the chiefly compensated test on an account-by-account basis, and likely would incur significant costs to develop these systems, we believe this administrative exemption is of limited benefit.

Furthermore, while we appreciate the Commission’s efforts to develop a “safe harbor” for banks that seek to comply with the Commission’s account-by-account interpretation of the statute, the terms of the exemption are unduly restrictive and very complex. These conditions likely would require banks to develop and maintain costly compliance systems in order to track over a moving 5-year period the number and identity of individual accounts that did not comply with the Commission’s interpretation of the statute’s chiefly compensated test.

Finally, we note that the exemption would strictly limit the number of individual trust and fiduciary accounts that could exceed the Commission’s chiefly compensated test in a given year even where the bank documents that this failure was caused by the bank’s exercise of its fiduciary responsibilities to its customers. There are certain times during the life of a trust or fiduciary account when the account may naturally have a large number of securities trades, but will still be a bona fide trust account. For example, in the exercise of a bank’s fiduciary duty, a bank may find it necessary to rebalance an account’s assets, such as immediately after the opening of an account or after major life events of either the settlor of a trust or the trust’s beneficiaries. This may result in a significant number of securities transactions and

annual compensation for a given year that exceeds the chiefly compensated standard as interpreted by the Commission. However, when looked at over the life account, the annual relationship compensation received by the bank from the account clearly would regularly be greater than the sales compensation received. The Proposed Rules' artificial numerical limits, however, may restrict banks from engaging in transactions dictated by their fiduciary duties. We do not believe it is appropriate to limit the number of trust and fiduciary accounts that may exceed the Commission's chiefly compensated test due to the bank's exercise of its fiduciary responsibilities to its customers.

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[25] We understand that the Commission developed the 11-percent limit based primarily on estimates that SEC staff obtained on an informal basis from a handful of banks concerning the overall ratio of sales compensation to relationship compensation that these banks receive on a bank-wide basis from their trust and fiduciary accounts. However, we understand that in preparing these estimates the banks (i) used definitions of "sales compensation" and "relationship compensation" that differ significantly from those included in the Proposed Rules, and (ii) excluded significant trust and fiduciary business lines from their calculations. Moreover, even these rough estimates were obtained from only a small number of banks. Accordingly, these estimates do not provide a sound basis for establishing a bank-wide or department-wide compensation threshold for the thousands of banks that engage in trust and fiduciary activities.

[26] **See** Adopting Release at 39,695.

[27] This is especially true because there remains uncertainty in the banking industry as to how certain types of compensation should be classified under the Proposed Rules.

[28] **See** Adopting Release at 39,718.

[29] As discussed in Part II.B below, the Employee Benefit Plan Exemption would not cover many types of employee benefit plans that currently obtain securities transaction services from banks. Most banks manage and operate all of their employee benefit plan accounts as a single, integrated line of business. Accordingly, it would be operationally infeasible for a bank to establish a separate "line of business" only for those employee benefit plan accounts not covered by the Employee Benefit Plan Exemption and, in any event, the Proposed Rules' definition of a "line of business" may well prohibit a bank from doing so. **See** Proposed Rule 242.724(e).

[30] Proposed Rule 242.721(a)(3) and (4).

[31] Although the language of the Proposed Rule refers only to banks acting as a trustee or custodian, the Adopting Release indicates that the Rule also was intended to cover banks that act as a non-fiduciary administrator for an eligible plan. **See** Adopting Release at 39,718. The statute itself allows banks to effect transactions for benefit plans when acting as a custodian or administrator for the

plan. **See** 15 U.S.C. § 78c(a)(4)(viii)(I)(ee). Accordingly, we have assumed that the Proposed Rule was intended to cover banks that provide administrative services to a plan in a non-fiduciary or non-custodial capacity.

[32] **See** Proposed Rule 242.770(a)(1).

[33] **See** Adopting Release at 39,718, n. 330.

[34] **See** 29 U.S.C. § 1106(b)(1) & (3). Under ERISA, a bank or other person is considered a "fiduciary" with respect to a plan to the extent that the bank or person (i) exercises any discretionary authority or control respecting management of the plan or any authority or control respecting management or disposition of its assets, (ii) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so, or (iii) has any discretionary authority or responsibility in the administration of the plan. See 29 U.S.C. § 1002(21)(A).

[35] **See** ERISA Advisory Opinion 97-15A and ERISA Advisory Opinion 97-16A. Because the Proposed Rule would require that a bank provide an offset or credit for "any compensation" that the bank receives from a mutual fund complex in which a plan's assets are invested, the Proposed Rule's compensation restriction could be read to cover other fees—such as investment advisory fees—that the bank receives from a mutual fund. We understand, however, that Rule's reference to "compensation" was intended to refer only to the types of compensation discussed in the Department of Labor's Advisory Opinions 97-15A and 97-16A.

[36] The Proposed Rule also would require that a bank clearly and conspicuously disclose the fees its receives from a mutual fund to the sponsor of an eligible plan (or its designated fiduciary) in a manner that will allow the plan sponsor (or its designated fiduciary) to determine that the bank has credited or offset its fees in the manner required by the Rule. These disclosure requirements also are inconsistent with ERISA to the extent they would apply in situations where ERISA would **not** require a fee offset or credit.

[37] **See** ERISA Advisory Opinion 97-15A and ERISA Advisory Opinion 97-16A; see also 29 U.S.C. §§ 1104(a) and 1106(b). In the case of benefit plans that are not subject to ERISA, banks are subject to state laws that often impose requirements that are similar to those applicable under ERISA.

[38] **See** Proposed Rule 242.770(a)(3) and (b)(3).

[39] For example, the exemption does not cover personal estates for which the bank acts as executor, administrator or representative; conservatorships or guardianships; or personal accounts to which a bank provides investment advice in a non-trustee capacity. In addition, as noted above, the exemption does not cover **any** personal account established after July 30, 2004.

[40] Although paragraph (a) of Proposed Rule 242.722 also purports to provide banks an exemption from the Commission's account-by-account chiefly compensated test, this paragraph appears to simply restate the Commission's general interpretation of

the chiefly compensated test while also imposing **additional** restrictions on banks that seek to comply with the Commission's account-by-account interpretation. Accordingly, paragraph (a) of the Proposed Rule does not appear to provide banks any exemptive relief.

III. Exception for Custodial and Safekeeping Activities

Custody and safekeeping activities—like trust and fiduciary activities—are core banking services that historically have involved certain securities-related functions. For example, banks have for many years served as custodians for self-directed individual retirement accounts ("IRAs"). Bank-offered custodial IRAs provide customers throughout the United States a convenient and economical way to invest for retirement on a tax-deferred basis. In fact, the Internal Revenue Code prohibits non-bank entities from offering custodial IRAs absent the specific approval of the Secretary of the Treasury,[41] and imposes strict requirements on banks offering custodial IRAs.

Banks also provide custodial and safekeeping services to 401(k) and other retirement and benefit plans where a third party acts as trustee and investment adviser to the plan. As part of these custodial and safekeeping services, banks may accept and process orders from the plan, the plan's fiduciary or the plan's participants for the investment of new contributions or the re-allocation of existing contributions. In these circumstances, the custodial bank performs its order-taking and order-execution functions pursuant to the direction and supervision of one or more plan fiduciaries.[42] These bank-offered services allow plan administrators to obtain securities execution and other administrative services in a cost-effective manner, thereby reducing plan expenses and benefiting plan beneficiaries.

Bank custodians also have a long-standing history of accommodating their other custodial customers by accepting and transferring, on an unsolicited basis, orders for securities to a registered broker-dealer. This customer-driven service allows customers to avoid having to go through the unnecessary expense of establishing a separate account with a broker-dealer to effect occasional trades associated with the customer's custodial assets. Because these services customarily are provided only as an accommodation to custodial accounts, banks typically do not solicit the securities orders, do not publicly advertise their order-taking services, and do not charge transaction-based fees that vary depending on whether or not the bank accepted the customer's order. Banks have offered these services for many years without significant consumer-related problems under the supervision and regulation of the Banking Agencies.

The custody and safekeeping exception in the GLB Act was designed to permit banks to continue to engage in their customary custodial and safekeeping activities, including related securities order-taking activities. The Exception expressly permits a bank, without being considered a broker, to engage in a variety of custodial- and safekeeping-related activities "as part of its customary banking activities," including —

> (1) providing safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers; and
>
> (2) serving as a custodian or provider of other related administrative services to any IRA, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan.[43]

In addition, the Custody and Safekeeping Exception provides that a bank must transmit any order it receives for a publicly traded security to a registered broker-dealer for execution.

The Commission, however, continues to assert that the statutory Custody and Safekeeping Exception does **not** permit banks to accept securities orders from their custodial customers. This interpretation is wholly inconsistent with the language of the Act, its legislative history, and the normal custodial and safekeeping operations of banks. The conflict between the Commission's interpretation and the language and intent of the Act is most starkly presented with respect to IRAs and employee benefit plans. As noted above, the statute's express language permits banks to continue to provide custodial and other administrative services to IRAs and a wide range of benefit plans. *This language was specifically added to the GLB Act by the Conference Committee to permit banks to continue to accept and process securities orders for these customers.*[44]

The Banking Agencies believe the Commission should interpret the statute's Custody and Safekeeping Exception in a way that gives effect to the language and purposes of the exemption and does not disrupt traditional custodial banking relationships. Specifically, the Commission should provide that the Custody and Safekeeping Exception itself permits banks to accept securities orders from custodial IRAs and the other types of accounts expressly described in subsection (ee) of the exception, as well as from other custodial customers on an unsolicited and accommodation basis.

We recognize that the Commission has adopted certain administrative exemptions that would allow banks to continue to accept securities orders from some custodial accounts in certain circumstances. However, these administrative exemptions do not comport with the existing custodial and safekeeping activities of banks and would prevent banks from continuing to provide services that customers have come to expect and demand of bank custodians. For example, exemptions that are available only for preexisting custodial accounts have a chilling effect on the ability of banks to provide comparable services to future customers; exemptions limited to "qualified investors" deny other bank customers valued choices; and exemptions limited to smaller banks preclude larger institutions for offering longstanding traditional banking services to their customers.

Accordingly, the limited administrative exemptions would significantly disrupt the traditional custody and safekeeping activities that Congress intended to protect, would reduce customer choice and would force the custodial customers of banks to incur additional and unnecessary burdens and expenses. More fundamentally, these administrative exemptions, and the complexities and disruptions they involve, would be unnecessary if the Commission were to give effect to the words and purpose of the **statutory** Custody and Safekeeping Exception that Congress debated and adopted.

Finally, we note that the Proposed Rules also provide that a bank will be considered to be acting as a "custodian" for an account (other than an IRA) only if the bank has a written agreement with the customer that sets forth the bank's obligations with respect to seven specific types of actions.[45] It is inappropriate and inconsistent with functional regulation for the Commission to attempt to define what provisions must be in a bank's custodial agreement with a customer. Moreover, the Proposed Rules would require that

banks review each custody agreement already in place with existing customers to determine whether the agreement includes each of the provisions specified in the Proposed Rules and, if not, to modify their existing agreements that do not meet the Commission's definitional conditions. This will further increase the costs and disruptions caused by the Proposed Rules.

In light of the problems caused by the Commission's unduly narrow interpretation of the statutory Custody and Safekeeping Exception, the Proposed Rules include two general administrative exemptions for the custodial activities of banks.[46] The first exemption would permit "small" banks to effect securities transactions for any custodial customer provided that, among other things, the annual "sales compensation" that the bank receives from such transactions does not exceed $100,000 (as indexed after 2004 to the Consumers Price Index All Urban Consumers).[47] A bank would qualify as a "small" bank for purposes of this exemption only if—

- The bank had less than $500 million in assets as of December 31st of both of the prior two calendar years;
- The bank is not, and since December 31st of the 3rd prior calendar year has not been, affiliated with a bank holding company that as of December 31st of the prior two calendar years had consolidated assets of more than $1 billion; and
- The bank is not associated with a broker-dealer.

The second exemption is available to any bank, other than a small bank that utilizes the Small Bank Exemption. However, this exemption permits a bank to effect securities transactions **only** for those custody accounts that (i) were opened before July 30, 2004, or (ii) are held by a "qualified investor."[48]

We appreciate the Commission's decision to loosen some of the restrictions that were contained in the custody exemptions of the Initial Rules. Nevertheless, the conditions retained in the Small Bank and General Custody Exemptions are incompatible with the custody business of many banks and would significantly limit the ability of banks to continue to engage in customary banking practices that Congress intended to protect.

In particular, we see no reason to allow larger banks to provide a customary banking service—securities order-taking services—only to existing custody accounts and those established in the future by "qualified investors." Prohibiting banks from providing these services to new accounts essentially forces this long-standing customer service out of banks over time, prohibits banks from providing the same level of custody services to new customers, and forces many custody clients—regardless of their desire—to incur the additional expense of establishing an account at a broker-dealer.

The exception for "qualified investors" also does not provide meaningful relief given the Commission's very restrictive definition of this term. For example, a corporation or natural person generally would qualify as a "qualified investor" under the Proposed Rules only if the entity or person owns or invests on a discretionary basis at least $25 million in investments. Very few new custodial customers of a bank are likely to satisfy such a high threshold. This threshold certainly is not sufficient to accommodate the

typical customer base of custodial IRAs or the participants in 401(k) and other participant-directed benefit plans—customers that Congress specifically sought to ensure could continue to receive securities services from their custodial bank.

It is notable that the Commission's own Regulation D[49] governing private placements of securities permits unregistered securities to be marketed and sold to any person (i) whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million, or (ii) who had individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years. Given these thresholds for purchasing unregistered securities, it is difficult to understand why a person would be prohibited from giving a bank an unsolicited order to buy and sell the securities held in custody by the bank unless the person had $25 million in investments.[50]

Small banks that grow beyond the $500 million asset threshold, that decide to establish or become affiliated with a registered broker-dealer or that are acquired by a bank holding with more than $1 billion in consolidated assets would face similar, and perhaps even more severe, problems. For example, a small bank that permitted non-qualified investors to open custodial IRAs at the bank after June 30, 2004, under the Small Bank Exemption would appear to be prohibited from effecting transactions for these custodial IRA customers if the bank's assets grew to more than $500 million. Thus, the established customers of a bank may find their access to services cut-off by the artificial thresholds and restrictions included in the Small Bank Exemption.

Finally, we see no reason to deny a small bank the ability to offer its customers a traditional banking product solely because the bank is affiliated with a broker-dealer—a restriction that effectively penalizes a bank for an affiliation that the GLB Act expressly permits.

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[41] **See** 26 U.S.C. §§ 408(a)(2) and 408(h).

[42] Under Department of Labor regulations, a bank may provide securities execution services to an ERISA plan without becoming a "fiduciary" to the plan so long as the transactions are conducted pursuant to instructions received from a plan fiduciary that is not an affiliate of the bank. **See** 29 C.F.R. § 2510.3-21(d).

[43] **See** 15 U.S.C. § 78c(a)(4)(B)(viii)(I)(aa) and (ee).

[44] **See** 2001 Comment Letter, Appendix, at 27-28 (discussing legislative history of the Custody and Safekeeping Exception).

[45] **See** Proposed Rule 242.762(a). These actions are (i) the safekeeping of securities; (ii) settling trades; (iii) investing cash balances as directed; (iv) collecting income; (v) processing corporate actions; (vi) pricing securities positions; and (vii) providing recordkeeping and reporting services. We note that it is unclear whether this definition would apply to a bank acting under the Custody and Safekeeping Exception as well as under the administrative exemptions the Commission has adopted for custodial activities. For purposes of this letter, we have assumed that the Commission would

apply this definition of a "custody" account to banks seeking to operate under the statutory exception.

[46] The Proposed Rules also include an exemption that would allow banks to effect securities transactions for certain types of employee benefit plans (not including IRAs) for which the bank acts as custodian. As discussed in Part II.B above, this exemption does not cover the full range of employee benefit plans currently serviced by bank custodians and includes restrictions that would significantly disrupt existing customer relationships.

[47] **See** Proposed Rule 242.761 ("Small Bank Exemption").

[48] **See** Proposed Rule 242.760 ("General Bank Exemption").

[49] 17 C.F.R. §§ 230.501 – 230.508.

[50] The General Bank Exemption also prohibits a bank from directly or indirectly soliciting securities transactions from its custodial customers, with certain limited exceptions. The Adopting Release provides that this solicitation restriction "would not permit a bank to solicit through another bank department securities activities in its custody department." **See** Adopting Release at 39,710. Banks often market their trust and fiduciary, deposit sweep, and other bank services to their custody customers and it is unclear whether the solicitation restriction in the exemption would prohibit banks from conducting these normal cross-selling activities.

IV. Exception for "Networking" Arrangements

The GLB Act permits banks, subject to certain conditions, to establish and maintain "networking" arrangements with registered broker-dealers through which the services of the broker-dealer are offered to customers of the bank.[51] The Networking Exception generally prohibits bank employees (other than those who are employed by the broker-dealer and registered with the NASD or another self-regulatory organization) from receiving "incentive compensation" for a brokerage transaction, but explicitly permits bank employees to receive compensation for the referral of a customer to a broker-dealer "if the compensation is a nominal one-time cash fee of a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction." The Networking Exception and the conditions incorporated into the Exception were based on a line of no-action letters issued by SEC staff, as well as guidance issued by the Banking Agencies, concerning networking arrangements.[52]

The Commission has proposed a number of changes to the provisions of the Initial Rules implementing the Networking Exception in order to provide banks increased flexibility and reduce the significant compliance burdens that would have been imposed by the Initial Rules. Nevertheless, the Proposed Rules in this area remain unnecessarily rigid and inflexible. Additional flexibility is particularly warranted in light of the limited nature of the bank activities involved. Because the Networking Exception permits banks to refer a customer to a broker-dealer, registered representatives of a broker-dealer would continue to have the opportunity and responsibility to ensure that any securities transactions actually conducted by the customer comply with the suitability and other standards of the Federal securities laws.

A. Definition of "Nominal One-time Cash Fee of a Fixed Dollar Amount"

The Proposed Rules provide that a referral fee paid in cash will be considered "nominal" if the fee does not exceed the greater of: (1) the employee's base hourly rate of pay; (2) $25; **or** (3) $15 in 1999 dollars, adjusted for inflation (based on the Consumer Price Index All Urban Consumers published by the Department of Labor on June 1st of the preceding year) to the whole dollar amount nearest to $15 dollars. These complex restrictions are unnecessary, unworkable and ill advised.

As we indicated in the 2001 Comment Letter, the base hourly approach is unworkable in practice and has significant problems. In addition, the Banking Agencies do not believe that the dollar amounts established by the Proposed Rules properly reflect what may constitute a nominal payment for the full range of employees that may receive these payments. For example, branch managers and platform personnel typically are more highly compensated than tellers and, accordingly, should be permitted to receive higher referral fees than tellers. Institutional referrals also typically are made by employees who are more highly compensated than employees making retail referrals. Establishing higher dollar thresholds for these types of referrals would free banks from the significant burden of monitoring the base hourly rate of pay of the individual involved simply to pay referral fees that are clearly "nominal" within the circumstances. If any dollar thresholds were to be established, those thresholds (expressed in current dollars) should be

indexed for inflation. We see no reason to allow for indexing based only on a *lower* dollar threshold expressed in 1999 dollars. This approach is unnecessarily complicated and effectively prevents referral fees to be adjusted for inflation until such time as inflation causes $15 in 1999 dollars to equal or exceed an estimated $26 in current dollars.

We continue to believe that the Commission should not establish a fixed definition of what constitutes a “nominal” referral fee that attempts to fit one size to all cases. Whether a referral fee paid in a particular instance is “nominal” depends on a wide variety of factors including, for example, the geographic location of the employee making the referral (*e.g.*, high cost urban area vs. low cost rural area), the employee’s overall compensation, the amount paid by the bank for other types of referrals (*e.g.*, insurance referrals), the nature of the customer and business involved (institutional vs. retail), and the overall structure of the bank’s referral compensation program.

Accordingly, the determination of whether a referral fee is “nominal” is one that is best made in the context of the supervision and examination process. This process allows examiners to review the referral fee in light of all relevant circumstances and to make appropriate adjustments for geographic and other differences between institutions and referral programs.

This, in fact, is the way that the Commission and the self-regulatory organizations historically have monitored the “nominal” requirement embodied in the SEC staff no-action letters, on which the Networking Exception is based. Our Agencies also have used this approach in monitoring the “nominal” referral fee element of our inter-agency guidelines governing retail networking arrangements, as well as the “nominal” component of our inter-agency regulations implementing the insurance customer protection provisions established by Congress in the GLB Act.[53] We believe this supervisory approach has worked well and has allowed us to monitor and enforce these “nominal” requirements in both an effective and flexible way. We would welcome the opportunity to discuss with the Commission how we would apply this same process to monitor the “nominal” requirement in the Networking Exception on an ongoing basis.

The Proposed Rules also impose restrictions on non-cash referral programs that are unnecessary and unduly restrictive. For example, the Proposed Rules would allow banks to pay securities referral fees in the form of points only if the points are awarded under an incentive program that covers a broad range of products and that is designed primarily to reward activities unrelated to securities. We see no reason for this requirement. So long as the points awarded for a securities referral have a nominal value it should not matter whether the bank’s program covers just securities or both securities and non-securities products.

In addition, the Proposed Rules provide that any non-cash referral fee must have a “readily ascertainable cash equivalent.” The Adopting Release explains that this would require that the value of a points-based referral fee must be "known to an employee before the employee makes a brokerage referral."[54] However, it is often not possible to establish precisely a cash equivalent value of points because the gifts or prizes that an

employee may obtain by the points often may vary in value and may not be determinable until a later date (such as, for example, the end of a fiscal quarter). A non-cash, "points" program should be permissible so long as the methodology for granting points for securities referrals is fixed in advance (even though the precise value of a point may not be known until a later time) and the ultimate value of the points awarded for any securities referral is nominal. Such a change would provide banks important flexibility without creating undue incentives for bank employees. In all cases, employees would know at the time a securities referral is made that their compensation for the referral would not exceed a nominal amount.

The Proposed Rules also provide that a bank may not pay a referral fee to an employee more than one-time **per customer**. The statute, however, prohibits an employee from receiving a referral fee more than one-time for each referral the employee makes to the registered broker-dealer; it does not prohibit an employee from receiving separate referral fees if a customer is referred to the broker-dealer on separate occasions or by different employees. Moreover, we understand that it would be difficult for banks to develop the systems that would be necessary for them to track each customer referred to a broker-dealer, and the employee that referred that customer, on an ongoing basis.

B. Contingent on a Securities Transaction

The Networking Exception provides that a referral fee paid to an unregistered bank employee may not be "contingent on whether the referral results in a transaction." We appreciate the Commission's decision to clarify that this restriction does **not** prohibit a bank from making a referral fee contingent on whether the customer (1) contacts or keeps an appointment with the broker-dealer, or (2) has assets, net worth, or income meeting any minimum requirement that the broker-dealer, or the bank, may have established generally for securities referrals.[55]

We believe the rule also should be expanded to allow a bank to make the payment of a referral fee contingent on whether the customer meets **any** general and objective criteria established by the broker-dealer or bank for customer referrals (so long as the fee is not contingent on whether the referral results in a transaction). Broker-dealers may well establish other objective criteria (such as residency requirements or tax bracket criteria) for customer referrals, and allowing bank employees to screen customers for compliance with these restrictions would help prevent the unnecessary referral of customers.

C. Bonus Programs

The Adopting Release includes a discussion of the bonus programs employed by banks and bank holding companies. However, it is unclear from the text of the Adopting Release whether the Commission believes it has jurisdiction to regulate the general bonus programs of banks and bank holding companies through the referral fee restrictions embedded in the Networking Exception of the GLB Act and, if so, on what basis the Commission believes it has such jurisdiction.

We agree that an unregistered bank employee who has received a fee for a securities referral fee under the Networking Exception cannot receive additional compensation for that referral through the form of a bonus in a way that would cause the employee's compensation for the referral to exceed a nominal amount. We believe the most appropriate way to monitor that bonus programs are not used as a conduit for such payments is through the bank supervisory and examination process.

We do not believe, however, that Congress, in authorizing banks to have networking arrangements with broker-dealers, intended to grant the Commission broad authority over the bonus programs utilized by banks and bank holding companies to compensate their employees generally. Indeed, we see nothing in the Networking Exception or its legislative history that would even hint that Congress intended to give the Commission such broad authority.

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[51] **See** 15 U.S.C. § 78c(a)(4)(B)(i) ("Networking Exception").

[52] **See** Chubb Securities Corp., 1993 SEC No-Act. LEXIS 1204 (Nov. 24, 1993); Interagency Statement on the Retail Sale of Nondeposit Investment Products, reprinted in Federal Reserve Regulatory Service, 3-1579.51.

[53] **See** 12 U.S.C. § 1831x(d)(2)(B); 12 C.F.R. § 14.50(b) (OCC); § 208.85(b) (Board); and § 343.50(b) (FDIC).

[54] **See** Adopting Release at 39,690, n. 67.

[55] **See** Proposed Rule 242.710(a).

V. Exception for "Sweep" Activities

The GLB Act permits banks, without being considered a broker, to sweep "deposit funds into any no-load, open-end management investment company registered under the Investment Company Act of 1940 that holds itself out as a money market fund."[56] In light of the continuing and outdated restriction on banks paying interest on demand deposits, many banks have developed "sweep" programs in order to allow their customers a way to earn interest on their deposit balances held at a bank. These services are particularly important to small businesses, which generally can not hold other types of interest-paying accounts (such as negotiable order of withdrawal accounts) and often rely on their local banks for cash management services.

The Proposed Rules continue to provide that a money market fund will be considered a "no load" fund for purposes of the Sweeps Exception only if the fund does not charge a front-end or deferred sales load **and** does not charge a fee in excess of 25 basis points for sales related expenses or other shareholder services. While this definition of "no-load" is the one used by the NASD for advertising purposes, adopting this definition under the Sweeps Exception would disrupt the existing sweep programs of many banks. Moreover, the Commission's interpretation may not provide any meaningful benefit to consumers. As the Commission recognizes, banks can raise the fees they directly charge their sweep customers if they are unable to fully recoup the costs associated with operating a sweeps program from the 25 basis point payments authorized by the Proposed Rules. So long as the total fees associated with a sweep program are properly disclosed to the customer—as is required under existing rules—we believe banks and their customers should be free to decide whether these fees are paid at the account level or through a fee levied by the fund in which the account's assets are invested.

Accordingly, we encourage the Commission to define a "no-load" fund for purposes of the Sweep Exception as a fund that does not charge a front-end or deferred sales load. If the Commission chooses not to adopt such a definition, we believe the Commission should adopt an administrative exemption allowing banks to continue to provide their customers "sweep" services involving such a money market mutual fund.

Finally, we disagree with the Commission's statement that the Sweeps Exception does not permit a bank to provide sweep services for deposits held at another bank.[57] The Exception itself permits a bank to sweep "deposit funds" into a no-load money market mutual fund; the statute does **not** require that those deposit funds be held at the bank providing the sweep services. In order to provide their customers sweep services in a cost-effective manner, small banks may contract with a larger bank or an affiliated bank to provide these services to their customers and we no reason for the Proposed Rules to prevent this practice.

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[56] **See** 15 U.S.C. § 78c(a)(4)(B)(v) (the "Sweeps Exception").

[57] **See** Adopting Release at 39,706.

VI. Rule 3040

As discussed in our 2001 Comment Letter, the Banking Agencies believe it is critical that the Commission take action to clarify that NASD Rule 3040 does not apply to bank employees that also are registered representatives of a broker-dealer when these employees operate in their capacity as bank employees (including when they effect bank-permissible securities transactions under the one of the bank exceptions adopted by Congress). We believe it is inconsistent with the principles of functional regulation for the Commission or NASD to attempt to assert supervisory and examination jurisdiction over bank employees when these employees are performing functions on behalf of a bank and not a broker-dealer.

Furthermore, we believe it is imperative that the Commission take the steps necessary to clarify the application of NASD Rule 3040 to bank employees before any rules implementing the "broker" exceptions for banks are finalized. We understand that many banks are considering whether to expand their use of dual employees in order to comply with the requirements of the Proposed Rules. To fully assess the potential impact of the Proposed Rules, however, banks need to know whether use of dual employees would open up the institution's *banking* activities to examination by the SEC or NASD under Rule 3040.

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[56] **See** 15 U.S.C. § 78c(a)(4)(B)(v) (the "Sweeps Exception").