PUSHING BACK THE PUSHOUTS: THE SEC's BROKER-DEALER RULES

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

AND THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

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FINANCIAL SERVICES

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PUSHING BACK THE PUSHOUTS: THE SEC's BROKER-DEALER RULES

THURSDAY, AUGUST 2, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES,
JOINT WITH THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The joint subcommittees met, pursuant to call, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Michael G. Oxley, [chairman of the Committee on Financial Services], Hon. Richard H. Baker, [chairman of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises], and Hon. Spencer Bachus, [chairman of the Subcommittee on Financial Institutions and Consumer Credit], presiding.

Present from the Committee on Financial Services: Chairman Oxley.

Present from the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises: Chairman Baker; Representatives Bachus, Hart, Cox, Weldon, Ackerman, Bentsen, Sherman, Inslee, Capuano, K. Lucas of Kentucky, Israel, and S. Jones of Ohio.

Present from the Subcommittee on Financial Institutions and Consumer Credit: Chairman Bachus; Representatives Baker, Kelly, Cantor, Grucci, Capito, C. Maloney of New York, Manzullo, Hart, Ackerman, Bentsen, Sherman, K. Lucas of Kentucky, Waters, Tiberi, and Watt.

Chairman BAKER. Good morning. I just wanted to make an announcement for those interested in the hearing this morning. I am advised that we will have a minimum of two votes which just were called. It appears that because of the timing of the votes we would probably have a likely start time of about 10:30. I know how it feels to be on the tarmac in the plane wondering what's going on. Our on-time departure will now be probably 10:35. We hope to make up for that in the air, and we will be back soon. Thank you.

[Laughter.]

[Recess.]

Chairman BAKER. Due to the time constraints of not only our panelists, but Members this morning, there are numerous activities ongoing this morning, I'm going to call our meeting to order. I do expect Members' participation as they return from the vote currently pending. To facilitate important testimony, I'd like to recognize Chairman Oxley at this time for his opening statement.

Mr. OXLEY. Thank you, Chairman Baker and also to Chairman Bachus for calling this hearing on the Securities and Exchange Commission's interim final rules. One of the important duties of these subommittees is not only to make law, but also ensure that the laws are correctly understood and implemented by agencies under our jurisdiction. Today's hearing provides us an opportunity to demonstrate why this second rule is so important.

When Gramm-Leach-Bliley became law in November of 1999, the regulatory landscape for the American financial services industry was fundamentally changed. The Gramm-Leach-Bliley Act replaced Depression-era laws with a comprehensive framework for banking, securities and insurance geared for the 21st century. The old financial services laws were not designed for a world where technology would give consumers almost limitless investment options. But in order for consumers to exercise that freedom, artificial barriers to providing banking, insurance and securities services needed to be removed, and that's exactly what Gramm-Leach-Bliley did.

Functional regulation has taken the place of the inflexible one-size-fits-all approach that existed before the Act. The "push-out" provisions were designed to allow banks to continue to perform such traditional activities as providing investment advice and acting as trustees without having to register under the securities laws. At the same time, banks would not be given limitless authority to engage in the securities business.

Functional regulation means that banking activities will be regulated by the banking authorities and securities activities will be regulated, of course, by the SEC.

The SEC's interim final rules raise troubling questions as to whether that agency has upheld the letter and the spirit of the law. GLB was never meant to make banks disrupt their customer relationships and force traditional banking activities into broker-dealer affiliates. But the SEC's rules, were they to become final as written, would do just that. I'm encouraged that the SEC has extended both the comment period and the effective date of its rules, and I hope this hearing will provide the SEC with an opportunity to receive valuable input on how the law was meant to be implemented.

I want to say I look forward to hearing from all of our witnesses today and exploring this topic further. The great strides made by Gramm-Leach-Bliley are too important to be undone by misguided attempts to implement the law, no matter how well intentioned. And I want to emphasize that GLB, in particular, the functional regulation provisions of Title II, was negotiated over a very long period of time. Boy, was it long.

[Laughter.]

And the Congress gave consideration to concerns raised by not only every witness represented here today, but every other affected party and the public, and I'm proud of our work on that historic piece of legislation and have no intention of reopening debates that were so carefully and fairly resolved.

The SEC's interim final rules, however, clearly need substantial revision to accurately reflect Congress' intent in that statute, and this hearing is an important step in that process.

And let me pay a special welcome to Chairwoman Unger for being here two days in a row. You'll get combat pay. And in your final appearance as Acting Chairwoman, we've been proud of the work that you've done there and hope you continue on as a Commissioner there doing the fine work that you've done over a number of years. And with that, Mr. Chairman, I yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 50 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman. I, too, would like to add my expression of appreciation, Ms. Unger, for your work. We certainly have enjoyed having your opinions and professional guidance in matters before the committee and certainly wish you well in all future endeavors.

Ms. UNGER. Thank you.

Chairman BAKER. Our hearing here this morning is a joint hearing, which I am acting as Chair for Panel I. Chairman Bachus will chair Panel II. The Financial Institutions Subcommittee and the Capital Markets Subcommittee both have expressed concern about the pending rules which were pursuant to Title II of Gramm-Leach-Bliley. The Commission, on May 11th issued an interim final rule concerning definitions and exemptions for banks, savings associations pursuant to Sections 3(a)(4) and 3(a)(5) of the Act of 1934.

Initially, the implementation date was October of this year. Now as a result of the Commission's actions, the date has been pushed back to May 2002 to give affected parties and the Congress the opportunity to make comment.

Without doubt, the rule has generated controversy not only from market participants' perspective, but also among almost all financial regulatory interests.

The intent of Gramm-Leach-Bliley was, to the best of our ability, to the field not only from a market, but a regulatory perspective, among banking, insurance and securities participants. And certainly that was aimed at fairness in regulatory constraints. I would only add at this point that I feel it is important from here forward that all financial regulators given the consolidated business structures which are now commonplace in the market, should to the extent practicable discuss and consider from all perspectives rules which will have effect on your respective market participants.

The lines which historically divided business practice was clearly eroded by market practice and by statute, and this creates additional burdens, understandably, on the regulators to consult and understand the consequences. But I think it very important that the development of this rule perhaps could have had an easier road had such preliminary discussions been engaged in.

At this time, to facilitate, I'm going to ask the Members' permission. Chairman Bachus has an opening statement. I don't know if a Member on the other side would have an opening statement. Ms. Unger has some time constraints, and for Members to facilitate questions of Ms. Unger, I would suggest, with your permission, that Mr. Bachus be recognized for an opening statement, and to go directly to Chairwoman Unger so Members may have an opportunity for questions.

Without objection, Chairman Bachus.

Chairman BACHUS. Thank you. I have a written statement. I'm going to introduce it into the record and in the interest of time depart from that and just make two points.

The first point is that when Chairman Baker says there's been concern expressed, "concern" is too mild a word. Hysteria may be more——

Chairman BAKER. I'm always a person of understatement. You know that.

[Laughter.]

Chairman BACHUS. This rule would cause changes that I think our financial institutions—that they're not necessary and unwise and would cause many of the traditional functions that they've done, done well, and done safely to unnecessary changes in how they do it and pushing those out.

The other point that I would emphasize is that with the blending of securities, insurance and banking, the regulators have got to work together. You've got to rely on each other for expertise. Not talk at each other, but talk with each other. Sit down and have serious discussions I think before some of these rules are released. It undermines I think the faith in the regulatory system when we have rules that come out that are then—well, they come out and there are flaws and I think significant, fundamental problems with them. And you can tell that in this instance we have that case, because you can read what the Federal Reserve and other bank regulators say about it, what the industry says about it, and see the profound differences in opinion. And I think some of these can be avoided. And I'm not criticizing any one agency. I think we could have that happen by any agency.

But I would hope that there would be much more cooperation and discussions and reviews among the agencies before these things are announced to the public.

And those are my two points, Mr. Chairman.

Chairman BAKER. Thank you, Chairman.

Chairman BACHUS. And I appreciate you convening this hearing.

[The prepared statement of Hon. Spencer Bachus can be found on page 52 in the appendix.]

Chairman BAKER. Thank you very much for your interest and leadership in this matter as well.

At this time I'd like to recognize our first witness, which we will depart a little bit from customary practice. We would receive Ms. Unger's testimony and then have subcommittee questions in order to facilitate her departure time.

It's a pleasure to have you back, Chairwoman Laura Unger, of the Securities and Exchange Commission. Welcome.

STATEMENT OF HON. LAURA S. UNGER, ACTING CHAIRWOMAN, SECURITIES AND EXCHANGE COMMISSION

Ms. UNGER. Thank you very much, Chairman Baker and Chairman Bachus. And I appreciate your kind words, Chairman Baker, as to my tenure as Acting Chairwoman. This may be the last time you get to call me Chairwoman, so feel free to use it as many times as you like.

[Laughter.]

I am actually pleased to be here today to talk about Gramm-Leach-Bliley and the historic legislation and the implementation of the functional regulation provisions in Title II of this legislation. We recognize, as has already been indicated today, that there are a number of significant issues that have been raised about the Commission's rulemaking in this area, and I want to assure you that we are listening very closely to these concerns.

I thought I would just touch on a couple of general issues today rather than the more specific and technical parts of our rules since the comment period is still open on those rules.

Most importantly, I do want to emphasize to you our commitment to implement Title II of Gramm-Leach-Bliley Act in a manner that faithfully upholds the plain meaning of the Act and Congress's intent in enacting the legislation. We are eager to work with the banks and the bank regulators to reach the appropriate balance in the rules consistent with our mandate to protect investors. We also are committed to easing the transition process for banks in implementing this historic legislation.

In enacting the Gramm-Leach-Bliley Act, Congress determined that functional regulation was necessary. That is, any bank that conducts a full-scale securities business has to do so through a registered broker-dealer. Without functional regulations, some investors would have different rights and protections than others, depending on where they did business. And we at the Commission strongly believe that investors deserve the same protection, regardless of where they buy and sell securities.

In preserving some of the exemptions to the definitions of "broker" and "dealer", however, Congress determined that certain traditional bank activities should not be disturbed. This creates a tension in the statute between the objective of having the full-scale brokerage activities occur in a registered broker-dealer, and the goal that certain traditional bank activities, such as trust activities, would not be disrupted.

The Commission, as you know, is statutorily charged with interpreting the functional regulation provisions of the Act, and the rules that we issued represent our judgment as to how to effectively implement the statute consistent with Congress's intent. The rules were intended to provide legal certainty about some issues of concern that the banking community actually brought to our attention as creating some ambiguity.

I thought I would take a few minutes to talk about the process that we used to interpret the terms in the statute. The Gramm-Leach-Bliley Act does not specifically mandate or require the Commission to engage in rulemaking in this area. And initially, we didn't think that we would engage in rulemaking in this area, and that, in fact, we would act on a case-by-case basis and provide exemptions and interpretive relief. At the time, the banking community did not bring any particular concerns to our attention, so we assumed this was the correct approach.

As we moved closer to the effective date for implementation of the Act, however, the banking community became more vocal about the nature and degree of uncertainty regarding the scope of the statutory exceptions.

As we gradually heard from more banks and their representatives, we realized that more general guidance was necessary. Unfortunately, at the point that this occurred, we were bumping up against the effective date of the functional regulation provisions. So we issued these rules as interim final rules, a procedure the Commission does not often use, but that our banking regulators do use, and we thought maybe this was the appropriate time to try them in the context of banking legislation. By issuing interim final rules, we were able to provide quick and definitive guidance to the industry in the short time remaining before the effective date.

We determined that the interim final rules would grant immediate relief to banks from certain of the statutory provisions while affording opportunity to get substantive comments by delaying the effectiveness of the other provisions. We have definitely gotten some substantive comment.

But I want to underscore that the rules were interim in nature and that we have sought public comment on these rules. Our interim final rules extended the May 12, 2001 effective date for the functional regulation provisions so that we could meaningfully respond to the comments. On July 18th, as you know, we extended the comment period for the interim final rules until September 4th of this year, and the effective date for the rules even further, to May 12th, 2002. As a result of this extension, banks have another year to conform their securities activities to the requirements of the Gramm-Leach-Bliley Act.

We also indicated that we intend to amend the interim final rules. And we do not expect the banks to adjust their internal compliance systems until after the amendments are adopted. And we will extend the compliance date once again for the rules once the amended rules are issued.

Our expectation is that these extensions of time should provide ample opportunity for the Commission to continue what we believe have become constructive dialogues with the banking industry and the bank regulators to craft rules that will implement the functional regulation provisions in the most reasonable, cost-effective possible manner consistent with investor protection.

I want to stress, as Chairman Oxley pointed out, that the statutory exemptions are extremely complex and that it did take a long time to adopt the legislation. In fact, it took 20 years, to the best of my knowledge. So our goal in this rulemaking is not to extend our jurisdiction, but to adopt rules that are consistent with the language and Congressional intent of the Gramm-Leach-Bliley Act, and with the Commission's primary mandate to protect investors.

We welcome your continuing interest in this issue, and we commend you all for your important role that you have played in modernizing the Nation's financial services industry.

Thank you very much for the opportunity to testify, and I look forward to any questions.

[The prepared statement of Hon. Laura S. Unger can be found on page 59 in the appendix.]

Chairman BAKER. Thank you very much, Ms. Unger. To try to put a fine point on this, in my view the Gramm-Leach-Bliley provisions relative to broker-dealer matters was constructed to facilitate certain activities in which banks traditionally engaged, which included trust and fiduciary activities, the offering of investment advice, custody and safekeeping activities, the use of sweep accounts, and transactions and asset-backed securities.

The concern I have in the operational consequence of the rule as promulgated is that activities historically engaged in by financial institutions, particularly in communities where financial services providers are limited in many rural areas of the Nation, the consequences of the Act where an institution does not deem it advisable financially to create the structure necessary to provide the services outside its own bank lobby will in net effect result in a public consequence of services simply not being provided.

Is there a view at the Commission that the consequence of the rule would, in fact, result in that, or was this something that was not foreseen when the rule was ultimately promulgated?

Ms. UNGER. If you're asking about small banks and what the Commission's——

Chairman BAKER. Trust activities.

Ms. UNGER.——has been with respect to that, there are two parts to that answer. One is the trust activity generally and the other is small bank trust activity. With respect to small banks, the Commission has always been concerned about small entities, including broker-dealers and other institutions that we regulate on an ongoing basis. We have reached out to the small bank community, and in fact we are instituting a number of meetings that are upcoming to really find out from them how the interim final rules impact the way they do business and how we can preserve their ability to carry on these traditional bank activities without them crossing the line into wholesale brokerage.

As far as trust activities, I think the interim final rules don't preclude certain trust activities such as custody. When you get into order-taking—and areas where we traditionally have regulated order-taking—it really depends on what the activity is by the institution. Order-taking with a de minimis payment for order-taking is different than commission-based order-taking. Once you move toward a commission-based order-taking, to me that looks like brokerage activity.

This is why a dialogue is very important. We wouldn't want to preclude order-taking for a de minimis cover-your-cost kind of fee, but once a bank has a salesman's stake in that transaction, then that is securities activity. And so we start with that concept and that belief, and we want to hear why it's not.

Chairman BAKER. I just want to express the view that the more, how shall I say it, generous terms of defining appropriate conduct, particularly in the area of trust activities in the community bank environment, would be very, very helpful I think in the overall receptivity of the rule as currently constructed.

Now there are other issues, and I'm sure other Members will speak to those. But that is one around which I had particular interest.

Ms. Waters, did you have questions?

Ms. WATERS. Thank you very much, Mr. Chairman, and thanks to our panelists for being here today. I would like to ask you about certain parts of your testimony. As you note in your statement, you reference the fact that Congress directed the SEC not to disturb the traditional trust activities of banks. The rules that your agency adopted for trust activities, however, appeared to create a great deal of disturbance in the trust departments of banks, inserting the SEC far into the relationship of the banks and their customers in particular.

The rules your agency has adopted may require many banks to renegotiate trust compensation agreements with customers that were designed to comply with the requirements of the trust and fiduciary laws. Could you comment as to why you thought it was necessary to impose very detailed, account-by-account requirements even though trust compensation arrangements must comply with the bank's fiduciary obligations?

Ms. UNGER. Well, my testimony noted that we were charged with interpreting what the exemptions meant and that, in doing so, Congress charged us to make sure that banks don't engage in wholesale brokerage inside the bank yet enable banks to keep intact their traditional bank activities.

The account-by-account interpretation was intended to prevent wholesale brokerage from occurring within the institution. If we were to say, OK, 51 percent of your activity is banking and 49 percent could be wholesale brokerage or could be brokerage, then there could be a number of accounts in the trust department that were, in fact, wholesale brokerage. So we determined that an account-by-account calculation would prevent wholesale brokerage activity from occurring in the trust department.

Now we did say that a bank would not have to engage in an account-by-account calculation if its sales compensation from the trust activities is less than 10 percent of the total compensation coming from these activities. So our understanding was that the 10 percent exception would allow banks that have just traditional trust activities to continue those activities. If that 10 percent level is too low, then of course we would like to consider what would be the appropriate level. But that 10 percent threshold would mean you would not have to keep track on an account-by-account basis.

Ms. WATERS. Could you refer to the part of my question that asked whether or not the rules your agency adopted may require banks to renegotiate trust compensation agreements with customers that were designed to comply with the requirements of the trust and fiduciary laws?

Ms. UNGER. I might not know enough of the specifics to answer this fully, but I will get you a more fulsome answer. My understanding is that we will look not just at the label of the relationship, but the actual nature of the relationship. And as in my answer to Chairman Baker, the more there is a salesman's stake in the outcome of the account, the more it looks like brokerage activity.

So to the extent you're advising the clients and managing their trust account, that would probably not come under traditional brokerage. But we can't just say, well, because you say it's a fiduciary relationship, that's enough to satisfy us that it's not brokerage activity.

Ms. WATERS. OK. So, I guess we are at this point because the Act itself did not specifically require you to do rulemaking and you decided that you didn't have to do it, and you came up with some new rules that kind of say, well, the 10 percent rule and some other things and case-by-case, and you think that that is good enough, that that takes care of any concerns that one may have about the intent of the Act?

Ms. UNGER. No. I think we're trying to balance what Congress told us to do, and that is to maintain the traditional bank activities without allowing wholesale brokerage in the bank. We sought input from the banking industry who told us they wanted more guidance, and that is what led to the rules, and to the timing of the rules.

We continue to seek input on this provision. It was our best judgment that, based on the information we had at the time, the 10 percent was sufficient to allow banks to continue traditional trust activity without having to account for it on an account-by-account basis.

Ms. WATERS. Do you still think that you made the correct decision not to do rulemaking, but rather the way that you are doing it is going to work out?

Ms. UNGER. Well, this is a rulemaking. It's not the way the Commission traditionally proposes its rules. But again, we had the time pressure that led us to conclude this was the best.

Ms. WATERS. Well, of course, you know this is not the rulemaking, the traditional rulemaking that we're referencing. You know this is different.

Ms. UNGER. This is different for us, too. It's not different for the bank regulators. So we're trying to emulate the bank regulators, but maybe not to your satisfaction.

Ms. WATERS. You're right about that.

Ms. UNGER. I suspected. The reason that we extended the time period, though, is that we heard a lot from the banking industry and from the bank regulators that we didn't get it exactly right. So we're going to continue to work to get it exactly right.

Ms. WATERS. That's right. You didn't get it right and we're glad to hear you say that, and you're right. We've got to get it right. Thank you.

Ms. UNGER. You're welcome. Thank you.

Chairman BAKER. Before recognizing Mr. Bachus, I think I want to take just 30 seconds to make the expression of my position more clear. And as I am understanding it, if you get to the activities of a trust—and let's assume for the moment now we're not talking about a small bank, we're talking about a complicated trust—where there may be various accounts within the construct of that trust, the presumption under the rule as constructed would be you'd have to go to each account activity to determine the appropriate regulatory constraint as opposed to what I would view as the historic presumption that the trust itself—that any activity performed by a bank in the capacity of trustee is covered by the trust exemption, unless there is a specific finding by the Commission that a particular activity should not.

So I think the view is a reversal of the presumptions here, not necessarily the applicability of the regulatory oversight. Thank you, Mr. Bachus. Mr. Bachus?

Chairman BACHUS. Thank you. Looking at Gramm-Leach-Bliley in its entirety, does the SEC maintain that it was Congress's intent to require traditional bank practices such as trust and fiduciary services to be moved from the bank to a broker-dealer?

Ms. UNGER. Well, you know, what is interesting, Chairman Bachus, is the fact that what people might consider to be traditional bank activities has really evolved in the 20 years of talking about financial modernization. And I think there has always been some concern about securities activities being conducted in the banks.

So now that we are supposed to functionally regulate banks' securities activities, I think the fact that the banks have been conducting these activities for a long period of time doesn't make them any less securities activities. And so we're trying to balance our urge to regulate securities activities with the business practices of banks.

So, we want to fulfill our mandate of protecting investors and regulating securities activities, as we think you want us to, while preserving the ability of the bank to conduct what they consider to be traditional bank activities.

Chairman BACHUS. But, I guess my question was, are you contending that these trusts and fiduciary activities should be moved from the bank to a broker-dealer? Or do you think that that's what the Congress intended?

Ms. UNGER. You mean wholesale? It would probably make it a lot easier.

Chairman BACHUS. Any move. Any change in the present status quo?

Ms. UNGER. No, I don't. I think it's something that we really need to work with the bank regulators and the banking industry on to figure out where to draw the lines.

Chairman BACHUS. All right. How can Congress be assured that the Commission will amend their interim final rules in a way that meaningfully addresses the concerns that the other regulators on our panel expressed in their opening statements that I've read and have raised regarding bank trust activities, custodial activities, investment advisory activities? In other words, can we get some assurance?

Ms. UNGER. That we'll get it right the second time.

Chairman BACHUS. Can we get some commitment?

Ms. UNGER. I can absolutely commit to you that I would not want to come back and testify after our final rules are adopted about why we didn't get it right the second time. We are committed to working with the bank regulators and the industry to balance the two competing interests, which are very difficult to balance. I think, given the time extension, that we can do that.

Chairman BACHUS. And substantial changes will be made?

Ms. UNGER. I don't know if your definition of "substantial" would be the same as mine, but I can assure you that we absolutely intend to amend the rules that were proposed.

Chairman BACHUS. I don't know if I still have some time. I'll ask the bank regulators. Have there been any problems in the areas of trust and fiduciary services that would lead to the need for an SEC oversight in addition to the oversight that Federal and State banking regulators supply today?

Mr. MEYER. Mr. Chairman, I don't believe so. But as the Chairwoman has indicated, there is an urge on the part of the SEC to oversee and to regulate all securities activities wherever they lie. Banking agencies for a long time before there was an SEC were supervising security activities that are going on in banks. We have a process of doing so. We operate under the fiduciary and trust law. We have bank examinations that effectively assure compliance with those laws. No, we don't think there's any necessity to have another regulator duplicate and oversee those activities.

Mr. KROENER. Let me just add to that, I think a fair reading of the legislative history and the intent here of the Congress indicates an awareness that there had not been significant securities-related problems arising out of these traditional activities, and that was the fundamental basis on which Congress created these exemptions.

Chairman BACHUS. I would agree.

Ms. BROADMAN. I'll agree with both of those statements. We're not aware of reasons to push these activities out of the bank. And in fact, we will note that bank fiduciary and trust activities are subject to a comprehensive regulatory scheme. They are closely examined by bank regulators. Trustees have the highest duties that they owe to their customers, higher in many respects than broker-dealers.

Chairman BACHUS. Thank you. And let me just close by saying Chairwoman Unger, I am very impressed with your willingness to work and to promise cooperation and to make a commitment to go forward with an upside-down look and review of these rules. I mean that sincerely. I thank you.

Ms. UNGER. Well, thank you, Chairman. I think you just heard the dilemma that we face, which is how we accomplish functional regulation of "traditional" bank securities activities.

Chairman BACHUS. I don't think Congress intended another layer of regulation over what has been in place.

Ms. UNGER. No. Nor do we want to provide another layer.

Chairman BACHUS. And I think what's been in place has worked well. But I sincerely appreciate your willingness to work with us and with the industry and with the other regulators. I mean that.

Ms. UNGER. Thank you.

Chairman BAKER. Thank you, Chairman Bachus.

To restate where we are for Members since folks are busy this morning, in and out, we recognized Ms. Unger for her opening remarks and we have not yet heard the testimony from our other three witnesses in order to facilitate an early departure for Ms. Unger. Mr. Watt, you would be next for questions. I would ask that Members, if you do not feel the need to pursue questions of Ms. Unger at this time, because we will have further discussions from the other witnesses as well, but, Mr. Watt, you're up next in regular order.

Mr. WATT. Thank you, Mr. Chairman. I assume your encouragement not to ask questions doesn't extend to an encouragement not to praise the Chairman. So I want to start by praising the Chairman, both Chairs, for convening this hearing quickly and helping to kind of create some momentum here for a discussion, public discussion, about what I think is an extremely difficult issue.

My initial reaction, and I continue to have this reaction, is that the SEC clearly probably overstepped. And my initial inclination was to do a letter expressing that as a number of people on the subcommittees have done. But once a hearing was scheduled, it seemed to me to be an appropriate step to have the benefit of the testimony and discussion before getting too far out there.

And I want to join with Chairman Bachus in expressing my feeling that your response appears to me to be a very, very appropriate response and balanced response. That you put something out there, you probably realized that it would provoke some discussion, probably not as much as it has provoked, and you want to now proceed with caution and try to work out what the appropriate balance is.

I think we should resist the temptation to get into a battle between the regulators, though, just on the question of whose turf is here and remember that our objective is to create a set of rules going forward that work for the new world that we have created and sanctioned under Gramm-Leach-Bliley. So it can't always be business as usual, because Gramm-Leach-Bliley is not business as usual. And I think inherently, we are going to have these kinds of tensions being raised, and it is good to have an aggressive public discussion about them. And while I don't want to leave any impression that I think the balance that you achieved in the initial rule-making was the appropriate balance, I think it's good to have this discussion, and I think it's good that this discussion has been provoked by the rules or the proposals that you have come forward with.

So, in that context, I think we've got some difficult times ahead not only on this set of issues, but on a number of issues that I think we're going to have to work out between historical patterns of regulation. And I do think it's important for us as Members of these subcommittees to keep in mind that the overwhelming responsibility of the SEC is to assure the protection of the public and customers. And while that is not adverse to any of the other regulators, they have exercised that jurisdiction historically in an aggressive fashion, and I hope they will continue to exercise it in an aggressive fashion. And I hope the regulators won't get to the point where you are just kind of jockeying for power and position here, but that all of the regulators will keep in mind that this is about protecting the public and consumers and customers at the end of the day.

I didn't ask a single a question.

Ms. UNGER. I could pretend you did.

Chairman BAKER. You started out very well, though.

Mr. WATT. But I praised the Chairmen and I praised the SEC representative, so I guess I'm doing all right.

Chairman BAKER. I won't forget that. Thank you, Mr. Watt.

Ms. UNGER. Thank you.

Chairman BAKER. Mr. Manzullo, you're next by time of arrival, but I have to advise the subcommittees that the Chairwoman needs to be out of here by 11:20, so Mr. Manzullo, proceed accordingly, but we have to excuse our witness timely.

Mr. MANZULLO. I just have a comment. In addition to being on the panel here, I'm the Chairman of the Small Business Committee. And you're in a very difficult position. I think you did a great job of defending the interim final regulations, whatever those are called. But my question would be on behalf of the small banks in this country and also of the tons of small banks that are in the Congressional district that I represent, which has a lot of rural areas, did you seek any comment prior to issuing the interim final rules from the small banks or small bank organizations or Congressional panels?

Ms. UNGER. We did, but we are making a much more concerted effort to reach out to the small bank community. We have scheduled a number of meetings, and are in the process of scheduling more meetings to make sure that we do address the particular concerns of small banks. The Commission has always expressed concern about small institutions. We're always mindful in any regulation of the cost and benefit and burdens to the smaller institutions, and we routinely grant exemptions to smaller institutions.

Mr. MANZULLO. I guess the other question would be with regard to whether or not the SEC should have even promulgated rules into traditional bank activities where the area there was gray and you went ahead and issued the rules. Did you confer with any Congressional panels or Members of the Banking Committee for further elucidation on that issue?

Ms. UNGER. We did not reach out to the Members. I believe we worked with the staff, we worked with the banking community, the bank regulators and really it was the banking community that led us to believe that the interim final rules were necessary and that there was more general guidance needed than what we were intending to provide, given our statutory obligation under Gramm-Leach-Bliley, which was through granting exemptions and providing interpretive relief.

Mr. MANZULLO. Thank you. I yield the balance of my time to Mrs. Kelly.

Mrs. KELLY. Thank you. Thank you very much, Mr. Manzullo.

Ms. Unger, an interim final rule sounds to me like an oxymoron. I don't see that that's something—I mean, if you're going to amend an interim final rule, how is it final?

My concern with regard to what is happening here is twofold. Normally when an agency issues a major rule in a final form without having any kind of a comment period, no area, no time period for notice and comment, that's very, very unusual. And taking the form of an interim final rule, I'd like to know why the SEC took that stand.

Ms. UNGER. That's a very fair question, because the Commission does not usually issue interim final rules. I had said in my testimony that what happened was, we had initially intended to issue interpretive relief and guidance on a case-by-case basis, and we encouraged the industry to let us know if there was confusion and a need for guidance.

It wasn't until we bumped up to the time where the statute was going to take effect that we found out there was general confusion and the need for more general guidance. We actually looked to the bank regulators practice in issuing the interim final rules. They do this type of rulemaking routinely. It's unusual for our agency. There is a comment period, however, even with interim final rules.

We even extended that comment period. The comment period had originally expired on July 18th.

We extended it to September 4th in response to the numerous comments and letters that we received with respect to the interim final rules. We've been using the time in the interim to meet with the interested groups, to reach out to small banks, to really try to get together with the constituencies who expressed concern about our interim final rules. We also have plans to sit down with the bank regulators. I think we're in the process of scheduling something so that we may resume our conversations with them as well.

But what's interesting about this is what Congressman Watt was talking about. We don't want to duplicate regulation. We want efficient, effective regulation. We want a seamless web of regulation, and that's what we're trying to achieve with the bank regulators. You hear them talk about them regulating bank securities activities, and yet we're told to regulate bank securities activities. So we just need to figure out how we can do the best job consistent with the business practices of banks and make it work.

Mrs. KELLY. Well, I guess what I find disappointing here is the fact that when we worked so hard to craft the Gramm-Leach-Bliley bill, we were very clear that we expected the regulators to work together. And what I feel here I'm really disappointed that the SEC didn't work with the other regulators before they did this interim final rule.

I just think that this has created a tremendous legal uncertainty for the banks that are trying to figure out what their obligations are under this new rule and by extending a comment period and by doing the issue of an interim final rule prior to having enough period for comment and workout, I think that this has the potential for allowing the banks and the bank customer relations to deteriorate during this timeframe. I would hope that you would address that. And I would hope that you would be very specific and very clear when you're dealing with the banks. They need some guidelines. And I feel that this may unfairly affect their relationship with the general public. I don't know how you feel about that, if you want to respond to that.

Ms. UNGER. Well, I think the fact that we didn't know they wanted more general guidance was maybe the first misstep in what may be viewed as a series of missteps. We're trying to have a relationship with the bank regulators—but this is really the first time we're charged with coming up with a seamless web or system of regulation.

We sat down with them. I think they didn't like what we said and maybe we didn't agree with some of what they said. I think now it's clear we came up with our best judgment about how to make sure banks don't engage in wholesale brokerage activity within the institution, yet preserve the traditional bank activities.

I think a certain amount of it reflects a learning curve. I think we're continuing to learn, we're continuing the dialogue, and we really don't want to duplicate regulation. But I don't want to be called up here in 6 months and have you say that it's your job to regulate the securities activities of banks, and you didn't. So I think we want to be very careful that we get it right, because this is very big, it's historic legislation, as you said, and you're talking about a substantial part of the financial industry.

Chairman BAKER. Ms. Unger, Mr. Manzullo's time has expired, Mrs. Kelly, and I feel an obligation to facilitate Ms. Unger's departure here. She's been gracious with her time and we're past your departure schedule.

With the subcommittees' understanding, we will return to regular order and hear the testimony of our other witnesses. I'd like to at this time excuse Ms. Unger. I am confident there are Members who would like to make further expression or pose further questions with regard to the testimony. The record remains open, and we may get back to you in writing.

Ms. UNGER. Thank you very much.

Chairman BAKER. Thank you for your participation this morning.

Ms. UNGER. I appreciate that. I hope the Members leave feeling that we are sincere in our efforts to continue a cooperative dialogue with everybody who's interested in having one.

Chairman BAKER. For that, we are appreciative. Thank you very much for your appearance here today.

Proceeding now in regular order, our next witness this morning is the Honorable Laurence Meyer, a Member of the Board of Governors of the Federal Reserve System, no stranger to the subcommittees. Welcome, sir.

STATEMENT OF HON. LAURENCE H. MEYER, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. MEYER. Thank you. Chairman Baker and Members of the subcommittees, I appreciate this opportunity to present the views of the Federal Reserve system on the interim final rules issued by the SEC to implement the bank securities provisions of the Gramm-Leach-Bliley Act. The manner in which these provisions are implemented is extremely important to banks and their customers and well deserves your attention.

As the banking agencies detailed in our official comment to the Commission, we believe the rules are, in a number of critical areas, inconsistent with the language and purposes of the GLB Act and create an overly complex, burdensome, and unnecessary regulatory regime. The rules as currently drafted would disrupt the traditional operations of banks and impose significant and unwarranted costs on banks and their customers.

We support the Commission's recent actions to address important procedural aspects of the rules by providing or promising various extensions to the rules and the underlying statutory provisions. We believe these procedural steps are both necessary and appropriate to ensure there is a meaningful public comment process and that the SEC receives much needed information regarding the practical effects of its rules on the traditional activities of banks.

More importantly, we look forward to engaging in a constructive dialogue with the Commission and its staff and to assisting them in modifying the substance of the rules in a manner that gives effect to Congress's intent and does not disrupt the traditional activities of banks.

However, we are concerned that the SEC testimony today—and I refer specifically to their more detailed written testimony—suggests that the SEC is not prepared to make the substantive changes needed to make the rules conform to the language of the GLB Act and the intent of Congress.

Congress worked carefully in designing the securities provisions so as not to disrupt the traditional activities of banks. It is important to keep in mind that these provisions were not imposed because abuses had occurred in the traditional securities activities of banks. In fact, banks generally have conducted their securities activities responsibly and in accordance with bank regulatory requirements and other applicable law. Nor was this change undertaken in order to extend regulation to an unsupervised activity. Banks in the securities activities they conduct as part of their banking business are supervised, regulated, and examined by the relevant Federal and State banking agencies.

Rather, the review of the bank exception was undertaken to address a concern that, with Glass-Steagall repeal, security firms might acquire a bank and move the securities activities of the broker-dealer into the bank in order to avoid SEC supervision and regulation.

Some also expressed concern that banks might in the future significantly expand their securities activities beyond the traditional services provided to bank customers. Congress sought to balance these concerns with a desire to ensure that banks could continue to provide their customers the securities services that they had traditionally provided as part of their customary banking activities, without significant problems, and subject to the effective supervision and regulation of the banking agencies.

The end result—the GLB Act—replaced the blanket exception for banks from the definitions of “broker” and “dealer” with 15 exceptions tailored to allow the continuation of key bank security activities.

While we differ with the Commission on a number of aspects of the rules, we are most concerned with the provisions that implement the statutory exception for the trust and fiduciary activities of banks. Trust and fiduciary activities are part of the core functions of banks, and banks have long bought and sold securities for their trust and fiduciary customers, under the strong protections afforded by fiduciary laws and under the supervision and examination of the banking agencies. In fact, the Conference Report for the GLB Act specifically states that, I quote: “the conferees expect that the SEC will not disturb the traditional bank trust activities” under this exception.

The interim final rules, however, impose compensation requirements on an account-by-account basis that are unworkable, overly burdensome, and at odds with both the language and the purposes of the exception. Under the rules as written, many customers that have chosen to establish trust and fiduciary relationships with banks will be forced to terminate these relationships or have duplicate accounts at the bank and a broker-dealer resulting in increased costs and burden. This was very clearly not the result intended by Congress.

Another of the exceptions included by Congress in the GLB Act was designed to protect the custodial and safekeeping services that banks have long provided as part of their customary banking activities. Bank-offered custodial IRAs provide consumers throughout America a convenient and economical way of investing for retirement on a tax-deferred basis, and banks have long executed securities transactions for these accounts, subject to IRS requirements and the supervision and regulation of banking agencies.

Banks, as part of their customary banking activities, also provide benefit plans with security execution services and execute securities transactions on an accommodation basis for other custodial customers. The Commission has stated, however, that the custody exception does not allow a bank to effect security transactions for its custodial IRA accounts, for benefit plan accounts, or as an accommodation for custodial accounts. This position essentially reads the explicit authorization adopted by Congress out of the statute, is completely contrary to the purposes of the Act, and would disrupt longstanding relationships between banks and their customers.

The interim final rules also impose unworkable or overly broad restrictions on the networking arrangements a bank may have with a third-party broker.

In addition, we strongly believe that the rules should provide a cure or leeway period to banks that are attempting in good faith to comply with the exceptions, particularly given the complexity of the rules. Indeed, in some cases, banks will not even be able to confirm that their security transactions will comply with an exception at the time they are conducted.

The Board stands ready to work with the SEC and the banking industry to make sure the significant extent of changes to the rules that are needed to ensure that any final rules reflect the words of the statute and the intention of Congress.

Thank you.

[The prepared statement of Hon. Laurence H. Meyer can be found on page 81 in the appendix.]

Chairman BAKER. Thank you very much, Governor Meyer.

Our next witness is the General Counsel for the Federal Deposit Insurance Corporation, Mr. William Kroener. Welcome, sir.

STATEMENT OF WILLIAM F. KROENER III, GENERAL COUNSEL, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. KROENER. Thank you. Chairman Baker, Chairman Bachus, Members of the subcommittees, I appreciate the opportunity to testify on behalf of the FDIC regarding the implementation by the Federal Deposit Insurance Corporation and other Federal banking agencies of Title II of the Gramm-Leach-Bliley Act.

My testimony today will discuss our view of the Securities and Exchange Commission's interim final rules that seek to implement the bank broker-dealer exceptions set forth in Title II. Those views are also set out very completely in the official comment letter of the banking agencies to the SEC.

We are concerned that the burden on banks resulting from the SEC's interim final rules would force the push-out of various lines of business by banks that meet the statutory exceptions in Title II of the Gramm-Leach-Bliley Act. As you know, Title II was a carefully crafted compromise intended to allow these lines of business to be offered by banks. The SEC's interim rules would effectively overturn this compromise.

The adverse impact of the interim final rules would be especially painful for hundreds of community banks that do not have SEC-registered broker-dealer affiliates. These banks provide important trust and custody services to their communities. If the SEC's interim final rules stand as currently drafted, customers of community banks would lose these important services.

As published in the *Federal Register* of May 18th, the interim final rules are intended to clarify the SEC's interpretation of various bank exceptions from the definition of "broker" and "dealer" in the Exchange Act. However, instead, the rules in effect significantly revise the statutory language in Title II and disregard Congressional intent regarding the various statutory exceptions.

First, the trust and fiduciary exception. Of greatest concern to the FDIC and the other banking agencies are the provisions of the final rules that implement the statutory exemption for traditional trust and fiduciary activities. We believe many of these provisions conflict with the statutory language of the Gramm-Leach-Bliley Act and will significantly interfere with the traditional trust and fiduciary activities of banks. These activities are a key component of the business of banking for many banks, including more than 1,000 community banks. They have long been offered to bank customers without significant securities-related problems, and are already regularly examined by bank examiners for compliance with trust and fiduciary principles that provide strong customer protections.

The trust and fiduciary exception in Title II broadly authorizes the bank, without registering as a broker-dealer, to effect securities transactions in a trustee capacity so long as the bank is "chiefly compensated" for such securities transactions by forms of trustee compensation and if other statutory conditions are met.

The SEC's interim final rules provide that a bank meets the Act's chiefly compensated requirement only if, on an annual basis, the amount of the relationship compensation received by the bank from each trust account exceeds the sales compensation received by the bank from that account.

The FDIC and the other banking agencies strongly disagree with the SEC's position that the Act's chiefly compensated condition for the trust and fiduciary exception may be implemented on an account-by-account basis.

Second, the custody and safekeeping exception. We also disagree with the SEC's treatment of the Act's custody and safekeeping exception. That statutory exception permits a bank, without registering as a "broker" under the Exchange Act, to engage in various custodial and safekeeping-related activities, "as part of its customary banking activities." This exception also allows banks to engage in other activities as part of their customary safekeeping and custody operations, including facilitating transfer of funds or securities as a custodian or clearing agency, effecting securities lending and borrowing transactions from customers, and holding securities pledged by a customer.

We strongly disagree with the SEC's position that the custody and safekeeping exception does not permit banks to accept securities orders for their custodial IRA customers, for Section 401(k) and benefit plans that receive custodial and administrative services from the bank, or as an accommodation to custodial customers. We understand that one of the changes made in the Conference Committee in enacting the Gramm-Leach-Bliley Act was intended to address precisely this. Although the SEC's interim final rules include two SEC-granted exemptions for custodial-related transactions, including a small bank exemption, these exemptions are subject to numerous burdensome conditions so that the result is little benefit to banks and enormous disruption.

Third and finally, the networking exception. We are concerned with respect to that exception that the SEC's interpretation of the term, "nominal one-time cash fee of a fixed dollar amount", imposes unnecessary limitations on the securities referral programs of banks that are not required by the statute. Prior SEC precedents regarding networking arranged by banks and savings associations did not involve such restrictions on bonus programs and referral fees as are contained in the interim final rules.

To conclude, the FDIC commends the subcommittees for focusing attention on the significant impact of the SEC's interim final rules on the banking industry.

Given the profound impact of the interim final rules on the functional regulation of securities activities of banks, we hope that the SEC will engage in a meaningful dialogue with the banking agencies to produce a final rule that significantly limits unnecessary termination of traditional banking services or, in the alternative, does not force customers to have to seek duplicative account arrangements.

Thank you.

[The prepared statement of William F. Kroener can be found on page 99 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Kroener.

Our final witness on this panel is Ms. Ellen Broadman, Director of Securities and Corporate Practices, Office of the Comptroller of the Currency. Welcome, Ms. Broadman.

STATEMENT OF ELLEN BROADMAN, DIRECTOR OF SECURITIES AND CORPORATE PRACTICES, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Ms. BROADMAN. Thank you. Chairman Baker, Chairman Bachus, Members of the subcommittee——

Chairman BAKER. And you need to pull that mike. They're not very sensitive. You have to just pull it close.

Ms. BROADMAN. Can you hear me now?

Chairman BAKER. Absolutely.

Ms. BROADMAN. Oh, good. OK. Chairman Baker, Chairman Bachus, Members of the subcommittees, thank you for this opportunity to discuss the SEC's interim final rules. We appreciate the subcommittees' efforts to review the significant issues that the rules raise.

To begin, I would like to commend the Commission for its recent actions on the rules. The Commission's recent decision to extend the time for banks to comply with the rules was a constructive first step.

We also welcome and view as essential its commitment to further extend the compliance time once final rules are adopted so banks have sufficient time to bring their operations into compliance with the rules. And we are especially pleased that the Commission recognizes the importance of and anticipates amending the rules.

The banking agencies are currently working together to develop for the Commission suggested approaches for revising the rules. We look forward to working with the Commission in developing rules that are workable for banks and that are consistent with the statutory language and Congressional intent behind the rules.

We especially appreciate the subcommittees' support for this collaborative effort. The Office of the Comptroller of the Currency and the other banking agencies provided the Commission with comprehensive and detailed comments on the rules because of the significant issues they raise. We are concerned that the rules create unworkable requirements that would force banks to discontinue traditional banking activities that Congress specifically intended to preserve under the Gramm-Leach-Bliley Act.

We are concerned that the rules would significantly disrupt longstanding relationships between banks and their customers, would restrict customer choices and increase customer costs. This result is unnecessary and inconsistent with the intent expressed by Congress in enacting these provisions.

One particularly troubling area is how the rules would treat trust and fiduciary activities subject to the exemption. Congress adopted this exemption to permit banks to continue offering traditional trust and fiduciary services. To qualify for this exemption, the rules require banks to conduct account-by-account reviews and establish for each individual account that the account meets very complicated compensation requirements. This provision and other provisions in the rules are so burdensome for banks and so impractical that they will effectively force banks of all sizes, large and small, to discontinue significant aspects of their traditional trust and fiduciary business.

Another area of concern is the treatment of custody and safekeeping activities. These activities, like trust and fiduciary activities, are part of the core business of banking. Congress created a custody and safekeeping exemption to allow banks to continue providing the full range of customary custody and safekeeping services. Bank custodians have a long history of providing to customers order transfers to registered broker-dealers. Despite this longstanding history, the rules do not include customary custodial order-taking within the exemption. Instead, the rules create an exemption that permits bank custodians to continue taking orders if they do not charge any fees for the service.

To the extent that the rules force banks to stop offering order-taking as a convenience, customers will no longer have the choice of using their selected custodian to submit their orders. We believe this is contrary to both the language and the Congressional intent of the statute.

We have a number of other areas of concern that are detailed in our comment letter that also are very important and that need to be addressed by the Commission in revising its rules.

Our comment letter also expressed concerns with the process that was employed in adopting the rules. Final rules were issued prior to a notice and public comment period. This is not the normal way that the banking agencies issue their rules. This placed banks in an untenable position. Without knowing how the rules would be changed, banks were required to take immediate steps to comply with the rules without knowing how the rules would be changed prior to the effective date. Our letter urged the Commission to review public comments before establishing final rules and then grant banks sufficient time to bring their operations into compliance.

We appreciate the Commission's response in which it pledged to address these problems. We believe the Commission has taken a positive step by extending the dates for compliance and acknowledging that the rules must be changed after consideration of the public comments.

We stand ready to provide the Commission assistance in this process. And again, we appreciate the attention the subcommittees have given to the significant issues raised by the Commission's rules and appreciate this opportunity to express our views.

[The prepared statement of Ms. Ellen Broadman can be found on page 116 in the appendix.]

Chairman BAKER. Thank you very much, Ms. Broadman. I would quickly add to your comment, it's apparent Members of the subcommittees have a very keen interest in resolution of the matter. And as you and the other panelists reach conclusions about remedies that would be appropriate, we would be very appreciative of being engaged in that discussion.

I was visiting with Chairman Bachus during the course of the hearing this morning—and we've pretty much, at least on our behalf, reached a conclusion that we'd like to have those remedies—so in the event the remaining months ahead don't bring appropriate resolution, we might have an approach that might be helpful. And Chairman Bachus may wish to address that at a later time.

Mr. Kroener, I want to understand it from a consumer perspective here for a minute. You're my banker. I come in to see you and I want to set up a trust for the kids. And pre-Gramm-Leach-Bliley, as long as your compensation package didn't trigger certain things, you could in your capacity as the trustee get all of it done and tell me where to sign. Today if the SEC rule would go into effect, depending on account-by-account how your income is derived, not with regard to my business, but generally in the banking practice, you may in order to facilitate the distribution of my investment strategy, have to go to a broker-dealer.

Now beyond the disruptive effect of that new arrangement, there is a potential to increase the cost to me as the consumer for those services, because in your capacity as a trustee, you're going to be compensated because of those arrangements. And now we have to add on the broker-dealer for whatever it is he's going to do. Is that a fair assumption.

Mr. KROENER. Yes. I think it's fair. Let me expand on that a little. Right now if you come to me to set up a trust account for your family and others, the bank will act as trustee, agree to set up the trust account, look at the asset composition and decide, given the objectives of your trust and the needs, the various transactions needed to be performed to set the portfolio correctly. And the bank will then charge you fees, and it may also do transactions through a registered broker-dealer and charge the account amounts for those transactions.

Under the new rule as proposed, the process of initially setting up the portfolio will incur fees through the broker-dealer that will count as the bad type of compensation that banks cannot receive—not relationship compensation. So if the bank actually has the misfortune that you've come to them to set up the portfolio in December of a year and the bank goes ahead and executes the transactions in December of that year, the compensation to the broker-dealer for setting up the portfolio the way it needs to be in the bank's view as trustee will be much higher than the other fees that the trustee would receive for the year. So that account would not be exempt, even on an account-by-account basis. And it would be necessary for the bank in that circumstance to require you not only to open the trust account, but also for you to open a separate brokerage account with a broker-dealer and for the customer to actually go to the broker-dealer to arrange these transactions, as I understand it.

Now that's an extreme example, because I've picked December of a year. But that's a single account. And that one account may cause the bank to not avail itself of the exemptions in the Act for these traditional trust services. The bank has to track it in a very different way than it would have prior to the Act. And it may not even be possible for the account to be done at all.

Chairman BAKER. Well I take that as a yes.

[Laughter.]

Chairman BAKER. And secondarily, my point is, this is not just a matter of which regulator gets to look at the books, nor a matter of which industry makes the fees, there is an operative consequence to a consumer as a result of the implementation of these rules, and my concern is that we are, in fact, layering a regulatory oversight, increasing the net cost to the consumer of fiduciary services. And I think that is the principal focus which I hope the subcommittees will take.

I'm just about to expire my time.

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

Mr. Meyer, let me understand whether your position is that if a bank were engaging in an activity before Gramm-Leach-Bliley, would there be any circumstance under which you would think that the SEC would come in and do regulation of that activity as opposed to the banking regulators?

Mr. MEYER. I think the issue here is: are there activities that should be legitimately pushed out of banks under these rules?

Mr. WATT. All right. So you're saying if there is such an activity, it ought to be pushed out of the bank and not be retained in the bank and therefore there is no activity that should be retained in the bank——

Mr. MEYER. And double-regulated.

Mr. WATT.——that the SEC should have any jurisdiction over?

Mr. MEYER. No. Not double regulation, not double oversight, no. But I think the tension here is that the SEC may have concerns that banks would try to become engaged in a general retail brokerage business not related to their trust accounts, not related to their custodial accounts. And it seems to me that's what this whole push-out was about—to prevent banks from moving in directions beyond their customary ones.

Mr. WATT. OK. Let me go back to not a trust account, but an IRA account. Maybe there's no difference between the two technically, but in my mind—I'm directing my own IRA account. Are banks doing that inside the bank now?

Mr. MEYER. Absolutely.

Mr. WATT. OK. And when there is a transaction of securities, I call and I say I want to transfer——

Mr. MEYER. You want to make a change.

Mr. WATT. I want to sell IBM and buy something else. Does the bank get a separate commission there?

Mr. MEYER. It can. It takes the order, and it can get paid for taking that order, although it is effected and actually executed ultimately through a broker-dealer.

Mr. WATT. OK. Does the bank get a commission, or does the commission go to the broker-dealer?

Mr. MEYER. Well, the bank can charge for that.

Mr. WATT. I think you're sidestepping my question. Does the bank get a commission? Do they get a commission, or have they been paid a separate fee for just being the administrator of my IRA?

Mr. MEYER. Well, no, they can get a fee for administering, but they get a fee that has to cover any fee charged by the broker-dealer for executing the commission, and they can also charge a fee for taking that order.

Mr. WATT. OK. But they can't get a commission on the sale itself?

Mr. MEYER. They get a commission for taking the order, if you like. The actual execution is done ultimately by the broker-dealer. But they pass that through to the customer.

Mr. WATT. Well, I'm assuming they pass all this through to the customer.

Mr. MEYER. Right.

Mr. WATT. The question is whether that person—well, let's cut the broker-dealer out. Let's say they did it online. They can't do that?

Mr. MEYER. They always do it and they have to do it through a broker-dealer.

Mr. WATT. OK. So you can't do it online. They can't just sit in the office and do it online and take a commission there. But they can charge a fee and then charge the broker-dealer's commission back to the customer, right?

Mr. MEYER. Of course.

Mr. WATT. OK. All right. I don't have a position on this. I'm just trying to figure out what the appropriate response is. And you're saying the broker-dealer part of that has got to be pushed out?

Mr. MEYER. What the SEC says is that the bank can hold as a custodian the securities, but can't be involved in any activities related to order-taking.

Mr. WATT. OK. If they have a securities subsidiary or affiliate, can they go to their own affiliate and use them as the broker-dealer?

Mr. MEYER. Well, of course, they could do that, certainly. They could use a broker-dealer, including an affiliate.

Mr. WATT. OK. I'm just——

Mr. MEYER. But the issue here is that customers are used to working with banks who administer their IRA accounts and doing their customary business. If I want to make a change in my IRA account, I can do it through the bank. I call up the bank. I tell them exactly what I want to do. I don't have to set up two accounts, one with my bank and another with a separate broker-dealer in order to get that transaction done. That would be burdensome, break the normal relationships, and be added cost for the bank customer.

Mr. WATT. Thank you, Mr. Chairman. This is enlightening. I think more educational than——

Mr. MEYER. Could I make another point about this, because this was an issue that came up during the Conference Committee, as Members of the subcommittees I'm sure are aware. At that time, we thought there was no problem with these transactions and this order-taking as part of custodial IRA accounts, but the banking agencies got wind that the SEC was taking a different interpretation, and we included a specific provision, or the Conference Committee added a provision to the bill that clarified, we thought, that these kinds of order-taking and securities transactions could be undertaken as part of custodial IRA accounts, and we thought the issue was settled.

Chairman BAKER. Mr. Watt, if I may jump in just for a moment. I recall the confusion in the Conference about the disposition of these accounts, and there was an affirmative line inserted which said traditional trust activities would not be affected by the adoption of the Act, and at issue is the SEC rule affecting those historic traditional services being provided by the bank. I'm told that about 90 percent of the securities activities that result in commissions are done through broker-dealers anyway. So this is not about diverting order flow from broker-dealers to banks, who are going to take the commissions from the SEC certified broker-dealer. It is more a question of how the customer engages with the bank and gets a product delivered by his bank to him. Either way you go, the customer is going to pay. You're absolutely right. My concern is that just with a different layer of authority, you could have the potential for higher cost assessments on the consumer.

Mr. WATT. I appreciate the Chairman giving me a little extra time. And I guess my concern is in that 10 percent. I think the 90 percent, there's a clear understanding of that.

Chairman BAKER. And my understanding is, and Governor Meyer may want to jump in, is that in that remaining area where the trustee is compensated in his capacity as a trustee and administration official of the trust activities, he is compensated in that fashion and not as a commission as a broker-dealer would be compensated. So as long as he's engaging in his administrative responsibilities to facilitate the order or the instructions for the trust, I think that's sort of the catch-all here. And when you get beyond that pale, then you do have to have a broker-dealer. I think.

Mr. Bachus.

Mr. BACHUS. Thank you. I'm not going to ask any questions of the panel, because everything you said I agreed with.

[Laughter.]

I don't want to elicit a negative response. Let me simply say this. I am going to yield to the gentlewoman from Pennsylvania for questions. But I will tell you, picking up on what Chairman Baker said, that there is sentiment on both sides of the aisle. I've talked to my counterpart in the Senate. I think we've got a commitment here this morning for substantial changes in the rules by the SEC. I know Chairman Pitt will be on the Hill in discussions. We hope to get the same commitment from him.

If there are not substantial changes in the rules by the SEC, then substantial changes will be made legislatively, and I hope we can avoid that. But there will be substantial changes to the rules one way or the other.

Chairman BAKER. Thank you.

Chairman BACHUS. Thank you.

Chairman BAKER. Thank you, Mr. Bachus.

Ms. Jones.

The gentleman has yielded his time to Ms. Hart. Thank you.

Ms. HART. Thank you, Mr. Bachus, I appreciate that. And thank you, Mr. Chairman. I won't take too much time either. Listening to the testimony actually from the SEC and now from the three of you, I still don't know if before these rules were issued there was some contact or conference among the four of you or your organizations. Could you sort of enlighten me a little bit more about exactly what type of contact there was prior to these rules actually being issued?

Mr. KROENER. Let me try to respond to that. I, as FDIC General Counsel, was involved with the general counsels of the other banking agencies in overseeing and monitoring the implementation of Gramm-Leach-Bliley generally, including these rules. There came a time when speeches were made by SEC staff members, with the disclaimer they did not represent the official position of the SEC, that gave us great concern. And we, the banking agency general counsels, sought to schedule, did schedule and had a meeting with the SEC staff to discuss our concerns about the rules, our view of how the rules ought to be—our views of the legislative history. That occurred, I think, in March of this year. It did take a long time, and it was late in the game.

In the course of that meeting, I think we did give them a letter that had been received by one of the banks that one of us regulates saying that one of the big mutual fund groups was actually going to discontinue business with that bank because of continuing uncertainties. But we did express our views. We did make our views known about the legislative history. As I say, I think that meeting was March 7th of this year. And the next thing that really happened was the interim final rules came out.

Ms. HART. Which was something that you didn't actually expect to see?

Mr. KROENER. That is correct.

Ms. HART. Mr. Meyer.

Mr. MEYER. I would just point out that the SEC did not reach out to the banking agencies as they were beginning their thinking about formulating the rules. The banking agencies had to initiate the meeting when we understood they were going into this process, and we had an idea from their speeches that they were going to be very contrary to what our view was of the intent of Congress in the provisions of GLB.

That meeting was not, shall we say, interactive and collaborative, but it was an opportunity to voice our concerns. But we got very little from that effort by the time those rules were actually released.

Ms. HART. And there was no contact? OK. And I guess we have a vote. But I just quickly also wanted to ask one question as well. Did you foresee after Gramm-Leach-Bliley that the regulation of the traditional securities-related activities would be overseen more by the SEC?

Mr. MEYER. No. Actually, we thought the plain language of the Act in this case was very clear. And for a time, we didn't think there would be any rule writing and that it might not be necessary.

So the rules were a surprise and the content was a major surprise.

Ms. HART. Is that pretty fair to assume that all of you agree?

Mr. KROENER. Yes.

Ms. BROADMAN. We agree with that.

Ms. HART. OK. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Hart.

Just as sort of announcement of schedule here, Mr. Bachus has departed for the floor to vote, so we can continue with our hearing. Those who wish to leave and come right back, I would encourage you. Ms. Jones is next for questions, and you're recognized.

Ms. JONES. Thank you, Mr. Chairman. I'm sitting here smiling only because last year when I came to Congress, last year, last term, and Gramm-Leach-Bliley was on our plate, I can't believe that none of us or you did not contemplate the possibility of the situation that you find yourselves in right now. Now that's not to say I don't support or that I do support the position.

But let's look at it from this perspective just for a moment. If we're talking about the consumer and we're talking about you acting in trust, I'm saying a banker acting in trust for a consumer, assume, just for example, that something goes wrong with the transaction. Assume that the consumer then tries to figure out who is responsible for the problem with the transaction with their trust. Should not they be able to come back to you or to the broker-dealer or to understand the obligation or who's regulating that conduct if you are, in fact, engaging in conduct that traditionally had not been the conduct you had engaged in prior to Gramm-Leach-Bliley?

Mr. Meyer.

Mr. MEYER. No. But we're talking about activities that were engaged in prior to Gramm-Leach-Bliley and that banks have sought to retain after Gramm-Leach-Bliley. So those activities were customary. Should the customer have a place to go to? Absolutely. It can complain to the bank and its supervisors that oversee this, and we look at those complaints. We have that responsibility to protect the investor's interest. Absolutely. It is not a question that the SEC is the only supervisor out there that is capable of protecting investors' interests. Bank supervisors have acted in this capacity for a long time.

Ms. JONES. But in the course of your discussion——

Ms. BROADMAN. May I add something?

Ms. JONES. I only have 5 minutes, so I don't want two answers to the same question, unfortunately. I'm sorry. In the course of our whole discussion are 20 years of trying to decide whether we were going to let banks and securities and everybody do each other's business. Surely you contemplated down the line that there would be a point where you would cross over and there would have to be some type of interagency regulation. Mr. Kroener, are you confused by my question? You had a frown on your face. So if you are, I want to clear it up for you.

Mr. KROENER. Let me try. Sorry. No, I wasn't confused by the question. It has been clear for decades that a bank acting as trustee has responsibilities to the customer, is fully answerable to the customer. It is one of the highest duties in the law.

Ms. JONES. And can receive compensation for the work that they do?

Mr. KROENER. The trustee receives compensation. And a trustee may be surcharged for mishandling the trust. That had been long established. Banks have executed security transactions in their capacity as trustee for decades, without major problems having arisen. And so when the legislation was passed, there were discussions about whether it was necessary for those traditional activities that banks were doing to be swept into the push-out provisions that would subject them to——

Ms. JONES. Let me just stop you for a moment. Assuming I agree with you for purposes of this short discussion that we had that these are traditional conduct or business that you've previously engaged in, none of you are saying then that if you operate outside of the traditional trust conduct that you should not be regulated by the SEC? If your bank decides to sell securities or whatever, right? Question? In other words, you act outside of the traditional trust relationships. That's what you were just saying, what you traditionally do as a trustee. If you act outside of that and you begin to engage in conduct that is that of a broker-dealer that you should not be regulated by the SEC.

Maybe I'll go to Ms. Broadman. Maybe she understands my question.

Ms. BROADMAN. I understand. I think that Congress recognized that nobody wanted to put full-scale brokerage operations in banks. And in fact, that was the intent of the Gramm-Leach-Bliley Act. Our concern is that the way the Commission has implemented the Act. They're doing it a way that is not needed to to make sure that full-scale brokerage activities are pushed out.

If you look at the trust area, there are enormous regulations, fiduciary duties. There are customer protections. I think you're right to be looking at is the customer protected. Where a bank is acting as a trustee, they have the highest duties. Consumers can sue them if they don't act in the best interest of the customers. They can recover costs. There is customer protection there.

Ms. JONES. I'm almost running out of time, Ms. Broadman. Let me just ask you this question. But there is nothing in Gramm-Leach-Bliley that keeps a bank from deciding that now I want to be a broker-dealer and creating a broker-dealer within the bank? That's what the purpose——

Ms. BROADMAN. There are. There are advertising restrictions. A bank can't run a full-scale brokerage operation such as——

Ms. JONES. Stephanie Tubbs Jones Incorporated Bank could create Stephanie Tubbs Jones, a broker and agency separate and apart from the bank, right?

Mr. MEYER. No. But that is not one of the exceptions. There are specific exceptions that are tailored——

Ms. JONES. But my question is not whether that's one of the exceptions. I'm just saying that you could, in fact, create a broker. Someone else could create it and call it Stephanie Tubbs Jones Inc.

Mr. MEYER. Could not.

Ms. BROADMAN. Banks can create subsidiaries that are brokers. They're separate. But they can't put it in the bank.

Ms. JONES. Right. So the answer is yes?

Mr. MEYER. No, not inside the bank.

Ms. BROADMAN. It's a separate entity.

Ms. JONES. A separate entity. That's what I just said.

Ms. BROADMAN. But Gramm-Leach-Bliley doesn't permit that to take place within the bank.

Ms. JONES. I should not have said within the bank. Because really you're just engaging in the same shell game that you engaged in before Gramm-Leach-Bliley, that there was another company that you could use to do what you couldn't do under Gramm-Leach-Bliley. Are you with me?

Mr. KROENER. Absolutely.

Chairman BAKER. Ms. Jones, your time has expired.

Ms. JONES. Thank you very, very much.

Chairman BAKER. I would clarify it as a pot plant rule. This one you can't do behind the pot plant, you've got to have it down the hall in another room.

Ms. JONES. Exactly. Thank you.

Chairman BAKER. And the question is, if the bank doesn't have the money to do that, are we depriving customers of services they are otherwise provided? I'd like to recognize Mr. Tiberi at this time.

Mr. TIBERI. Thank you, Chairman Baker.

Kind of following up on my colleague from Ohio's comments, having now established that we all agree that there's differences between bank trust departments and the way the oversight is and the oversight on brokerage firms. Would you all agree—could you explain, I guess, first, the oversight that a bank trust has, and would you all agree that the need for additional SEC oversight is unnecessary?

Mr. MEYER. Yes. I think there are two major areas. One, the bank trust departments operate under trust and fiduciary law. And bank examiners examine these departments for compliance with that law. Then they examine to make sure that there are policies and procedures in place that govern that compliance. They make sure that there are no conflicts of interest, and all the other things that the SEC could do to protect investors' interests are being undertaken by the bank regulators and their examination of the trust departments.

So there is absolutely no need for a duplicative second set of supervisors and oversight of these responsibilities. I mean, the problem here is clearly that the SEC believes that they're the only ones that should have the authority to supervise those activities.

Mr. TIBERI. Thank you.

Ms. BROADMAN. I think it's important, too, just to add to that, to look at it from the customer perspective. There are customers who would prefer to do business with a bank than with a registered broker-dealer. And to the extent that the rules force activities out into broker-dealers, they are denying customers that choice.

Also, some people feel that the regulation in the banks, the fiduciary or the trust requirements, impose higher duties than those that are imposed on broker-dealers, so they would rather do business there. But in any case, we agree fully with Governor Meyer's comment that in the trust and fiduciary area, there are extensive regulations both under State law, under Federal law, and under our regulations.

We have examiners that are in the banks. In the largest banks, we have examiners that are there on a full-time basis constantly reviewing what's going on, and in the smaller banks on a regular basis looking at their activities, so that you do have a pervasive legal regulatory scheme as well as pervasive oversight by the bank examiners.

Mr. KROENER. I don't have anything to add to the prior answers of the other two witnesses.

Mr. TIBERI. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Tiberi. We're down to about two-and-a-half minutes. I'm going to have to run to the vote. Mr. Bachus, I understand, is on his way back. So we would stand in recess for just a few minutes until Chairman Bachus returns.

I would just make the observation, it appears to me just from a casual reading of the papers that the SEC has a lot of responsibilities to conduct in other areas, and it would seem pursuing inappropriate conduct within the bank that's already subject to banking regulators' oversight might not be an effective use of resources. So we have some concerns that I think need to be addressed.

We stand in recess.

[Recess.]

Chairman BACHUS. The Capital Markets and the Financial Services Joint Committee hearing is called to order. When we recessed, we had anticipated—two Members had requested that we return and allow them to ask questions. They have not returned. I'm going to ask one final question. Once you answer that, if they're not back, we will adjourn the first panel.

My question—and this for the record—in defending their rulemaking process on the push-out proposal, the SEC testified earlier that the banking agencies routinely issue, "interim final rules." Is that true? Under what circumstances have your agencies issued such interim final rules in the past?

Mr. MEYER. We occasionally issue interim final rules, and I'll give you an example. Under Gramm-Leach-Bliley, we were operating under very short timeframes for when new activities in the statute were becoming effective. And so we had interim rules to open up access to the new activities for banks so they wouldn't be delayed. So when it came to qualifications for financial holding companies, that was an interim final rule to get that going so that banks could immediately have access to it. When it came to new activities that banks could engage in, in affiliates, and so forth, those were interim final rules.

When we had a controversial case that would impose a new burden on a bank, we did not use interim final rules. The capital under merchant banking is a perfect example. We put out a proposal. We knew it would be contentious. After all of the discussion, we didn't put out then a final rule, but we issued it again as a proposal to allow further comment on it. And I think that's the model that we feel is the appropriate one in this context.

Chairman BACHUS. And "routine" would be that you all don't routinely issue?

Mr. MEYER. Right.

Ms. BROADMAN. We are the same. We would not routinely use the interim final rule approach. We've used it in unusual circumstances to relieve burden. We would not use it in a case like this where we're imposing new burdens on banks that are going to be very controversial. So we take a similar approach to the Federal Reserve Board.

Mr. KROENER. And the same is true, Congressman, of the FDIC. We have used interim final rules where it expands authority of banking organizations, but not for the first time to restrict or prohibit or significantly affect existing activities.

Chairman BACHUS. I appreciate your answers. If there are no further questions, the first panel is discharged. And we'll go right to the second panel. We certainly appreciate your testimony and appreciate you being here, and apologize for the delay.

I want to welcome the second panel and look forward to your testimony. The second panel is consisted from my left to right of Mr. Michael Patterson, Vice Chairman, J.P. Morgan Chase & Company; Mr. Edward Higgins, Executive Vice President, U.S. Bancorp. You're testifying on behalf of the American Banking Association?

Mr. HIGGINS. Yes, Mr. Chairman.

Chairman BACHUS. I see. And Mr. Robert Kurucza, General Counsel of the Bank Securities Association. Mr. Reid Polland, President and Chief Executive Officer, Randolph Bank & Trust Company, also testifying on behalf of the Independent Community Bankers. And finally, Mr. Eugene F. Maloney, Executive Vice President and Corporate Counsel, Federated Investors. Welcome to you all. We have a mix of veterans before the subcommittees and first-time witnesses. At this time, Mr. Patterson, we'll start with you. Thank you.

STATEMENT OF MICHAEL E. PATTERSON, VICE CHAIRMAN. J.P. MORGAN CHASE & CO.

Mr. PATTERSON. Thank you, Chairman Bachus. I very much appreciate the opportunity to be with you today to comment on the SEC's interim final rules. My brief remarks will touch only on a few specific aspects of the rules that are illustrative of our broader concerns. And my written statement addresses additional issues which have been part of an ongoing dialogue between banking organizations and the Commission's staff.

At the outset, let me emphasize that we are not opposed to functional regulation or to full compliance with Title II of the Gramm-Leach-Bliley Act. Quite the contrary. Congress made a clear determination that certain activities once conducted by banks should now be conducted by SEC-registered broker-dealers, and at J.P. Morgan we are moving various activities into our broker-dealers and, indeed, over 1,000 of our bank employees have qualified to become SEC-registered representatives.

Our basic concern is that the interim final rules impose detailed, complex requirements on activities that Congress decided to leave in banks. The cost of complying with these requirements would be very substantial, and in some cases, the rules would make it virtually impossible for banks to continue those activities.

The rules evince a suspicion on the part of the Commission that without the straitjacket of the rules, banks would conduct a wholesale brokerage operation under the guise of a trust or a custody department. Given the conditions in the statute itself, we don't think that suspicion has any basis that would justify the burdens imposed by the rules. These bank activities are subject to extensive fiduciary and other legal duties and potential liabilities and are intensively supervised by bank regulators. Given these constraints, we don't believe it would be rational or possible for a bank to try to provide a full service brokerage in disguise.

Several of our concerns with the interim final rules relate to compensation. Under the Act, transactions in a trustee or fiduciary capacity are exempt only if the bank is "chiefly compensated" on the basis of administration or certain other fees. The SEC rules propose that the chiefly compensated test, which has very complex definitions of different categories of compensation, be applied to every single account. For J.P. Morgan, this would require a periodic review of more than 50,000 trust and fiduciary accounts to determine and document their compliance. Our firm's existing management information systems—and we suspect those of most other banks—do not provide data using all the categories required by the SEC's test. We could, of course, create new systems given enough time and money. In fact, I believe one bank has estimated that doing so will cost it at least $15 million.

But we do not believe that Congress could possibly have intended banks to assume a burden of this magnitude in order to demonstrate that a traditional banking business should not be pushed out of the bank. Instead of an account-by-account approach, we agree with the banking regulators that the Commission should adopt a test that measures chiefly compensated "on an aggregate basis," and hopefully, with simplified compensation calculations.

We're also concerned about the provisions related to employee compensation, including the SEC's discussion of bonus plans. Bonus plans are not mentioned in the Act. However, the Commission seems to take the view that unregistered bank employees may not receive bonuses based in any part on securities transactions unless the bonuses are based on the overall profitability of the bank. But few if any bonus plans are based on the stand-alone profitability of a bank as opposed to the profitability of the overall financial institution or a business unit within it. This requirement would effectively regulate the structure of bank bonus compensation plans and we think is another example of the SEC's unnecessarily broad approach to eliminate the perceived, but we think unsubstantiated, risk of evasion.

One final example of overreaching intervention in traditional bank activities is the interim rules' treatment of bank employees who also have been registered as employees of a broker-dealer affiliate, of whom, as I mentioned, we have over 1,000. When performing in the latter role, these dual employees would quite properly be subject to the supervision of the broker-dealer. However, the SEC's release indicates that it believes that the bank securities activities of the employees should also be subject to broker-dealer supervision, including approval and recordkeeping requirements. This duplicative supervision is not only unnecessary and burdensome, but in our view flies in the face of the principal of functional regulation underlying Title II.

Thank you for your attention, and I'd be pleased to answer any questions.

[The prepared statement of Michael E. Patterson can be found on page 168 in the appendix.]

Chairman BACHUS. Thank you.

Mr. Higgins.

STATEMENT OF EDWARD D. HIGGINS, EXECUTIVE VICE PRESIDENT, U.S. BANCORP, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION AND THE ABA SECURITIES ASSOCIATION

Mr. HIGGINS. Mr. Chairman, I'm Ed Higgins, Managing Director of the Private Client Group at Firstar, a subsidiary of US Bancorp. We operate in 25 States, primarily in the Midwest, West, and in Florida. I am here today on behalf of the American Bankers Association and the ABA Securities Association.

As you have heard, the issues raised by these rules are of great concern to all banks, large and small. Many services offered to bank clients, including self-directed IRA account holders and Section 401(k) plan participants will be significantly and negatively impacted if the SEC's interim final rules are not amended. Brokerage services offered to retail customers from the bank lobby through registered broker-dealers and sweep services offered deposit account holders are two other products that will suffer under the SEC's rules.

Before I discuss these issues in greater detail——

Chairman BACHUS. Could you slide that mike up a little closer?

Mr. HIGGINS. Before I discuss these issues in greater detail, however, I wish to go on record regarding the recent initiatives undertaken by the SEC. We are grateful that the SEC has moved the compliance date to next May and has indicated further additional time to comply will be given once the SEC issues amended final rules. Industry discussions held since the SEC first issued its interim final rules have been helpful, and we hope that they will continue as the SEC continues to learn more about our banking industry.

One of the industry's top concerns with the final rules is the trust and fiduciary exemption's chiefly compensated requirement as interpreted by the SEC. We believe that the SEC has interpreted the statute in such a way that banks will be forced to push out many of the traditional trust and fiduciary activities in direct contravention of Congressional intent, or alternatively, expend millions of dollars to develop the requisite technology to comply.

The SEC's narrow interpretation also harms consumers. For example, employers who sponsor retirement plans for employees often negotiate for bank trustees of Section 401(k) plans to be compensated through the use of Section 12(b)(1) shareholder servicing fees and other fees paid by the mutual funds in which the plan assets are invested. Although this process and practice has been allowed for years by the Department of Labor, the agency charged under the Employee Retirement Income Security Act with regulating Section 401(k) plans, accounts earning these fees would not pass the chiefly compensated test. Many small employers can only afford to offer their employees' Section 401(k) plans through these fee arrangements. At a time when we are encouraging consumers to save for their retirement, it just does not seem right to eliminate options that would allow consumers to do just that.

Order taking is another service offered by the banks where SEC has taken an exceedingly narrow position with regard to the pushout provisions that effectively prohibit banks from taking orders from Section 401(k) participants, self-directed IRA customers and many other consumers. The Act provides without limitations that banks as part of their customary banking activities, that offer safekeeping and custody services with respect to securities, will be exempted from the brokerage registration.

Order taking and buying or selling securities at customer direction, and as an adjunct to custody relationships, has long been a traditional bank service. The Department of the Treasury, bank regulators and well-known trust authorities dating back as early as the 1930s have all recognized that order taking is a customary custody service.

The SEC disagrees, despite the fact that Members of the subcommittees specifically added self-directed IRAs to the statute to make clear that these accounts were adequately protected under the legislation.

Broker-dealer firms do not want to assume order execution responsibility for bank custody accounts. Thousands of accounts would have to be opened under individual customer account names. Records for these accounts would have to be established and maintained, compliance responsibilities would be expanded by adding these accounts to the broker's book. Yet no assets would be held in the account as the actual custodial account and assets would remain in the bank. Consequently, not even our members' broker-dealer affiliates wish to assume a business that significantly increases compliance costs and regulatory burdens for very little compensation.

For the first time ever, the SEC has defined the term "nominal one-time cash fee of a fixed dollar amount" to mean a payment that does not exceed one hour of the gross cash wages of the unregistered bank employee making the referral. In addition, the SEC interpretation requires all points paid under a referral fee program to be the same for all products.

Our members, banks and broker-dealers alike, have long operated their referral fee programs in compliance with all applicable guidance, including guidance previously issued by the Securities and Exchange Commission. In fact, the requirements that formed the framework for the development of many bank referral fee programs involving products and other services rather than just securities are based on these SEC guidelines.

Finally, the Gramm-Leach-Bliley Act provides an exemption from push-out for bank sweep services. I know that other members of this panel will also discuss this issue, so I'll merely close by suggesting that before the SEC takes any action that might encourage consumers to move their sweep deposit accounts from banks to broker-dealers, consideration should be given as to what impact such movement would have on the availability of deposits to fund loans in our local communities. It would be prudent for the SEC and the bank regulators to consider this issue jointly before any regulatory action is taken that could cause significant disintermediation of bank deposits.

Thank you for your time.

[The prepared statement of Edward D. Higgins can be found on page 179 in the appendix.]

Chairman BACHUS. Thank you.

Mr. Kurucza.

STATEMENT OF ROBERT M. KURUCZA, GENERAL COUNSEL, BANK SECURITIES ASSOCIATION

Mr. KURUCZA. Thank you, Chairman Bachus. My name is Bob Kurucza. I am a partner in the law firm of Morrison & Foerster and serve as General Counsel to the Bank Securities Association (BSA). Prior to joining Morrison & Foerster, I served as Director of the Securities and Corporate Practices Division at the OCC, and as an Assistant Director in the Division of Investment Management at the SEC. Accordingly, I have been involved in bank securities matters for over 20 years, both as a regulator and as a private practitioner.

I am pleased to have the opportunity to appear today to discuss the SEC's "push-out" rules. As you know, these rules relate to the bank broker-dealer exceptions in Title II of the Gramm-Leach-Bliley Act, the so-called Title II Exceptions. This is a vitally important matter for the banking industry, and we commend your leadership in holding this hearing. We clearly need your help.

The Gramm-Leach-Bliley Act was intended to modernize the regulatory scheme for the financial services industry. There is no question that functional regulation is a key component of the new regulatory regime. However, Congress recognized the limits of functional regulation. This is why it provided the Title II Exceptions.

There was no need to subject activities that had been conducted safely and soundly by banks—in many cases for over 100 years—such as trust, fiduciary and sweep account services—to redundant broker-dealer regulation. These activities have and continue to be effectively regulated by Federal and State banking authorities without any history of significant problems.

The Title II Exceptions were clearly intended to allow banks to continue to conduct traditional securities-related activities undisturbed, without having to register as broker-dealers. The SEC seems to have missed this fundamental point.

It is not surprising that the push-out rules, which in effect nullify many of the Title II Exceptions, have met with almost universal criticism. The BSA has been a loud voice in this chorus of critics. It believes the rules are fundamentally flawed from both a procedural and substantive perspective.

As to process, the BSA believes that a substantial doubt exists, from a legal standpoint, as to whether the SEC in issuing the rules as "final rules" has met the stringent standards imposed under the Administrative Procedures Act. There clearly was no urgent need to adopt definitive rules. The only thing that had to happen immediately was the deferral of the May 12th effective date.

By issuing final rules without providing prior notice or the opportunity for public comment, the SEC placed banks in a Catch–22 position. To its credit, the SEC recognized the quandary in which it had put banks, and recently extended the Title II compliance dates until May of next year. This is a welcome first step in the right direction. However, no amount of time delay will cure the substantive defects in the rules.

In this regard, the BSA believes that most of the rules will greatly diminish the ability of banks to provide longstanding services to their customers. Accordingly, they clearly contravene Congressional intent and reflect a basic lack of understanding as to the nature, structure and pricing of these services. The rules are replete with departures from Congressional intent. This is the case with almost all of the Title II Exceptions. Even in cases where the SEC ostensibly is attempting to provide relief or flexibility, it conditions the availability of the relief on such onerous and unworkable conditions that it is rendered meaningless.

As the SEC has acknowledged, banks now conduct most of their core securities activities, such as full service brokerage, through registered broker-dealers. Nonetheless, the SEC somehow believes that banks will use the Title II Exceptions to evade broker-dealer regulation. This is pure sophistry of the highest degree. Banks have been conducting most of their securities activities through registered broker-dealers for many years. They have done so voluntarily even though a blanket exemption from regulation was available.

Where does this leave us? There is no question that the rules must be rebuilt from the ground up. We would hope that the SEC would heed the concerns expressed by your subcommittees and other interested parties. Based on this input, we would urge the SEC to start afresh and republish the rules as proposed rules that follow Congress's mandate and conform to a normal rulemaking process.

Thank you again for the opportunity to appear. We greatly appreciate it. I would be happy to answer any questions that you may have.

[The prepared statement of Robert M. Kurucza can be found on page 198 in the appendix.]

Chairman BACHUS. I appreciate that.

Mr. Pollard.

STATEMENT OF K. REID POLLARD, PRESIDENT AND CHIEF EXECUTIVE OFFICER, RANDOLPH BANK & TRUST COMPANY, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. POLLARD. Chairman Bachus, Members of the subcommittees, my name is Reid Pollard, and I am President and CEO of Randolph Bank & Trust Company, a $186 million community bank in Asheboro, North Carolina. I also serve on the Federal Legislation Committee of the Independent Community Bankers of America (ICBA), on whose behalf I am testifying today.

Thank you for this opportunity to express our views on the effect the SEC's proposed broker-dealer rule would have on community banks. We believe the SEC's rule in its present form is incompatible with Congressional intent. To quote from your letter of July 19 by Chairman Oxley and every subcommittee chair: "We are troubled that the rules do not reflect the statutory intent of Congress to allow certain traditional banking activities involving securities, such as trust and custody services, to remain in the bank and outside SEC regulation."

A separate letter sent by Ranking Member LaFalce expressed similar concerns. Clearly, this subcommittee, the subcommittee of primary jurisdiction, knows what Congress intended when it passed the Gramm-Leach-Bliley Act. We encourage the SEC to develop a regulatory scheme that meets this intent.

We are greatly concerned that the SEC's proposal in its present form would impose unworkable and burdensome requirements on small banks.

Indeed, we believe that in some cases the additional requirements placed on banks to comply with the rule would essentially nullify the exceptions that Congress wisely wrote into the law. These exceptions are extremely important for community banks and our customers. Registering as broker-dealers is simply not an option for most small banks.

It appears that the SEC has failed to take into account the extensive fiduciary requirements that other laws impose on bank trust and fiduciary activities as well as the existing supervisory framework that Federal banking agencies have established to supervise these activities.

Nullifying the exceptions or rendering them useless because of unnecessarily restrictive regulations would have a damaging effect on our banks and our communities.

If community banks lose these exceptions, customers in many rural areas might not have anywhere else to turn for these services. That is why it is so important to get this rule right, to adhere to the intent of Congress as closely as possible to allow banks to continue to do the things we have been doing for many years without any problems. And many banks have been doing it for quite some time. Our bank has been offering securities and other non-deposit products and services for over 9 years. We are very pleased with how we have assisted our customers and grown to become a total financial services center in our community.

Like you, Mr. Chairman, we have a number of substantive concerns which we have spelled out in detail in our comment letter. We feel the interim final rule would be very disruptive for custodial services, retirement plans, and many other products and services that include security services that banks have offered their customers for many years without problems. These products and services were and should be exempted by statute. Unfortunately, the existing SEC approach goes in a very different direction, and in some instances what is supposed to be investor protection would actually be investor exclusion.

Like you, Mr. Chairman, we very much welcome and appreciate the SEC's announcement on July 17 that the compliance date and comment period for this rule would be extended and that the rule would be amended. But we ask the SEC to take it a step further. We believe the SEC should issue a substantially revised proposal for public comment. We believe it would be an error for the SEC to try to fix this rule based on comments on the existing flawed interim final rules. Rather, a new proposal is needed that takes into account the comments the agency has already received, and it is extremely important that the public have a further opportunity to comment on a revised proposal.

We believe the SEC should work closely with the Federal banking agencies as it drafts a proposal that would impact the banking industry.

Finally, we believe that the SEC should defer compliance for at least 12 months after a final rule is published. This is critical to allow banks the time to adopt systems, procedures and products and services.

Mr. Chairman, we want to thank you and the other Members on the subcommittees who have brought critical attention and focus to this issue. You have provided the leadership necessary to get the bank broker-dealer exceptions back on the right track, the track that you intended in adopting the Gramm-Leach-Bliley Act some 20 years ago.

Thank you again for this opportunity to testify. I will be happy to answer any questions you may have.

[The prepared statement of K. Reid Pollard can be found on page 230 in the appendix.]

Chairman BACHUS. Mr. Maloney, I noticed from reading your written testimony that you are also a faculty member at Boston University.

Mr. MALONEY. I had the misfortune of being trained as a lawyer, yes, Mr. Chairman.

Chairman BACHUS. But you teach trust and securities activities.

Mr. MALONEY. Yes, sir.

Chairman BACHUS. So we're very much looking forward to your testimony.

STATEMENT OF EUGENE F. MALONEY, EXECUTIVE VICE PRESIDENT AND CORPORATE COUNSEL, FEDERATED INVESTORS, INC.

Mr. MALONEY. I have two roles, Mr. Chairman. I'm a senior officer in my company, and for the last 13 years, I have been a member of the faculty of Boston University Law School. And I teach a course on the trust and securities activities of banks. So this is an issue that I've been involved in both corporately, but academically as well.

My company is involved in Gramm-Leach-Bliley primarily because of the $160 billion in the mutual funds that we manage. Easily 50 percent comes from the 1,400 bank trust departments throughout the country that we do business with. And I'm really not here today in behalf of my company. I'm here in behalf of our clients. And they aren't just clients, they're friends.

I got involved in H.R. 10 when to our surprise it made it through the House by one vote. We looked at Title II and the 11 Exceptions from broker-dealer status, and we superimposed those 11 Exceptions on the typical book of business of a community bank trust department, and were very, very concerned that between 10 and 15 percent of the traditional products and services offered by a community bank trust department would have to be pushed out to a broker-dealer.

We came down here and spoke to folks on the Senate side. And we had two questions. One, here's an examination procedures checklist. And every time a bank examiner goes into a bank trust department, he or she is required to make sure that the bank employee has the requisite level of training, supervision and education to perform their role. We don't see the need for SEC supervision and a securities license for those kinds of people. And I guess we were interested in hearing what had come to the attention of Congress that would somehow warrant the involvement of the SEC in an industry that certainly in my 29 years has largely been problem-free.

We were told that our arguments had merit, but we were simply too late. Congress, as you know, time ran out. We knew there would be a son of H.R. 10. And we were here first at the table in the spring of 1999. We again worked with the folks on the Senate side of the table. And again, our concern was that the overly broad language in Title II would cause our clients to have to discontinue services which they had been offering problem-free for decades.

Participant-directed Section 401(k) was one that we were particularly concerned about. We were told that again our arguments had merit. The Senate would certainly consider them. The Senate version of Title II, as you know, was not passed, and Title II in the House version was, in fact, passed. I gave my first speech on Gramm-Leach-Bliley in Chicago in January of 2000 to 400 community bankers, and they were in a very celebratory mood. They had party hats on and noisemakers. And my comments were twofold. One, if this thing is read wrong, it could take 2,000 community bank trust departments off the competitive board in a heartbeat. And number two, anything that takes 50 lawyers two days to explain can't be all that great. And I sat down.

It was clear to us that the SEC was going to make a place for itself in bank trust departments. My company has a habit of working with the regulatory agencies in behalf of our clients, and I was dispatched to Washington to really work with the staff of the Securities and Exchange Commission, not to dispute their jurisdiction, but to rather educate them on what goes on inside a bank trust department. I can tell you personally that I have not had a better, more positive, constructive experience with a regulatory agency than we did with the professionals at the Securities and Exchange Commission. We found them willing to listen. We had access anytime we wished. They were eager to learn. And frankly, the 158-page effort we feel is extraordinary, given an agency that came from a standing start.

But there are problems. And I think the problems really stem from what the SEC is and how they go about the regulatory process. To the SEC, everything is brokerage and everything is a brokerage commission until proven to the contrary. It's almost like the French system of justice. We have taken the position—and you'll see it in our comment letter, Mr. Chairman—that the assumption should be that everything that goes on inside of a bank trust department should be fiduciary in nature. And indeed, there's a pervasive body of State trust law and ERISA at the Federal level that basically precludes a fiduciary from receiving a commission as a by-product of an investment decision. So if there is brokerage activity lurking out there, it certainly escaped our observation.

We're particularly concerned as banks start to take their rightful place in the financial services community, they're starting to price their products, processes and services the same way their competitors are. And they're starting to use mutual funds packaged products, if you will, as delivery vehicles for pooled investment management. They're starting to replace traditional trust delivery vehicles, common trust funds and collective investment funds.

There are statutes in all 50 States that permit a fiduciary to make an investment decision to use a mutual fund and at the same time provide discrete services to those mutual funds for which they receive additional fund-level compensation. All three bank regulatory agencies have examined these statutes, looked at the practices, and concluded that they're consistent with the law of trust. The problem, of course, is it bumps right into the chiefly compensated test.

We were the organization in the spring of 1994, in response to requests from our very large bank clients, that came up with the concept of bundled fees for defined contribution plans. Large bank after large bank would complain to us that in a competitive setting, the explicit nature of their fees when matched against mutual funds sponsors or broker-dealers, where their fees were built into the products and processes, put them at an enormous competitive advantage. So why can't you, with all of your legal resources, come up with a way for us to price our products and process implicitly as well?

The Department of Labor looked at fund-level compensation in defined contribution relationships for the better part of two-and-a-half years, issued two advisory opinions specifically authorizing directed trustees to receive fund-level compensation, and while doing so, not creating a conflict of interest or a prohibited transaction. That's what Ed Higgins was referring to in his comments. It was wonderful for us to see our clients now being able to offer competitive products and processes to that defined contribution marketplace.

And now, of course, you run into the issue of whether or not if all of the compensation takes place at the fund level, if that's deemed to be brokerage, the vast majority of community banks in this country simply can't organize broker-dealers. I wish Mrs. Jones was here to hear this. When the prospect of push-out and community banks surfaced, we hired a former senior official from the Securities and Exchange Commission to advise us on the likelihood of community banks being meaningful players if they had to organize broker-dealers. He said simply, forget it. It's too expensive. The compliance process is too overbearing.

So there are practical issues at work here as well. The chiefly compensated test is hopelessly complex. If I was going to give you a two-word summary of where our clients would be on this, they won't do it. It's very simply. They simply won't do it. A large bank client of our firm in anticipation of my appearing today called and said we have 8,000 separate fee schedules for personal trust. I was going to bring one fee schedule with me of a large bank client of ours. It looks like a small suburban telephone book. And if you read the SEC release, the assumption is that since all clients pay the same fee, it's a simple arithmetic calculation to determine if the chiefly compensated test has been met or exceeded. That simply isn't reality.

So it's a problem. It's a great problem. And we're not here today to suggest solutions. But we are here today to suggest there has to be a dialogue between the Commission and the bank regulatory agencies, and the community banks of this country can't be in the middle of the problem.

Thank you.

[The prepared statement of Eugene F. Maloney can be found on page 262 in the appendix.]

Chairman BACHUS. We very much appreciate your testimony.

Mr. Watt, you were so kind to yield to multiple opening statements over here. I would like to return the favor.

Mr. WATT. That's mighty kind of you, Mr. Chairman. And I want to thank all of you for being here. I apologize to the first two-and-a-half witnesses for missing your testimony. I was trying to get back, but just couldn't get here in time, to extend a special welcome to Mr. Pollard from North Carolina, a well respected and admired member of our community in North Carolina.

I think we were doing all right until we got to Mr. Maloney, and all of a sudden, what everybody had been saying, it sounds to me like he may have exploded. Mr. Pollard—well, I'd have to say, I leaned over to one of the staff people back here when Mr. Pollard said if there's anybody who knows what the intent of Gramm-Leach-Bliley was, it was Members of this subcommittee, I said "I don't think so." You ask 50-some Members of this subcommittee, you'd probably get 50-some different intents of what Gramm-Leach-Bliley was all about. And a lot of uncertainty and a lot of, well, I didn't even think about that issue.

So then we get to Mr. Maloney and he says, OK, well, we had a legislative intent. We took it to the U.S. Senate. And the U.S. Senate put it in their bill, but the U.S. Senate bill was not the bill that got passed. So if that's the case, then maybe this clarity about what the legislative intent was is not nearly as clear as we would like to think that it is. Because if Mr. Maloney was working with the Senate and he put what he wanted in the Senate bill and then the House didn't pass that version of it and the final bill was the House version, what does that do to the legislative intent that we thought was so clear on this issue?

Now, having said that, we've got a problem and I think we put our finger on it. I may have stumbled on the right question in my question to Mr. Meyer when I asked him whether there were any things that banks were doing that the SEC ought to be regulating. He said if banks are doing anything that the SEC ought to be regulating, then that activity has to be pushed out, which presents some serious, it sounds to me, problems for particularly community banks, because I thought I heard Mr. Pollard say at least a substantial minority part of what he does—maybe 10, 15 percent, according to Mr. Maloney—is securities services. I'm not sure what that is. But if those securities services are the things that are typically under the review and jurisdiction of the SEC, Mr. Meyer just told me on the preceding panel that those services have to be pushed out, which is something that community banks don't want. But if they are securities services that are typically regulated by SEC, then I hear everybody else saying we don't want the SEC regulating them if they're being done inside banks. So we've got a real problem on that 10 to 15 percent of business unless I'm misdefining the problem.

So I've defined the problem. First of all, I guess the question is, what is your reaction to Mr. Meyer's position that everything that banks are doing that SEC ought to have some—may have some jurisdiction over has got to be pushed out of the bank?

Mr. MALONEY. Mr. Watt, let me help you with your problem.

Mr. WATT. All right. Help me.

Mr. MALONEY. Let's take participant-directed Section 401(k). A growth area for banks, large, medium and small. This is the way the product works. Now bear in mind, in Title II, there's a two-part test. Part one is the nature of the relationship the bank has with its customer, the so-called fiduciary relationship.

Now the SEC has given us a specific exemption in their release for participant-directed Section 401(k). They argued the issue of whether or not it was a fiduciary relationship, but they conceded maybe it is. That's part one of the test. Number two is the chiefly compensated test. So you could have a fiduciary relationship that passes part one, but flunks part two because of the nature of the compensation arrangement you have.

Now in a participant-directed Section 401(k) product, it's typically a menu of mutual funds. If it's a large bank, it's proprietary funds—FirstUnion would be a good example in your State, sir, or Bank of America—and a mix of third-party funds, depending on their investment objectives and policies. It's almost certain that the compensation that the bank is going to receive for the various services it provides in connection with that product is going to come from payments at the mutual fund level.

The services the bank provides are investment, directed trustee, reporting and recordkeeping. You probably didn't notice sales or commission-driven activities. The mere fact that the bank gets all of its compensation at the fund level, because that's the way its competitors are pricing their services, triggers the chiefly compensated test. That was the point I was making.

Mr. WATT. All right. Let me ask Mr. Pollard whether there are any things in what you called securities services—that's the term you used—that you're doing in the bank, inside the bank, that would traditionally be regulated by the SEC, and what your reaction is to the prospect of having to push those things out.

Mr. POLLARD. The prospect of having to push those things out is very scary.

Mr. WATT. What are they? Just give me a couple of examples.

Mr. POLLARD. Those securities services, they're the things like you talked about with the previous panel. A customer may come in and want a self-directed retirement plan or just funds that they want to invest for their financial welfare that they do not intend to put in an insured bank product. That can be mutual funds, that can be annuities, that can be a basket of stocks. Those activities we are conducting at the present time in a wholly-owned subsidiary of the bank.

Our State commissioner's office has interpreted Gramm-Leach-Bliley to say that the intent of Gramm-Leach-Bliley is that we could conduct those activities in the bank without a separate wholly-owned subsidiary in the future. They have told banks in the State that you no longer have to form that subsidiary to conduct that per Gramm-Leach-Bliley. So there you have an interpretation very much different than that of the SEC as to what the intent of the subcommittees and the Congress was with Gramm-Leach-Bliley.

But we conduct that, have conducted it for 9 years, in a subsidiary of the bank. We have a third-party broker-dealer relationship with a large, established, SEC-regulated broker-dealer. Our revenue comes from a split of that revenue from the third-party vendor. We do not charge the customer additional fees. I think that was the question you were trying to get at with the previous panel. As Mr. Maloney stated, our revenue comes from our agreement with the third-party provider out of those products. And it would be difficult for a $186 million bank to push those out, whatever they may be. Right now it is very difficult to determine, and it's very, I guess you could say, frightening to determine where it could be pushed out.

Mr. WATT. Mr. Chairman, I'm well over my time. You've been very generous. You all have been very generous with your time. Could I just ask Mr. Maloney to do one thing? Not a verbal response, but it would be helpful if we knew if you had the ideal that would have addressed this issue had we adopted that language as opposed to the language that's actually in Gramm-Leach-Bliley. Because it may well be that this is sufficiently murky at this point that we may have to go back and revisit this issue, because from what I'm hearing, the legislative intent may not be as clear as everybody is saying the legislative intent was. But if we were going to address this problem and correct it in the way that you would have had Gramm-Leach-Bliley address it in the first place, it might be helpful to have that specific language.

Mr. MALONEY. Yes, sir. Be happy to.

Mr. KURUCZA. Mr. Watt, may I jump in here?

Mr. WATT. Sure. I'm sorry. I didn't mean to cut anybody off. My red light has been on for a good while, so I was just trying to make a graceful exit.

Mr. KURUCZA. It might be useful to just back up a little bit and provide a perspective. As I mentioned in my remarks today, while a general bank exemption still exists, which would have expired on May 12th without the deferral by the SEC, over 90 percent of all bank securities activities are today conducted through registered broker-dealers. And so you have a situation where banks, for safety and soundness and other reasons, and being very prudent for well over 15 years, have pushed out voluntarily, their activities into registered broker-dealers. Stated simply, when the banks recognize a true securities activity without any prompting, without any forcing from the SEC, they have volunteered registration as broker-dealers.

Mr. WATT. But if we got a State regulator who's telling community banks all of a sudden you don't have to push that out anymore, you don't even have to have a separate subsidiary to do it, maybe that 10 percent gets bigger over time. But even if it doesn't, the gray area is still that 10 percent, which is what I was saying to Mr. Baker earlier. It's not the 90 percent that's causing the problem. I think everybody is in agreement on that. The question is, who has regulatory authority in that 10 percent area and how does it get exercised in some responsible way? And how does it get exercised in a nonduplicative way? Because I think we all agree that you shouldn't have—maybe you've got shared responsibility for the regulation, but you shouldn't have one set of regulations by the banking regulators and a separate set superimposed on top of that by SEC.

Mr. KURUCZA. Mr. Watt, I believe you're quite correct. It's that 10 percent. But I would submit to you that I think we need further refinement of that 10 percent in terms of what are the nature of the activities involved? In other words, if in talking about that 10 percent bucket, we're talking about pure full-service brokerage activities, registration may be appropriate, versus what I think has been the topic of today, the nature of the activities covered by the Title II exceptions, which, quite frankly, get into a marginal gray area of traditional bank activities where registration is not justified. In all cases we must concede there is some securities-related aspect. It's almost by definition. There would be no need for the exceptions but for this fact.

If you looked at these activities in isolation, putting on my old SEC hat, I'd conclude that they were brokerage activities. But the reason for the exceptions is notwithstanding this, because they're traditional activities that have been effectively regulated by the bank regulators for umpteen years, there's really no need to superimpose redundant regulation by the SEC on top of that.

Chairman BACHUS. I appreciate that. Regulatory oversight of a bank trust department is significantly different from oversight of a brokerage firm. Could you briefly describe the oversight that a bank trust department receives and why additional SEC oversight would be unnecessary? And Mr. Higgins representing a large bank, and Mr. Pollard, maybe a smaller institution. Mr. Maloney, your clients are obviously banks. And either of the other two gentlemen that would like to offer any comment. If you agree with that.

Mr. HIGGINS. Thank you, Mr. Chairman. The primary regulator of national banks is the Office of the Comptroller of the Currency. And with all due respect to Ms. Broadman and her demure presence here today, it is a five-alarm fire when a complaint letter flows through the OCC to our bank or any national bank. We take that extremely seriously.

We have OCC regulators who, because of the size of our organization, are resident in the bank. They have offices in the bank 5 days a week, 52 weeks a year, and are almost a part of our management team. Their efforts are supplemented by our outside auditors, in our case, Price-Waterhouse-Coopers. In addition, we have an audit department that oversees all of our banking activities. We have a compliance group specifically dedicated to trust, headed in our case by a former OCC bank examiner. So I think our self-policing is extremely strong.

I also question whether or not the consumer is better served by having the SEC represent their interests. As I understand it, the course of action open most often to an aggrieved investor in a brokerage firm is mediation or arbitration I should say. On the other hand, if you have a grievance against a bank trust department, you're free to sue us in State court before a jury with the opportunity perhaps to collect punitive damages. So I'm not so sure that necessarily pushing out these accounts to a broker-dealer puts the consumer in a better position.

Chairman BACHUS. Mr. Pollard.

Mr. POLLARD. The FDIC is our primary regulator, and they have always reviewed thoroughly our activities in the securities business. We have never had any significant problems. In fact, they're in there now. In another 3 weeks, I hope to be able to tell you the same thing.

Our bank compliance officer regularly reviews these types of transactions. We are audited periodically by the compliance manager of our broker-dealer. A representative of our broker-dealer that we use, comes into the bank, comes into these offices, and reviews the various transactions for compliance with all the laws and regulations. We have not had any significant problems from customers because we are trying to look out, we hope, for their best interest and to develop a full relationship.

We believe that the FDIC, our State office of Commissioner of Banks, and the regulation from the compliance department of our broker-dealer, have been very adequate for our activities.

Chairman BACHUS. Thank you. Anyone else who would like to comment?

Mr. MALONEY. The checklist that a bank examiner is required to work from, when he or she examines a bank trust department is very detailed, exquisitely detailed. When we were talking to folks on the Senate side with respect to Gramm-Leach-Bliley, they asked us to prepare a memorandum of law comparing the standard of care that exists between a brokerage client and a brokerage representative and a fiduciary and a beneficiary. I had never done that before, but it was interesting to read the outcome.

The standard to which a bank is held is far higher than that which exists between a broker and his customer. When we were talking to the staff, the result of which were the three exemptions we were granted, I got a sense of how this could go wrong. And I'd just like to share that anecdote with you.

We were talking about entry-level trust accounts, Mr. Baker's question earlier, and how that all works. And you come in the trust department and there is a variety of options available as to how they're going to manage your assets. Common trust funds, individual securities, mutual funds, perhaps a combination thereof, or one or the other. And the folks from the Commission said aha! Just like a Reimbursement Account Plan account, which of course in their calculus is a brokerage relationship. I said it's not just like a RAP account. I said there's this standard to which the bank is held. It's called the Uniform Prudent Investor Act, which has been passed in all 50 States. And that's the standard to which the bank is held in managing your wealth. And if there are problems, if the assets are mismanaged or a conflict of interest, whatever the case may be, as Ed pointed out, there are remedies available in State court for misconduct by banks. And those remedies are equally if not more severe than anything meted out under the various securities laws.

So the idea that there aren't any protections in place for clients of bank trust departments is simply not the case.

Chairman BACHUS. All right. Thank you. There have been some comments made about the intent of Congress. I think what we intended to do was very clear. I think that we, at least in pretty plain language, I thought expressed our intent. But perhaps what the Senate language might have is it may be tighter drafted and have anticipated something that we didn't anticipate. So I think it would be helpful to look at that as we move forward.

But I can tell you that it was the fairly unanimous intention of Congress to let trust departments, fiduciary relationships and for the oversight of that to remain with the banking regulators. And I think we all agree. I think I've heard nothing on this panel which—but, you know, obviously sometimes you anticipate problems, and those may have been addressed in the Senate bill.

Mr. Higgins, I'm going to quote something you said. You said since the SEC first issued the interim final rules in mid-May, members of the SEC staff have conducted a series of meetings with various industry groups in order to get a clearer understanding of the difficulties that the industry would experience when the interim final rules went into effect.

I'll ask all of you this. Did the SEC hold meetings with you or your groups prior to issuing the final interim rules? That would be my first question.

Mr. MALONEY. We had extensive contact with the staff of the SEC, Mr. Chairman. And as I mentioned in my earlier remarks, all of it was positive.

To your question, nobody seems to know the answer yet, but we hope we can get it. We've undertaken to both the SEC and to the Office of the Comptroller of the Currency, we're going to have a law firm go in and do a Gramm-Leach-Bliley audit of a $3.2 billion national bank trust department that's engaged in virtually all of the activities described in Title II, and we want to get a sense back of what if any dislocations will be caused as a result of what's in the release. I think we all need that kind of practical information.

Chairman BACHUS. So there was contact between you and the SEC?

Mr. MALONEY. Yes, sir.

Chairman BACHUS. Prior to issuing the final interim rules?

Mr. MALONEY. Yes.

Mr. HIGGINS. Mr. Chairman, I've also learned that members of the American Bankers Association staff contacted the SEC staff very early on in this process. And once schedules permitted, senior staffers met in the fall of last year to begin a dialogue.

Mr. KURUCZA. I can also add to that, Mr. Chairman, the Bank Securities Association did have meetings with the SEC staff and in one case an individual commissioner. And again, I think they are to be applauded for that in terms of trying to gather a baseline of information. But I'd also state that I think there is no substitute for a public comment period in a normal rulemaking. Quite frankly, on an informal level, perhaps the candor is better than it would be in terms of written comments. Perhaps it's not. But again, the Administrative Procedure Act does require it, and I think qualitatively that was missing from this exercise.

Chairman BACHUS. Right. Many people have pointed out to us that the provisions of the Administrative Practice Act obviously were not followed.

Mr. Pollard.

Mr. POLLARD. Yes. Our bank was not contacted. The ICBA received minimal contact, and a meeting was discussed, but it did not occur prior to the publication of the rule. There has been contact since, and that effort has improved.

Chairman BACHUS. One pattern that I sometimes see is that the smaller banks are not contacted and do not participate to the level that the larger institutions do. And of course, the larger institutions have a more effective, well-paid lobby here in the city. But that should not account for the lack of an invitation to the table.

My next question, were your concerns addressed in the interim final rules? And please limit your remarks. And we'll start with Mr. Patterson.

Mr. PATTERSON. Well, we participated in conversations with the Commission staff through trade associations, in particular, the ABA Securities Association. The areas of concern are addressed in the rules. But, as you can tell from our testimony and our extensive comments, not to our satisfaction.

Chairman BACHUS. Mr. Higgins, were your concerns addressed in a constructive way?

Mr. HIGGINS. The SEC staffers we met with appeared to listen, but I don't think they quite understood exactly how mechanically a bank trust department works. And push-out of function is push-out of relationships, and that's a very big deal for us. We have relationships that are two or three trusts, two or three custody accounts, perhaps a family foundation, and they may have been with us for 20 years, and now we'll have to ask that client who chose us, who chose a bank trust department, to leave.

Chairman BACHUS. They listened, but your concerns were not——

Mr. HIGGINS. To give them credit, I believe they thought they were right.

Chairman BACHUS. Thank you.

Mr. Kurucza.

Mr. KURUCZA. I would add, and let me just single out one particular issue that the Bank Securities Association, a number of members have been keenly interested in, which has not come up as a specific topic, are the sweep accounts. Again, a very important product, whether it's for business customers, small business customers, whether it's a retail product, whether it's used in a trust context, very, very important product Mr. Higgins mentioned earlier. What the SEC has done in the interim final rules was to adopt from an unrelated disclosure context a National Association of Securities Dealers definition of what is "load." And again, it's ironic that, as you well know, Mr. Chairman, again, the long history of financial modernization, that definition has been in here for over 15 years going back to legislation, never been changed because of the compromise that had been reached on it, and they reached back and decided to select this NASD definition.

You know, we went through all the analysis, we went through all the arguments. We discussed in detail the terrible impact that this would have. And really, quite frankly, most importantly, there was no need for it from an investor protection perspective. We're talking about a money market fund. While no securities product is risk-free, if there ever was one that was risk-free, or relatively risk-free, it's a money market fund, largely due to the very stringent and effective SEC regulation of money market funds. Nonetheless, they chose to do that.

Two named sponsors of the Gramm-Leach-Bliley Act wrote letters on this very point to the SEC, one in the end of December from Mr. Leach and one on the Senate side from Mr. Gramm indicating their view on this, which was contrary to the SEC position. These views were apparently dismissed in the interim final rules. So that's a long-winded answer to your question, but I guess in terms of the satisfaction point, the answer is no.

Chairman BACHUS. Thank you.

Mr. MALONEY. We were satisfied, Mr. Chairman. We put in three exemption requests and they in large measure were granted.

Chairman BACHUS. OK. Thank you.

Mr. Pollard.

Mr. POLLARD. Really nothing else to add.

Chairman BACHUS. Thank you. I think at this time I want to express to you that your message has reached the Hill. We are as concerned as you are about these interim final rules. We're also concerned about the effect that it's already had on your institutions in incurring expenses and reviewing the rules and preparing for something that we hope won't happen, but you can't simply assume that. So you've already had expenses. Your testimony has been helpful. Your representatives I think have done an effective job of letting us know where the problems are.

The bank regulators have done an exceptionally good job of highlighting the problems with the new rules, and I think the Securities and Exchange Commission as a result of that is responsive and will be responsive to these concerns. In fact, they made a commitment here today to make substantial changes to those rules. At least that's what I heard.

I think it's the wish of the industry, of the Congress, of your institutions that the Securities and Exchange Commission with the aid and advice of the Federal bank regulators who have the experience in this field and with your input that they will make the necessary changes. And I'm optimistic that they will.

No one wants to reopen Gramm-Leach-Bliley. That's not an option that we want to pursue unless absolutely our backs are to the wall and there's no other option. If that's pursued, it will have to be done I think in a bipartisan way with the agreement of both Houses to do it in some legislation that is not open to amendment with other issues coming in that may be problematic, basically an agreed solution that moves by maybe consent document, something of that nature.

This concludes our hearing. I appreciate your testimony.

Ms. Hart, I will recognize you at this time, the lady from Pennsylvania. A very valuable Member of our subcommittee.

Ms. HART. Wow. I'm really glad I came now. Thanks for your indulgence, Mr. Chairman. As you know, we had a conference and I had a lot of conflicts and I really had hoped to be here. One thing I want to thank the Chairman for indulging our request also to have Mr. Maloney be one of the witnesses today. My counsel was here for the testimony, and she just whispered in my ear, and I wanted to thank him for taking the time to do this. And I understand that you did a nice introduction.

But I also want to let everybody know, and unfortunately, we don't have that many colleagues here, and perhaps I'll send a memo around to them, to let them know that obviously we know this is an extremely important issue, but that Mr. Maloney has been involved for quite a while professionally in working with both banking and securities industries and I think as well as some other witnesses has been able to shed some light on this issue for us so that we kind of push to have it dealt with in a reasonable way, to come to a conclusion that isn't going to be burdensome for the industry. And I want to thank you, Mr. Chairman, for completing the hearing, and I don't have any questions for the witnesses.

Chairman BACHUS. Thank you. Ms. Hart said this is hopefully the last day of our session, and we're dealing with a very important issue that apparently today finally is working itself out on the floor. We have various press conferences about it, dueling press conferences and the like.

Mr. Maloney has given some very valuable testimony, and as have all you gentlemen. And at this time, the hearing is adjourned.

[Whereupon, at 1:39 p.m., the hearing was adjourned.]

A P P E N D I X

August 2, 2001

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets,
Insurance, and Government Sponsored Enterprises and
Subcommittee on Financial Institutions and Consumer Credit

"Pushing Back the Push-Outs:
the Securities and Exchange Commission's Broker-Dealer Rules"
August 2, 2001

Chairman Bachus and Chairman Baker, thank you both very much for calling this hearing on the SEC's interim final rules. One of the important duties of the Financial Services Committee is not only to make law, but also to ensure that the laws are correctly understood and implemented by agencies under our jurisdiction. Today's hearing provides us an opportunity to demonstrate why this second role is so important.

When the Gramm-Leach-Bliley Act became law in November of 1999, the regulatory landscape for the American financial services industry was fundamentally changed. The Gramm-Leach-Bliley Act replaced Depression-era laws with a comprehensive framework for banking, securities and insurance geared for the 21st century. The old financial services laws were not designed for a world where technology would give consumers almost limitless investment options. But in order for consumers to exercise that freedom, artificial barriers to providing banking, insurance and securities services needed to be removed. The Gramm-Leach-Bliley Act removed those barriers.

Functional regulation has taken the place of the inflexible, one-size-fits all approach that existed before the Gramm-Leach-Bliley Act. The push-out provisions were designed to allow banks to continue to perform such traditional activities as providing investment advice and acting as trustees without having to register under the securities laws. At the same time, banks would not be given limitless authority to engage in the securities business. Functional regulation means that banking activities will be regulated by the banking authorities, and securities activities will be regulated by the SEC.

The SEC's interim final rules raise troubling questions as to whether that agency has upheld the letter and the spirit of the law. The Gramm-Leach-Bliley Act was never meant to make banks disrupt their customer relationships, and force traditional banking activities into broker-dealer affiliates. But the SEC's rules, were they to become final as written, would do just that. I am encouraged that the SEC has extended both the comment period and the effective date of its rules, and I hope this hearing will provide the SEC with an opportunity to receive valuable input on how the law was meant to be implemented.

Chairmen Bachus and Baker, I look forward to hearing from all of our witnesses today and exploring this topic further. The great strides made by the Gramm-Leach-Bliley Act are too important to be undone by misguided attempts to implement the law, no matter how well-intentioned. I want to emphasize that Gramm-Leach-Bliley, in particular the functional regulation provisions of title II, was negotiated over a very long period of time, and the Congress gave consideration to concerns raised by not only every witness represented here today, but every other affected party and the public. I am proud of our work on that historic piece of legislation, and have no intention of reopening debates that were so carefully, and fairly, resolved.

The SEC's interim final rules, however, clearly need substantial revision to accurately reflect Congress's intent in that statute, and this hearing is an important step in that process.

Let me say a word of appreciation to Laura Unger, acting Chairman of the Commission, on her final appearance before the Committee as acting Chairman. Thank you for your work, as you prepare to resume your position as Commissioner.

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OPENING STATEMENT OF CHAIRMAN SPENCER BACHUS ON SECURITIES "PUSH OUT" PROVISIONS OF THE GRAMM-LEACH-BLILEY ACT AUGUST 2, 2001

Thank you, Chairman Baker, for convening this joint hearing of our two subcommittees to review the SEC's proposed rule governing the securities activities of banks.

As Chairman Oxley has often reminded us, one of our Committee's central responsibilities in this Congress is overseeing implementation of the historic Gramm-Leach-Bliley financial modernization legislation enacted by the last Congress. The Financial Institutions Subcommittee has played an active role in that effort. In April, these same two subcommittees reviewed rules promulgated by the Federal financial regulators governing merchant banking operations authorized by Gramm-Leach-Bliley. In May, the Financial Institutions Subcommittee held hearings on the proposal by the Federal Reserve Board and the Treasury Department to permit banks to offer real estate brokerage and real estate management services.

Today, our focus is on an SEC proposal implementing the so-called "push-out" provisions of Title II of Gramm-Leach-Bliley, which generally require banks to conduct securities activities through registered broker-dealers. Title II contains important exemptions from these requirements, however, which are designed to permit banks to continue offering their customers trust and fiduciary, custody and safekeeping, and other traditional banking products and services outside of a broker-dealer structure.

The legislative history of these provisions reflects an attempt to balance two competing concerns. On the one hand, Congress sought to ensure that banks could not conduct full-blown brokerage operations shielded from SEC oversight and the application of the Federal securities laws. On the other hand, Congress wanted to avoid disrupting longstanding trust and other fiduciary relationships between banks and their customers, which are already governed by comprehensive State laws enforced by Federal and State bank regulatory authorities. The Gramm-Leach-Bliley Act conference committee, on which I was proud to serve, instructed the SEC that, in writing regulations implementing Title II, the agency should "not disturb traditional bank trust activities." The interim final rule that the SEC released earlier this year simply cannot be squared with this clear expression of congressional intent.

Particularly troubling to me is the effect that the SEC's proposal would have on the availability of trust and other fiduciary services at America's small community banks. For large Wall Street firms with integrated banking and securities units, the burden of "pushing out" activities previously conducted in a bank trust department into an affiliated broker-dealer, while significant, would not be insurmountable. But for many smaller banks, the cost of registering as a broker-dealer or creating a broker-dealer affiliate from scratch would be prohibitive. The likely consequence of the SEC rule on some of these institutions would be that they would discontinue their trust operations, to the obvious detriment of customers who have come to rely on those services. For community banks already facing funding pressures caused by a declining deposit base, the SEC proposal could not come at a worse time.

In closing, let me just say that the SEC's recent decision to extend the comment period and effective date on its interim final rule is welcomed by this Committee. As it heads back to the drawing board, I hope that the SEC will seriously consider the views of the Federal banking regulators and others who have identified serious shortcomings in the "push-out" proposal, resulting in a final agency product that all of us can support.

I yield back the balance of my time.

Opening Statement of Hon. John J. LaFalce
Ranking Member, Committee on Financial Services
Hearing on the SEC's Broker-Dealer Rules
August 2, 2001

I'd like to thank Chairman Baker and Chairman Bachus for holding this hearing today. Passage of the Gramm-Leach Bliley Act of 1999 represented a tremendous step forward in the modernization of our financial system, freeing banking and securities firms to affiliate to an extent not possible for over 60 years. Title II was an important component of that legislation, ensuring that the bulk of securities activities in a banking organization would be carried out in a registered broker-dealer subject to SEC oversight.

At the same time, Congress recognized that there were long-standing traditional banking activities involving securities that banks were uniquely qualified to provide and that were already subject to an appropriate regulatory framework. In writing the statutory language, a great deal of attention was given to determining which activities were most appropriately housed in a registered broker-dealer and which should be permitted to remain in the bank. Given the significant implications of Title II for banks and their customers, I believe that the implementation of these provisions must be undertaken with deliberation and care.

I am very concerned that the interim final rules adopted by the Securities and Exchange Commission (SEC) to implement Title II have taken a one-sided approach that is not reflective of the either the statutory language or Congress's intentions. In many cases, the rules adopted by the SEC will not allow banks to continue to conduct trust, custody, safekeeping, and other activities that Congress determined were appropriately conducted in a bank. The rules appear to add restrictions that are not part of the statute and impose a far greater administrative burden than is necessary or appropriate to implement the statute, creating significant added expense for both banks and their customers. As is clear from some of the concerns raised by the banks and bank regulators, in some cases the rules effectively negate the exemptions created by Congress.

I believe that the SEC has taken a significant step forward in addressing these issues by providing the time needed to work with the banking regulators, industry representatives, and other commenters to gain a better understanding of their concerns. I urge the SEC to use this additional time to work closely with the banks and bank regulatory agencies to develop final rules that fairly reflect Congressional intent and minimize unnecessary burdens on banking institutions and their customers.

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Eugene F. Maloney
Executive Vice President
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Federated

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August 9, 2001

Hon. Melvin L. Watt
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn Building
Washington, D.C. 20515

Dear Congressman Watt:

I would like to thank you for your attention to my testimony on the "push-out" rules issued by the Securities and Exchange Commission pursuant to the Gramm-Leach-Bliley Act ("GLBA"). The SEC's rules have serious implications for the ability of bank trust departments to continue offering traditional trust services, and my company is grateful for the attention given to this matter by you and the Financial Services Committee.

I am following up in response to your specific question to me at the August 2 hearing concerning language in the Senate version of GLBA that was advocated by Federated and that would have avoided some of the issues now raised by the SEC's rules.

As a preliminary matter, I should emphasize that the legislative history makes clear that neither the House nor the Senate intended the SEC to regulate bank trust departments, and both bodies made clear their intent that participant-directed 401(k) plan accounts and individual retirement accounts were to remain undisturbed.

At the time GLBA was being considered by the House and Senate in 1999, it was Federated's view that the Senate version of the legislation, S. 900, established this intent more effectively, particularly with respect to custodial accounts. Indeed, Federated worked with the Senate Banking Committee staff in drafting language to clarify this intent in S. 900. Unlike the House bill, the Senate bill specifically included in the statutory definition of exempt activities the role of a bank as "custodian, either under a uniform gift to minor act *or for an individual retirement account*." S. 900, § 501 *(emphasis added)*. This language was not included in the House version of the legislation and was omitted from the bill in conference. In addition, the Senate version of the bill did not include the "chiefly compensated" test that, as interpreted by the SEC, has proven to be so controversial.

In reconciling the differences between the House and Senate versions of GLBA, the joint House-Senate conference committee retained the "chiefly compensated" test and adopted an exemption for banks in their role as "custodian or provider of other related administrative services to any

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individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan." Pub. L. No. 106-102 § 201, *codified at* 15 U.S.C. § 78c(a)(4)(viii)(ee).

As you know, the SEC has interpreted the custodial exemption as strictly limited to custodial activities and as not covering transactions in a custodial account, thereby rendering the exemption meaningless to allow banks to offer traditional custodial IRA accounts. Federated believes that the SEC's narrow interpretation is not justifiable in light of the clear legislative history indicating that both the House and the Senate intended custodial IRA accounts to be exempt from broker-dealer regulation.

In this regard, a press release by then Committee Chairman Leach summarizing the Conference Committee Actions specifically states:

> The broad exemptions banks have from broker-dealer regulation would be replaced by more limited exemptions designed to permit banks to continue their current activities and to develop new products. The limited exemptions would cover transactions in connection with the following bank activities: trust, safekeeping, custodian, shareholder and employee benefit plans, sweep accounts, private placements (under certain conditions), ***self-directed IRAs,*** third party networking arrangements to offer brokerage services to bank customers, etc.[1]

The Senate Committee Report specifically states:

> The Committee does not believe that an extensive "push-out" of or restrictions on the conduct of traditional banking services is warranted. Banks have historically provided securities services largely through their trust departments, or as an accommodation to certain customers. Banks are uniquely qualified to provide these services and have done so without any problems for years. Banks provided trust services under the strict mandates of State trust and fiduciary law without problems long before Glass-Steagall was enacted; there is no compelling policy reason for changing Federal regulation of bank trust departments, solely because Glass-Steagall is being modified. Under IRS regulations, banks must offer self-directed Individual Retirement Accounts ("IRAs") in either a trustee or custodial capacity. Services rendered as a trustee do not require registration as a broker-dealer to the extent that these services fall within the trust exemption. ***The Committee believes that bank custodial, safekeeping, and clearing activities with respect to IRAs do not need to be pushed-out into a Commission registered broker-dealer.***[2]

[1] Press Release dated October 20, 1999, by James A. Leach, Chairman, House Committee on Banking and Financial Services, "Financial Services Modernization Act: Summary of Provisions of Chairmen's Mark." (emphasis added)

[2] S. Rep. No. 106-44, 106th Cong. 10 (1999) on S. 900. (emphasis added)

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Federated was disappointed that the language in the Senate bill was not included in the final version of GLBA as enacted. We believe that some of the current controversy regarding the SEC's interpretation of the push-out provisions could have been avoided had the Senate language been enacted. Nevertheless, Federated believes that the clear intent of both the House and Senate was to exempt traditional custodial IRA accounts, as demonstrated in the language adopted in conference amending the custodial exemption to specifically reference custodial IRA accounts.

I hope this letter is responsive to your question and would be happy to provide any further information at your request.

Sincerely,

Eugene F. Maloney

Eugene F. Maloney
Executive Vice President
and Corporate Counsel

lmc

cc: Hon. Richard H. Baker, Chairman
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises

Hon. Spencer Bachus, Chairman
Subcommittee on Financial Institutions and Consumer Credit

✓Terry Haines
Carter McDowell

TESTIMONY OF
LAURA S. UNGER, ACTING CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING THE FUNCTIONAL REGULATION PROVISIONS OF THE GRAMM-LEACH-BLILEY ACT

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES AND THE SUBCOMMITTEE ON FINANCIAL INSITUTIONS AND CONSUMER CREDIT OF THE COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

August 2, 2001

Chairmen Baker and Bachus, Ranking Members Kanjorski and Waters, and Members of the Subcommittees:

I appreciate the opportunity to testify on behalf of the Securities and Exchange Commission ("SEC" or "Commission") regarding the Gramm-Leach-Bliley Act's ("GLBA" or "Act") functional exceptions to the definitions of "broker" and "dealer" contained in the Securities Exchange Act of 1934 ("Exchange Act") and the Commission's rules that provide guidance on these exceptions and grant additional exemptions from broker-dealer registration to banks and other financial institutions.

We recognize that a variety of issues have been raised about the Commission's rules. We are paying attention. The Commission has been engaged in a constructive dialogue with the banking industry and regulators to understand their concerns. Discussions to date have narrowed some of the issues and provided useful guidance for amending some of the rules. We remain committed to adopting rules that faithfully uphold the plain meaning of the GLBA and the intent of Congress in enacting the legislation.

I. Brief Overview

The GLBA repealed the blanket exception of banks from the definitions of "broker" and "dealer" in the Exchange Act. In its place, the GLBA amended the Exchange Act to provide a number of functional exceptions to the definitions of "broker" and "dealer." As a result, banks that engage in securities activities either must conduct those activities through a broker-dealer or assure that their securities activities meet the conditions of a functional exception.[1] The GLBA's amendments to the Exchange Act became effective on May 12, 2001.

Prior to the May 12 effective date, the Commission received requests for guidance on the new functional exceptions. To better understand what guidance was needed, the Commission staff met with representatives of the banking industry and banking regulators. Based on these discussions and letters from the banking industry, the Commission, on May 11, 2001, issued rules ("Rules") defining certain key terms used in the new functional exceptions to the definitions of "broker" and "dealer."[2] The Rules also granted banks and other financial institutions additional exemptions from the definitions of "broker" and "dealer." Significantly, the Rules do not impose new obligations in addition to those created by the GLBA. The Commission's goal was to adopt rules that are consistent with the language and Congressional intent of the GLBA and the Commission's mandate to protect investors. The Commission solicited comment on the Rules.

To give banks additional time to adjust to the requirements of the GLBA and the guidance provided by the Rules, one exemption extended the effective date of the GLBA's

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1 As a practical matter, it is unlikely that a bank would register as a broker-dealer.

2 See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Release No. 34-44291 (May 11, 2001), 66 FR 27760 (May 18, 2001).

amendments to the definitions of "broker" and "dealer" to October 1, 2001. In response to requests from commenters on the Rules, the Commission recently issued an Order further extending the time for banks to comply with the requirements of the GLBA until May 12, 2002. The Order also gave notice that the Commission expects to amend the Rules, and that it does not expect banks to develop compliance systems for the provisions of the GLBA discussed in the Rules until after the Rules are amended. The Commission also stated that it expects to extend the date for compliance with the GLBA yet again when it adopts amended rules.

Banks, bank trade groups, and banking regulators have raised a variety of issues about the Rules. The Commission is sensitive to the concerns of the banking industry and will explore opportunities to permit greater flexibility and to alleviate practical concerns. To that end, the Commission staff has been meeting frequently with industry representatives and seeking specific factual information relating to the banking industry's practices, including compensation arrangements. These meeting have been very productive, and we hope to continue this dialogue as we amend the Rules.

II. Background on the Gramm-Leach-Bliley Act and the Commission's Rules

A. Gramm-Leach-Bliley Act

In seeking to modernize the law of financial services, Congress was faced with a simple but vexing question – when banks act like brokers, how should they be regulated? The answer to that question ultimately determines the kind of consumer protection that investors receive. The Commission supported functional regulation to ensure that all customers purchasing securities receive the protections of broker-dealer regulation, whether they are customers of a bank or a registered broker-dealer, and that broker-dealer activities are consistently regulated.

The GLBA reflects Congress' endorsement of functional regulation of bank securities activities by the SEC, as well as its desire to provide "certain limited exemptions to facilitate certain activities in which banks have traditionally engaged."[3] The statute replaces the blanket exception of banks from the definitions of "broker" and "dealer" with 11 functional exceptions to the definition of "broker" and four functional exceptions to the definition of "dealer."

The GLBA functional exceptions are complex and highly negotiated provisions. Like many difficult compromises that Congress has to make, the Act and its exceptions did not completely satisfy everyone. The Commission, as the agency charged with administering the federal securities laws, supported passage of the Act, including the functional exceptions, because it believed that investors would remain protected under the Act.[4]

B. The Commission's Rules

1. The Commission's Rules Responded to Requests for Guidance

The GLBA provided an 18-month transition period between the date of adoption of the statute and the effective date of the new definitions of "broker" and "dealer" to give banks time to adapt to the new statutory scheme. The GLBA did not require the Commission to engage in rulemaking in this area, and the Commission originally anticipated that rulemaking would not be necessary. Rather, the Commission expected that difficulties in implementing the statute would

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3 H.R. Conf. Rep. No. 106-434, 164 (1999).

4 As then-Chairman Levitt wrote to Senator Gramm days before passage of the Act:

> As you know, the Securities and Exchange Commission has long supported financial modernization legislation that provides the protections of the securities laws to all investors. I believe that the changes to the securities laws contained in the proposed amendments to the Chairmen's Mark that we agreed upon today will significantly strengthen the investor protections of the bill.
>
> With the approval of those amendments, which I understand you are distributing now, I enthusiastically support the securities provisions contained in the Mark.

See Letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to Senator Phil Gramm, Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate (Oct. 14, 1999).

be isolated, mainly involving issues of specific interest to individual banks. Those types of issues could be addressed readily through individual exemptions tailored to a particular bank's circumstances, and would not necessarily implicate the banking industry as a whole.

As the transition period progressed, however, the Commission staff became increasingly aware, through contacts with representatives of the industry and banking regulators, of the areas of uncertainty in the industry about the scope of the new statutory exceptions. The Commission received several requests to delay the effective date of the GLBA provisions applicable to banks, as well as for general guidance in interpreting some of the terms used in specific functional exceptions.

We concluded that rulemaking was necessary for three reasons. First, rules would provide predictability, thereby helping banks plan their ongoing business operations. Second, the Commission staff was told that banks are more familiar with implementing standards imposed by formal regulations rather than by interpretive guidance. Third, the rapidly approaching statutory deadline, coupled with the level of industry uncertainty, strongly suggested that it would be best to provide prompt and definitive guidance on issues needing clarification.

2. The Commission Received Substantial Input from the Banking Community and the Rules Reflect This Input

The Commission issued its Rules only after receiving substantial input from the banking community, including its trade organizations and regulators. In the months prior to the effective date of the GLBA amendments to the Exchange Act, the Commission received a number of letters asking how some of the key terms in the new definitions of "broker" and "dealer" should be interpreted.[5] Several of the letters asked the Commission to delay implementing the GLBA amendments to the definition of "broker" and "dealer."[6] Commission staff also engaged in a dialogue with representatives of the banking community to solicit their input on the GLBA amendments.

Many of the Rules' definitional provisions respond directly to interpretive questions raised by banks during this period. Other rules create new exemptions that the banking industry requested, such as the rule exempting thrifts from broker-dealer registration on the same terms and conditions as banks and the rule granting an exemption to allow banks to process mutual fund trades through a facility of the National Securities Clearing Corporation ("NSCC"), which is a registered clearing agency.[7]

Commission staff also met with representatives of the Federal Reserve Board ("Fed"), the Office of the Comptroller of the Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC") prior to issuing the Rules. While there was disagreement on certain

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5 See, e.g., Letter from Melanie L. Fein, Counsel, Federated Investors, Inc., to Robert L.D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 30, 2001). Letter from Melanie L. Fein, Counsel, Federated Investors, Inc., to Robert L.D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 13, 2001). Letter from Barry Harris, Chair, Bank Retail Broker-Dealer Committee, Securities Industry Association, to Laura S. Unger, Acting Chairman, Commission (Mar. 13, 2001); Letter from Senator Phil Gramm, U.S. Senate Committee on Banking, Housing, and Urban Affairs, to Arthur Levitt, Chairman, Commission (Feb. 6, 2001).

6 See, e.g., Letter from Lawrence R. Uhlick, Executive Director and General Counsel, Institute of International Bankers, to Robert L.D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission, (Mar. 15, 2001); Letter from Barry Harris, Chair, Bank Retail Broker-Dealer Committee, Securities Industry Association, to Laura S. Unger, Acting Chairman, Commission (Mar. 2001); Letter from Robert M. Kurucza, General Counsel, Bank Securities Association, to Laura S. Unger, Acting Chairman, Commission (Mar. 12, 2001); Letter from Sarah A. Miller, Director, Center for Securities, Trusts, and Investments, American Bankers Association, to Laura S. Unger, Acting Chairman, Commission (Feb. 28, 2001).

7 Letter from Scott M. Albinson, Managing Director, OTS, to Annette L. Nazareth, Director, Division of Market Regulation, and Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission (March 20, 2001); Letter from Sarah A. Miller, American Bankers Association, to Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Securities and Exchange Commission (November 7, 2000).

substantive issues, it is fair to say that our rulemaking was informed by the input and insights we received during these discussions. The Commission adopted three exemptions to address issues raised by the banking regulators. First, the Commission created an alternative aggregate compensation calculation so that many banks would not have to do an account-by-account calculation to decide whether they were "chiefly compensated" by the fees enumerated in the Act. The Commission set the compliance limit for the alternative computation at a level that industry participants told the Commission staff would avoid triggering the account-by-account calculation in the "chiefly compensated" requirement.

Second, the Fed, the OCC, and the FDIC expressed concern that investors could void securities transactions if banks inadvertently exceeded the "chiefly compensated" calculation. Although experience for the past 70 years shows that investors have seldom voided securities transactions, particularly because doing so is an equitable remedy imposed by courts, the Commission created a temporary exemption from the application of investors' rescission rights.

Third, the FDIC expressed concern that the statutory exceptions could be unduly burdensome for small banks. Although it had been subject to negotiations at one point, the Act did not contain a small bank exception. In response to the FDIC's concerns, the Commission added a small bank custody exemption so that small banks that did not have ready access to broker-dealers could continue to provide this service to their clients on an accommodation basis.

In addition, the Fed expressed concern about how the chiefly compensated calculation would be applied to account clusters. The Commission specifically sought comment on how such a calculation could be applied in that situation.

3. The Commission Issued the Rules as Interim Final Rules and Solicited Comment

The Commission issued the Rules as interim final rules, a rulemaking procedure that also was used by the banking regulators in several of their GLBA rulemakings. Because banks were asking for our guidance, we believed that it was important to provide banks with legal certainty as quickly as possible, given the May 12, 2001 statutory date. We were particularly concerned about an open-ended extension of a statutorily mandated effective date. Through interim final rules we also could grant immediate relief to banks from certain of the provisions of the statute. At the same time, we could afford an opportunity for substantive comment by delaying the effectiveness of the GLBA amendments and soliciting comment on the Rules and a number of the other issues and approaches. The Commission indicated a willingness to change the Rules, as appropriate, in light of those comments.

Use of interim final rules also seemed appropriate because the Rules do not impose new obligations in addition to those created by the GLBA. Instead, the Rules provide guidance as to the meaning of certain provisions of the Act or provide exemptive relief consistent with the intent of those provisions.

4. The Commission Extended the Statutory Deadline Further

Based on the comments the Commission received on the Rules and recent discussions with banks and banking regulators, the Commission determined that the temporary exemption that it granted banks from the definitions of "broker" and "dealer" might not provide banks with sufficient time to adapt to the new statutory scheme of the GLBA.

In addition, in light of the continuing dialogue between the Commission and industry participants, the Commission recognized that some of the Rules in their current form will need to be amended. As such, banks would be faced with the challenge of complying with the new statutory scheme based on the guidance (and exemptions) provided under the current Rules only to have that guidance (and exemptions) change when the Rules are amended. Consequently, several commenters requested that the Commission extend the temporary exemption from the definitions of "broker" and "dealer," thereby extending the date for compliance with the new statutory scheme. The Commission responded to these concerns by issuing an Order extending the temporary exemption of banks from the GLBA's amended definitions of "broker" and "dealer" until May 12, 2002.

The Commission's Order also gave notice that it expected to amend the Rules and to extend further the temporary exemption from the definitions of "broker" and "dealer," as appropriate, so that banks would have a sufficient transition period to bring their operations into compliance with the new statutory scheme based on the amended Rules. The Commission also stated that it does not expect banks to develop compliance systems for the provisions of the GLBA discussed in the Rules until after the Rules are amended. At the same time it issued the Order extending the temporary exemption of banks from the definitions of "broker" and "dealer," the Commission extended the comment period on the Rules to September 4, 2001.

III. The Commission's Rules Define Terms and Provide Exemptions Consistent with Congressional Intent

Two of the Commission's Rules, Rules 3b-17 and 3b-18, define key terms used in several of the functional exceptions from the definitions of "broker" and "dealer." These exceptions apply when banks enter into networking arrangements with broker-dealers, act in a trustee or fiduciary capacity, sweep funds into no-load money market funds, and hold funds and securities for investors. The Rules were designed to clarify the boundaries of these new statutory exceptions and to promote the clear Congressional intent to prevent banks from running full-scale brokerage operations outside the protections of the federal securities laws. These exceptions and the Rules interpreting these exceptions are discussed below.

In addition to the definitional provisions, the Rules provide banks with eight additional exemptions from broker-dealer registration. One of these exemptions grants banks a temporary reprieve from the operation of the GLBA by exempting banks from the amended definitions of "broker" and "dealer" until October 1, 2001, which has now been extended to May 12, 2002. The Commission granted other exemptions to enable banks to continue to conduct many of their current securities activities that do not raise significant sales practice concerns. The Commission did this because, although the negotiations leading up to the passage of the GLBA lasted many years, the statute imposed some requirements that would have created serious operational and practical problems for banks. These problems were inevitable in a statute that applies to an entire industry that has developed multiple business models over a long period of time.[8]

A. Networking Exception

1. <u>The Statutory Language</u>

Under the Exchange Act, banks that contract with broker-dealers to provide brokerage services to their customers, known as broker-dealer "networking" arrangements, may be excepted from broker-dealer registration. A bank is not considered a broker if it "enters into a contractual or other written arrangement" with a registered broker-dealer through which the broker-dealer "offers brokerage services on or off the premises of the bank."[9] The conditions to the exception address separation of brokerage and banking services, compliance with advertising conditions, functions and compensation of bank employees, full disclosure of customers' accounts to broker-dealers, and restrictions on banks acting as carrying brokers.

[8] For example, banks typically process mutual fund orders through a facility of the NSCC. Because the GLBA generally prohibits banks from executing securities trades except through a registered broker-dealer, banks would have had to discontinue processing mutual funds orders through the NSCC. In response to a request from the American Bankers Association, the Commission adopted a rule to allow banks to process mutual fund orders through the NSCC.

The networking exception specifically provides that bank employees (other than employees who are associated persons of a broker-dealer and are qualified pursuant to the rules of a self-regulatory organization) may not receive:

> incentive compensation for any brokerage transaction unless such employees are associated persons of a broker or dealer and are qualified pursuant to the rules of a self-regulatory organization, except that the bank employees may receive compensation for the referral of any customer 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 (emphasis added).[10]

2. The Rules Provide Flexibility to Banks to Compensate Employees

The Rules sought to keep Congress' limit on incentive compensation in mind in interpreting two terms in this provision. The Rules define the term "referral" to mean a bank employee arranging a first securities-related contact between a registered broker-dealer and a bank customer. The term "referral," and therefore the activity for which a referral fee may be paid, is limited and does not extend to any activity beyond arranging that first securities-related contact (including any part of the account opening process) that is related to effecting transactions in securities.[11]

In addition, the Rules provide two alternative definitions of the term "nominal one-time cash fee of a fixed dollar amount." First, the Rules provide that a nominal one-time cash fee of a fixed dollar amount may be a payment that does not exceed the gross cash wages that the unregistered bank employee making the referral receives for one hour of work. Second, the Rules provide that a nominal one-time cash fee of a fixed dollar amount may be a payment in the form of points in a system or program that covers a range of bank products and non-securities

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9 Exchange Act Section 3(a)(4)(B)(i) [15 U.S.C. 78c(a)(4)(B)(i)].

10 Exchange Act Section 3(a)(4)(B)(i)(VI) [15 U.S.C. 78c(a)(4)(B)(i)(VI)].

related services, where the points count toward a bonus. However, the points awarded for referrals involving securities may not be greater than the points awarded for products or services not involving securities. Banks may use either alternative in setting nominal payments.

The Rules provide the two alternatives to give banks the flexibility of compensating their employees for securities referrals based either on their current wages or on what the banks pay for referrals of other products and services. The Act does not provide for banks' use of a point system to pay for securities-related referrals. Nevertheless, the Commission adopted a point system alternative based on discussions between the Commission staff and banks about industry practice. By creating two alternative standards, the Rules seek to allow banks to develop a market-based approach to employee compensation, consistent with the compensation limitation in the networking exception.

The Rules include a definition of these terms in response to requests for guidance from industry participants. In addition, they are intended to give substance to Congressional limits on compensation that otherwise could induce bank employees to encourage customers to trade securities. Because payments can create conflicts of interest, the exception is intended to limit the size of these payments to "nominal amounts."

A bank certainly may give bonuses to its employees based on the overall profitability of the bank regardless of the specific contribution of the employees receiving the bonus. However, to rely on the networking exception, banks cannot indirectly pay their employees through a bonus program related to the securities transactions of a branch, department, or line of business. We solicited comment on practical ways to draw this line.

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11 The "account opening process" commences at the point of first contact between a broker-dealer and a customer. See NASD Notice to Members 97-89 (1997), at Question 7.

Some commenters have expressed concerns about the difficulty of paying "nominal" referral fees on the basis of hourly wages for banking employees with many different pay structures across the breadth of the country. To determine whether a more flexible approach is feasible and appropriate, we are discussing with banks their current compensation arrangements.

B. The Trust and Fiduciary Activities Exception

1. The Statutory Language

The trust and fiduciary activities exception in the Act is limited to banks that act as trustees or in one of eleven fiduciary capacities, including acting as an investment adviser if the bank receives a fee for its investment advice, and acting in any capacity in which the bank possesses investment discretion on behalf of another. Under the terms of this exception, a bank will not be considered a "broker" if it: (1) effects transactions in a trustee or fiduciary capacity; (2) effects such transactions in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards; (3) 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 such securities transactions or any combination of such fees; and (4) does not publicly solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising its other trust activities.[12]

[12] Exchange Act Sections 3(a)(4)(B)(ii)(I) and (II) [15 U.S.C. 78c(a)(4)(B)(ii)(I) and (II)]. A bank also must execute such transactions through a registered broker-dealer or in a cross trade if using the trust and fiduciary activities exception. Exchange Act Section 3(a)(4)(C) [15 U.S.C. 78c(a)(4)(C)].

This exception recognizes that banks traditionally have held securities in trust accounts, and Congress directed the Commission not to disturb banks' traditional trust business when interpreting this exception.[13] Congress, however, indicated that the Commission should interpret the exception so that banks could not run a full-scale brokerage operation in their trust departments without the appropriate investor protections provided under the federal securities laws.[14] There is a tension between these two directives, and our Rules sought to be faithful to both.

2. The Rules Provide Certainty on the Conditions of the Exception

The Rule's interpretation of the statutory conditions to the trust and fiduciary activities exception sought to address these two conflicting goals.

a. Trustee and Fiduciary Capacities

As stated previously, a bank may use the trust and fiduciary activities exception only if it is effecting transactions as a trustee or in one of the enumerated fiduciary capacities. The statute unequivocally addressed trustees, which are subject to the strongest of fiduciary duties. Questions were raised with the Commission staff, however, regarding indenture trustees, ERISA trustees, and IRA trustees, because of the legal uncertainty as to whether these three capacities are subject to the same fiduciary duties and obligations as "traditional" trustees. The Commission believed it important to provide certainty for banks acting in these capacities that wanted to use the trust and fiduciary activities exception. Therefore, the Rules provide a definitional exemption for banks acting as indenture, ERISA, and IRA trustees that makes clear that they qualify for this exception, irrespective of questions regarding their fiduciary status.

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13 H.R. Conf. Rep. No. 106-434, 164 (1999).

14 H.R. Rep. No. 106-74, pt. 3, at 164 (1999).

Another fiduciary status addressed under the Rules was "fiduciary capacity" for banks acting as an investment adviser if the bank "receives a fee for its investment advice" or "possess[es] investment discretion on behalf of another."[15] Questions arose in the situation where a bank provides both investment advisory services and brokerage to a non-discretionary advisory account for a fee. In particular, should a fee be considered payment for investment advice if the bank provides an occasional, impersonal research report and unlimited brokerage?

To give banks guidance in these situations, the Rules provide that when banks give both non-discretionary investment advice and brokerage services to an account for a fee, the bank must be providing "continuous and regular investment advice . . . that is based on the individual needs of the customer" in order for it to be clear that the fees paid are for investment advice, rather than for brokerage. The guidance seeks to give effect to Congress' intent, as discussed earlier, that a bank not be permitted to offer full scale brokerage services absent the investor protections of the federal securities laws. We are considering comments that indicate there are other meaningful forms of investment advice that are provided for a fee.

b. Examination for Fiduciary Principles and Standards

Another requirement for banks using the trust and fiduciary activities exception is that banks must effect their transactions in the trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards. Congress believed that this requirement would provide customers with "some basic protections" to mitigate the lack of federal securities law protections.[16]

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15 Exchange Act Sections 3(a)(4)(D)(i) and (ii) [15 U.S.C. 78c(a)(4)(D)(i) and (ii)].

16 H.R. Conf. Rep. No. 106-434, 164-65 (1999).

The Rules deferred to bank regulators in determining whether a particular bank's activities are conducted in an area that is regularly examined by bank examiners for compliance with fiduciary principles. The Rules noted that the condition in the statute was not limited to particular portions of the securities transaction. We are willing to explore aspects of handling transactions, like post-trade processing, that may not need the protections of the fiduciary department.

c. Chiefly Compensated

Another condition banks must meet to rely on the trust and fiduciary activities exception is that they must be "chiefly compensated" for securities transactions by certain enumerated fees. Banks sought guidance on how this new condition should apply.

Congress stated that this provision should limit a bank's ability to conduct a full-scale brokerage operation in its trust department and that the Commission should not disturb traditional trust activities. Clearly, "chiefly compensated" was designed to be a meaningful condition, and the Rules sought to apply it as intended.

With these considerations in mind, the Rules look to the compensation of each account to determine whether that account is chiefly a brokerage account. An account-by-account calculation is consistent with assuring the protection of each investor, reflects the fact that bank trust departments typically charge for securities transactions at the account level, and is consistent with determinations that trustees must make under state trust law. If we adopted a business line approach, a bank potentially could operate a full-scale brokerage business within its trust department as long as it was combined with a larger non-brokerage trust business.

For purposes of the chiefly compensated calculation, the Rules separate the fees to be used in the calculation into the categories inherent in the statute, labeled in our Rules as "relationship compensation," "sales compensation," and "unrelated compensation." Consistent with the statute, "relationship compensation" must exceed "sales compensation" on an account basis.

To reduce the potential costs of compliance, the Rules exempted bank trust departments that receive small amounts of sales compensation from the requirement to consider when an account is "chiefly compensated" from the enumerated fees. This exemption was intended to reduce calculation burdens on bank trust departments that do not receive a large percentage of sales compensation.

The comments received to date have emphasized the difficulties of account-by-account calculations of compensation for existing accounts, and the limited utility of the exemptive rule designed to alleviate these difficulties. We recognize these concerns are significant, and we are considering, and discussing with the banking industry, how best to address these matters.

The comments also highlighted problems under the "chiefly" calculation and other compensation limits for bank-administered 401(k) and other employer accounts that invest primarily in mutual funds. These comments raise valid concerns, and we are discussing with the banking industry ways to address the problems while also achieving the purposes of the statute.

The Commission recognizes that this new statutory provision is complicated and that banks may, in good faith, try to meet the "chiefly compensated" condition, but inadvertently violate it. At the same time, however, the Commission believes that it is important that banks strive for full compliance with the statute. With these considerations in mind, the Commission looks forward to working with banks, the banking regulators, and the industry to craft a cure period or safe harbor.

C. Sweep Accounts Exception

1. The Statutory Language

Under the statutory exception, a bank is not considered a broker if it "effects transactions as part of a program for the investment or reinvestment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund."[17] The sweep accounts exception is intended to allow banks to sweep funds into no-load money market funds without having to register as broker-dealers.

2. The Rules Provide Definitional Clarity

The term "no-load" is not defined in the GLBA or in the federal securities laws. Historically, the term "no-load" was viewed as meaning that neither investors in the fund, nor the fund itself, bore the costs of distributing the fund's shares, including making payments to broker-dealers.[18] The Commission's adoption in 1980 of Investment Company Act Rule 12b-1, which for the first time permitted funds to use their assets to finance distribution expenses, created some confusion as to the meaning of the term.[19] To address this confusion, the National Association of Securities Dealers, Inc. ("NASD") adopted Rule 2830(d)(4), which describes what a "no-load" investment company is. Rule 2830(d)(4) allows an NASD member broker-dealer to describe an investment company as being "no-load" or as having "no sales charge" if the investment company does not have a front-end or deferred sales charge, and if its total charges against assets to provide for sales related expenses and/or service fees do not exceed 0.25 of 1% of average net assets per year.[20]

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17 Exchange Act Section 3(a)(4)(B)(v) [15 U.S.C. 78c(a)(4)(B)(v)].

18 See Investment Company Act Release No. 15431 (June 13, 1988), 53 FR 23258.

19 Investment Company Act Release No. 11414 (Oct. 28, 1980), 45 FR 73898 (Nov. 7, 1980).

20 NASD Rule 2830(d)(4) specifically states that a member broker-dealer may not "describe an investment company as being 'no-load' or as having 'no sales charge' if the investment company has a front-end or deferred sales charge or its total charges against net assets to provide for sales related expenses and/or

The Rules provide that a mutual fund is "no-load" if: (1) purchases of the investment company's securities are not subject either to a front end or deferred sales load; and (2) its total charges against net assets that provide for sales or sales promotion expenses and for personal services or the maintenance of shareholder accounts do not exceed 0.25 of 1% of average net assets annually and are disclosed in the mutual fund's prospectus.[21] The Rules reflect current industry and public understanding of what the term "no-load" means. Nonetheless, we acknowledge the comments on the impact of this condition on bank sweep account programs and believe that there are grounds to consider exemptions from the statutory requirement under appropriate circumstances.

D. Safekeeping and Custody Exception

1. The Statutory Language

Banks also may be excepted from broker-dealer registration for certain safekeeping and custody activities.[22] Under the exception, a bank will not be considered a "broker" because, as part of customary bank activities, it engages in certain specified types of safekeeping and custody services with respect to securities on behalf of its customers.[23]

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service fees exceed .25 of 1% of average net assets per annum." (emphasis added). See Exchange Act Release No. 30897 (July 7, 199), 57 FR 30985-02 (July 13, 1992). NASD Rule 2830(d)(4) was formerly classified as Article III, Section 26(d)(3) of the NASD Rules of Fair Practice. See Exchange Act Release No. 36698 (Jan. 11, 1996), 61 FR 1419 (Jan. 19, 1996).

[21] Rule 3b-17(f) provides, however, that certain charges a money market fund makes against fund assets will not be considered charges for personal service or the maintenance of shareholder accounts. In particular, charges against a money market fund's assets for transfer agent and subtransfer agent services for beneficial owners of the fund shares; aggregating and processing purchase and redemption orders; providing beneficial owners with statements showing their positions in the investment companies; processing dividend payments; providing subaccounting services for fund shares held beneficially; and forwarding shareholder communications, such as proxies, shareholder reports, dividend and tax notices, updating prospectuses to beneficial owners; and receiving, tabulating, and transmitting proxies executed by beneficial owners will not count toward the 0.25 of 1% limit in Rule 3b-17(f)(2).

[22] 15 U.S.C. 78c(a)(4)(B)(viii).

[23] Exchange Act Section 3(a)(4)(B)(viii)(aa - ee).

The safekeeping and custody exception explicitly allows banks that hold securities, on behalf of their customers, to exercise warrants or other rights, facilitate the transfer of funds or securities in connection with the clearance and settlement of the customers' transactions, effect securities lending or borrowing transactions when the securities are in the custody of the bank, invest cash collateral pledged in connection with securities lending or borrowing transactions, and facilitate the pledging or transfer of securities that involve the sale of those securities. Moreover, banks may provide custody and related administrative services to IRAs, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plans without being considered a broker.

This exception provides legal certainty to banks holding funds and securities, because holding funds and securities traditionally has been a contributing factor in determining broker-dealer status. In addition, the exception explicitly covers executing securities transactions, such as investing cash collateral. Thus, the safekeeping and custody exception provides banks legal certainty that they would not be required to shift their custody business to broker-dealers just because they held funds and securities and conducted the specified securities activities.

However, the safekeeping and custody exception does not include any language that would permit banks generally to take orders for custody accounts. Accordingly, the Commission views order-taking for custody accounts where not specifically provided as outside the custody exception. Otherwise, banks could offer brokerage accounts merely by labeling them "custody" accounts. The Commission's view is consistent with Congressional intent not to permit a full-scale brokerage operation to operate in a bank without the investor protections provided under the federal securities laws.

Moreover, the safekeeping and custody exception, in particular, must be considered in light of the other broker-dealer exceptions. For trust and fiduciary accounts, which unlike custody accounts are subject to fiduciary principles,[24] the statute imposed five conditions to prohibit banks from running a full-scale broker-dealer through those accounts. Stronger conditions would be needed for custody and safekeeping accounts if full-scale brokerage were allowed through those accounts.

2. The Rules Accommodate Some Order-Taking Activity

Nonetheless, to enable banks to take orders as an accommodation to custody customers without involving a broker-dealer, the Rules provide two limited exemptions. These exemptions are designed to permit banks to take orders under conditions that limit the concerns for which the Commission regulates broker-dealers, but are not designed to let them run full-scale brokerage operations outside of the federal securities laws.

First, the Commission adopted a small bank custody exemption to allow a small bank that is not in a networking relationship to take orders for mutual funds from customers in tax-deferred accounts and to be compensated for those sales. Second, the Commission adopted an exemption to allow any bank to take orders for any security from its custody customers, so long as the bank only passes along the broker-dealer's charges for executing the transactions.

Banks that want to offer transaction services to custody customers and charge additional amounts over the broker-dealer's charges for those services may do so by arranging for a broker-dealer to take and execute orders under the networking exception, while still holding the customers' funds and securities in the custody account. We will carefully weigh the comments

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24 In fact, the OCC does not treat nondiscretionary custodial activities as fiduciary. See Fiduciary Activities of National Banks; Rules of Practice and Procedure, 61 FR 68543, 68545 n. 4 (Dec. 30, 1996).

on the scope and workability of these exemptions, to seek to reduce burdens on banks while maintaining investor protections.

IV. Concluding Remarks

In enacting the GLBA, Congress drew lines reflecting a compromise between functional regulation and a desire not to disrupt certain traditional bank activities. In some cases, those lines will require banks to restructure their securities operations. It is not the role of regulators to redraw those lines. Nevertheless, in amending the Rules, the Commission will explore ways to minimize the business impact of the rules it adopts consistent with the language and intent of the GLBA and the Commission's mandate to protect investors.

In conclusion, we want to emphasize that the Commission will do everything in its power to ease the conversion process required by the GLBA consistent with our mandate. The Commission is eager to continue its discussions with banks and the bank regulators about their concerns. Discussions to date have narrowed some of the issues raised by commenters and provided useful guidance for amending some of the Rules.

The Commission appreciates your continuing interest in this issue and the important role that you have played in modernizing the nation's financial services industry.

Thank you.

Statement of

Laurence H. Meyer

Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

and the

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

of the

Committee on Financial Services

of the

U.S. House of Representatives

August 2, 2001

I appreciate the opportunity to present the views of the Federal Reserve on the interim final rules issued by the Securities and Exchange Commission (SEC or Commission) to implement the bank securities provisions of the Gramm-Leach-Bliley Act (GLB Act). The manner in which these rules are implemented is extremely important to banks and their customers and well deserves your attention.

As the banking agencies detailed in our official comment to the Commission on the rules, we believe they are, in a number of critical areas, inconsistent with the language and purposes of the GLB Act, and create an overly complex, burdensome, and unnecessary regulatory regime. The rules as currently drafted would disrupt the traditional operations of banks and impose significant and unwarranted costs on banks and their customers.

In our comment letter, the banking agencies also objected to the Commission adopting the rules in final form and making them effective beginning October 1 of this year. The banking agencies urged the Commission to treat the interim final rules as proposed rules and to give banks sufficient time after modified rules are adopted by the Commission to implement systems and make other changes necessary to comply with the rules.

We support the Commission's recent actions to extend the public comment period on the rules until September 4, 2001, and to extend the effective date of the interim final rules and the statutory provisions that they implement until at least May 12, 2002. We also support the Commission's statement that it will further extend the effective date for an appropriate period of time to provide banks with a sufficient transition period to come into compliance with any revised rules the Commission ultimately adopts. We believe these procedural steps are both necessary and appropriate to ensure that the public comment process, which is so critical to the development of fair and effective rules, allows for meaningful comment and the collection of much needed information regarding the practical effects of the SEC's rules on the traditional activities of banks. Most importantly, we look forward to engaging in a constructive dialogue with the Commission and its staff and to assisting them in modifying the substance of the rules in a manner that both gives effect to the Congress' intent and does not disrupt the traditional customer relationships and activities of banks.

Before highlighting some of the most significant provisions of the interim final rules that we believe must be modified, a brief background of the treatment of banks under the Securities Exchange Act of 1934 and the purposes of the GLB Act's bank securities provisions is useful.

History of the Bank Exception and Bank Securities Activities

In 1934, the Congress first adopted a federal scheme requiring all entities that act as securities brokers or dealers to register with the SEC. The Securities Exchange Act of 1934, however, specifically exempted all banks from the definitions of "broker" and "dealer" and, accordingly, did not require banks providing securities services to their customers to register with the SEC as broker-dealers. Although the ability of banks to underwrite, deal in, and purchase securities was limited by the Glass-Steagall Act of 1933, banks continued to have the ability to buy and sell securities for the account of their customers and to buy and sell securities for their own account when specifically authorized by law. The Congress recognized that these permissible securities activities were already supervised and examined by the appropriate federal and state banking authorities and that subjecting these activities to an additional layer of regulation was not necessary or appropriate. In fact, one of the primary purposes of the Securities Exchange Act of 1934 was to subject nonbank stockbrokers and securities traders to the type of government supervision and examination that was already applied under the banking laws to banks.

Long before 1934 and since, banks have offered their customers securities services in a variety of circumstances in connection with their banking activities. For example, banks have long bought and sold securities for their trust and fiduciary customers. These services are an essential part of the trust and fiduciary operations of banks—operations that have long been considered a core banking function. Banks that have discretionary investment authority over a trust or fiduciary account purchase and sell securities for the account to ensure that the account is properly diversified and managed in the manner required by the governing trust agreement and applicable fiduciary principles. Banks also provide investment advice concerning securities, real estate, and other assets to non-discretionary fiduciary accounts, and have long been able to execute securities transactions for these accounts.

Another core banking function is providing custody and safekeeping services. The five largest global custodians are banks, and banks, both large and small, act as trusted custodians for the securities, real estate, and other assets of customers. One of the most recognizable custody services provided by banks is for Individual Retirement Accounts (IRAs). Under applicable Internal Revenue Service regulations, banks may act as custodians for IRAs, and bank-offered custodial IRAs provide consumers throughout the nation with a convenient and economical way to buy and sell securities for retirement purposes on a tax-deferred basis. Banks, as part of their customary banking activities and as an accommodation to their customers, also have long permitted customers that hold securities in custody accounts at the bank to buy and sell securities related to the account. These services allow customers to avoid the unnecessary expense of having to establish a separate securities account at a broker-dealer to effect such trades. Other securities services traditionally offered by banks include "sweeping" deposit funds into overnight investment vehicles, such as money market mutual funds, privately placing securities for customers, and providing transfer agency services to issuers and benefit plans.

Banks have offered these services to their customers without significant concerns for years. It is important, moreover, to highlight that these activities are not unregulated—they are supervised, regulated, and examined by the relevant federal and state banking agencies. In the trust and fiduciary area, these protections are enhanced and supplemented by well-developed principles of state and federal trust and fiduciary law that provide customers with strong protections against conflicts of interests and other potential abuses. Bank examiners regularly examine a bank's trust and fiduciary departments for compliance with these fiduciary principles. These examinations frequently are conducted by examiners who have received special training in trust and fiduciary law and practice, and the federal banking agencies assign banks engaged in fiduciary activities separate ratings under the Uniform Interagency Trust Rating System. These ratings are based on an evaluation of, among other things, the capability of management; the adequacy of the bank's operations, controls, and audits; the bank's compliance with applicable law, fiduciary principles and the documents governing the account; and the management of fiduciary assets.

GLB Act

It was in the context of this existing regulatory framework that the Congress, during consideration of the GLB Act, reviewed the blanket exception for banks from the definitions of "broker" and "dealer" in the Securities Exchange Act. This review of the blanket exception was not undertaken because abuses or concerns existed concerning the traditional securities activities of banks. In fact, banks generally have conducted their securities activities responsibly and in accordance with bank-regulatory requirements and other applicable law, including the antifraud provisions of the federal securities laws.

Rather, the review of the bank exception was undertaken to address a concern that, if the blanket exception for banks was retained at the same time that the barriers hindering the affiliation of banks and securities broker-dealers were removed, securities firms might acquire a bank and move the securities activities of the broker-dealer into the bank in order to avoid SEC supervision and regulation. Some parties also expressed concern that banks might in the future significantly expand their securities activities outside the services traditionally provided customers under the blanket exception. The Congress sought to balance these concerns with the desire to ensure that banks could continue to provide their customers the securities services that they had traditionally provided as part of their customary banking activities, without significant problems, and subject to the effective supervision and regulation of the banking agencies.

The end result, the GLB Act, replaced the blanket exception for banks from the definitions of "broker" and "dealer" with fifteen exceptions tailored to allow the continuation of key bank securities activities. These exceptions were broadly drafted and were intended to ensure that banks could continue to provide their customers with most, if not all, of the services that they traditionally had received from banks. For example, these statutory exceptions permit banks, subject to certain conditions, to continue to (1) buy and sell securities for their trust and fiduciary customers, (2) buy and sell securities for their custodial clients as part of their customary banking activities, (3) establish so-called "networking" arrangements with registered broker-dealers to offer securities services to the bank's customers, (4) sweep deposit funds into shares of no-load money market mutual funds, (5) privately place securities with sophisticated investors, (6) issue and sell to qualified investors securities that are backed by assets predominantly originated by the bank, its affiliates or, in the case of consumer-related receivables, a syndicate formed by the bank and other banks, and (7) broker securities in up to 500 transactions per year that are not otherwise exempt.

Interim Final Rules Adopted by the SEC

The interim final rules as currently written are, in many respects, not consistent with the language or purposes of the GLB Act and would impose unnecessary costs and burdens on banks and their customers. In the interest of time, I will focus only on some of our most significant concerns with the substantive provisions of the rules. A more detailed discussion of our numerous concerns is included in the comment letter issued jointly by the Federal Reserve, the OCC, and the FDIC.

Trust and Fiduciary Activities. We are most concerned with the provisions of the interim final rules that implement the statutory exception for the trust and fiduciary activities of banks. In our judgment, these provisions would significantly disrupt the trust and fiduciary customer relationships and activities of banks. As I noted above, trust and fiduciary activities are part of the core functions of banks, and banks have long bought and sold securities for their trust and fiduciary customers under the strong protections afforded by fiduciary laws and under the supervision and examination of the banking agencies.

In light of this history, the GLB Act specifically permits banks to effect transactions in a trustee capacity, and to effect transactions in a fiduciary capacity in any department of the bank that is regularly examined by bank examiners for compliance with fiduciary principles. To ensure that banks did not attempt to operate a full-scale brokerage operation out of their trust department, the GLB Act established two limitations. First, a bank relying on the trust and fiduciary exception must be "chiefly compensated" for the securities transactions it effects for its trust and fiduciary customers on the basis of certain types of traditional trust and fiduciary fees specified in the act. Second and importantly, the act prohibits the bank from publicly soliciting securities brokerage business other than in conjunction with its trust activities. The Congress did not expect that these compensation requirements and advertising restrictions would interfere with the traditional trust and fiduciary activities of banks, nor were these provisions intended to grant the SEC broad authority to regulate or "push-out" the trust and fiduciary activities of banks. In fact, the Conference Report for the GLB Act specifically states that the "Conferees expect that the SEC will not disturb traditional bank trust activities" under this exception.[1]

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[1] See H.R. Conf. Rep. No. 106-434 at 164 (1999).

The interpretation of this exception currently reflected in the interim final rules, however, would significantly disrupt the customary trust and fiduciary activities of banks and is at odds with both the language and purposes of the exception. Most importantly, the interim final rules provide that a bank qualifies for the exception only if each of its trust and fiduciary accounts independently meets the act's "chiefly compensated" requirement. We strongly believe that the act's "chiefly compensated" requirement was intended to apply to a bank's aggregate trust and fiduciary activities and not on an account-by-account basis. An approach focused on the bank's aggregate trust and fiduciary activities is consistent with the nature and operations of bank trust departments and would—in conjunction with the act's prohibition on banks publicly soliciting brokerage business apart from their trust and fiduciary activities—effectively prevent banks from running a full-scale brokerage operation out of their trust departments.

The account-by-account approach adopted by the interim final rules, on the other hand, is both unworkable and overly burdensome. First, this approach appears premised on the notion that an individual trust or fiduciary account that engages in a significant number of securities transactions during a year is not a traditional trust and fiduciary account. This premise is flawed, however. It is entirely natural for a bank to engage in numerous securities transactions for a trust or fiduciary account. For example, there may be numerous securities transactions for an account when a trust is initially established and the assets provided by the grantor are initially invested or when the investment strategy of a fiduciary account is altered to reflect changes in the beneficiary's investment objective. An account-by-account approach also does not accommodate the complex, multi-account relationships that a bank's trust department is frequently called upon to establish to achieve the individualized wealth preservation and transfer goals of its customers.

The account-by-account approach also proves too much. To put this in context, a moderately sized trust department may have on the order of 10,000 separate trust and fiduciary accounts and a large trust department may have more than 100,000 such accounts. Under the account-by-account approach adopted by the interim final rules, changes in the amount of compensation received during a year from a single trust or fiduciary account could cause a bank and its entire trust operation to become an unregistered broker-dealer, thereby opening the bank to the threat of enforcement action by the SEC and, after January 1, 2003, suits by private parties for the rescission of securities contracts entered into by the bank. Such a result is unreasonable, especially because a bank would not be able to determine an account's compliance with the rules' "chiefly compensated" requirement until the end of a year, and then may have only a single day to restructure its operations if the compensation from one account did not meet the rules' requirements.

The proposed account-by-account approach also would impose significant and unnecessary burdens on banks. Most banks do not have the systems in place to track the various categories of compensation that they receive from each individual trust and fiduciary account. In order to comply with the rules, and to continue providing traditional trust and fiduciary services, banks would have to establish complex and costly systems and procedures for monitoring the amount and types of fees received from each trust and fiduciary account and these costs likely would be passed on to consumers.

The Commission recognized the significant burdens imposed by the rules' account-by-account requirement and used its discretionary authority under other provisions of the securities laws to adopt an exemption for banks that comply with certain conditions established by the Commission. These conditions, however, require the bank to establish procedures to ensure that each trust and fiduciary account complies with the rules' chiefly compensated requirement, effectively maintaining the account-by-account approach from which the exemption was supposed to provide relief. In addition, a bank may take advantage of the exemption only if it significantly limits its receipt of fees that would otherwise be permissible under the GLB Act.

The rules also impose restrictions on the trust and fiduciary activities of banks that simply are not found in the statute and that are not consistent with the nature of the trust and fiduciary operations of banks. For example, although the statutory exception is, by its terms, available for all accounts where a bank acts as trustee, the rules suggest that the SEC will review bank-trustee relationships and may determine that some of these relationships do not qualify for the exception. Accordingly, the rules not only cast doubt on whether banks may continue to effect securities transactions for a wide variety of traditional trust accounts, such as self-directed personal trust accounts and charitable trusts, but also suggest that the SEC intends to review and regulate the types of trust relationships that banks may have with customers. The interim final rules also place restrictions on when a bank will be deemed to be acting in a "fiduciary capacity" that were not included in the statute or contemplated by the Congress.

Finally, the rules interpret the statute's examination requirement in a manner that will effectively prevent many banks from taking advantage of the statutory trust and fiduciary exception at all. As I mentioned earlier, the Congress required that any securities transactions under the exception be effected either in the bank's trust department or in another department that is regularly examined by bank examiners for compliance with fiduciary principles and standards. These requirements ensure that the customer's relationship with the bank continues to be subject to the fiduciary examination programs of the banking agencies that have effectively protected customers for years.

The interim final rules, however, allow a bank to effect transactions for a trust or fiduciary account only if all aspects of the transaction—including associated data processing and settlement—occur in a department regularly examined by bank examiners for compliance with fiduciary principles and standards. Many bank trust and fiduciary departments outsource securities settlement and processing functions to a third party or affiliate, or delegate these functions to other departments of the bank to achieve cost and operational efficiencies. The customer relationship is fully protected by trust and fiduciary principles in this case, while the mechanics of the transaction are handled in the most cost-efficient manner. However, banks that have structured their operations in these ways would be prohibited by the rules from taking advantage of the exception granted by the Congress, even though their relationships with customers are maintained in a trust or fiduciary department and regularly examined by bank examiners for compliance with fiduciary principles.

In our view, the end result of these narrow interpretations and burdensome requirements is that banks will be forced to significantly restructure their traditional trust and fiduciary activities, and some banks may well be required to cease providing these traditional banking services to customers. In addition, customers that have chosen to establish relationships with banks will be forced to terminate these relationships or have duplicate accounts at the bank and a broker-dealer, resulting in increased costs and burden.[2] We do not believe that this was the result intended by the Congress.

Custodial and Safekeeping Activities. Another of the exceptions included by the Congress in the GLB Act was designed to protect the custodial and safekeeping services that banks have long provided as part of their customary banking activities. In particular, the act allows banks, as part of their customary banking activities, to provide safekeeping and custody services with respect to securities and to provide custodial and other related administrative services to Individual Retirement Accounts and pension, retirement, and other similar benefit plans.[3] In this area, as well, the Commission has interpreted the exception in a manner that is inconsistent with the language and purposes of the act and that prevents or significantly disrupts the customary banking relationships and activities that Congress sought to preserve.

In particular, as I noted a moment ago, the act explicitly permits banks to continue providing custodial and related administrative services to IRAs and benefit plans. This language was added to the bill during the House-Senate Conference to resolve any ambiguity concerning the ability of banks to continue to provide securities execution services to their custodial IRA customers and to benefit plans that receive custodial and administrative services from the bank. Bank-offered custodial IRAs provide consumers throughout the United States with a convenient and economical way of investing for

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[2] The GLB Act already requires that banks send any U.S. securities trades for a trust or fiduciary account to a registered broker-dealer for execution. See 15 U.S.C. § 78c(a)(4)(C).

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

retirement on a tax-deferred basis, and banks have long executed securities transactions for these accounts subject to IRS requirements and the supervision and regulation of the banking agencies. Banks also provide benefit plans with custodial and administrative services, including securities execution and recordkeeping services, under the direction and supervision of the plan's fiduciaries. 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.

The Commission, however, has stated that the custody exception does not allow a bank to effect securities transactions for its custodial IRA or benefit plan accounts. This position essentially reads the explicit authorization adopted by the Congress out of the statute, is completely contrary to the purposes of the act, and would disrupt long-standing relationships between banks and their customers.

In addition, the interpretation of the custody exception adopted by the Commission would prohibit banks from executing securities transactions for their custodial customers on an accommodation basis. Banks, as part of their customary banking activities, have for many years effected securities transactions as an accommodation to their custodial clients. These customer-driven transactions occur only upon the order of the customer and allow the customer to avoid having to go through the unnecessary expense of establishing a separate account with a broker-dealer to effect occasional securities trades associated with the customer's custodial assets at the bank.

In an effort to mitigate the adverse impact of these interpretations on the banking industry, the Commission proposed two exemptions that would permit small banks, on one hand, and all banks, on the other hand, to continue to accept orders from their custodial clients. These SEC-granted exemptions, which could be revoked or modified by the SEC at any time in the future, would not be necessary if the rules gave effect to the language and purposes of the custody exception adopted by the Congress. Furthermore, these exemptions are subject to numerous and burdensome restrictions that were not contemplated by the act and that will make it difficult, if not impossible, for many banks to take advantage of the exemptions.

Third-Party Networking Arrangements. The GLB Act also permits banks to establish so-called "networking" arrangements with registered broker-dealers, under which the broker-dealer makes securities brokerage services available to the bank's customers. One provision of the statutory exception permits bank employees who are not registered representatives of the broker-dealer to receive a nominal, one-time cash fee for the referral of customers to the broker-dealer so long as payment of the fee is not contingent on whether the referral results in a securities transaction.

This exception was intended to reflect and codify the arrangements that the SEC staff has sanctioned in no-action letters issued to the banking and securities industries concerning networking arrangements.[4] These letters, like the statutory exception, permit bank employees to receive a nominal, one-time fee for the referral of customers to the broker-dealer, and do not attempt to establish a rigid mechanism for determining what constitutes a "nominal" fee in every circumstance. This flexible approach has worked well for both the banking and securities industries and has not, to our knowledge, caused significant problems.

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[4] See Chubb Securities Corp., 1993 SEC No-Act. LEXIS 1204 (Nov. 24, 1993).

Despite the success of this flexible approach, the interim final rules establish a rigid and complex approach for determining whether a referral fee is "nominal." In addition, the rules impose, or request comment on, other restrictions on referral fees that were not authorized by the Congress. For example, the rules provide that a referral fee is nominal if it does not exceed one hour of the gross cash wages of the employee receiving the fee. By pegging permissible fees to the hourly wage of each employee, the rules create significant administrative problems and may conflict with state privacy requirements that restrict access to information concerning an employee's salary. Although the rules also allow a bank to pay referral fees in the form of "points" in a bonus program, the rules require that any points awarded must not only be nominal, but also must be the lowest amount awarded for any product or service covered by the bonus program. Thus, for example, the points awarded for a securities referral could not exceed the amount of points awarded for a safe deposit referral, even if the points awarded for the securities referral were nominal in amount.

Failure to Address All Exceptions or Adopt Cure or Leeway Periods. The interim final rules also fail to address the scope of a majority of the exceptions to the definitions of "broker" and "dealer" that were adopted in the GLB Act. Given the fact that the Board believes that many of the SEC's interpretations of the scope of the exceptions it has chosen to address do not comport with the unambiguous words of the GLB Act and the legislative intent of the Congress, we are concerned about the manner in which the SEC will interpret the other exceptions. The Board fears that if the SEC does not adopt rules concerning the scope of all of the exceptions, it will aggressively interpret some of the exceptions through enforcement actions and no-action letters, without banks and other members of the public having the opportunity to comment on these interpretations.

The interim final rules also fail to provide any cure or leeway periods to banks that are attempting in good faith to comply with the exceptions when they discover that some of their securities transactions do not comply with the exceptions due to inadvertent errors or unforeseen circumstances. Given the complexity of the exceptions, it is expected that banks that are attempting to conform their securities activities to the exceptions will identify some securities transactions that do not meet the terms of the exceptions. In some circumstances, banks will not even be able to confirm that their securities transactions will comply with an exception at the time they are conducted. For example, banks will not be able to confirm that they meet the "chiefly compensated" standard in the trust and fiduciary exception until they review all of their compensation earned at the end of the year. For these reasons, the Board believes that the SEC must provide banks that have adopted policies reasonably designed to comply with the exceptions a reasonable period of time to cure any inadvertent or unforeseen violations. This period of time must at least be long enough for a bank to establish an affiliated broker-dealer to which nonqualifying securities activities can be transferred.

<u>Preserving Regulatory Roles Established by the Congress</u>. On a broader level, we also are concerned that several aspects of the rules appear to reflect an attempt by the Commission to regulate the <u>banking</u> activities of banks. For example, as I mentioned earlier, the interim final rules seek to limit the traditional trust, fiduciary, and custodial activities of banks and would indirectly give the Commission the ability to regulate the scope and nature of these activities. Similarly, there is language in the adopting release

concerning the networking exception that would appear to impose restrictions on employee bonus programs operated by banks in general, even where the affected employees have no connection with any networking arrangement established with a broker-dealer.

In addition, NASD Rule 3040, which is referenced in the preamble to the rules, purportedly provides the Commission and the NASD the authority to review all the securities activities engaged in by an employee who is both an employee of a bank and a broker-dealer, including those securities transactions that are conducted as part of the bank's traditional banking activities and protected by one of the GLB Act's exceptions. We anticipate that such dual employee arrangements will become more common, as banks seek to modify their activities to ensure compliance with the GLB Act. We believe that subjecting these activities, which the Congress has identified as part of the business of banking, to dual regulation by both the banking agencies and the SEC would be inconsistent with the principles of functional regulation and subject banks to unnecessary and duplicative regulation.

Conclusion

The Board believes that the manner in which the bank securities provisions of the GLB Act are implemented is critically important to the ability of banks to continue to provide high-quality banking services to their customers. We appreciate the steps the SEC has taken to extend the public comment period on the interim final rules and delay the effective date of the rules and the statute. However, the Board believes that significant substantive changes must be made to the interim final rules so that they reflect the words of the statute and the intention of the Congress. The Board stands ready to work with the SEC and the banking industry in revising the interim final rules.

STATEMENT OF

WILLIAM F. KROENER, III
GENERAL COUNSEL
FEDERAL DEPOSIT INSURANCE CORPORATION

on

TITLE II OF THE GRAMM-LEACH-BLILEY ACT OF 1999

before the

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT-SPONSORED ENTERPRISES

and the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

August 2, 2001
Room 2128, Rayburn House Office Building

Chairman Baker, Chairman Bachus, Ranking Members Kanjorski and Waters, and Members of the Subcommittees, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the implementation of Title II of the Gramm-Leach-Bliley Act of 1999 (GLB Act). My testimony today will discuss our view of the interim final rules promulgated by the Securities and Exchange Commission (SEC) to implement the bank broker-dealer exceptions set forth in Title II. Our view of the SEC's rules is additionally reflected in the interagency comment letter to the SEC, dated June 29, 2001, from the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the FDIC (collectively, the banking agencies).

The FDIC is heartened that the SEC recently decided to extend the deadline for compliance until May 12, 2002. We hope that the SEC will use this time to carefully study and listen to the comments of the banking agencies and the banking industry. We believe that a more open process will produce rules that are consistent with the intent and requirements of the GLB Act without imposing undue burden on the banking industry.

The FDIC is concerned that the SEC's interim final rules would force many banks that in fact satisfy the statutory exceptions in Title II of the GLB Act to move major lines of business out of the bank, i.e., "push out" the activities — the exact opposite of what the law intended. As you know, Title II was a carefully crafted legislative compromise intended to permit banks to continue certain lines of traditional bank business. The SEC's interim rules would effectively overturn this compromise. The adverse impact of the interim final rules would be especially painful for hundreds of community banks that do not have SEC-registered broker-dealer affiliates. These banks provide important trust and custody services to their communities. If the SEC's interim final rules stand as currently drafted, customers of community banks might lose these important services.

Bank Broker-Dealer Exceptions in Title II

Prior to the enactment of the GLB Act, banks were completely exempt from the definitions of "broker" and "dealer" under the Securities and Exchange Act of 1934 (Exchange Act). With the increasing involvement of banks in broader securities activities, the GLB Act eliminated this exemption, instead providing specific exceptions from the "broker" and "dealer" definitions in the Exchange Act. These exceptions were intended to permit banks to continue providing trust, custody and safekeeping, sweep accounts, asset-backed securities, and other specified traditional banking products and services in the bank itself. The Conference Report to the GLB Act notes that Congress enacted these exceptions "to facilitate certain activities in which banks have traditionally engaged." Congress also expressed concern throughout the legislative history that in implementing these exceptions the SEC "not disturb traditional bank trust activities." Based on the latest data available to the banking agencies, over 2,000 depository institutions currently engage in trust activities with more than $22 trillion of assets under administration held in 27 million accounts.

Reflecting the functional regulation imperatives in the GLB Act, Congress enacted Section 204 of the GLB Act, which directs the banking agencies to adopt recordkeeping requirements for banks that rely on the broker-dealer exceptions. Section 204 also requires the banking agencies to provide the SEC, at its request, any records maintained by a bank pursuant to the agencies' recordkeeping regulations. Since the Congress granted no similar statutory authority to the SEC, this requirement serves as the sole method for the SEC to obtain records of banks' compliance with the broker-dealer exceptions. Section 204 states that the recordkeeping requirements established by the banking agencies "shall be sufficient to demonstrate compliance [by banks] with the terms of such exceptions and be designed to facilitate compliance with such exceptions."

SEC's Issuance of its Interim Final Rules

The SEC published its interim final rules implementing various bank broker-dealer exemptions in Title II in the Federal Register (66 FR 27760) of May 18, 2001, without any prior notice to the banking agencies of their form or content. In these rules, the SEC sought to clarify various statutory exceptions in Title II. However, the banking agencies believe that the SEC went further by imposing numerous burdensome conditions on the use of the exceptions by banks and added certain exemptions that included extensive conditions that minimize banks' ability to make any meaningful use of those exemptions.

In the interim final rules, the SEC imposed a compliance deadline of October 1, 2001, on all non-compensation requirements in the rules, and a compliance deadline of January 1, 2002, for the compensation requirements in the rules. On July 18, 2001, the SEC issued a press release that extended the compliance deadlines in its interim final rules until May 12, 2002. We expect that when the SEC issues its final rules, it will provide for an effective date of at least one year after the date of the rules' publication for purposes of compliance by banks.

Response to SEC's Interim Final Rules

The SEC's interim final rules in effect significantly revise the statutory language in Title II and disregard Congressional intent regarding various statutory exceptions. The FDIC's principal concerns regarding various statutory exceptions in Title II covered under the interim final rules are the following:

1. **Trust and Fiduciary Exception.** Of greatest concern to the FDIC and the other banking agencies are the provisions of the SEC interim final rules that implement the statutory exemption for traditional trust and fiduciary activities of banks (the Trust and Fiduciary Exception). The FDIC believes many of these provisions conflict with the statutory language of the GLB Act and significantly interfere with the traditional trust and fiduciary activities of banks. These activities are a key component of the business of banking for most banks (including hundreds of community banks), have long been offered to bank customers without significant securities-related problems, and are already regularly examined by bank examiners for compliance with trust and fiduciary principles that provide strong customer protections.

The Trust and Fiduciary Exception broadly authorizes a bank, without registering as a broker-dealer, to effect securities transactions in a trustee capacity. The bank also may effect securities transactions 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. This exception is effective so long as the bank is "chiefly compensated" for the securities transactions that it effects for its trust customers on the basis of certain fees set forth in the statute (referred to as "relationship compensation" in the SEC's interim final rules). In addition, the Trust and Fiduciary Exception prohibits banks from publicly soliciting brokerage business except in conjunction with advertising its other trust activities.

The SEC's interim final rules provide that a bank meets the GLB Act's "chiefly compensated" requirement only if, on an annual basis, the amount of the relationship compensation received by the bank from <u>each</u> trust account exceeds the sales compensation received by the bank from that account. We do not believe an account-by-account calculation of compensation is consistent with the GLB Act. The plain language of the Act requires only that the bank be chiefly compensated for the securities transactions that it effects for all of its trust customers from the fees set forth in the statute. The FDIC and the other banking agencies believe the GLB Act's "chiefly compensated" condition cannot be interpreted to require a higher percentage than 50 percent of its fees, measured in aggregate terms, from its trust and fiduciary accounts from the types of revenues specified in the Act.

The FDIC is especially concerned that the provision in the SEC's interim final rules which requires banks to track the compensation received from all trust customers on an account-by-account basis will impose significant burdens on banks. Most banks currently do not have the systems in place to track the compensation received from the trust activities on an account-by-account basis and would incur significant compliance expenses in order to meet the SEC's rules that we do not believe are required by the statute. These costs likely would be passed on to trust customers in the form of higher fees. The practical effect of the SEC's interpretation and the potentially severe consequences of noncompliance will cause many banks — especially small community banks — to discontinue providing securities services that they have long offered as part of their traditional trust operations. We do not believe the Congress intended this harsh result.

In recognition of the significant regulatory burdens that the SEC's "chiefly compensated" requirements will impose on banks, the SEC did adopt an exemption in its interim final rules (Rule 3a4-2). That exemption apparently is intended to permit banks to avoid calculating their compliance with the "chiefly compensated" requirement on an account-by-account basis. However, the exemption itself requires a bank to comply with equally burdensome conditions. For example, the bank must maintain procedures to demonstrate that the "chiefly compensated" requirement is met when compensation arrangements for the account are changed and when sales compensation received from the account is reviewed by the bank for determining any employee's compensation. The most restrictive of these SEC-imposed conditions is a requirement that a bank relying on the exemption must ensure that during any year the sales compensation received from all trust accounts does not exceed 10 percent of relationship compensation received from such accounts. The statute does not impose such a limitation; thus, the SEC's action would artificially constrain this revenue source.

Numerous other aspects of the interim rules appear to conflict with either the provisions of the statute or Congressional intent or both. Regarding the scope of the term "trustee capacity" as used in the Trust and Fiduciary Exception, the SEC, in its preamble to its interim final rules, asserts that there is uncertainty concerning whether banks acting as an indenture trustee, or as a trustee for ERISA plans or individual retirement accounts (IRAs), are "trustees" for purposes of the Trust Exception. The FDIC disagrees with the interpretation of the SEC that there is any ambiguity concerning the scope of that term. Congress designed the "trustee capacity" definition on the basis of a long-standing Federal regulation covering bank fiduciary activities (12 C.F.R. Part 9). The plain meaning of the term encompasses all relationships in which a banks acts as a trustee under applicable Federal and state law. A bank acts in such a capacity when it is named as trustee by written documents that create the trust relationship under applicable law. There is no indication that Congress intended to grant the SEC broad authority to review specific types of trustee services provided by banks to determine whether such relationships constitute a "trustee" relationship for purposes of the GLB Act's bank broker-dealer exceptions. The SEC's position on this matter could result in unnecessary uncertainty by bank customers involving the status of such trust relationships as self-directed personal trusts, charitable foundation trusts, insurance trusts and rabbi and secular trusts.

For purposes of qualifying under the Trust and Fiduciary Exception, the GLB Act provides that a bank acts in a "fiduciary capacity" when it acts "as an investment adviser if the bank receives a fee for its investment advice." The SEC's interim final rules, however, provide that a bank will qualify as acting in an investment advisory capacity for purposes of this Exception only if the bank provides "continuous and regular" investment advice to the customer's account that is based upon the individual needs of the customer, and owes a duty of loyalty to the customer (arising out of state or Federal law, contract, or customer agreement). The FDIC believes that there is no basis in the GLB Act for additional conditions that the SEC has imposed on its definition of "fiduciary capacity" regarding the fee-based investment adviser activities of banks. In particular, the "continuous and regular" requirement in the SEC's interim final rules is overly broad and would prevent banks from relying on the Trust and Fiduciary Exception even in circumstances where the statutory test for such investment advice is met.

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 preamble to the SEC's interim final rules provide that "all aspects" of the securities transactions conducted by a bank for its trust and fiduciary customers must be conducted in a part of the bank that is regularly examined by bank examiners for compliance with fiduciary principles and standards. In the preamble, the SEC also suggests that such areas include any area that facilitates the execution of a securities transaction, handles customer funds and securities, or prepares and sends confirmations for securities transactions (other than for the executing broker-dealer).

The SEC's "all aspects" test conflicts with the delegation of various functions involving fiduciary activities under state trust law. Under state trust law, banks that conduct fiduciary activities may delegate securities processing and settlement activities to a separate department or affiliate that is responsible for all of the bank's back-office securities settlement and processing tasks. Many banks, and particularly small banks, also outsource processing, settlement and other back-office functions to third parties because the bank cannot achieve the economies of scale to provide such services directly to their customers on a cost-effective basis. While these separate bank departments, affiliates or third party providers may be subject to examination by bank examiners, they do not themselves have fiduciary relationships with customers and accordingly, may not be regularly examined for compliance with fiduciary principles and standards.

As described in the June 29, 2001, comment letter from the banking agencies to the SEC, the FDIC also has various problems with the SEC's inclusion of Rule 12b-1 fees from ERISA plans, certain service fees from mutual funds, and certain finders' fees as "sales compensation" for purposes of the "chiefly compensated" standard in the Trust and Fiduciary Exception.

2. <u>Custody and Safekeeping Exception</u>. Another primary concern of the FDIC and the other Federal banking agencies involves the SEC's treatment of the GLB Act's safekeeping and custody exception from the definition of "broker" and "dealer" in the Exchange Act (the Custody and Safekeeping Exception). The Custody and Safekeeping Exception as enacted in the GLB Act permits a bank, without registering as a "broker" under the Exchange Act, to engage in various custodial- and safekeeping-related activities "as part of its customary banking activities." The activities expressly permitted by the statute include (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 Individual Retirement Account (IRA), pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan. This Exception also allows banks to engage in other activities as part of their customary safekeeping and custody operations, such as facilitating the transfer of funds or securities as a custodian or clearing agency, effecting securities lending and borrowing transactions for customers, and holding securities pledged by a customer.

The FDIC strongly disagrees with the SEC's position in the interim final rules that the Custody and Safekeeping Exception does not permit banks to accept securities orders for their custodial IRA customers, for 401(k) and benefit plans that receive custodial and administrative services from the bank, or as an accommodation to custodial customers. The SEC's interpretation is not consistent with the GLB Act, its legislative history, or the purposes of the Custody and Safekeeping Exception. As a result, the SEC's interpretation will improperly interfere with core banking activities that Congress intended to protect and will impose unnecessary costs on consumers, including securities execution services to self-directed IRA accounts for which the bank acts as custodian. Applicable Internal Revenue Service regulations generally require that a bank serve as trustee or custodian for an IRA, and many banks offer self-directed custodial IRA services to their customers.

Banks as part of their customary banking activities effect securities trades as an accommodation to their custodial customers and generally only upon the order of the customer and on an incidental and infrequent basis. Because these services are customarily provided only as an accommodation to custodial accounts, banks typically seek to recover only the costs incurred in placing the trade for the customer.

Although the SEC's interim final rules also include two SEC-granted exemptions for custodial-related transactions, these exemptions are subject to numerous burdensome conditions that make the exemptions of little benefit. More fundamentally, these exemptions impose newly created SEC conditions on bank activities that Congress determined to be protected under the Custody and Safekeeping Exception. For example, one of the SEC-granted exemptions would allow small banks (generally defined as under \$100 million in bank assets) to conduct securities order-taking under the Custody and Safekeeping Exception solely for effecting transactions in securities of SEC-registered mutual funds in an IRA account (not a 401(k) account) for which the bank acts as custodian. This small bank exemption would not cover order-taking for individual securities or bonds purchased by the bank custodian for its customers and would be subject to numerous conditions, including that (1) the bank's total compensation relating to effecting securities pursuant to this exemption would be less than three percent of its annual revenue, (2) the bank is not associated with a broker-dealer, (3) the bank must not have a networking arrangement with a broker-dealer as expressly permitted under the Networking Exception of the GLB Act, and (4) various restrictions on advertising and bank employee compensation. The restrictions in this SEC-granted exemption would functionally prohibit a bank from advertising its permissible private placement, sweep account, municipal securities, stock purchase plan or networking activities.

Another of the SEC-granted exemptions from its prohibition on securities order-taking under this Exception also would prohibit a bank from directly or indirectly receiving any compensation for effecting securities transactions. In addition, the SEC would impose burdensome advertising and employee compensation restrictions on banks as a result of this exemption. We believe that this exemption would direct banks to provide customary banking services at a loss and would conflict with the Congressional intent to preserve securities order-taking as part of the Custody and Safekeeping Exception.

3. Networking Exception. The GLB Act permits banks to enter into arrangements with registered broker-dealers to offer brokerage services to bank customers provided the "networking" arrangement meets certain requirements set forth in the Act (Networking Exception). One of the requirements in the Networking Exception is that bank employees (other than employees also employed by the broker-dealer who are registered with the NASD or another self-regulatory organization) are prohibited from receiving "incentive compensation," except that a bank employee may receive compensation for the referral of any customer "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."

In the SEC's interim final rules, the Commission interpreted the statutory term "nominal one-time cash fee of a fixed dollar amount" to be limited to only (1) payments that do not exceed one hour of the gross cash wages of the bank employee making the referral; or (2) points in a system or program that covers a range of bank products and non-securities related services where the points count toward a bonus that is cash or non-cash if the points (and their value) awarded for referrals involving securities are not greater than the points (and their value) awarded for activities not involving securities. In addition, the SEC's interim final rules state that referral fees cannot be paid in the form of bonuses.

The FDIC and the other banking agencies are concerned that the SEC's interpretation of the statutory term "nominal one-time cash fee of a fixed dollar amount" imposes unnecessary limitations on the securities referral programs of banks that are not required by statute. In enacting this referral compensation standard in the Networking Exception, Congress relied, in part, on prior SEC precedents regarding networking arrangements by banks and savings associations which did not involve the types of restrictions on bonus programs and referral fees as those contained in the SEC's interim final rules. The FDIC is concerned that the SEC's excessively restrictive interpretation of the statutory referral compensation standard will inappropriately limit the discretion of the banking agencies to apply the statutory standard on a case-by-case basis to securities or insurance sales activities of banks.

We believe that the restriction in the interim final rules that a payment not exceed one hour of the gross cash wages of the unregistered bank employee making the referral is unworkable. Banks often offer all of their employees, regardless of the level of their compensation, the same nominal award value for referring securities customers. Under the interim final rules, banks will be forced to incur increased burden because a separate referral fee calculation now will be required for each employee who makes a referral, and adjustments in an employee's salary or wages would need to be tracked. Additional administrative burden not required by the statute and not involving securities transactions would be imposed on banks through the requirement that the securities-related referral points have a value that is no greater than the points received under the system for any other product or service.

The SEC's interim final rules also provide that banks are prohibited from indirectly paying their unregistered bank employees incentive compensation for securities transactions through a branch, department, or line of business or through a bonus program related to the securities transactions of a branch, department or line of business. This language is drafted so broadly that it would appear to prevent a bank with a networking arrangement from paying any officer a bonus based on the success of a department or line of business that engages in securities transactions even in the event that employee, department or line of business has no connection with the networking arrangement.

The interim final rules also mandate that securities referral fees may not be related to (1) the size or value of any securities transaction, (2) the amount of securities-related assets gathered, (3) the size or value of any customer's bank or securities account, or (4) the customer's financial status. This requirement is not contained in the statutory language of the Networking Exception. The statute only prohibits a nominal referral fee if it is "contingent on whether the referral results in a transaction." These additional SEC-imposed conditions have been arbitrarily established and are unnecessary given the existing “incentive compensation” standard.

4. Other Statutory Exceptions Treated in the SEC's Interim Final Rules. The banking agencies' comment letter to the SEC covers various problems with the SEC's treatment of the broker exception for no-load sweep accounts, the dealer exception for asset-backed securitization activities, and the broker exception for transactions with affiliates. The FDIC continues to support the position taken in the banking agencies' comment letter to the SEC that the interim final rules' treatment of those statutory exceptions conflicts with the statutory language of the GLB Act and Congressional intent and would render those exceptions to be of no functional benefit to long-standing commercial services provided by banks for their customers.

Conclusion

The FDIC commends the Subcommittees for focusing attention on the significant impact of the SEC's interim final rules on the banking industry. The SEC's final interim rules as currently drafted mandate restrictions that effectively negate the intent of Congress and the statutory language designed to preserve traditional trust, fiduciary, and custodial activities of banks. If the interim final rules force traditional trust activities out of banks, customers will have fragmented relationships with their chosen trustee and a third-party broker-dealer.

We appreciate the SEC's recent press release that extended the compliance deadlines in the interim final rules until May 12, 2002. Given the profound impact of the SEC's interim final rules on the functional regulation of the securities activities of banks, we propose that the SEC provide a meaningful dialogue with the banking agencies to produce a final rule that significantly limits any unnecessary termination of traditional banking services to communities and consumers.

TESTIMONY OF

ELLEN BROADMAN

DIRECTOR, SECURITIES AND CORPORATE PRACTICES DIVISION

OFFICE OF THE COMPTROLLER OF THE CURRENCY

before the

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

and the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

August 2, 2001

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent those of the President.

Chairman Baker, Chairman Bachus, Ranking Members Kanjorski and Waters, and Members of the Subcommittees, thank you for this opportunity to discuss the Securities and Exchange Commission's (Commission's) recent Interim Final Rules (Rules) implementing the bank broker-dealer exemptions under Title II of the Gramm-Leach-Bliley Act of 1999. The OCC appreciates the Subcommittees' efforts to review the significant issues the Commission's Rules raise.

To begin, I commend the Commission for its recent actions on the Rules. The Commission's decision on July 18, 2001, to extend the time for banks to comply with the rules was a constructive first step. We also welcome and view as essential the Commission's commitment to further extend the compliance date once final rules are adopted to give banks sufficient time to comply with changes. We are especially pleased that the Commission anticipates amending the Rules after considering public comments.

The OCC, Federal Reserve Board and Federal Deposit Insurance Corporation (Banking Agencies) provided the Commission with comments on the Rules. As you requested, our testimony below briefly describes the reasons we decided to file joint comments and highlights a few of the areas of concern. Those comments provide a more comprehensive discussion of significant substantive concerns the Banking Agencies had with the Rules, and are attached to this testimony. We offer this summary with the understanding that the Commission has recognized the need to make changes to the Rules. The Banking Agencies are currently working together to provide additional specific recommendations to the Commission. We look forward to working with the Commission in developing Rules that are workable for banks and consistent with the Gramm-Leach-Bliley Act and congressional intent. We appreciate the Subcommittees' support for such a collaborative approach.

Banking Agencies' Concerns

The Banking Agencies provided comments to the Commission because of the significant issues the Rules raise. We are concerned that the Rules create unworkable requirements that would force banks to discontinue traditional banking activities Congress intended to preserve under the GLB Act. We also are concerned that the Rules would significantly disrupt longstanding relationships between banks and their customers, restrict customer services, and increase customers' costs. We believe this result is unnecessary and inconsistent with the intent expressed by Congress in enacting these provisions. We strongly encourage the Commission to address our concerns in revising the Rules.

Trust and Fiduciary Activities

One area of particular concern is how the Rules would implement the trust and fiduciary exemption. Congress adopted this exemption to permit banks to continue providing the types of trust and fiduciary services banks have traditionally offered customers, subject to existing regulatory protections.[1] In response to concerns that banks might use the exemption to operate full scale retail brokerage operations, Congress required banks to be "chiefly compensated" for trustee and fiduciary related transactions on the basis of non-brokerage related fees and to not publicly solicit brokerage business.

To qualify for this exemption, the Interim Final Rules require banks to conduct an account-by-account review for each trust or fiduciary account and establish for each account that the bank is "chiefly compensated" by specified fees.[2] We believe this approach is enormously burdensome for banks and creates serious practical difficulties, particularly as applied to banks' multi-faceted trust and fiduciary services and multi-party trust and fiduciary relationships. Banks do not have systems to compute the complex calculations required for each account under the Rules and would be required to expend enormous resources to restructure their operations to meet this requirement. A single account that fails to meet a technical requirement under the Rule could cause banks to become an unregistered broker-dealer subject to considerable liabilities under the Exchange Act. Some banks would be forced to discontinue providing brokerage services to trust and fiduciary customers who have chosen to do business with the banks.

Our comments, therefore, recommend that the chiefly compensated limit be applied on an aggregate basis to the bank's trust and fiduciary activities, and not on an account-by-account basis.

Under the Rules, a bank meets the "chiefly compensated" requirement if its "relationship compensation" exceeds its "sales compensation" from each account on an annual basis. Unfortunately the Rules create a unique definition of "relationship compensation" that excludes legitimate, long-recognized forms of fiduciary compensation. Thus, even when a bank is predominately compensated for its services through traditional fiduciary fees, the bank may not meet the "chiefly compensated" test under the Rules. In such cases, banks will be ineligible for the statutory exemption and unable to continue providing customers certain trust and fiduciary services.

We believe the above provisions and the other requirements in the Rule would seriously disrupt traditional trust and fiduciary activities, contrary to congressional intent.

Trustee Capacity

As noted above, the GLB Act expressly provides an exemption when banks effect transactions in a "trustee" capacity. The Interim Final Rules suggest there is "uncertainty" concerning whether banks acting as ERISA, IRA or indentured trustees are "trustees" under this exemption, and grant a special exemption to resolve this ambiguity.

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[1] This exemption is particularly important since State laws generally permit banks and trust companies, but *not* broker-dealers, to act as trustees.

[2] Although the Rules provide an exemption from the account-by-account calculation requirement, provisions in the exemption effectively require an account-by-account calculation of compensation.

We believe the Commission's narrow view of the term "trustee" is inconsistent with the plain language of the GLB Act and casts a cloud over a wide range of other trust relationships banks have with their customers. We recommend that the Commission instead interpret the term "trustee" consistently with its plain and ordinary meaning, which would eliminate the need for the "special exemption" in the Rules.

Investment Advice for a Fee

As described above, the GLB Act provides an exemption for banks acting in a fiduciary capacity. Our comments express concern that the Rules exclude from the fiduciary exemption activities that the GLB Act expressly includes within the term "fiduciary capacity." For example, the GLB Act specifically provides that a bank acts in a "fiduciary capacity" when the bank offers investment advice for a fee. That statutory language tracks the banking agencies' definition of "fiduciary capacity" which also includes investment advice for a fee.[3] The Interim Final Rules add new requirements, such as that the investment advice must be "continuous" and "regular", that are not included in the statute and that differ from the banking agencies' definition of "fiduciary capacity." Banks that offer investment advice for a fee, and do not meet those requirements, will be forced to discontinue offering transaction services to their customers. We believe the Commission should develop a definition of "fiduciary capacity" that is consistent with the definition in banking regulations and permit banks to continue conducting the fiduciary services covered by the plain language of the statutory exemption.

Custody and Safekeeping Activities

Custody and safekeeping activities, like trust and fiduciary activities, are part of the core business of banking. Congress created a custody and safekeeping exemption to allow banks to provide the full range of custody and safekeeping activities they traditionally provided "as part of customary banking activities."[4] Bank custodians have a long-standing history of accommodating customers by accepting and transferring orders for securities to a registered broker-dealer. Nonetheless, the Interim Final Rules do not include customary custodial order-taking services within the exemption.

The Interim Final Rules create special exemptions that are unnecessary if order-taking services to customers fall within the custody and safekeeping exemption. One of these special exemptions permits bank custodians to continue providing customary order taking services if they do not charge *any fees* for the service. Our comments expressed concern that this restriction will cause banks either to stop offering this service, or to move custodial activities outside the bank, contrary to the statutory language and

[3] 12 C.F.R. § 9.2(e).

[4] GLB Act, Section 201(4)(B)(viii)(I), 15 U.S.C. § 78c(a)(4)(B)(viii)(I).

congressional intent.[5] This would deny customers the convenience and choice of placing orders through their chosen bank custodian.

We believe the Commission should instead include order taking within the custody and safekeeping exemption.

Networking

National banks may establish arrangements with registered broker-dealers to offer brokerage services to bank customers on or off bank premises ("networking arrangements"). Under the GLB Act, a bank employee may receive a nominal one-time cash fee of a fixed dollar amount for referring customers to a broker-dealer under a networking arrangement. The Interim Final Rules define "nominal" in a manner that imposes new requirements on the amounts and manner banks may compensate their employees that create practical and operational difficulties for national banks, and effectively negate for many banks the availability of the specific statutory provision allowing for referral fees.

Other Areas of Concern

Our letter also describes in detail serious concerns with other areas, including affiliate transactions, sweep accounts, and supervision of dual employees. We also express particular concern with provisions that unduly restrict the ability of banks to sell their loans through asset-securitization to qualified investors.[6] We believe those exemptions should not be implemented in a manner that denies banks the ability to use the exemptions or disrupts longstanding bank relations with customers who have chosen to do business with the banks.

Concerns with Process

Our letter also expressed concern with the process that the Commission employed in adopting the Rules. The Commission issued the Rules without the benefit of the normal notice and public comment process. Further, the Commission's decision to use Interim Final Rules with an immediate effective date, coupled with exemptions that only temporarily suspend the Rule's effectiveness, placed banks in an untenable position. Without knowing how the Rules would be changed, banks were required to take immediate steps to comply with the Rules by the effective date. Our comment letter urged the Commission to review public comments *before* establishing final rules and then grant banks a sufficient time period to bring their operations into compliance. We appreciate the Commission's response in which it pledged to address these problems.[7]

[5] The other exemption applies only to small banks and includes numerous burdensome restrictions.

[6] By selling loans, banks are able to enhance their liquidity and expand the amount of credit they can offer to meet community, business and individual needs.

[7] Once the Commission adopts final Rules, the Banking Agencies will proceed in adopting record-keeping requirements under the GLB Act.

Conclusion

The Banking Agencies provided comments to the Commission because of the significant issues raised by the Rules. The Commission has taken a positive step by extending the dates for compliance, and acknowledging that the Rules must be amended after careful consideration of the comments. We stand ready to provide assistance to the Commission in this process.

We thank the Subcommittees again for this opportunity to express our views, and for its attention to this issue.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
FEDERAL DEPOSIT INSURANCE CORPORATION
OFFICE OF THE COMPTROLLER OF THE CURRENCY

June 29, 2001

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

Re: Interim Final Rules for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 (the "Exchange Act"), Release File No. S7-12-01 ("Interim Final Rules")

Dear Mr. Katz:

The Federal Reserve Board, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency ("Banking Agencies") appreciate this opportunity to provide comments on the Interim Final Rules issued by the Securities and Exchange Commission (the "Commission" or "SEC"). In brief, we have very serious concerns about the validity and content of a number of provisions of the Interim Final Rules, as well as the process the Commission employed to issue them.

The Interim Final Rules implement provisions of the Gramm-Leach-Bliley Act ("GLB Act") that eliminate the blanket exemptions for banks from the definitions of "broker" and "dealer" under the Exchange Act, and replace those exemptions with more specific activity-focused exemptions. Congress designed the new exemptions to permit banks to continue providing trust, fiduciary, custodial, and other traditional banking services to meet customers' financial needs.

The Interim Final Rules, however, are, in a number of critical respects, contrary to the express statutory language in the exemptions and congressional intent. The Interim Final Rules also create an extremely burdensome regime of overly complex, costly and unworkable requirements that effectively negate the statutory exemptions and the congressional intent underlying those exemptions. By regulating and restricting banking operations, the Rules adopt an approach that is fundamentally inconsistent with the principles of functional regulation that underlie the GLB Act.

As we discuss in more detail in the attached Appendix, the Interim Final Rules are premised on misunderstandings of how certain activities are conducted by banks. As a result, the Rules will significantly disrupt and may force discontinuation of major lines of business for banks and longstanding relationships with their customers. Because of the complexity and numerous non-statutory conditions imposed by the Rules, the Rules will also impose substantial additional costs on banks. As a result, customer costs may increase. These consequences of the Rules are wholly unwarranted given longstanding customer protections provided under federal and state banking and fiduciary laws, and congressional recognition that banks have provided these services "without any problem for years."[8]

The Interim Final Rules also were issued without the benefit of the normal notice and public comment process. This is a particular concern because our agencies advised Commission staff of the significant practical operational implications of potential approaches to implementing the revised exemptions. We specifically urged that understanding and resolution of those issues could be greatly aided by an open process of public comment on a proposal. Given the magnitude of the impact of the Rules on the traditional practices of banks and on bank customers, we believe that the process used by the Commission of publishing Interim Final Rules without first receiving the benefit of public comment is fundamentally unfair and inconsistent with sound administrative practice.

Moreover, use of Interim Final Rules with an immediate effective date, coupled with exemptions that function only to *temporarily* suspend the Rules' effectiveness, places banks in an untenable position. Although the Rules require substantial modification, banks must take steps now to comply with them by the effective date, since they have no way of knowing how or when the Rules may be changed. We believe it is wrong to require banks to establish procedures to comply with the Interim Final Rules before the Commission has reviewed public comments and addressed the significant concerns raised by the Banking Agencies and the banking industry.

Given the critical flaws in the Interim Final Rules and their impact, we strongly urge the Commission to take steps immediately to formally treat the Interim Final Rules as proposed rules and take the steps necessary to address the concerns outlined in this letter, the attached Appendix and public comments. In addition, because of the fundamental unfairness of requiring banks to conform to costly requirements that need to be revised substantially, we believe that the Commission should immediately further extend the effective date of the GLB Act's push-out provisions until after the proposed rules are issued as final rules. We also believe that the Commission should provide banks at least a one-year transition period after the revised rules become final to bring their operations into compliance with those new rules.

Our major concerns with the Interim Final Rules are summarized below, and are set forth in detail in the attached Appendix.

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[8] S. Rep. No. 106-44 at 10 (1999).

I. Background

The GLB Act provides specific exemptions from the broker and dealer definitions that permit banks to continue providing trust and fiduciary, custody and safekeeping, asset-backed securities, and other specified traditional banking products and services. In enacting these exemptions, Congress recognized that banks have the expertise and customer relationships that make them uniquely qualified to provide these products and services. Congress also recognized that banks have provided these products and services effectively, under applicable regulatory requirements, for years. As noted in the Conference Report, the GLB Act provides specific exemptions for banking activities from broker-dealer requirements to "facilitate certain activities in which banks have traditionally engaged." Congress also expressed its expectation, "that the Commission will not disturb traditional bank trust activities."[9]

II. Trust and Fiduciary Activities

The Interim Final Rules are contrary to the GLB Act's exemption for trust and fiduciary activities because they impose unworkable requirements not found in the statute that effectively negate the availability of the exemption for many banks. This result also is directly contrary to congressional intent that traditional bank trust and fiduciary activities not be disturbed by the Commission's rules. [10] Trust and fiduciary products and services have long been offered to bank customers subject to comprehensive legal requirements that offer extensive customer protections. Bank examiners regularly examine these activities for compliance with trust and fiduciary principles. In light of the extensive regulation of bank trust and fiduciary activities, Congress adopted the exemption to permit banks to continue providing these traditional customer services.[11]

The Interim Final Rules also fail to recognize the fundamental reality of the trust business. State laws typically limit which corporations may serve as trustees. Banks and trust companies, but not broker-dealers, generally are authorized to act as trustees subject to a comprehensive regulatory scheme under state and Federal law. If the Interim Final Rules force trust activities out of banks, customers will have fragmented relationships with their chosen trustee and a third-party broker-dealer, and be burdened with additional

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[9] *See* H.R. Conf. Rep. No. 106-434 at 163, 164 (1999).

[10] *Id. See also* S. Rep. No. 106-44 at 10 (1999).

[11] The Senate Report states "Banks have historically provided securities services largely through their trust departments, or as an accommodation to certain customers. Banks are uniquely qualified to provide these services and have done so without any problems for years. Banks provided trust services under the strict mandates of State trust and fiduciary law without problems long before Glass-Steagall was enacted; there is no compelling policy reason for changing Federal regulation of bank trust departments, solely because Glass-Steagall is being modified." S. Rep. No. 106-44 at 10 (1999).

costs that are unnecessary in light of the strong protections already afforded by the fiduciary requirements imposed on trustees.

A. Chiefly Compensated

Although Congress wanted to preserve traditional trust and fiduciary activities of banks, Congress did not want banks to circumvent the securities laws by operating a full-scale brokerage business through their trust departments. Congress addressed this concern through the exemption for trust and fiduciary activities by requiring a bank to be "chiefly compensated" for its trustee or fiduciary related transactions on the basis of non-brokerage related fees and by prohibiting the bank from publicly soliciting brokerage business. At the same time, Congress concluded that the trust and fiduciary laws and the oversight by Federal and state banking agencies provide sufficient consumer protection for banks that operate within the statutory standards. The Interim Final Rules, on the other hand, attempt to address the Commission's concern by unduly narrowing the limits on compensation a bank can receive from its trust and fiduciary accounts.

The language of the GLB Act and its legislative history suggest that the chiefly compensated limit should be applied on an aggregate basis to the bank's trust and fiduciary activities, and not on an account-by-account basis, to achieve its purpose.[12] The Interim Final Rules, however, require banks to conduct an account-by-account review, and establish for each individual trust or fiduciary account, that the bank is "chiefly compensated" by specified fees. This approach is inappropriate and, in many cases, unworkable as applied to banks' multi-faceted trust and fiduciary services and frequent multi-party trust and fiduciary relationships. Moreover, the Rules create a unique definition of compensation for purposes of the "chiefly compensated" computation that excludes legitimate, long-recognized forms of fiduciary compensation. These exclusions are nowhere found in the statute and will unnecessarily force banks to restructure existing customer relationships at great costs to both themselves and their trust and fiduciary customers.

B. Trustee Exemption

The GLB Act expressly provides that the exemption is available when banks effect transactions in a "trustee" capacity provided the bank complies with certain requirements. Despite the plain language of the GLB Act, the Interim Final Rules create ambiguity concerning the scope of this important term by suggesting that some parties treated as trustees under Federal and state law may be excluded from the definition of "trustees" for purposes of this exemption. This provision, too, is contrary to plain language and the clear intent of Congress to preserve traditional bank trust activities.

[12] *See* H.R. Rep. No. 106-74, pt. 3, at 164 (1999) (A "bank must be chiefly compensated for its trust and fiduciary activities" on the basis of the fees specified by the Act.) (*emphasis added*).

C. Investment Advice for a Fee

The Interim Final Rules also are contrary to the statutory language in the GLB Act that defines investment advice for a fee as a fiduciary activity. The plain language of the GLB Act establishes that banks providing investment advice for a fee fall within the trust and fiduciary exemption. These activities are explicitly defined as fiduciary under Federal banking regulations.[13] The Interim Final Rules here again devise a new, more constricted, definition not found in the statute. Under the Interim Final Rules, an investment advisor is engaged in fiduciary activities only if it provides continuous and regular investment advice to the customer's account and meets other additional requirements. This result also is contrary the literal words of the GLB Act and to congressional intent to preserve this longstanding fiduciary activity.

III. Custody and Safekeeping Activities

The Interim Final Rules also are contrary to the statute and legislative history of the GLB Act's exemption for custody and safekeeping activities because they exclude order-taking activities that are part of customary banking activities. Bank custodians have a long-standing history of accommodating customers by accepting and transferring orders for securities to a registered broker-dealer. The GLB Act includes an exception for safekeeping and custody services to preserve the traditional role of banks in providing customary custodial services for their customers, which customarily included order-taking. In enacting this exemption, Congress expressed clear intent that traditional custodial, safekeeping and clearing activities, including custodial IRA relationships, be allowed to remain within the bank.[14] Contrary to this statutory scheme and congressional intent, the Interim Final Rules do not include customary custodial order-taking services within the exemption.

The Interim Final Rules create two special exemptions that would not be needed if the Commission recognized that the Act permits banks to continue offering order-taking services to customers. One exemption permits bank custodians to continue providing customary order taking services if they do not charge <u>any fees</u> for the service. Neither the statute nor its legislative history provides any support for prohibiting banks from charging fees for their customary custody and safekeeping activities. This restriction will cause banks either to stop offering this service, or to move custodial activities outside the bank, contrary to the statute and congressional intent.[15]

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[13] 12 C.F.R. § 9.2 (e).

[14] The Senate Report states "the Committee believes that bank custodial, safekeeping, and clearing activities with respect to IRAs do not need to be pushed-out into a Commission registered broker-dealer." S. Rep. No. 106-44, at 10 (1999).

[15] The other exemption applies only to small banks and includes numerous burdensome restrictions.

IV. *Networking*

The Interim Final Rules are contrary to the statutory language of the GLB Act's exemption for networking because they create new limits on referral fees that are not found in the statute. The GLB Act specifically permits a bank employee to receive a nominal one-time cash fee of a fixed dollar amount for referring customers to the broker-dealer. The Interim Final Rules impose completely new requirements on the amount that may be paid for these referrals and the manner in which they may be paid that will effectively negate for many banks the availability of the specific statutory provision allowing for referral fees.

V. Cure Mechanism

The Interim Final Rules fail to address their effect on banks that discover some securities transactions do not comply with an exemption due to inadvertent errors or unforeseen circumstances. Banks that take reasonable steps and attempt in good faith to comply with the Rules may suffer unduly harsh and inappropriate consequences from minor infractions. For example, because some calculations required under the Rules are completed at year-end, a bank may not learn until then that a minor inadvertent error caused it to be out of compliance during the entire past year. Or, a single transaction that fails to meet a technical requirement under the Rules may cause a bank to become an unregistered broker-dealer, subject to considerable liabilities under the Exchange Act. The Banking Agencies believe it is critically important for the Commission to clarify that a bank will not be considered a broker-dealer if it has policies and procedures reasonably designed to comply with exemptions and attempts in good faith to conform to the exceptions. The Commission should offer the bank a reasonable period of time to bring its operations into compliance in these circumstances.

VI. *Recordkeeping Requirements*

Section 204 of the GLB Act explicitly directed the Banking Agencies to establish recordkeeping requirements for banks relying on the broker-dealer exemptions. Even so, the Commission solicits comments on whether it should issue these recordkeeping requirements. This proposal is contrary to the plain language of § 204, which specifically grants the Banking Agencies authority to establish these recordkeeping requirements.

VII. *Other Areas of Concern*

The Interim Final Rules also raise concerns in several other significant areas that are addressed in more detail in the attached Appendix. These areas include the exemptions for affiliate transactions, sweep accounts, asset-backed securities activities, and supervision of dual employees. Further, the failure of the Interim Final Rules to comply with the language and intent of the GLB Act raises serious questions about how the Commission may later interpret exemptions that are not addressed by the Rules. We believe it is imperative that the Interim Final Rules comport with the language and intent of the GLB Act provisions they address, so that banks know they may rely on the language and intent of other GLB Act provisions in conducting their activities.

VIII. <u>Conclusion</u>

In summary, we believe the Interim Final Rules are contrary to the plain language of the GLB Act and its legislative history in various critical respects. By imposing unnecessarily burdensome, costly and unworkable requirements, the Interim Final Rules effectively eliminate exemptions established by statute, disrupt existing customer relationships and force traditional banking activities out of banks, a result that Congress specifically sought to avoid. Given the magnitude of the issues presented and the extent of the impact of the Rules on major activities in the banking industry, we urge the Commission to take the steps described at the outset of this letter in order to faithfully implement the statute in accordance with its terms and legislative intent. Our agencies stand ready to provide the Commission with information concerning the traditional and customary activities of banks that Congress sought to protect and to work with the Commission and its staff to address the concerns expressed in this letter in order to develop rules that are consistent with both the spirit and language of the GLB Act.

Sincerely,

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

/s/
Donna Tanoue, Chairman
Federal Deposit Insurance Corporation

/s/
John D. Hawke, Jr.
Comptroller of the Currency

Appendix

**Comments of the Federal Reserve Board,
the Federal Deposit Insurance Corporation, and
the Office of the Comptroller of the Currency
Regarding the Interim Final Rules of
the Securities and Exchange Commission Concerning
the "Push Out" Provisions of the Gramm-Leach-Bliley Act**

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Statutory Exception for Trust and Fiduciary Activities

Of greatest concern to the Banking Agencies are the provisions of the Interim Final Rules that implement the statutory exception for traditional trust and fiduciary activities of banks ("Trust and Fiduciary Exception").[16] We believe many of these provisions are inconsistent with the language of the GLB Act and are based on a flawed view of the purposes of the Exception. As a result, the Interim Final Rules will achieve precisely what the exception was intentionally designed to avoid—a significant interference with the traditional trust and fiduciary activities of banks. These activities are a key component of the business of banking, have long been offered to bank customers without significant securities-related problems, and are already regularly examined by bank examiners for compliance with trust and fiduciary principles that provide strong customer protections.

The Trust and Fiduciary Exception broadly 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).[17]

The Act's compensation and advertising limitations were designed to prevent a bank from "conduct[ing] a full-scale securities brokerage operation in the trust department exempt from SEC regulation."[18] In this way, the limits sought to address the concerns that the Commission had voiced during the legislative process—that a banking organization would take advantage of the new affiliations permitted by the GLB Act to

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[16] 15 U.S.C. § 78c(a)(4)(B)(ii).
[17] See id.
[18] H.R. Rep. No. 106-74, pt. 3, at 164 (1999); see also S. Rep. No. 105-336 at 10 (1998)("The Committee believes that the House-passed version of H.R. 10 required too many activities to be 'pushed-out' of the bank and placed too many restrictions on the conduct of traditional banking services. Clearly, to the extent banks want to engage in full-service brokerage activities, such activities should be 'pushed-out' to an SEC-registered affiliate or subsidiary.")(emphasis added).

acquire a securities firm and then transfer the securities firm's brokerage activities into the bank's trust department to evade SEC regulation.[19]

At the same time, Congress clearly intended the Trust and Fiduciary Exception to protect the securities services that banks traditionally have provided their trust and fiduciary customers. The Conference Report for the GLB Act explicitly states that "[t]he Conferees expect that the SEC will not disturb traditional bank trust activities under this provision."[20] Similarly, the Senate Banking Committee Report provides:

> "The Committee does not believe that an extensive 'push-out' of or restrictions on the conduct of traditional banking services is warranted. Banks have historically provided securities services largely through their trust departments, or as an accommodation to certain customers. Banks are uniquely qualified to provide these services and have done so without any problems for years. Banks provided trust services under the strict mandates of State trust and fiduciary law without problems long before Glass-Steagall was enacted; there is no compelling policy reason for changing Federal regulation of bank trust departments, solely because Glass-Steagall is being modified."[21]

Importantly, Congress did not sacrifice customer protection by broadly protecting traditional bank trust and fiduciary activities, nor did it view SEC regulation as the only method of protecting investors. Rather, Congress recognized that trust and fiduciary customers of banks are already protected by well-developed principles of trust and fiduciary law and that banks' compliance with these standards is already subject to regular examination by the banking agencies.[22]

The Interim Final Rules also fail to recognize the fundamental reality of the trust business. State laws typically limit which corporations may serve as trustees. Banks and trust companies, but not broker-dealers, generally are authorized to act as trustees subject to a comprehensive regulatory scheme under state and federal law. If the Interim Final Rules force trust activities out of banks, customers will be forced to have a fragmented relationship with their chosen trustee and a separate broker-dealer, and be burdened with additional costs that are unnecessary in light of the strong protections already afforded customers by the fiduciary requirements imposed on trustees.

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[19] See *The Financial Services Act of 1998—H.R. 10: Hearing Before the Senate Committee on Banking, Housing and Urban Affairs*, 105th Cong. at 361 (1998)(Statement of Chairman Arthur Levitt)(Commission concerned that earlier versions of the GLB Act could have permitted banks "to operate full-service brokerage departments" out of the trust department).

[20] See H.R. Conf. Rep. No. 106-434 at 164 (1999) (emphasis added); see also H.R. Rep. No. 106-74, pt. 3, at 164 (GLB Act "provides an exception for bank trust activities, recognizing the traditional role banks have played in executing securities transactions in connection with their trust accounts.")

[21] S. Rep. No. 106-44 at 10 (1999); see also S. Rep. No. 105-336 at 10 (1998).

[22] In fact, one of the fundamental purposes of the Exchange Act was to subject nonbank stockbrokers and securities traders to the type of government supervision and examination that was already mandated for banks. See American Bankers Assoc. v. SEC, 804 F.2d 739, 745 (D.C. Cir. 1986).

The Banking Agencies' examiners regularly examine the trust departments of banks, as well as other bank departments that conduct fiduciary activities (e.g., private banking and asset management departments), to ensure that the bank has implemented effective processes to ensure compliance with applicable fiduciary principles and the terms of the trust or other agreement creating the fiduciary relationship. As part of these examinations our examination staffs review –

- The processes and controls used by the bank to recommend investments to the bank's discretionary and non-discretionary fiduciary accounts, including whether recommended investments are consistent with the terms of the governing instrument and the customer's investment objectives, the bank's guidelines for the diversification of trust investments, and the depth of the bank's investment analysis;

- The effectiveness of the bank's policies and procedures for preventing self-dealing and other conflicts-of interest, including inappropriate trading practices, the allocation of brokerage transactions and the use of inside information;

- The qualifications of bank employees engaged in trust and fiduciary activities to ensure that such employees have the appropriate training, education and background to fulfill their duties in a manner consistent with law;

- The operational and procedural controls utilized by the bank to ensure compliance with law and applicable fiduciary principles, including procedures designed to ensure the proper separation of duties, segregation of trust assets from the bank's own assets, and authorization of all securities trades; and

- The bank's compliance with applicable securities-related rules, including the Banking Agencies' detailed recordkeeping and trade confirmation rules for securities transactions (12 C.F.R. Part 12 (OCC); Part 208 (Board); and Part 344 (FDIC)) and the SEC's rules concerning bank transfer agents and the forwarding of proxies and shareholder communications.

These examinations frequently are conducted by specially designated examination personnel who have received special training in trust and fiduciary law and practice, and the Banking Agencies have developed extensive training and examination manuals to assist all examiners in reviewing the trust and fiduciary activities of banks.[23] For large,

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[23] See Trust Examination Manual (Board); Trust Examination Manual (FDIC); Comptroller's Handbook for Fiduciary Activities (OCC); see also Comptroller's Handbooks for Asset Management, Conflicts of Interest and Community Bank Fiduciary Activities Supervision. The Agencies also have issued other forms of guidance on fiduciary activities to bank examiners and the banking industry through advisory or supervisory letters, bulletins, press releases and other similar communications.

complex banking organizations, periodic examinations are supplemented by a more continuous and interactive supervisory process, which often includes the assignment of "resident" examiners who are based on-site year-round. Following examinations, the fiduciary activities of banks are assigned a composite rating under the Uniform Interagency Trust Rating System (UITRS). This rating is based on an evaluation of five primary components of the bank's fiduciary activities: the capability of management; the adequacy of operations, controls and audits; the quality and level of earnings; compliance with governing instruments, applicable law (including self-dealing and conflicts-of-interest laws and regulations), and sound fiduciary principles; and the management of fiduciary assets.

In light of the extensive and effective regulation of bank trust and fiduciary activities, Congress determined that the "push-out" of traditional bank trust and fiduciary activities was not warranted by the public interest. The Interim Final Rules, however, diverge substantially from the terms of the GLB Act and Congress's intent and would, in fact, disrupt the traditional trust and fiduciary activities of banks.

Account-by-Account Calculation of Compensation.

The GLB Act provides that a bank must be "chiefly compensated" for the securities transactions that it effects for its trust and fiduciary customers on the basis of certain types of fees set forth in the statute (referred to as "relationship compensation" in the Interim Final Rules). The Interim Final Rules provide that a bank meets the statute's "chiefly compensated" requirement only if, on an annual basis, the amount of relationship compensation received by the bank from each trust and fiduciary account exceeds the sales compensation received by the bank from that account. In essence, the Interim Final Rules apply the Act's "chiefly compensated" requirement to each trust and fiduciary account held by the bank, rather than to the bank's trust and fiduciary activities as a whole, and provide that a bank meets the Act's "chiefly compensated" requirement if the relationship compensation received from each trust and fiduciary account during a year exceeds 50 percent of the aggregate relationship and sales compensation received from the account during the year.

The Banking Agencies do not believe the Act's "chiefly compensated" condition may be interpreted to require a higher percentage threshold than the 50 percent standard included in the Interim Final Rules.[24] In addition, we do not believe an account-by-account calculation of compensation is consistent with the wording or purposes of the Act.[25] The plain language of the Act requires only that the bank be chiefly compensated for the securities transactions that it effects for all of its trust and fiduciary customers from the

[24] As the Commission has noted, the most common definitions of "chiefly" include "most of all," "principally" and "mainly." See 66 Federal Register 27760, at 27776, n. 155 (May 18, 2001)("Adopting Release").

[25] We separately address below in Part I.E the definition of the terms "relationship compensation" and "sales compensation" in the Interim Final Rules.

fees enumerated in the statute.[26] The House Commerce Committee's Report, on which the Commission greatly relies, also suggests that the Act's compensation limits were intended to apply to the bank's total trust and fiduciary activities, and not on an account-by-account basis.[27]

This reading also is more consistent with the purposes of the exception—to protect traditional bank activities while preventing a bank from conducting a "full-scale brokerage operation" through its trust department. Requiring that a bank's aggregate revenue from its trust and fiduciary accounts be primarily composed of relationship compensation would, in our view, effectively prevent a bank from running a full-scale brokerage business out of the bank's trust and fiduciary departments. This is especially true in light of the fact that the Act already prohibits a bank relying on the Trust and Fiduciary Exception from publicly soliciting brokerage business for its trust and fiduciary accounts.

On the other hand, imposing the chiefly compensated requirement on each account will interfere with the traditional trust and fiduciary activities of banks. For example, when a trust is initially established or receives a large influx of new assets from the grantor, the bank may conduct a significant number of securities transactions for the account in order to invest the trust's assets in a manner consistent with the trust's objectives and the bank's fiduciary duties.[28] If, however, these transactions generated more in sales compensation than the bank received in relationship compensation from the account during the year, the Interim Final Rules would cause the bank to become an unregistered broker-dealer in violation of the securities laws. In fact, under the interpretation adopted by the Commission, the vagaries in the compensation received at the end of a year from a single account could jeopardize a bank's status under the securities laws and potentially subject the bank to enforcement action by the SEC and private suits by the bank's customers for rescission of the securities contracts entered into by the bank.[29]

An account-by-account approach also is unworkable in the context of the complex, multi-party operations of a bank's trust department. Customers often come to bank trust departments to obtain highly individualized solutions to complex estate, inheritance, business-transition and other wealth-preservation issues that may involve numerous parties. Trust departments often are called on to establish multi-layered account structures or individualized payment arrangements to address the needs of the particular customer and fulfill the bank's fiduciary duties. These tailored arrangements may allow applicable fees to be paid by only one of the parties involved or out of only one of the accounts. An account-by-account approach fails to allow for the individualized arrangements characteristic of a bank trust department.

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[26] See 15 U.S.C. § 78c(a)(4)(B)(ii). Specifically, the "such transactions" referred to in subclause (I) of the exception clearly refers to all of the transactions effected by the bank in a trustee or fiduciary capacity pursuant to the exception. There simply is no reference to individual accounts anywhere in the exception.

[27] See H.R. Rep. 106-74, pt. 3, at 164 (A "bank must be chiefly compensated for its trust and fiduciary activities" on the basis of the fees specified by the Act.) (emphasis added).

[28] This is especially true if the trust is funded with a large amount of the securities of a single issuer (e.g. stock received over time through an employer stock purchase plan), since the bank trustee may very well determine that greater diversification is required.

[29] 15 U.S.C. § 78cc(b).

The requirement in the Interim Final Rules that banks track the compensation received from all trust and fiduciary customers on an account-by-account basis also will impose significant and unnecessary burdens on banks. Our supervisory experience indicates that most banks do not currently have the systems in place to track the compensation received from their trust and fiduciary activities on an account-by-account basis and, accordingly, would incur significant expense to comply with a regulatory requirement that we do not believe is required by the statute. These costs likely would be passed on to trust and fiduciary customers in the form of higher fees.

We believe the practical effect of the Commission's interpretation, and the potentially severe consequences of noncompliance, will be to cause many banks to discontinue providing securities services that they have long offered as part of their traditional trust and fiduciary operations. This result clearly was not intended by Congress in drafting the Trust and Fiduciary Exception and is explicitly contrary to Congress' direction that the Commission not disrupt bank trust activities.

For these reasons, the Interim Final Rules should be amended to permit banks to determine compliance with the Trust and Fiduciary Exception based on the aggregate revenue that the bank receives during a year from the trust and fiduciary accounts for which the bank has effected securities transactions on the basis of the Exception. This approach is fully consistent with the terms of the GLB Act. In addition this approach would fulfill Congress' intent by preserving the traditional trust and fiduciary activities of banks while, at the same time, preventing banks from operating a full-service brokerage operation out of the bank.

Rule 3a4-2—SEC-Granted Exemption from Account-by-Account Calculation.

The Commission correctly acknowledges that its interpretation of the statute's chiefly compensated requirements will impose significant regulatory burdens on banks.[30] In light of these burdens, the Commission has adopted an exemption, under its general exemptive authority, that permits banks to avoid calculating their compliance with the "chiefly compensated" requirement in the Interim Final Rules on an account-by-account basis if they comply with certain SEC-imposed conditions. Under these conditions, a bank may take advantage of this exemption only if—

(1) The bank demonstrates that the total sales compensation received from its trust and fiduciary accounts during the year does not exceed 10 percent of the relationship compensation received from such accounts during the year;

(2) The bank maintains procedures reasonably designed to ensure that each trust and fiduciary account is chiefly compensated from relationship compensation—

(a) When each account is opened;

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[30] See Adopting Release at 27776.

  (b) When the compensation arrangements for the account are changed; and
  (c) When sales compensation received from the account is reviewed by the bank for purposes of determining any employee's compensation; and
(3) The bank complies with the Act's limitations on the public solicitation of brokerage business for trust and fiduciary accounts.

The Banking Agencies concur with the Commission's determination that an account-by-account calculation of compensation is not necessary to achieve the purposes of the Trust and Fiduciary Exception or the GLB Act. The Banking Agencies also support the Commission's efforts to reduce the regulatory burden imposed by the Interim Final Rules on banks.

The Banking Agencies believe, however, that Congress did not intend the "chiefly compensated" requirement to be applied on an account-by-account basis and, thus, that it is unnecessary for the SEC to exercise its exemptive authority to achieve this result. In addition, while the Commission has attempted to provide a "safe harbor" in this area, we believe the conditions imposed by the Commission will allow few banks to safely reach this harbor. The restrictions included in Rule 3a4-2 essentially negate the usefulness of the exemption and, in fact, make the exemption stricter than the Act itself.

In this regard, the rule as written does <u>not</u> relieve banks from the burden of complying with the "chiefly compensated" requirement on an account-by-account basis. Rather, the exemption essentially mandates account-by-account compliance by requiring banks that seek to take advantage of the exemption to maintain procedures to ensure that <u>each</u> trust and fiduciary account complies with the chiefly compensated requirement of the Interim Final Rules at the inception of the account and at several stages during the life of the customer relationship.

Furthermore, a bank relying on the exemption must ensure that, during any year, the sales compensation received from all of its trust and fiduciary accounts does not exceed <u>10 percent</u> of the relationship compensation received from such accounts. Thus, even though sales compensation could account for <u>49 percent</u> of a bank's total compensation from its trust and fiduciary accounts under the Interim Final Rules (assuming each account generated the maximum amount of sales compensation permitted by the rule), the "exemption" is available only if the bank limits its sales compensation to <u>10 percent</u> of relationship compensation.

Together, these requirements make the safe harbor virtually unattainable and fail to relieve the unnecessary burden created by the Interim Final Rules.

<u>Definition of Trustee and Fiduciary Capacity.</u>

The GLB Act provides that the Trust and Fiduciary Exception is available for securities transactions that a bank effects "in a trustee capacity . . . or in a fiduciary capacity."[31] The Act also specifically defines the term "fiduciary capacity" to mean—

> (1) in the capacity of trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gift to minor act, or as an investment adviser if the bank receives a fee for its investment advice;
> (2) in any capacity in which the bank possesses investment discretion on behalf of another; or
> (3) in any other similar capacity.[32]

This definition was drawn from Part 9 of the OCC's regulations governing the fiduciary activities of national banks and was intended to encompass the broad range of services that banks provide as a fiduciary.[33]

The Banking Agencies appreciate the efforts of the Commission and its staff to identify instances where model codes or state laws use different terminology to describe legal capacities that are expressly included in the Act's definition of "fiduciary capacity."[34] We support the Commission's efforts to clarify that banks may take advantage of the Trust and Fiduciary Exception when acting in these capacities regardless of the nomenclature used to identify the capacity. In other areas, however, the Interim Final Rules fail to give effect to the plain meaning of the terms "trustee capacity" or "fiduciary capacity"—terms that are critical to the scope of the Trust and Fiduciary Exception and that were carefully chosen by Congress to ensure that traditional activities conducted by a bank in a trust or fiduciary capacity could remain in the bank and would not have to be "pushed out" to another entity.

Limitations on the Scope of "Trustee Capacity".

As noted above, the Act expressly provides that the Trust and Fiduciary Exception is available for transactions that a bank effects in a "trustee capacity," provided the bank complies with the Act's compensation and advertising restrictions. The Act does not include a specific definition of trustee capacity because the term is not ambiguous and is not subject to manipulation. A bank acts in such a capacity when it is named as trustee by written documents that create the trust relationship under applicable law.

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[31] 15 U.S.C. § 78c(a)(4)(B)(ii).
[32] See 15 U.S.C. § 78c(a)(4)(D).
[33] See 12 C.F.R. § 9.2(e).
[34] See Adopting Release at 27772. For example, the Adopting Release confirms that a bank acting as a "Personal Representative" in a state that has adopted the Uniform Probate Code is acting in a fiduciary capacity, since that is the term used by the Code to refer to the person acting as an executor or administrator for a decedent.

Nevertheless, the Adopting Release asserts that there is "uncertainty" concerning whether banks acting as an indenture trustee, or as a trustee for ERISA plans or individual retirement accounts ("IRAs"), are "trustees" for purposes of the Trust and Fiduciary Exception. The Adopting Release then reviews the services provided by banks when acting as these types of trustees and purportedly grants an "exemption" for banks acting in these capacities to resolve this ambiguity.

The Banking Agencies disagree that there is any ambiguity concerning the scope of the term "trustee capacity" used in the Trust and Fiduciary Exception. The plain meaning of the term encompasses all relationships in which a bank acts as a trustee under applicable law, and this plain meaning is consistent with Congress' desire to protect the services that bank trust departments have long-performed as trustee under applicable state or Federal law.[35] There is no indication that Congress intended to grant the Commission broad latitude to review particular types of trustee services provided by banks to determine whether such relationships constitute a "trustee" relationship for purposes of the GLB Act's broker-dealer registration exceptions. In fact, Chairman Levitt himself acknowledged that banks acting in a trustee capacity operate "at the highest level of responsibility."[36]

The Commission's position, in fact, casts a cloud over a wide range of trust relationships that banks have offered their customers, including self-directed personal trusts, charitable foundation trusts, insurance trusts and rabbi and secular trusts. Accordingly, far from resolving any alleged ambiguity on this issue, the Commission's position raises the possibility that, at some point in the future, the Commission may determine that traditional types of trustee services provided by banks are outside the scope of the term "trustee capacity." This uncertainty will further disrupt the traditional trust and fiduciary activities of banks in direct contravention of Congress' instructions.[37] We see no public purpose in creating uncertainty concerning the ability of banks to continue to provide long-standing trust services and disrupting bank trust activities that have been effectively regulated and supervised by the Banking Agencies for decades.

The Banking Agencies strongly believe the Commission should clarify that the term "trustee capacity," as used in the Act's Trust and Fiduciary Exception, has its plain and ordinary meaning and includes a bank acting as an indenture trustee, ERISA trustee or IRA trustee. The Banking Agencies also believe the Commission should withdraw its "definitional exemption" that purports to achieve this result only by Commission action.

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[35] See Board of Governors of the Federal Reserve System v. Dimension Financial Corp., 474 U.S. 361, 368 (1986) (deference to agency interpretations can not "be applied to alter the clearly expressed intent of Congress"); Chevron U.S.A. Inc. v. Natural Resources Defense Council, 467 U.S. 837, 843 (1984) (agency "must give effect to the unambiguously expressed intent of Congress").

[36] See *The Financial Services Act of 1998—H.R. 10: Hearing Before the Senate Committee on Banking, Housing and Urban Affairs*, 105th Cong. at 361 (1998)(Statement of Chairman Arthur Levitt).

[37] See H.R. Conf. Rep. No. 106-434 at 164 ("The Conferees expect that the SEC will not disrupt traditional bank trust activities.").

SEC-Created Restrictions on Investment Advisory Activities.

The Banking Agencies are similarly concerned about the Commission's efforts to limit the scope of activities that the GLB Act expressly includes within the scope of the term "fiduciary capacity." In this regard, the Act specifically provides that a bank acts in a "fiduciary capacity" when it acts "as an investment adviser if the bank receives a fee for its investment advice."[38]

The Interim Final Rules, however, provide that a bank will be deemed to be acting in an investment advisory capacity for purposes of the Trust and Fiduciary Exception only if the bank—

(1) provides continuous and regular investment advice to the customer's account that is based upon the individual needs of the customer; and
(2) owes a duty of loyalty to the customer (arising out of state or federal law, contract, or customer agreement).[39]

The Banking Agencies agree that the term "investment advice" can fairly be interpreted to require the provision of advice that is based on the particular needs of a customer. Under Part 9 of the OCC's fiduciary regulations, a national bank provides investment advice for a fee only if the bank provides advice or recommendations concerning the purchase or sale of specific securities.[40]

We believe, however, there is no basis for the other conditions imposed on the fee-based investment adviser activities of banks by the Interim Final Rules. In particular, the GLB Act does not provide that a bank acts in a "fiduciary capacity" only when the bank provides "continuous and regular" investment advice to a customer and has a duty of loyalty to the customer. These conditions also are not included in Part 9 of the OCC's regulations. Importantly, the definition of "fiduciary capacity" in the GLB Act was drawn from--indeed mirrors--the definition of "fiduciary capacity" in Part 9 of the OCC's fiduciary regulations.[41] Accordingly, review of the scope of Part 9 is particularly informative in interpreting the meaning of acting "as an investment adviser if the bank receives a fee for its investment advice" in the statute.

The Act requires only that a bank receive a fee for the investment advice it provides. This fee requirement is intended to distinguish situations when a bank provides investment advice only as an incident to its non-fiduciary activities.[42] The "continuous

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[38] 15 U.S.C. § 78c(a)(4)(D)(i).
[39] Interim Final Rules § 240.3b-17(d).
[40] See 12 C.F.R. § 9.101(a). Part 9 also notes that a bank does not provide "investment advice" merely by providing market information to customers in general. Id. at § 9.101(b)(2)(i).
[41] 12 C.F.R. § 9.2(e).
[42] In this way, the limit is consistent with both the Federal securities laws and Part 9 of the OCC's fiduciary regulations. A broker-dealer generally is not considered to be an "investment adviser" for purposes of the Investment Advisers Act of 1940 ("Advisers Act") if it provides incidental advice to its brokerage customers. See Certain Broker-Dealers Deemed Not to Be Investment Advisers, Exchange Act

and regular" requirement in the Interim Final Rules, however, is overly broad and would prevent banks from relying on the Trust and Fiduciary Exception even in circumstances where the purpose of the customer's contact with the bank is to obtain investment advice that is directly related to a securities transaction. For example, under the Interim Final Rules, a bank would not be considered to be acting in a "fiduciary capacity" even if the bank, in return for a fee, provided detailed investment advice to a non-discretionary accountholder at the initial one-on-one meeting with the customer to review his/her portfolio and, then, effected securities transactions that the account-holder determines are appropriate in light of such advice.[43] In these circumstances, there would be a direct linkage between the investment advice separately provided by the bank and the customer's securities transactions. Although the resulting transactions are clearly of the type intended to be protected by the Trust and Fiduciary Exception, they would not satisfy the "continuous and regular" requirement imposed by the Commission in the Interim Final Rules.

The Banking Agencies also believe the "duty of loyalty" requirement in the Interim Final Rules is misplaced. A duty of loyalty may arise as a consequence of a bank or other person acting as an investment adviser; it is not a precondition to acting as an investment adviser. The GLB Act's definition of "fiduciary capacity" does not require or refer to any such requirement. Part 9 of the OCC's regulations, from which the Act's definition of "fiduciary capacity" is drawn, also does not include such a requirement in defining when a national bank provides investment advice for a fee.[44] In fact, the securities laws also do not require a person to have a duty of loyalty as a precondition to being considered an investment adviser under the Advisers Act.[45] While the Banking Agencies concur that banks providing investment advice for a fee have fiduciary obligations to their customers, including the duty to disclose potential conflicts of interests, we believe the bank regulation and examination process provides the most appropriate method for ensuring compliance by banks with these important duties.

Rel. No. 42099, reprinted in [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,220 (Nov. 4, 1999). Similarly, a national bank does not provide investment advice for a fee under the OCC's regulations if it provides advice merely as an incident to its other services. See 12 C.F.R. § 9.101(a).

[43] We note, of course, that if a bank provides investment advice to a customer as an incident to another fiduciary relationship that the bank has with the customer, the bank is already acting in a "fiduciary capacity" with respect to the customer and may effect securities transactions for the customer under the Trust and Fiduciary Exception on that basis alone.

[44] See 12 C.F.R. §§ 9.2(e), 9.101.

[45] See 15 U.S.C. § 80b-2(a)(11).

Bank Departments that are Regularly Examined for 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.[46] The type and number of departments at a bank that are examined by Banking Agency examiners for compliance with fiduciary principles varies depending on the scope, structure and complexity of the bank's fiduciary activities. Accordingly, the Banking Agencies support the Commission's decision to rely on the Banking Agencies in determining whether a particular bank's activities are conducted in an area that is regularly examined by bank examiners for compliance with fiduciary principles and standards.[47]

The Adopting Release, however, also states that "all aspects" of the securities transactions conducted by a bank for its trust and fiduciary customers must be conducted in a part of the bank that is regularly examined by bank examiners for compliance with fiduciary principles and standards.[48] The Adopting Release also suggests that the areas that must be subject to such examination would include any area that identifies potential purchasers of securities, screens potential participants in a transaction for creditworthiness, solicits securities transactions, routes or matches orders, facilitates the execution of a securities transaction, handles customer funds and securities, or prepares and sends confirmations for securities transactions (other than for the executing broker-dealer).

Banks that conduct fiduciary activities, however, may delegate securities processing and settlement activities to a separate department or affiliate that is responsible for all of the bank's back-office securities settlement and processing tasks, in order to achieve cost and operational efficiencies. Many banks, and particularly small banks, also outsource processing, settlement and other back-office functions to third parties because the bank cannot achieve the economies of scale to provide such services directly to their customers on a cost-effective basis. While these separate bank departments, affiliates or third-party providers may be subject to examination by bank examiners, they do not themselves have fiduciary relationships with customers and, accordingly, may not be regularly examined for compliance with fiduciary principles and standards.

Because the examination requirements in the Interim Final Rules are not consistent with how banks operate or the Banking Agencies' supervisory and examination programs, imposing these requirements by rule will, as a practical matter, artificially constrain normal business activity and prevent many banks from taking advantage of the Trust and Fiduciary Exception granted by Congress. Moreover, the examination requirements in the Interim Final Rules are not necessary to ensure the protection of trust and fiduciary customers. The relationship that a bank has with its trust and fiduciary customers is

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[46] See 15 U.S.C. § 78c(a)(4)(B)(ii).
[47] See Adopting Release at 27772.
[48] Id.

governed by fiduciary principles, and examiners regularly examine banks to ensure that they have implemented effective processes to ensure that these relationships are managed in a manner consistent with fiduciary principles. These examinations regularly include a review of the bank's policies governing the direction of securities trades for execution, processing and settlement and the use of services provided by other departments of the bank and third parties.

Components of Relationship and Sales Compensation.

As noted above, the Banking Agencies believe the Act's "chiefly compensated" requirement can not be interpreted to require a bank to receive more than 50.1 percent of its fees from its trust and fiduciary accounts from the types of revenue specified in the Act. We also support the Commission's decision to require banks to meet the Act's "chiefly compensated" requirement on only an annual basis, rather than on a quarterly or other basis. We believe, however, that certain modifications to the definition of "relationship compensation" and "sales compensation" in the Interim Final Rules are necessary.

Relationship Compensation.

As required by the GLB Act, the Interim Final Rules define "relationship compensation" to mean (1) an administration or annual fee (payable on a monthly, quarterly or other basis), (2) a percentage of assets under management fee, (3) 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 trust and fiduciary accounts, or (4) any combination of such fees.

The Interim Final Rules provide, however, that these fees may be included in permissible "relationship compensation" only to the extent they are received directly from a customer or beneficiary, or directly from the assets of the trust or fiduciary account.[49] The GLB Act places no limit on the source of payment for the statutorily enumerated fees, so long as the fees are of the type specified. We fail to see how a type of fee expressly permitted by the Act (e.g. an administration fee) ceases to be permissible simply because the fee is paid by a third party.

This provision also unnecessarily and improperly limits the ability of bank trust departments to tailor account and reimbursement arrangements to the needs of particular fiduciary clients. As noted above, bank trust departments are often called upon to develop complex and individualized solutions to multi-faceted estate, inheritance, business-transition and other wealth- preservation issues involving several parties. In responding to customer needs, bank trust departments may establish multiple account structures and allow for fees arising from the entire relationships to be paid from a single account, from non-account assets at the bank or an affiliate, or by someone other than the

[49] Interim Final Rules § 240.3b-17(i).

accountholder or beneficiary. The limitations imposed in the Interim Final Rules on the source of payments are inconsistent with the nature of bank trust activities and add a level of complexity and ambiguity to the Exception that is wholly unnecessary.

The Banking Agencies also believe the definition of a permissible "per order processing fee" in the Interim Final Rules is unduly narrow and inconsistent with the terms of the Act. Under the Interim Final Rules, a per order processing fee may be included in permissible relationship compensation only if the fee does not exceed (1) the amount charged by the broker-dealer for executing the transaction, plus (2) the costs of any resources the bank exclusively dedicates to the execution, comparison and settlement of securities transactions for trust and fiduciary customers.[50] The plain language of the Act, however, allows a per order processing fee to include any cost incurred by a bank "in connection with executing securities transactions for trustee and fiduciary customers."[51] The Act simply does not require that the bank's costs arise exclusively from resources the bank has dedicated solely to executing transaction for trust and fiduciary customers.

The Commission's position, moreover, would essentially prevent banks from fully recouping the costs they actually incur in effecting securities transactions for their trust and fiduciary customers. In order to achieve economies of scale and efficiently manage their businesses, many banks have established centralized trading desks that handle all trades (both proprietary and customer-driven) effected by the bank. In addition, banks frequently establish centralized departments to handle securities settlement and processing and other "back office" functions. In many cases, this centralization of functions is necessary to allow the bank to "spread out" the costs associated with acquiring and maintaining the information-resources and other technology needed to properly operate the business. Many banks also may contract with a third party to provide securities settlement or clearance services and to generate and mail trade confirmations. The Interim Final Rules would prohibit banks from recouping the costs properly allocable to these shared resources, or paid by the bank to third parties for execution-related services. The Banking Agencies urge the Commission to eliminate the exclusivity requirement included in the definition of per order processing fee in the Interim Final Rules.

The Banking Agencies also do not believe that the entire amount of a per order processing fee should be excluded from permissible relationship compensation simply because some portion of the fee exceeds the costs incurred by the bank in executing the transaction. The portion of the fee up to the bank's costs is clearly permissible under the GLB Act if charged separately, and we see no reason to prohibit banks from including that portion in their relationship compensation. This is especially true since a bank, even under the Interim Final Rules, could "convert" this portion into permissible relationship compensation by separating the per order processing fee into its permissible and impermissible components and charging separately for each component.

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[50] Interim Final Rules § 240.3b-17(b).

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

Sales Compensation.

The Interim Final Rules define sales compensation to include, among other things, (i) fees received from an investment company under a plan adopted pursuant to Rule 12b-1 under the Investment Company Act of 1940 ("Rule 12b-1 fees"), (ii) "service fees" that a bank receives from an investment company (other than under a Rule 12b-1 plan) for providing personal service or the maintenance of shareholder accounts, and (iii) finders fees, other than referral fees paid pursuant to the statutory networking exception.[52]

a. Rule 12b-1 Fees Received from ERISA Plans. The Interim Final Rules consider Rule 12b-1 fees as sales compensation because such fees "create[] a conflict of interest between the bank distributor and investors."[53] However, under certain circumstances, the receipt of these fees by a bank does not create a conflict of interest and in fact benefits the bank's trust and fiduciary customers.

For example, under Department of Labor rulings, if a bank acts as a fiduciary for an ERISA plan and receives Rule 12b-1 fees in this capacity, the bank must reduce, on a dollar-for-dollar basis, the fees otherwise payable to the bank by the plan by the amount of the Rule 12b-1 fees received, or otherwise use the 12b-1 fees for the benefit of the plan.[54] Accordingly, in these circumstances, the Rule 12b-1 fees received by the bank either substitute, on a dollar-for-dollar basis, for the relationship compensation that the bank would otherwise receive from the plan or must otherwise be used to benefit the plan. The Banking Agencies believe the Interim Final Rules should be amended to provide that Rule 12b-1 fees are relationship compensation, and not sales compensation, when a bank is required by law or agreement to use any Rule 12b-1 fees received in connection with services provided to a fiduciary customer for the benefit of the customer.

b. Service Fees. Under applicable NASD rules, a bank may receive service fees from a mutual fund for providing a variety of shareholder liaison services to its customers invested in the fund, such as responding to customer inquiries and providing information on their investments.[55] The services provided under a non-Rule 12b-1 service plan are administrative in nature and may not include distribution-related services. Accordingly, the Banking Agencies believe that service fees are merely one type of "administration fees" that the statute expressly permits banks to receive and should be considered "relationship compensation" under the Interim Final Rules.[56] The Banking Agencies

[52] Interim Final Rules § 240.3b-17(j)(6).
[53] See Adopting Release at 27775.
[54] See Department of Labor, Pension & Welfare Benefit Programs, Opinion 97-15A (May 22, 1997); Ltr. to Jerry Shook, First American Bank, FSB, from Bette J. Briggs, Chief, Division of Fiduciary Interpretations, Department of Labor, April 10, 1998, 1998 ERISA LEXIS 7.
[55] NASD Notice to Members 93-12 (1993) at Question 17.

[56] As discussed earlier, the Agencies do not believe the statute requires that permissible administrative fees be received directly from the customer or the assets of the trust or

note, moreover, that NASD Rules limit service fees to no more than 25 basis points, and that, therefore, there is limited potential for these types of fees to affect a bank's duty of loyalty to its trust and fiduciary customers. The Banking Agencies also note that the Commission has permitted mutual funds to pay administrative "service fees" under plans that have been adopted under Rule 12b-1.[57] The Banking Agencies believe that any fees received by a bank under a Rule 12b-1 plan for providing non-distribution shareholder services to its customers also should be considered permissible administration fees and included in "relationship compensation."

The Interim Final Rules expressly exclude fees for certain services from the definition of service fees, such as aggregating and processing purchase and redemption orders, subaccounting services, and forwarding shareholder communications.[58] These fees also are administrative in nature and should be considered "relationship compensation," and not "unrelated compensation" as provided in the Interim Final Rules.

c. Finders Fees. The Adopting Release suggests that a bank's sales compensation includes any "fee received in connection with a securities transaction or account, except for those finders' fees received pursuant to [the GLB Act's networking exception]."[59] This provision is vague, potentially overbroad, and provides banks little guidance in determining how to comply with the Act's compensation restrictions. For example, the phrase could conceivably capture all fees associated with a trust and fiduciary account for which the bank conducts securities transactions under the Trust and Fiduciary Exception. We believe such an interpretation was clearly not intended and would be incompatible with the Act.

In addition, because this provision specifically excludes referral fees paid to bank employees under the networking exception, it implies that compensation received by an employee of a bank's trust, fiduciary or other department could be considered part of the bank's "sales compensation" under the Interim Final Rules. Congress provided that a bank may take advantage of the Trust and Fiduciary Exception so long as the bank is chiefly compensated by the fees set forth in the statute.[60] Congress did not place any limit on how a bank may compensate its employees that provide trust and fiduciary services, since such compensation must be in accordance with applicable fiduciary

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fiduciary account. In this regard, it would seem irrelevant whether the bank receives these non-distribution-related administrative fees from a mutual fund in which a customer is invested, or the bank charges the customer's account directly for providing these types of administrative services. We note, moreover, that NASD Rules prohibit an investment company from paying service fees to any third party of more than .25 percent of the average annual net asset value of shares sold.

[57] See, e.g., Investment Company Institute, SEC No-Action Letter, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,477 at 78,436, n. 14 and accompanying text (October 30, 1998).
[58] Interim Final Rules § 240.3b-17(j)(6).
[59] See Adopting Release at 27775.
[60] See 15 U.S.C. § 78c(a)(4)(B)(ii).

principles.[61] Although the text of the Interim Final Rules provide that "sales compensation" includes only fees received by "the bank," the language in the Adopting Release and reference to networking referral fees creates uncertainty on this point. Accordingly, the Commission should clarify that sales compensation does not include compensation or fees received by, or paid to, bank employees.

Advertising Restriction.

The Banking Agencies also request that the Commission clarify the scope of the advertising restriction included in the Trust and Fiduciary Exception. This restriction provides that a bank relying on the exception may "not publicly solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising its other trust activities."

The Banking Agencies believe the Commission should clarify that the Act generally prohibits a bank from publicly soliciting brokerage business only for the types of trust and fiduciary accounts covered by the exception. If the restriction was read more broadly, then it would prohibit the bank from publicly advertising its permissible private placement, sweep account, municipal securities, and stock purchase plan brokerage activities, even though the Act places no advertising restriction on those bank permissible securities activities.

Statutory Exception for Securities Transactions Effected as Part of Customary Safekeeping and Custody Activities

The GLB Act's "Custody and Safekeeping 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."[62] The activities expressly permitted by the statute include—

(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.[63]

The exception also allows banks to engage in other activities as part of their customary safekeeping and custody operations, such as facilitating the transfer of funds or securities

[61] We note that, where Congress intended to place restrictions on how a bank could compensate its employees, it did so specifically. See, e.g. 15 U.S.C. § 78c(a)(4)(B)(i) (networking exception).
[62] 15 U.S.C. § 78c(a)(4)(B)(viii).
[63] See id. at § 78c(a)(4)(B)(viii)(I)(aa) and (ee).

as a custodian or clearing agency, effecting securities lending and borrowing transactions for customers, and holding securities pledged by a customer.[64]

Custody and safekeeping activities—like trust and fiduciary activities—are part of the core business of banking. Congress intended the Custody and Safekeeping Exception to allow banks to continue to provide the full range of safekeeping and custodial services that banks have traditionally provided to their customers "as part of [their] customary banking activities." Of course, this includes the brokerage services that banks have customarily provided as part of their custody and safekeeping activities. If the exception did not allow banks to provide brokerage services, then this exception from the definition of "broker" is mere surplusage in the statute.[65] In fact, the statute presumes that banks execute securities transactions in connection with their customary custodial and safekeeping functions, since it generally requires that any trades of a U.S. publicly traded security effected in reliance on the Custody and Safekeeping Exception be directed to a registered broker-dealer.[66] Even the House Commerce Committee Report, on which the Commission relied heavily in interpreting the statute, recognized that "[b]ank safekeeping and custody services may involve effecting transactions for bank customers."[67]

The Commission, however, has asserted that this statutory exception does not permit banks to accept securities orders for their custodial IRA customers, for 401(k) and benefit plans that receive custodial and administrative services from the bank, or as an accommodation to custodial customers. This interpretation is not consistent with the Act, its legislative history, or the purposes of the Custody and Safekeeping Exception. As a result, the Commission's interpretation will unnecessarily and improperly interfere with core banking activities that Congress intended to protect and impose additional and unnecessary costs on consumers.

Although the Interim Final Rules also include two SEC-granted exemptions for custodial-related transactions, these exemptions are subject to numerous and stringent conditions that make the exemptions of spurious benefit. More fundamentally, these exemptions impose newly created SEC conditions on bank activities that Congress itself determined were to be protected.

Customary Order-Taking Activities of Custodial Banks.

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64 See id. at § 78c(a)(4)(B)(viii)(I)(bb), (cc) and (dd).

65 2A N. Singer, Statutes and Statutory Construction at § 46:06 (6th ed. 2000)("A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous.")(citations omitted).

66 See 15 U.S.C. § 78c(a)(4)(C). The Banking Agencies support the Commission's decision to clarify that broker-dealer execution is required only when the transaction will be effected in the open market. See Adopting Release at 27780.

67 See H. Rep. No. 106-74, pt. 3, at 168 (1999)

The Custody and Safekeeping Exception was intended to permit banks to continue to provide customers the custody and safekeeping services, including incidental and related securities execution services, that they traditionally have provided as part of their customary banking activities. The Commission's interpretation of the Custody and Safekeeping Exception is inconsistent with the statute and Congress' intent, however, because it does not permit banks to continue to provide the custody and safekeeping services, including the securities order-taking services, that they have long-provided as part of their customary banking activities.

As an initial matter, we note that the Banking Agencies—as the Federal agencies charged by Congress with the responsibility for supervising banking organizations—are uniquely qualified to identify the custody and safekeeping services that banks traditionally have provided as part of their "customary banking activities." The Banking Agencies have long supervised the custodial and safekeeping activities of both large and small banks. The five largest global custodians are banks and thousands of banks offer their customers custodial IRA and other types of custodial and safekeeping services. We believe this supervisory experience is critical in identifying the types of "customary" activities that the Custody and Safekeeping Exception was intended to protect.

For example, as the Commission is aware, banks have long-provided securities execution services to self-directed IRA accounts for which the bank acts as custodian.[68] Applicable Internal Revenue Service regulations generally require that a bank serve as trustee or custodian for an IRA,[69] and thousands of banks offer self-directed custodial IRA services to their customers. Bank-offered custodial IRAs provide consumers throughout the United States a convenient and economical way to invest for retirement on a tax-deferred basis. Bank-offered custodial IRA services are subject to strict regulation under the Internal Revenue Code, are subject to regular supervision by the Banking Agencies, and have been offered by banks for years without creating consumer protection concerns.

Banks may offer their self-directed custodial IRA customers the ability to invest in a full range of investment products, including bank deposits, mutual funds, and individual stocks and bonds. Offering a full range of investment options allows the customer to diversify his or her retirement assets in the manner that the customer deems most appropriate. Because banks generally must serve as the custodian for custodial IRA accounts, providing securities execution services to these accounts allows the public to avoid the unnecessary expenses and administrative complexities associated with establishing a separate account at a broker-dealer. Moreover, where banks serve as custodian for a self-directed IRA, the banks direct the customer's securities transactions

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68 If a bank serves as a trustee to an IRA, has investment discretion over an IRA account, or provides investment advice to the accountholder for a fee, the bank may effect securities transactions for the IRA under the statute's Trust and Fiduciary Exception. Accordingly, this discussion focuses on accounts for which transactions could only be conducted under the Custody and Safekeeping Exception, i.e. self-directed custodial IRAs where the bank does not provide investment advice to customers.

69 See 26 C.F.R. § 1.408-2(b)(2)(i) and (d). Other types of entities or persons may act as a trustee or custodian for an IRA but only if the Commissioner of the Internal Revenue Service determines that the person or entity will administer the IRA in the manner required by law. See id.

to a registered broker-dealer for execution and would be required to continue doing so under the GLB Act.[70]

In addition, banks 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. Frequently, banks offer these services as part of a bundle of recordkeeping, reporting, tax-preparation and administrative services for 401(k) and other plans. As the SEC has itself recognized, banks offering such a bundle of custodial and administrative services may accept and process orders from the plan or the plan's participants for the investment of new contributions or the re-allocation of existing contributions.[71] 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.[72] 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.

As the SEC also has recognized, banks as part of their customary banking activities effect securities trades as an accommodation to their custodial customers.[73] Based on our supervisory experience, banks customarily conduct accommodation trades for custodial customers only upon the order of the customer and on an incidental and infrequent basis. 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. Furthermore, because these services are customarily provided only as an accommodation to custodial accounts, banks typically seek to recover only the costs incurred in placing the trade for the customer.

As noted above, the Commission has improperly interpreted the statutory Custody and Safekeeping Exception in a manner that would deny banks the ability to continue to provide these customary services as part of their core custodial and safekeeping activities. The conflict between the Commission's interpretation and the language and intent of the Act is most starkly presented with respect to IRAs and benefit plans. As noted above, the statute, by its terms, permits a bank to provide custodial and other related administrative services "to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar plan." As Commission staff is well aware, this statutory language was included in the Act to ensure that there was no ambiguity

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[70] See 15 U.S.C. § 78c(a)(4)(C).

[71] See Universal Pensions, Inc., 1998 SEC No-Act. LEXIS 192 (Jan. 30, 1998).

[72] 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).

[73] See Provident National Bank, 1986 SEC No-Act. LEXIS 2782 (Oct. 6, 1982) (noting that bank, as part of its custody services, offered a broad range of clerical and administrative services including access to the bank's trading department for the purchase and sale of securities at the customer's instructions).

concerning the ability of a bank to accept orders for IRA custodial accounts or in connection with providing custody and other administrative services to benefit plans.[74]

In this regard, prior versions of the Custody and Safekeeping Exception did not include specific language relating to custodial IRA accounts and benefit plans.[75] This omission permitted the House Commerce Committee to opine in 1997 that the then-current version of the Custody and Safekeeping Exception would not permit a bank to "provide general securities execution services . . . to a self-directed IRA account."[76] The Senate Banking Committee, however, rejected this interpretation of the more limited statutory exception then included in the bill, stating in both 1998 and 1999 that the "Committee believes that bank custodial, safekeeping and clearing activities with respect to IRAs do not need to be pushed-out into a [] registered broker-dealer."[77] To resolve any ambiguity on this issue, the Conference Committee adopted the language now found in subclause (ee) specifically authorizing banks to provide customary custodial and related services to IRA custodial accounts and pension plans.[78] Commission staff is well aware that the purpose of this language was to ensure that banks could continue to provide securities brokerage services to their custodial IRA and benefit plan customers.

The Commission's impermissibly narrow interpretation of the Custody and Safekeeping Exception will disrupt the traditional custody and safekeeping activities of banks that Congress intended to protect.[79] As noted above, banks historically have allowed their custodial clients to effect trades on an accommodation basis. The Commission's interpretation of the Exception, however, will force custodial customers to incur additional and unnecessary burdens and expenses to effect occasional trades related to

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74 The Adopting Release suggests that the phrase "other related administrative services" was intended to allow banks to provide only non-brokerage "clerical and ministerial services" to custodial IRAs and benefit plans. See Adopting Release at 27780, n. 179. Of course, if the phrase does not permit banks to offer services that would be considered a "brokerage" activity under the Federal securities laws, then its inclusion in this "broker" exception would be unnecessary. Moreover, the context clearly indicates that the phrase was intended to refer to the types of non-fiduciary administrative services that banks and other service providers currently provide to 401(k) and other benefit plans, which, as described above, includes securities execution services. We note that this interpretation is, in fact, consistent with how the SEC has characterized the securities execution services offered by banks in conjunction with their custodial activities. See Provident National Bank at *2 (bank offered a "broad range of clerical and administrative functions" as part of its custodial services, including securities execution services through the bank's trading department); Universal Pensions at *2 (bank offered pension plans a package of custodial, recordkeeping and "other plan administrative services", including securities execution services).

75 See, e.g., H.R. Rep. No. 106-74, pt. 3, at 57 (1999); S. Rep. No. 106-44 (1999).

76 See H.R. Rep. No. 105-164, pt. 3, at 135 (1997).

77 S. Rep. No. 106-44 at 10 (1999); S. Rep. No. 105-336 at 10 (1998) (emphasis added).

78 Subclause (ee) was first included in the so-called "Chairmen's Mark" of the GLB Act issued on October 12, 1999, by Chairmen Gramm, Leach and Bliley for consideration by the joint House-Senate Conference Committee.

79 For the reasons discussed below, the Banking Agencies do not believe that the discretionary exemptions included in the Interim Final Rules fully reinstate the authority banks were intended to have under the statute or sufficiently address the practical impact the Commission's narrow interpretation of the exception will have on the banking industry.

their custodial assets. In light of this burden, customers may forego establishing custodial relationships with banks or decide to move existing custodial relationships out of the bank. The end result will be the further impairment of core banking functions that Congress intended to remain within the bank.

We understand that the Commission may have adopted its interpretation of the statutory Custody and Safekeeping Exception out of a concern that alternative interpretations could undermine other exceptions included in the GLB Act.[80] Such fears, however, do not permit the Commission to disregard the intent of Congress. Furthermore, giving effect to Congress' intent would not, in fact, undermine the GLB Act's other exceptions. The Custody and Safekeeping Exception protects the custody and safekeeping activities that banks have provided as part of their customary banking activities, including the securities order-taking activities described above. The exception is not "open-ended" and would not allow banks to offer general brokerage services to the public in contravention of the GLB Act. The Banking Agencies stand ready to discuss with the Commission how a rule might be drafted to protect the customary custodial and safekeeping activities of banks while, at the same time, preventing circumvention of the GLB Act.

SEC-Granted Exemptions for Traditional Bank Custodial Activities.

The Commission apparently understands that its interpretation of the GLB Act's Custody and Safekeeping Exception will disrupt activities that banks have customarily provided to their custodial customers and, for this reason, has granted two exemptions (Rule 3a4-4 and Rule 3a4-5) that would permit banks to accept orders from their custodial customers. The Banking Agencies support the Commission's efforts to avoid "unnecessarily disrupting" customary bank custodial and safekeeping activities.[81] We believe the best way to achieve this goal, however, is to give effect to the words and purpose of the statutory Custody and Safekeeping Exception that Congress debated and adopted. For the reasons discussed above, we believe that the statutory exception was intended to, and does, protect the securities-related activities that banks customarily have provided their custodial and safekeeping customers and that the discretionary exemptions adopted by the Commission are unnecessary and contrary to the statutory scheme adopted by Congress.

Furthermore, the custody exemptions adopted by the Commission are subject to a myriad of restrictions. These SEC-imposed conditions are not consistent with the banking practices that Congress sought to protect, would restrict activities that banks are expressly permitted to conduct under other provisions of the GLB Act, and would impose an unworkable framework of restrictions on traditional bank activities. As a practical matter, the restrictions make the exemptions virtually worthless for many banks and, in our view, are the regulatory equivalent of "death by a thousand cuts."

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[80] See Adopting Release at 27781, n. 182.

[81] See Adopting Release at 27782, 27783.

For example, a bank may effect securities transactions for a custody client under the exemption granted by Rule 3a4-4 only if the bank complies with the following laundry list of conditions:

Types of Banks Eligible for Exemption:

• The bank must have had less than \$100 million in assets as of December 31st of both of the prior two calendar years;

• The bank must not be, and since December 31st of the 3rd prior calendar year must not have 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;

• The bank must not be associated with a broker-dealer;

• The bank must not have a networking arrangement with a broker-dealer as expressly permitted under the Networking Exception of the GLB Act;

Types of Accounts for Which Orders May be Taken:

• The bank may accept securities orders <u>only</u> for custodial IRA accounts and other specified types of tax-deferred accounts (<u>excluding</u> 401(k) accounts) for which the bank acts as a custodian;

Types of Securities that May be Purchased:

• The bank may accept orders from such accounts <u>only</u> for the purchase and sale of SEC-registered mutual funds;

• If the bank makes available shares of an affiliated mutual fund, the bank must also make available shares of an unaffiliated mutual fund that has "similar characteristics";

Revenue Limits:

• The total compensation received by the bank for effecting securities transactions under this exemption (including any Rule 12b-1 fees received from the mutual funds in which the customer invests) may not exceed <u>3 percent</u> of the bank's annual net interest and noninterest income;

Advertising Restrictions:

The bank is generally <u>prohibited</u> from advertising that it effects <u>any kind</u> of securities transactions and must limit its securities advertising activities to—

• Providing customers with copies of mutual fund advertising and sales material prepared by the mutual fund or its principal underwriter;

• Responding to inquiries about a security initiated by a potential purchaser, provided that in responding to these inquiries the bank must limit its responses to information that is contained in the security's registration statement or in sales material prepared by the mutual fund's principal underwriter;

• Advertising its trust activities as permitted by the GLB Act; and

• Notifying its existing customers that it accepts orders for securities in conjunction with advertising the other services the bank provides to IRA and other tax-deferred accounts.

Limits on Activities of Bank Employees:

• Any bank employee effecting transactions under the exception—

* Must not be an associated person of a broker-dealer;

* Must primarily perform duties for the bank other than effecting securities transactions for customers; and

* Must not receive compensation for effecting securities transactions under the exemption from the bank, the executing broker-dealer or any other person related to (i) the size, value, or completion of any securities transaction; (ii) the amount of securities-related assets gathered; or (iii) the size or value of any customer's securities account;

Trades must be sent to a Broker-Dealer for Execution:

• Any trades effected by the bank under this exemption must be directed to a registered broker-dealer to the extent required by section 3(a)(4)(C) of the Exchange Act.

In addition, a bank may effect transactions for its custodial customers under the exemption provided in Rule 3a4-5 only if the bank does not, directly or indirectly, receive any compensation for effecting such transactions. Furthermore, the bank and its employees would be subject to advertising and compensation restrictions that are similar to those described above.

These conditions are inconsistent with the customary banking practices that Congress intended to protect, create an unworkable regulatory framework for banks, and appear punitive in several respects. For example, as noted above, large and small banks currently offer their customers the ability to invest in a full range of investment options through custodial IRAs and other tax-deferred accounts and the Act and its legislative history make clear that Congress intended to allow all banks to continue to provide these customary banking services to their customers. We see no basis for permitting only "small banks" to accept orders for custodial IRA and other tax-deferred accounts. Similarly, we see no reason to deny a bank the ability to offer its customers a traditional banking product solely because the bank has established a networking arrangement with a broker-dealer or affiliated with a broker-dealer—arrangements and affiliations that are expressly permitted by law. In addition, banks have long offered their custodial IRA customers the ability to invest in a full range of investment options. Allowing banks to offer IRA custodial customers only shares in registered mutual funds unnecessarily restricts the investment options open to the thousands of retirement investors that have already established custodial IRA accounts with banks, and places banks at a competitive disadvantage in the market for custodial IRA services.

Furthermore, because Congress intended to permit banks to continue to offer custodial IRA services, we fail to see any basis for limiting the amount of revenue that a bank may earn from engaging in these traditional banking activities. We also believe it is not appropriate for the Commission to prohibit a bank from receiving any compensation for effecting securities trades on an accommodation basis for its custodial clients. Requiring a bank to provide customary banking services at a loss is not, in our view, sound public policy, nor is it consistent with the customary banking activities that Congress sought to protect.

Finally, we note that the advertising restrictions included in Rule 3a4-4 and 3a4-5 are overly broad and would, in fact, prohibit banks from engaging in advertising activities that are expressly permitted by the GLB Act. For example, it appears that, if a bank sought to avail itself of these exemptions, the bank could no longer advertise its permissible private placement, "sweep" account, municipal securities, stock purchase plan or networking activities. Congress did not impose advertising restrictions on these activities directly and we believe it is improper for the Commission to attempt to restrict these activities indirectly through the conditional grant of an exemption.

Statutory Exception for Third Party Brokerage Arrangements.

The GLB Act permits banks to enter into arrangements with registered broker-dealers to offer brokerage services to bank customers provided the "networking" arrangement meets certain requirements specified in the Act.[82] One of the requirements is that bank employees (other than employees also employed by the broker-dealer who are registered with the NASD or another self-regulatory organization) are prohibited from receiving "incentive compensation," except that a bank employee may receive compensation for the referral of any customer "if the compensation is a nominal one-time cash fee of a

[82] 15 U.S.C. § 78c(a)(4)(B)(i).

fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction."[83]

The Commission has interpreted the term "nominal one-time cash fee of a fixed dollar amount" to be limited to only—

(1) payments that do not exceed one hour of the gross cash wages of the bank employee making the referral; or
(2) points in a system or program that covers a range of bank products and non-securities related services where the points count toward a bonus that is cash or non-cash if the points (and their value) awarded for referrals involving securities are not greater than the points (and their value) awarded for activities not involving securities.[84]

In addition, the Commission states that referral fees cannot be paid in the form of bonuses.

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

The Banking Agencies appreciate the interest of the Commission to provide banks flexibility in the form of payment they may pay to bank employees for referrals. However, the Commission's interpretation of the term "nominal one-time cash fee of a fixed dollar amount" imposes unnecessary limitations on the securities referral programs of banks that are not required by statute, create burdensome practical difficulties for banks, are inconsistent with the SEC's own practice, and raise employee privacy concerns. These limits simply are not found in the words of the statute and the legislative history does not even suggest that such severe restrictions were intended by Congress.

The SEC staff have long taken the position in no-action letters involving networking arrangements with banks, thrifts and others that the registration requirements of the Exchange Act are not triggered by networking arrangements in which a bank employee receives a "nominal fee" for referrals to the registered broker-dealer.[85] As the Commission has acknowledged, the GLB Act's networking exception is based on these letters and was intended to codify the existing framework that has long-governed these arrangements.[86] In none of these precedents, however, has the SEC staff provided additional guidance on the form of payments these nominal fees may represent or imposed limits on referral fees or bonus programs similar to those provided in the Interim Final Rules. In fact, we understand that SEC and NASD examiners typically have interpreted the "nominal" fee condition in these precedents to allow the payment of referral fees that are well beyond the $7 to $10 referral fee that the Interim Final Rules would allow banks to pay many of their employees.

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[83] Id. at § 78c(a)(4)(B)(i)(VI).
[84] Interim Final Rules § 240.3b-17(g)(1).
[85] See, e.g., Chubb Securities Corp., 1993 SEC No-Act. LEXIS 1204 (Nov. 24, 1993); Independence One Bank of California and BHS Service Corp., 1993 SEC No-Act. LEXIS 620 (Apr. 6, 1993).
[86] See Adopting Release at 27765, n.38.

The Commission appears to place severe limits on the payment of referral fees in order to reduce a perceived "salesman stake" in the sale of securities of a bank employee who is not familiar with the protections afforded investors under the securities laws. However, this concern is both misplaced and unfounded. The statute merely permits bank employees to be compensated for referrals to the registered broker-dealer, not for the actual securities transaction. There always will be a registered broker-dealer between the customer and any securities transaction effected. It is the registered representative of the broker-dealer who will be responsible for ensuring that the eventual securities transaction is consistent with the suitability standards and other investor protection requirements of the securities laws.

The Banking Agencies also believe that the restriction that a payment not exceed "one hour of the gross cash wages of the unregistered bank employee making the referral" is unworkable. Banks often offer all of their employees, regardless of the level of their compensation, the same nominal award value for referring securities customers. As drafted, banks will be forced to incur additional administrative burden because a separate referral fee calculation will now be required for each employee who makes a referral. Administrative burden is further increased because the referral fee program will have to keep track of each adjustment in an employee's salary or wages. In addition, the interpretation raises concerns that a referral fee program based on the salary or wages of an employee would not properly protect the privacy of a bank's employees because the employees administering networking arrangements typically do not otherwise have access to wage and salary information of employees.

Although the Banking Agencies appreciate the effort of the Commission to clarify that payment of referral fees may be in the form of points, the Interim Final Rules' provision concerning points is overly restrictive and inconsistent with the Act. For example, the Commission requires that the points for securities referrals be part of a "system or program that covers a range of bank products and non-securities related services."[87] The statute does not require that the points awarded for securities referrals be part of a broader system or program that also awards employees for banking and other non-securities related services and the Commission provides no justification why the requirement is imposed in the Interim Final Rules. This requirement is particularly unjustifiable in light of the fact that referral fees paid in cash are not required to part of a broader program.

The Interim Final Rules also require that the "securities-related referral points have a value that is no greater than the points received under the system for <u>any other</u> product or service."[88] This means that the points granted for a securities referral must be no more than the lowest amount of points awarded for the referral for any other product regardless of the nature of the other product. There is absolutely no requirement in the statute that the points awarded for securities referrals must be no more than the award for the referral of any other product. As long as the points awarded for securities referrals are "nominal," the amount awarded as compared to other awards is not relevant.

[87] Interim Final Rules § 240.3b-17(g)(1)(ii).
[88] Adopting Release at 27765 (emphasis added).

The Agencies also strenuously object to the Commission's prohibition on the payment of referral fees in the form of bonuses. The Interim Final Rules prohibit banks from deferring securities referral fees until the end of the year. The statute does not prohibit payment in this manner and to do so will prevent a legitimate compensation program that in fact furthers the SEC's stated objective of reducing the salesman's stake inherent in a referral fee by separating by time the referral from the payment of fees.

The Adopting Release also states that "banks cannot indirectly pay their unregistered bank employees incentive compensation for securities transactions through a branch, department, or line of business or through a bonus program related to the securities transaction of a branch, department or line of business."[89] This language is drafted so broadly that it would appear to prevent a bank with a networking arrangement from paying any officer a bonus based on the success of a department or line of business that engages in securities transactions, even if the employee, department or line of business has no connection with the networking arrangement. For example, an officer with oversight responsibilities for a trust department that effects securities transactions in accordance with the Trust and Fiduciary Exception could not receive a bonus based on the success of the department if the bank also was a party to a networking arrangement. We assume that the Commission did not intend to broadly regulate bank bonus programs, and any such restrictions would be incompatible with functional regulation.

Given the fact that the Commission has not historically imposed limits on referral fees, the words of the statute, and the administrative burden the limits adopted by the Commission would cause, the Banking Agencies do not believe it is necessary or appropriate for the Commission to change its practice regarding referral fees or to define the upper limits of permissible referral fees. The Commission should instead allow, as under current practice, banks to interpret the term in a manner that best fits their networking arrangements.

Gross Limits on Referral Compensation.

The Commission solicits comments on whether gross limits on the amount of referral fees an employee can receive should be adopted.[90] The Commission expresses concern that if aggregate limits are not adopted, a bank might pay referral fees that constitute a substantial portion of an employee's total compensation. The statute, however, does not provide any basis for the Commission to adopt an aggregate limit on referral fees. Instead, the law specifically allows payment of a "nominal one-time cash fee." If each "one-time" referral fee is nominal, it meets the specific terms of the statute without regard to any other limit. This is also consistent with the SEC staff's past interpretations of permissible networking arrangements. Any action by the Commission to impose an aggregate cap would, in our view, be in excess of its authority under law.

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89 Id. at 27766.

90 Id.

Commission-Designed Limits on Trigger for Referral Fee.

The Commission's limitations on the circumstances in which a bank may pay a referral fee go beyond the unambiguous words of the networking exception. The statute only prohibits a nominal referral fee if it is "contingent on whether the referral results in a transaction."[91] However, the Interim Final Rules also provide, with little explanation from the Commission, that securities referral fees may not be related to—

(1) the size or value of any securities transaction;
(2) the amount of securities-related assets gathered;
(3) the size or value of any customer's bank or securities account; or
(4) the customer's financial status.[92]

Imposing limitations beyond those authorized by the statute are not permitted and will simply impose additional burden on banks administering securities referral fees without effecting the purposes of the GLB Act.

Statutory Dealer Exception for Asset-Backed Activities

The GLB Act includes an exception that permits banks to continue issuing and selling asset-backed securities to qualified investors through a grantor trust or other separate entity.[93] Under the exception, the securities must be supported by loans, receivables or other obligations that were "predominantly originated" by (l) the bank, (2) any of the bank's affiliates (other than a broker-dealer), or (2) a syndicate of banks of which the bank is a member if the obligations are mortgages or consumer-related receivables. Accordingly, the statute requires only that the assets underlying the securities be "predominantly originated" by the relevant "Bank Group," which, in all circumstances includes the bank and its affiliates (other than any broker-dealer affiliate) and, where the underlying obligations are mortgages or other consumer-related receivables, includes a syndicate of banks of which the bank is a member.

The ability of banks to sell assets is essential to their liquidity and safe and sound operation. By selling loans through securitizations, banks also are able to expand the amount of credit they can offer to meet community, business and individual needs. The GLB Act exception recognizes the importance of preserving the ability of banks to continue selling assets through securitizations to maintain their liquidity and meet credit needs. In addition, the exception recognizes that banks frequently form a syndicate to pool their mortgage and consumer-related originations for purposes of issuing securities backed by these assets. These syndicates allow banks, and particularly small banks, to assemble a pool of originations sufficiently large and diverse to make their securitization feasible and the resulting securities attractive to potential investors.

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[91] 15 U.S.C. § 78c(a)(4)(B)(i)(VI).
[92] See Interim Final Rules § 240.3b-17(g)(2).
[93] See 15 U.S.C. § 78c(a)(5)(C)(iii).

Predominantly Originated by the Relevant Bank Group.

The Interim Final Rules provide that a pool of obligations will be considered to be "predominantly originated" by the relevant Bank Group only if at least 85 percent of the obligations were originated by the Bank Group. In devising this 85 percent test, the Adopting Release indicates that the Commission was guided by the language in section 4(n) of the Bank Holding Company Act, as amended by the GLB Act.[94]

The Banking Agencies believe that this definition of "predominantly originated" is not compelled by the GLB Act and is unduly restrictive. In this regard, the most common definitions of "predominant" include "prevailing" and "being most frequent or common."[95] The fact that the term was defined to mean 85 percent for purposes of section 4(n) of the BHC Act is not controlling, since that section is wholly unrelated to the treatment of asset securitizations by banks under the Federal securities laws. For these reasons, we believe that the relevant Bank Group could meet the statute's "predominantly originated" standard if the value of the obligations originated by the Bank Group exceeds the value of the obligations originated by entities outside the Bank Group.

Such an interpretation recognizes more effectively that banks, to securitize their own assets, may purchase loans from other lenders to establish a sufficiently diverse pool to meet investor requirements. We believe a more relaxed interpretation also is appropriate given that the asset-backed exception applies only to sales to qualified investors.

Definition of Syndicate.

As noted above, in the case of securities backed by mortgages and other consumer-related receivables, the statute permits the obligations to be predominantly originated by a "syndicate of banks of which the bank is a member." The Interim Final Rules, however, define a "syndicate" in a manner that is wholly inconsistent with banking practice and, thus, effectively eliminates the statutory provisions authorizing syndicate transactions.

In particular, the Act's "syndicate" provisions were designed to recognize that banks currently form syndicates to issue mortgage-backed and consumer-receivable-related securities that are backed by a pool of obligations independently originated by the banks in the syndicate. These syndicate arrangements are of particular importance to smaller banks that may not themselves have a pool of originations that is large and geographically diversified enough to make their securitization feasible or attractive to investors. The Interim Final Rules, however, define a "syndicate" to mean "a group of banks that acts jointly, on a temporary basis, to loan money in one or more bank credit obligations." This definition reflects a fundamental misunderstanding of how syndicates function in the banking industry, effectively precludes banks from taking advantage of

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[94] 12 U.S.C. § 1843(n).

[95] See Webster's Ninth New Collegiate Dictionary (1991).

the syndicate exception in the GLB Act, and will have seriously deleterious effects on bank securitization activities.

Statutory Exception for Sweep Accounts

The GLB Act allows banks to sweep deposit funds into a "no-load" money market mutual fund (the "Sweeps Exception").[96] The Interim Final Rules generally adopt the definition of "no-load" that the NASD has adopted in its Rule 2830(d)(4). That rule prohibits an investment company from being advertised as "no-load" if "the investment company has a front-end or deferred sales charge or [imposes] total charges against net assets to provide for sales related expenses and/or service fees [that] exceed .25 of 1 percent of average net assets per annum."[97]

The Banking Agencies assert that the Commission is not bound to the interpretation of "no-load" adopted by the NASD. First, as the Commission acknowledges in the Adopting Release, the interpretation of "no-load" by the NASD in Rule 2830(d)(4) was intended to address the circumstances in which investment companies can be advertised as "no load" in light of the SEC's Rule 12b-1 permitting investment companies to use their assets to finance distribution expenses.[98] The use of the term "no-load" in the Sweeps Exception is used in an entirely different context than the NASD Rule. Second, early legislative and regulatory versions of the Sweeps Exception included the term "no-load" long before the NASD adopted its interpretation. Senate bill S. 1886 in the 100th Congress used the term in the Sweeps Exception and the Commission also used the term when it adopted a similar sweeps exception in the now-defunct Rule 3b-9.[99]

We believe that it is not necessary to interpret "no-load" to include funds that impose asset-based sales and other charges in excess of 25 basis points and that the Commission's current position will impose a significant burden on the administration of bank sweeps program without providing a commensurate level of protection to sweeps customers. Bank customers already receive appropriate disclosures concerning any fees charged in connection with a sweep account—including any Rule 12b-1 and other fees charged by the relevant money market mutual fund—from the bank. The Banking Agencies understand that the "no-load" interpretation by the Commission will prevent many banks from operating sweeps programs in the manner they have been operating for years. As a result, banks will be forced either to "push out" the sweeps activities to a broker-dealer or be required to incur significant administrative expense in revising their programs to meet the Commission's interpretation of "no-load." The Commission's interpretation, moreover, likely will not provide significant benefit to sweeps customers because banks can, and likely will, increase the deposit account fees they charge sweep

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96 15 U.S.C. § 78c(a)(4)(B)(v).
97 NASD Rule 2830(d)(4).
98 Adopting Release at 27779.
99 See Proxmire Financial Modernization Act of 1988, S. 1886, 100th Cong. § 301 (1988); 12 C.F.R § 240.3b-9(b)(4).

customers to make up for the fees paid by the money market mutual fund that they no longer can accept.

Statutory Broker Exception for Transactions for Affiliates

One of the GLB Act's exceptions authorizes banks to "effect[] transactions for the account of any affiliate of the bank (as defined in section 2 of the Bank Holding Company Act of 1956) other than—

(1) a registered broker or dealer; or
(2) an affiliate that is engaged in merchant banking, as described in section 4(k)(4)(H) of the Bank Holding Company Act of 1956."[100]

The purpose of this exception was to allow banks to continue to facilitate the purchase or sale of securities by their affiliates that are not significantly engaged in securities activities. These affiliates may not have an account at a broker-dealer and permitting them to effect trades through an affiliated bank's trading desk allows them to effect trades in a cost-effective manner.

The Adopting Release states that the statutory exception "does not cover a bank effecting trades with non-affiliated customers, even when the customer transaction also is effected as part of a trade involving an affiliate. A separate exception is necessary for the customer side of the trade."[101] Read literally, this regulatory proscription effectively negates the statutory exception by prohibiting a bank from completing a brokerage transaction under the affiliate exception. We assume that the Commission did not intend to effectively repeal a statutory exception adopted by Congress.

Time Period for Banks to Comply with Exceptions.

Extensions of Time Granted by the SEC.

The Banking Agencies support the Commission's efforts to provide banks additional time to comply with the exceptions from the definition of broker and dealer in the Exchange Act, and to delay the ability of private parties to sue banks under section 29(b) of the Exchange Act on the basis that the bank is not in compliance with the broker-dealer registration exceptions included in the Exchange Act.

The Banking Agencies strongly believe, however, that the delay period granted generally from the Act's requirements is insufficient and unfairly requires banks to comply with requirements that are inconsistent with the Act. As described in detail above, the Banking Agencies believe the Commission must make significant changes to the Interim

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[100] See 15 U.S.C. § 78c(a)(4)(B)(vi).
[101] See Adopting Release at 27783.

Final Rules in order to give effect to the plain language and purposes of the GLB Act. The October 1, 2001, implementation date essentially requires banks to immediately restructure their operations to ensure that their activities comply with the interpretations adopted by the Commission in the Interim Final Rules.

We believe it is fundamentally inappropriate and unfair to require banks to establish procedures to comply with the requirements of the Interim Final Rules before the Commission has reviewed public comments on these newly established requirements and addressed the significant concerns raised by the Banking Agencies and the banking industry.[102] In fact, in light of the significant effect that narrow interpretations of the Act's exceptions could have on the banking industry, Banking Agency staff advised Commission staff that it was especially important for the Commission to seek public comment prior to adopting any binding rules. We believe that the Commission's decision to adopt interim final rules that significantly restrict the current activities of banks and require banks to incur substantial costs is inconsistent with the notions of due process and fundamental fairness that underlie the Administrative Procedures Act and our regulatory system. Accordingly, the Banking Agencies believe that the Commission should seek public comment on a revised proposal that implements the plain language and purposes of the GLB Act, and should further extend the effective date of the GLB Act's push-out provisions until after that rulemaking is completed. We also believe that the Commission should provide banks with at least a one-year transition period to implement the systems and make any other changes necessary to comply with the revised rule.

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[102] The Interim Final Rules note that the Banking Agencies have used interim rules to implement other provisions of the GLB Act. See Adopting Release at 27762, n. 15. The Banking Agencies have used interim rules to implement provisions of the GLB Act that expanded the authority of banking organizations to engage in activities or structure their operations. Thus, these rules did not have an adverse impact on the existing operations of banking organizations. The Interim Final Rules, on the other hand, implement restrictions that, for the first time, restrict the types of activities in which a bank may engage and that could have a significantly adverse impact on existing bank activities. In these circumstances, the public comment process provides a particularly valuable method for ensuring that any new requirements ultimately adopted do not unnecessarily and adversely affect the existing operations of the relevant industry.

Securities Transactions that Do Not Meet Exception Due to Inadvertent Errors or Unforeseen Circumstances.

The Commission fails to address the effect of the Exchange Act on a bank that discovers that some of its securities transactions do not comply with any exception in the GLB Act due to inadvertent errors or unforeseen circumstances. The most reasonable conclusion to be drawn from the Commission's silence is that under the Interim Final Rules a bank that conducts one securities transaction that does not qualify for an exception would be considered a broker-dealer under the securities laws and would be required to register immediately with the SEC. Because calculations necessary to determine compliance with some exceptions under the Interim Final Rules can only be done at year-end, a bank may not be able to determine whether it qualifies for an exception until the end of the year and may find at that time that it must immediately restructure its operations by the next day in order to be in compliance with the rule's restrictions. Worse, the Commission's silence also allows the inference that a bank in these circumstances was in violation of the securities laws during the past year.

The results of this approach are absurd and inconsistent with the purposes of the GLB Act for several reasons. First, it is to be expected that banks that are attempting to conform their securities activities to the exceptions will identify some securities transactions that do not meet an exception because of the complexity of the exceptions and the lack of clear guidance on some of the exceptions from the Commission. Second, under the Interim Final Rules, a bank will not even be able to confirm at the time it conducts many of its securities transactions that they will qualify for an exception. For instance, the Interim Final Rules require a bank relying on the Trust and Fiduciary Exception to calculate at the end of a year the total compensation it receives from each trust and fiduciary account during the previous year. It is possible that on December 31st of the year a bank would determine that one or more trust or fiduciary accounts did not meet the chiefly compensated requirements of the Interim Final Rules for the previous year due to unforeseen circumstances, such as an unexpected direction from a trust customer to liquidate an account by selling securities. In such circumstances, the bank must restructure its operations by the next day. Similarly, at the end of a year, a bank could determine that it engaged in 501 securities transactions and, therefore, one transaction would not fit within the de minimis exception.

The Banking Agencies believe that it is critically important for the Commission to clarify that a bank that attempts in good faith to conduct its securities activities in conformance with the exceptions, and that has in place policies and procedures reasonably designed to result in compliance with the exceptions, will not be considered a broker-dealer if it determines that some of its securities transactions do not meet an exception. Failure to provide such clarity will effectively force banks to take an overly cautious approach to conducting securities transactions in the bank because of the severe penalties that could arise from inadvertent or de minimis violations, including SEC enforcement actions and, after January 1, 2003, private suits for rescission of securities contracts entered into by the bank. This would result in the exceptions becoming meaningless for many banks, an outcome that is not consistent with the terms or purposes of the GLB Act. In addition, lack of clarity on this issue would have a disproportionate effect on small banks that are not affiliated with a registered broker-dealer. The Banking Agencies are concerned that many banks would choose to discontinue traditional securities activities that banks are expressly permitted by the GLB Act to conduct in the bank because of the potentially high consequences of any noncompliance.

The Banking Agencies also believe it is critically important that the Commission provide banks with a reasonable period of time to cure inadvertent or unforeseen violations. Such a cure period could be structured in a variety of ways. For example, a bank could be allowed to calculate its compliance with the "chiefly compensated" requirement of the Trust and Fiduciary Exception based on a rolling average of the bank's compensation over a period of time. This approach would allow a bank a reasonable opportunity to foresee when its sales compensation was approaching the statutory limit and take appropriate action to address the issue. In any event, the cure period provided must be sufficiently long for banks to take appropriate action to address the violations, including establishing an affiliated broker-dealer to which the nonqualifying securities activities can be transferred.

Areas Not Addressed by the Interim Final Rules

Failure to Address Scope of Many Exceptions.

The Banking Agencies are concerned that the Interim Final Rules fail to address the scope of a majority of the exceptions to the definitions of broker and dealer in the Exchange Act. The Interim Final Rules provide guidance on the scope of only certain limited aspects of six of the broker exceptions and one dealer exception. For example, the Commission does not discuss at all how it proposes to interpret the exception that permits banks to effect transactions in the securities of an issuer as part of its transfer agency activities.[103]

As discussed in detail above, the Banking Agencies believe that many of the Commission's interpretations of the scope of the exceptions it has chosen to address do not comport with the unambiguous words of the GLB Act and the legislative intent of Congress. The Banking Agencies are concerned that the SEC will, through enforcement actions and no-action letters, take similar aggressive positions in interpreting the scope of the exceptions it has not addressed by rule. Such a process would essentially deny banks and other members of the public an opportunity to comment on these interpretations and voice concerns when the interpretations are not consistent with the words or purposes of the GLB Act. We believe that it is very important for the public to have the opportunity to comment before the SEC interprets the scope of any exception. Accordingly, the Banking Agencies request that the Commission propose for comment rules that address the scope of each of the broker and dealer exceptions. The Commission should then take into account the comments made on the proposal and incorporate them into the final rule.

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[103] 15 U.S.C. § 78c(a)(4)(B)(iv).

Applicability of NASD Rule 3040.

The Commission also fails to address the applicability of NASD Rule 3040 to "dual employee" arrangements in which bank personnel serve as employees of both a bank and a broker-dealer. The Banking Agencies believe that it is absolutely critical that the Commission issue guidance that clarifies that NASD Rule 3040 does not apply to dual employees operating in their capacity as bank employees when effecting securities transactions pursuant to an exception. Failure of the Commission to provide such guidance will result in excessive administrative burden that will effectively force banks to "push out" of the bank securities activities that the GLB Act intended to remain in the bank.

The Banking Agencies expect banks to rely more frequently on dual employee arrangements when effecting securities transactions for bank customers in order to preserve the flexibility of either booking a securities transaction at the bank if the transaction is likely to comply with an exception or booking it with the broker-dealer. If Rule 3040 were applied to a transaction effected by a dual employee in his or her capacity as bank employee, it would require the transaction to be (i) approved by the broker-dealer and (ii) recorded on the broker-dealer's books and records.[104] Applying Rule 3040 in these circumstances would significantly increase the administrative burden of effecting a securities transaction at a bank. It would require that each separate transaction be approved and monitored by the broker-dealer and the funds for the transaction be transferred to the books and records of the broker-dealer. For example, a dual employee who effects a transaction on behalf of a trust account would be required to remove funds from the account and effect the transaction through the broker-dealer even though a statutory exception is specifically provided for the transaction in the GLB Act. The Banking Agencies are concerned that imposing this regulatory interpretation requires banks to "push out" all securities transactions to the broker-dealer effectively denying banks using dual employee arrangements the benefits of the exceptions in the GLB Act.

Equally as important, the Commission must clarify that Rule 3040 does not give SEC and NASD examiners the authority to examine or otherwise scrutinize the activities of dual employees acting in their capacities as bank employees, including effecting securities transaction in compliance with an exception of the GLB Act. The exceptions were adopted in order to preserve the authority of banks to continue to engage in securities transactions in connection with their traditional banking activities. The GLB Act also endorsed the principles of functional regulation and placed the authority with the Banking Agencies for examining the securities activities conducted by bank employees consistent with the exceptions.

Solicitation of Comments on Recordkeeping Requirements.

[104] NASD Rule 3040(c).

The Commission has requested comment on whether it should adopt recordkeeping requirements for banks that seek to rely on the broker-dealer exceptions included in the GLB Act.[105] Such action would not only be outside the Commission's statutory authority, but would be contrary to the Congress's express directive on this issue in the GLB Act.

Section 204 of the GLB Act added a new section 18(t) to the Federal Deposit Insurance Act (12 U.S.C. 1828(t)). This section directs the Banking Agencies to adopt recordkeeping requirements for banks that rely on the broker-dealer exceptions established by the GLB Act. The recordkeeping requirements established by the Banking Agencies "shall be sufficient to demonstrate compliance [by banks] with the terms of such exceptions and be designed to facilitate compliance with such exceptions." Section 204 also requires the Agencies to provide the Commission, at its request, any records maintained by a bank pursuant to the Banking Agencies' recordkeeping regulations.

No similar statutory authority was granted to the SEC.

In our view, Congress intended section 204 to serve as the sole method for the SEC to obtain records of banks relating to their compliance with the broker-dealer exceptions of the GLB Act. The Agencies serve as the appropriate functional regulator of banks and the SEC lacks the authority to establish recordkeeping requirements for banks that are not registered with the SEC.

As SEC staff is aware, the staffs of the Agencies had developed draft recordkeeping requirements for banks under section 204 in the spring of 2001. The Agencies placed development of these regulations on hold once we learned that it was likely that the Commission would issue some formal guidance on the scope of the GLB Act's exceptions. The Agencies anticipate moving forward on these recordkeeping requirements in the near future once the Commission has the opportunity to address the significant issues raised by the Interim Final Rules. As required by the statute, the Agencies will consult with the Commission and consider its views before promulgating the recordkeeping requirements.

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105 Adopting Release at 27763.

Testimony of Michael E. Patterson
Vice Chairman
J.P. Morgan Chase & Co.

Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises

and the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services
U.S. House of Representatives

Hearing on the
Securities and Exchange Commission's Interim Final Rules Relating to Provisions of
Title II of the Gramm-Leach-Bliley Act

August 2, 2001

My name is Michael Patterson. I am a Vice Chairman of J.P. Morgan Chase & Co., working primarily in the area of Investment Management and Private Banking

I very much appreciate the opportunity you have given JPMorgan Chase to comment on the implementation of Title II of the Gramm-Leach-Bliley Act ("G-L-B Act"). My remarks will focus on certain practical issues raised by the Securities and Exchange Commission's interim final rules (the " Interim Rules"), and they cover matters that have been part of a constructive, ongoing dialogue between banking organizations and the Commission and its staff. I hope that my remarks will be helpful to the Committee in its efforts to understand our concerns.

As many members of this Committee will recall, the so-called "push-out" provisions in Title II of the G-L-B Act were extensively debated prior to passage of the legislation. The provisions that were enacted reflect numerous compromises that were reached in an effort to reconcile two somewhat inconsistent goals: one, that the Commission should regulate broker-dealer activities; and two, that traditional banking activities should remain in banks. We think that the provisions of the Act struck the right balance, but that the Interim Rules reflect a strong—and we believe an inappropriate—bias in favor of imposing securities regulation on bank activities.

The Commission suggests in the introduction to the Interim Rules that part of the motivation behind the passage of G-L-B Act was to protect previously unprotected investors from banks that engaged in securities activities without being subject to the provisions of the federal securities laws. We strongly disagree with this interpretation. No problem of investor protection that needed to be addressed existed. The banking agencies had been diligent in protecting investors. Rather, the G-L-B Act sought to apply broker-dealer regulation to banks when banks' activities did not qualify for certain newly established exceptions from the definitions of broker and dealer.

I will give you several examples of where we believe the Interim Rules did not appropriately implement Congressional intent and would unduly disrupt the way banks have traditionally conducted their business.

Certain provisions in the Interim Rules implementing the trust and fiduciary exception present banks with serious compliance problems and are not mandated by law. The G-L-B Act provides that a bank will not be regulated as a "broker" solely because it engages in transactions as a trustee or as a fiduciary in its trust department, so long as, among other things, it is "chiefly compensated" on the basis of administrative or certain other fees. A key difficulty is the fact that the "chiefly compensated" test as contemplated by the Commission requires an account-by-account analysis to determine whether "relationship compensation" exceeds "sales compensation." Even the so-called safe harbor alternative test would in fact require this account-by-account analysis. For J.P. Morgan, this would require a review of in excess of 50,000 trust and fiduciary accounts periodically to determine and document their compliance with the proposed test. At J.P. Morgan, and we suspect most other firms, existing management information systems do not collect data using the categories required by this test. Although it would be possible to create a new data collection system given enough time and money, we do not believe Congress could possibly have intended banks to assume a burden of this magnitude in order to demonstrate that a traditional banking business should not be pushed out.

The account-by-account analysis would create other problems as well. Many of these trust accounts have fee arrangements that were individually negotiated years ago, obviously without regard to the detailed definitions of relationship and sales compensation contained in the Interim Rules. If it is determined that particular accounts have too high a level of sales compensation, we could be required to push these relationships out. That might involve amending existing documentation, which is a difficult if not an impossible task, particularly if all of the trust beneficiaries could not be contacted and/or did not have the legal competence to execute agreements. It also might require that one account in an overall relationship composed of many accounts be pushed out to a broker-dealer, while other related accounts remain in the bank. We do not believe Congress intended such a disruption of traditional bank trust and fiduciary relationships.

Instead of the account-by account approach proposed by the Commission, we suggest that the banks and the Commission's staff continue their efforts to establish a suitable test that measures "chiefly compensated" on an aggregated basis. More workable concepts include:

- Permitting banks to apply the "chiefly compensated" test at the business unit or department level.
- Including all trust and fiduciary compensation other than sales compensation as relationship compensation. This should include fees from managing non-securities investments such as real estate. We do not believe that there are any policy reasons to exclude such fees from a

calculation designed to determine what percentage of a business is comprised of sales-based compensation.

- Determining that all or a portion of service fees received from mutual funds be treated as relationship compensation.
- Grandfathering revenues received under fiduciary agreements existing prior to the effective date of Title II of the G-L-B Act, May 12, 2001.

The Interim Rules imply that the term "trustee" is to be interpreted in an unduly narrow manner. The G-L-B Act creates an exception for a bank effecting transactions in a "trustee capacity," a term that is not defined in the Act, but on its face includes all trusteeships. Nevertheless, in the introductory material to the Interim Rules, the Commission raised questions regarding whether certain trustee capacities qualify for the statutory exception" because banks in these situations may not be subject to significant fiduciary responsibilities. "Later in the explanatory materials, the Commission states that "the law is unclear as to whether banks acting in these three capacities [i.e., indenture trustees, ERISA and other similar trustees, and IRA trustees] should be covered by the trust and fiduciary activities exception because they are acting, at most, in a limited fiduciary capacity with regard to investors who direct their investments, despite their 'trustee' label." To "alleviate" this purported "uncertainty", the Commission adopted as exemptive rules defining "trustee capacity" to "include" indenture trustees and trustees for certain tax-deferred accounts (e.g., ERISA and IRA accounts). The adoption of an exemptive rule and the language of the explanatory material call into question whether other types of trustee capacities that are not subject to the highest possible fiduciary standards *(e.g.*, "Rabbi" trusts, estate planning trusts, insurance trusts, and trusts where another *(e.g.*, individual) trustee possesses the investment discretion) qualify for the statutory exception. We see no reason to doubt that Congress intended that all trustee capacities qualify for the trustee exception.

The investment advisory exception is also given an unwarrantedly narrow definition in the Interim Rules. The G-L-B Act defines investment advice for a fee as a fiduciary activity. However, the Interim Rules add additional restrictions that are not in the statute. Under the rules, an investment advisor is engaged in fiduciary activities only if it provides "continuous and regular investment advice" and has an undefined "duty of loyalty" to the customer.

The Interim Rules unduly narrow the definition of "broker" contained in the G-L-B Act by limiting the fees that banks may charge as custodians for order taking and other limited execution services. The term "custody and safekeeping" has traditionally been understood to include order taking, and there is no reason to believe that the G-L-B Act intended to change this understanding. On the contrary, the statute requires that custody trades be executed through a registered broker-dealer. There is no basis for the Commission to impose restrictions on custodial order-taking that go beyond those contained in the statute.

The Commission may be concerned that banks will offer full-service brokerage accounts in the guise of custodial arrangements. Custodial accounts, however, serve many important functions for which brokerage accounts are not suitable. Moreover, banks do not offer custodial services as a way to solicit trading activity; banks in the custodial business merely follow instructions. No salesman commissions are paid for trades, so there is no incentive to encourage trading activity. Custodial accounts generate shareholder servicing fees paid on the basis of assets held in custody and therefore create no incentive to encourage trading. Finally, we note that the ability of banks to advertise or promote their custodial services is severely restricted by the Interim Rule.

In addition to order taking, certain execution services are inherent in the custody business. For example, in the case of stock splits and mergers, banks must sell shares to give their customers cash in lieu of fractional shares. Custody customers often look to their custodians to sell odd lots of securities. These services should also be recognized as qualifying for the custody and safekeeping exception. Pushing order taking and these other execution services out of banks would adversely affect customers by requiring duplicative accounts (bank and brokerage) and increasing administrative costs.

The provisions of the Interim Rules related to employee compensation also constitute an unnecessary interference with traditional banking activities. One example is the discussion of bonus plans, which are not mentioned in Title II. However, the Commission's explanatory material states that "by their very nature [bonus plans] are incentive compensation," and that unregistered bank employees may not receive "incentive compensation for any brokerage-related activity" (other than permissible referral fees) including bonus plans based in part on securities transactions unless the bonus plan is based on the overall profitability of the bank. But, few, if any, bonus plans are based solely on the stand-alone profitability of a bank (as opposed to the performance of the overall financial institution or a business unit within the institution). The rule amounts to an attempt by the Commission to regulate the structure of bank bonus compensation plans. The final regulation should permit any bonus plan so long as it is not an indirect conduit for the payment of specific transaction-related referral fees to bank employees that are not registered through a broker-dealer.

The Interim Rules also impose limitations on bank-employee referral compensation that are too rigid. For example, "referral" is limited to arranging the first securities-related contact with an investor, and the term excludes subsequent activity. This is not mandated by the G-L-B Act or by established precedent. As a result, the rule permits referral payments to be based solely on the quantity of referrals made by an employee. Moreover, the Interim Rules define "nominal one time cash fee of a fixed dollar amount" in terms of an employee's hourly salary. This discriminates against lower paid personnel and raises privacy concerns because the administration of this rule will require individuals who would not normally be aware of others' salaries to have access to such information. Contrary to the G-L-B Act, the Interim Rules prohibit conditioning payment of a referral fee upon the opening of an account, or on the customer's completing a profile or providing other information with the assistance of bank personnel. Nothing in the G-L-B Act prohibits a referral fee from being based upon whether an account is actually opened and the size of the account, so long as it is not conditioned on, or calculated on the basis of, transactional activity.

The Commission, in its no-action Chubb Letter, and the bank regulators in the Interagency Guidelines, have already provided flexible guidance about the concept of "nominal one-time referral fee." In that letter the Commission's staff did not find it necessary to quantify the term "nominal" and did not prohibit the payment of referral fees based upon the opening of an account or on amount of assets gathered. The compensation language in the Act is based in large part on these precedents. Such flexible guidance has enabled banks to develop compensation programs that provide appropriate incentives to bank employees, while ensuring that customers are directed to the product that best suit their needs. After nearly ten years, we are aware of no incidence of abuse or problems that have arisen under the existing guidance. The Commission's rigid new limitations do not enhance customer protection and would require the overhauling of complex compensation plans that have not raised problems in the past.

Ironically, efforts to comply with the Interim Rules would undermine functional regulation and increase regulatory burdens. One way to comply with the rules is to register bank employees as broker-dealer representatives (making them dual employees of the bank and the broker-dealer). Such individuals would continue to perform their functions as bank officers as well as their duties in the broker-dealer. When performing in the latter role, the employees would quite properly be subject to the supervision of the broker-dealer. However, the Commission's discussion in the explanatory material to the Interim Rules indicates that the Commission believes that a broker-dealer should supervise bank securities activities performed in the bank by any dual employee. The position of the Commission appears to be that the conduct by dual employees of securities transactions that are permitted to remain in the bank under the Act are nevertheless subject to broker-dealer approval, record keeping and supervision, and, ultimately self regulatory organization and Commission oversight pursuant to NASD Rule 3040. We believe that this position is clearly inconsistent with Congressional intent, and that transactions properly conducted within the bank should not be subject to approval and oversight by anyone other than the bank itself and its bank regulators.

These issues are intended to be illustrative of the many issues raised by the Interim Rules. Other issues of concern include: the definition of "no load" funds for purposes of the sweep exception, the need for a safe harbor to protect a bank that inadvertently violates the Commission's regulations despite good faith efforts to comply, the need to have adequate time to implement procedures to comply with the final form of the Commission's regulations, the scope of the exemption for asset backed securities under the definition of "dealer," and the need for an exemption for transactions between a bank and a mutual fund's transfer agent.

We encourage members of the Committee to examine each of these issues to determine the extent to which the Commission's Interim Rules are consistent the G-L-B Act.

Testimony of

Edward D. Higgins

On Behalf of

The American Bankers Association

and

The ABA Securities Association

Before a joint hearing of

The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

and

The Subcommittee on Financial Institutions and Consumer Credit

Committee on Financial Services

United States House of Representatives

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Chairmen Baker and Bachus, Representatives Kanjorski and Waters, distinguished members of the subcommittees, my name is Edward D. Higgins. I am Managing Director of the Private Client Group at Firstar Bank-US Bank. US Bancorp, the parent company of Firstar Bank and US Bank, is the eighth largest domestic financial services holding company with $160 billion in assets and $116 billion in assets under management. We have over 10 million customers and operate through more than 2,200 branches and 5,200 ATMs located in 25 states, primarily in the West, Midwest and Florida.

I appear here today on behalf of the American Bankers Association and the ABA Securities Association. The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks—makes ABA the largest banking trade association in the country. ABASA is a separately chartered trade association subsidiary of the ABA, formed in 1995 to develop policy and provide representation for those bank and financial holding companies involved in investment banking and other similar capital markets activities.

I commend you, Messrs. Chairmen, for holding this hearing to focus on the interim final rules recently issued by the Securities and Exchange Commission ("SEC"). The issues raised by the SEC's interim final rules are of very great concern to members, both large and small. Like my bank, many of our members offer trust and asset management services to individuals, pension plans, and charitable foundations and endowments. Many services offered to these clients, including our self-directed IRA accountholders and 401(k) plan participants, will be significantly and negatively impacted if the SEC's interim final rules are not amended. Brokerage services offered to retail customers from the bank lobby though registered broker-dealers and sweep services offered to deposit account holders are two other services that will suffer tremendously under the SEC's rules. Many of these and other issues raised by the interim final rules are discussed in detail in the ABA and ABASA comment letter filed with the SEC on July 17, 2001.

Today, I wish to highlight in my testimony the following four issues:

- The hugely burdensome and expensive "chiefly compensated" standard imposed by the SEC's rules under the trust and fiduciary exception;
- The inability to perform in the bank customary order taking activities on behalf of our custodial clients, including self-directed IRA customers and 401(k) plan participants;

- The requirement to completely restructure our employee referral programs, despite the fact that these programs comply with all existing guidance issued to date by the SEC, the bank regulators and the Congress; and
- The inability to continue sweeping bank deposit balances into money market mutual funds.

Before I discuss these issues in greater detail, however, I wish to go on record regarding recent initiatives undertaken by the SEC. Specifically, the ABA and ABASA are extremely grateful that the SEC has moved the compliance date from October 1, 2001 to May 12, 2002 and has indicated further that additional time to comply will be given once the SEC issues amended final rules. We were especially heartened by the SEC's announcement that it did not expect banks to develop compliance systems until it amended its rules. Before the SEC made this announcement, my bank was just one of the many banks confronting the prospect of spending many millions of dollars and countless employee hours to comply with some of the more onerous provisions of the interim final rules. I can assure you that the industry breathed a collective sigh of relief upon hearing this most welcome announcement.

The announcement demonstrates that the SEC has heard the banking industry loud and clear on the need for more time for banks to get into compliance. Since the SEC first issued the interim final rules in mid-May, members of the SEC's senior staff have conducted a series of meetings with various industry groups in order to get a clearer understanding of the difficulties that the industry would experience when the interim final rules when into effect. We believe these discussions have been very helpful and hope that they will continue as the SEC continues to learn more about our industry.

The "Chiefly Compensated" Test under the Trust and Fiduciary Exception

The Gramm-Leach-Bliley Act recognized that traditional banking activities involving securities transactions should not trigger broker-dealer registrations requirements. Accordingly, Title II lists several exceptions under which banks would not be required to push certain securities activities out of the bank and into a broker-dealer affiliate (the so-called "push-out" exceptions). One such exception is the trust and fiduciary exception.

That exception requires that the bank: (1) not publicly solicit brokerage business, other than by advertising that it effects transactions in securities as part of its overall advertising of its general trust business; (2) be chiefly compensated by way of an administration or annual fee, a percentage of assets under management, a flat or capped per order processing fee that does not exceed the cost of executing the securities transactions, or any combination of such fees; and (3) generally direct all trades of publicly traded domestic securities to a registered broker-dealer for execution.

In providing this exception, the Congress recognized that "[b]anks are uniquely qualified to provide [trust] services and have done so without any problems for years. Banks provided trust services under the strict mandates of State trust and fiduciary law without problems long before Glass-Steagall was enacted; there is no compelling policy reason for changing Federal regulation of bank trust departments, solely because Glass-Steagall is being modified." S. Rep. No. 106-44, 106th Cong. 1st Sess. at 10 (1999). The House and Senate Conferees ratified this view when stating their expectation that "the

SEC...not disturb traditional bank trust activities under this [the trust and fiduciary] provision." Conf. Rep. 106-434, 106th Cong. 1st Sess. at 164 (1999).

The ABA and ABASA would submit that the SEC has interpreted the "chiefly compensated" requirement imposed by the statute in such a manner that, as a practical matter, banks will, in fact, be forced to "push-out" many traditional trust and fiduciary activities in direct contravention of Congressional intent. We also strongly oppose the SEC's interpretation, as it will create huge compliance burdens for the industry and, most importantly, harms consumers.

Several of our members have indicated that if the SEC continues to adhere to its position that each individual trust and fiduciary account must be individually analyzed according to the SEC's overly complex formulation of the "chiefly compensated" test, banks will be forced to expend millions of dollars to develop the requisite technology required to comply. One very large bank estimated a total technology cost to comply with the interim final rules of $15 million. In addition, many regional and smaller trust institutions outsource much of their system needs. System providers estimate that the costs to develop software required by the SEC's rules would be significantly higher than $15 million. These same providers have expressed doubt as to whether half or more of their client base could even afford the developed system.

We believe the SEC has taken what should be a fairly simple test requiring compensation permissible under the statute to outweigh or exceed brokerage or sales compensation and, instead, made the test one that is overly complex and burdensome. What should take a paragraph to explain has taken 11 pages of narrative text. The regulatory burdens associated with this test are enormous.

For example, bank trust and fiduciary departments often receive compensation for fiduciary services provided to one account from sources other than the account beneficiary. Employer/plan sponsors will often negotiate for bank trustees of company 401(k) plans to be compensated through the use of 12b-1, shareholder servicing fees, and other fees paid by mutual funds in which plan assets are invested.

This practice is allowed by the Department of Labor, the agency charged under the Employee Retirement Security and Income Act ("ERISA") with regulating 401(k) and other employee benefit plans. Extensive disclosure concerning these fee arrangements is given to bank fiduciary customers. Nevertheless, accounts earning these fees will not pass "the chiefly compensated" test as adopted by the SEC.

Trustee compensation paid by way of 12b-1 fees or shareholder servicing fees is not compensation permitted under the statute, the SEC tells us, because it is not paid out of fiduciary assets nor is it paid directly by the customer or beneficiary. Nowhere in Title II is there a suggestion that compensation under the trust and fiduciary exception must be paid from a particular source in order for it to be permissible under the "chiefly compensated" standard.

In addition, the SEC's position is not good for consumers. Companies that sponsor employee benefit plans for their employees like these fee arrangements. Moreover, for many small employers, it is the only way they can afford to offer their employees access to 401(k) plans. Plan sponsors understand prices quoted in an all-in or on a net asset value ("NAV") basis rather than a separate line disclosure for trustee services provided. If trustee expenses were not paid through 12b-1 or shareholder servicing fees, the plan's trustee or recordkeeper would, on a daily basis, have to calculate a unit value for each investment option under the plan, deducting from the NAV of each mutual fund option the proportionate trustee and recordkeeping charges for the day. This would be incredibly expensive and time-consuming and would discourage employers from offering employees the ability to save for their retirement though 401(k) plans.

A similar result occurs under the SEC's interpretation of "chiefly compensated" where families have several trusts with different family members as beneficiaries. All fees charged for services provided to all the trusts are charged to the founding grantor's trust.

Even if the SEC were to eliminate the "source" requirement, accounts earning these fees would still fail the "chiefly compensated" test. This is because the SEC maintains that these fees are sales compensation and that each account must pass the "chiefly compensated" test. Nothing in the statutory language creating the trust and fiduciary exception requires these calculations to be made on an account-by-account basis.

The purpose of the exception is to allow banks to keep in the bank the types of trust and fiduciary activities that banks have engaged in for many, many years, even where a substantial portion of those activities could involve fees that would otherwise trigger broker registration requirements. The Congress recognized that, unlike several other push-out exceptions, where banks conduct securities transactions in their fiduciary capacity they are subject to an entirely separate scheme of bank fiduciary regulation. In that context, where customers have alternative regulatory protections, the statute expressly recognizes that securities activities ought to be permissible in the bank even where there are significant amounts of transaction-based compensation.

The ABA and ABASA have repeatedly urged the SEC to require the "chiefly compensated" test to be performed on a line-of-business basis rather than on an account-by-account basis. A line-of-business calculation would comport with current bank practices, systems capabilities, and regulatory reporting requirements; would not result in increased regulatory burden for bank trust and fiduciary departments; and would be consistent with the statute and Congressional purposes in enacting the exemption.

Banks and regulators use line-of-business in order to track fiduciary fees, manage fiduciary business lines, and report fiduciary business to bank regulators. Specifically, banks and trust companies generally charge fees for fiduciary services according to fee schedules that vary from business line to business line.

In addition, many bank trust departments and trust companies currently generate internal tracking reports along lines of business. For example, bank trust departments generate monthly management reports that track, on a business-line basis, revenues earned and expenses incurred. Finally, bank regulatory reports also require income earned by bank trust departments to be reported on a line-of-business basis. In short, fees are generally tracked and aggregated on a line-of-business basis, and not on the more "granular" basis of types of fees charged to individual accounts.

Making the "chiefly" calculation on a more detailed or "granular" basis, would, in many cases, be extremely burdensome and practically unworkable. Banks would be required to perform yearly analyses of fees charged to over 19 million accounts valued at over $22 trillion. Expensive new software would have to be developed and installed;

systems would have to be substantially reconfigured; and such fine-tuned reporting would become more complex and burdensome.

The SEC maintains that a complex and burdensome "chiefly compensated" test is necessary to ensure that banking organizations do not in the future move their retail brokerage operations out of their broker-dealer affiliates, away from SEC supervision, and into the bank's trust and fiduciary departments.

I have over thirty years experience in the trust and asset management business. During those thirty years, I have worked in four major bank trust departments and managed three of them. I can tell you that, without a doubt, this will not happen. The market will not allow it.

Retail brokerage customers will not pay for trust services they neither need nor want. And bank trust departments will not assume fiduciary responsibilities and potential liability for accounts that are not priced to assume those risks and responsibilities. Let me explain.

Trust and fiduciary customers generally pay an annual fee, charged monthly, based upon the fair market value of the total assets held in their account. The fee is generally a percentage that declines as the size of the account increases, so for example, the fee may be 1.10% on the first $1 million, 1.00% on the next $2 million, 0.60% on the next $2 million and so on. In addition, most banks have a minimum annual fee, which varies depending on the size of the bank. Fees will also be assessed for other services including tax and accounting, distribution, certain transactions and specialized investments made, and certain extraordinary services. In addition, banks will also be compensated through 12b-1 fees, shareholder servicing and other fees paid by third parties.

Retail brokerage customers, on the other hand, pay a fee based on the dollar value of the transaction. Generally there is a minimum fee and then a commission rate multiplied by the dollar value of the transaction. For example, a full service brokerage firm might charge a minimum fee of $42 per trade plus 6 cents times the dollar value of the transaction. Discount brokerage operations charge much less.

Brokerage and trust services are priced according to the level of service demanded by the client—the more involved the service and the more complicated the system required to provide that service, the higher the cost of the service. Trust accounting systems, for example, are much more complicated than those used by brokerage firms. Trust systems must be able to separate principal and income on cash and investments whenever an account has primary income beneficiaries, as well as remainder or contingent beneficiaries. Brokerage accounting systems generally are not so complex.

Management of these trust and brokerage accounts differs significantly, as well, justifying the different pricing structures. Strict fiduciary duties require bank trust departments to perform frequent reviews of account holdings to determine, among other things, whether changing beneficiary needs require a modification in investment objectives; whether there are any inappropriate concentrations of investments; and whether the use of any affiliated brokers, mutual funds or bank deposits is appropriate. Serving as trustee may also involve arranging for home health care, paying all the client's bills, preparing tax returns, and maintaining various properties.

Regulatory oversight differs significantly, again justifying the pricing differential. As a general matter, bank trust departments are physically examined every 12 to 18 months depending on the size of the institution. Some larger institutions, like mine, even have examiners on-site at the bank. All bank examiners interface frequently with the institutions they examine as quarterly updates of the institution's risk ratings are required.

Bank trust department fees reflect the increased liabilities associated with assuming strict fiduciary responsibilities and the "high touch" service requirements of those accounts. Retail brokerage customers neither need nor want the services offered by bank fiduciaries and would not tolerate the fees that must be charged trust customers by banks. As a result, the market will not permit banks to move retail brokerage into bank trust departments and away from the SEC's oversight.

Of course, the "chiefly" language, interpreted reasonably on a line-of-business basis, along with the requirements of separate broker-dealer execution of securities trades resulting from fiduciary activities and the prohibition on brokerage advertising, further ensures that the trust exception may not be used simply to transfer a full-scale securities brokerage operation into a trust department to evade Commission regulation.

Order-taking under the safekeeping and custody exception

The Congress determined in the Gramm-Leach-Bliley Act that a bank that engages in safekeeping and custody activities, in accordance with the conditions outlined in the exception, would not be considered a broker under the Securities Exchange Act of 1934. Order taking clearly comes within the ambit of "custody services" and, contrary to the SEC's position, should not be "pushed out" of the bank.

Order taking is most easily understood in the context of self-directed individual retirement accounts ("IRAs") and 401(k) and other defined contribution plans. Generally speaking, employees who have contributed over the years to their company-sponsored 401(k) plans or participated in their employer-funded defined contribution plans will, upon leaving their jobs, opt to roll-over assets from their plans into IRA accounts. If employees have the time and the inclination to direct their own investments, they will frequently choose to open self-directed IRA custodial accounts. In this way, they can direct the custodian institution regarding the investment of their retirement assets.

Both banks and broker-dealers serve as custodians to self-directed IRA accounts. Individuals frequently choose banks to serve as custodians to their IRA accounts on the basis of the strong capital supporting that institution, the regulatory oversight provided by bank examiners, and the convenience and comfort of dealing with a local institution.

Other times, an employer/plan sponsor will hire a bank as a custodian to service the company's 401(k) or other defined contribution plan. Most often, those plans permit employee/plan participants to select investments from a range of options offered by the plan. Custodian banks effectuate securities trades only after taking employee/plan participants' investment orders.

The Gramm-Leach-Bliley Act provides, without limitation, that banks, "as part of customary banking activities," that offer "safekeeping and custody services with respect to securities" will be excepted from brokerage registration. Order taking or buying or selling securities at customer direction and as an adjunct to custody relationships has long been a customary custody service provided by banks. The Department of the Treasury, bank regulators and well-known trust authorities all have recognized order taking as a customary custody service.

In addition, the specific language of the exception recognizes that bank custodians take direction regarding the purchase and sale of securities from individual clients. One of the conditions to the exception requires that banks transmit publicly traded security buy or sell orders to a registered broker-dealer for execution. Clearly, if banks were not taking orders from consumers, there would be no need for any legislative requirement to direct the transaction to a registered broker-dealer.

Another provision of the statute makes clear that self-directed IRA custodial accounts are to remain in the bank. This provision was specifically added during the House and Senate Conference because questions had been raised as to whether self-directed IRA accounts were adequately protected under the legislation. By definition, banks take direction from the IRA customer when servicing these accounts.

Despite such clear evidence to the contrary, the SEC nevertheless claims that "...the exception does not allow banks,....to accept orders to purchase and sell securities." Under the SEC's narrow interpretation of the custody exception, banks would be **prohibited** from taking orders from 401(k) plan participants, self-directed IRA customers, and many other consumers. We do not believe that the Congress intended such a disruption to traditional bank custodial activities.

While the SEC maintains that the Gramm-Leach-Bliley Act does not protect bank order-taking activities, the SEC has nevertheless chosen to provide two regulatory exemptions that would allow banks, in certain limited circumstances, to engage in order-taking activities. While we appreciate the need for these regulatory exemptions given the

SEC's narrow reading of Title II, the issue remains that if the SEC had embraced the clear Congressional intent behind the custody exception, no need for these regulatory exemptions would exist.

Moreover, the exemptions adopted by the SEC do not provide any degree of meaningful relief for banks, both large and small, engaged in order-taking activities. The exemptions are conditioned on so many restrictions—restrictions that do not reflect current realities of the custody business—as to render them unworkable.

For example, one of the most troublesome exemptive conditions placed on banks providing order-taking services is the inability to charge customers for services provided. We are unalterably opposed to the notion that in order to keep a legitimate customary banking activity in the bank, a bank must forego compensation. Nothing in the Gramm-Leach-Bliley Act suggests that restricting compensation received by banks for providing safekeeping and custody services is warranted.

The fact is that banks do charge customers for providing order-taking services. Unlike brokerage firms, however, banks generally charge a flat fee to effectuate the transaction, i.e., the fee is not dependent on the number of securities involved in the transaction. The order-taking exemption provided by the SEC would force banks to provide these services to many customers at a significant loss, raising serious safety and soundness concerns. Moreover, the exemption prevents banks from establishing pricing structures that charge clients for the bank services they use.

We are equally concerned about several other conditions incorporated into the exemptions. These include the inability to have in the custody department dual employees—employees who are employed by both the bank and an affiliated brokerage firm; the inability to compensate employees for securing new custodial business; and the requirement to make only certain investment products available to custodial customers.

Banks unable or unwilling to meet the conditions of the exemptions would have to move their order-taking activities to broker-dealer affiliates unrestricted by similar SEC rules. This, of course, assumes that the banking organization has an affiliated broker-dealer firm. For many of our smaller bank members engaged in order-taking activities, this would not be true.

In any event, many broker-dealer firms affiliated with banks have expressed concern about assuming order execution responsibilities for bank custodial accounts. Thousands of accounts would have to be opened under individual customer account names. Records for these accounts would have to be established and maintained. Compliance responsibilities would be expanded by adding these accounts to the broker's book. Yet no assets would be held in the account as the actual custodial account and assets would remain in the bank. Consequently, not even our members' broker-dealer affiliates wish to assume a business that significantly increases compliance costs and regulatory burdens for very little compensation.

Bank referral fee programs under the networking exception.

The networking exception is the only push-out provision in which the Congress chose to address employee compensation, as opposed to bank or department compensation. Specifically, the exception provides that bank employees may not receive incentive compensation for any brokerage transaction but "may receive compensation for the referral of any customer 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 SEC has defined the term "nominal one-time cash fee of a fixed dollar amount" to mean a payment that does not exceed one hour of the gross cash wages of the unregistered bank employee making the referral. The definition also provides that a nominal one-time cash fee of a fixed dollar amount may be a payment in the form of points in a system or program that covers a range of bank products and non-securities related services, where the points count toward a bonus that is cash or non-cash, if the points awarded for referrals involving securities are not greater than the points awarded for products or services not involving securities.

Our members, banks and broker-dealers alike, have long operated their referral fee programs in compliance with all applicable regulatory guidance including guidance issued by the SEC applicable to broker-dealers operating on financial institution premises. That guidance generally has permitted referral fee programs where:

- The fee is a nominal, fixed-dollar amount;
- The amount of the referral fee is unrelated to the execution of securities transactions or the volume of securities traded by the customer;
- The referral fee is determined and paid by the financial institution and not the broker-dealer;
- No more than one fee per customer may be paid; and
- Non-cash referral programs are structured similarly to cash referral programs.

These requirements have formed the framework for the development of many bank referral fee programs involving products and services ***other than securities***. For example, the federal banking regulators, as directed by the Gramm-Leach-Bliley Act, recently adopted rules that required banks to adopt referral fee programs for insurance products that closely follow guidance given in the Interagency Statement on Retail Sales of Nondeposit Investment Products and SEC no-action letters. Currently, bank compliance staffs are reviewing and modifying, as necessary, their referral fee programs to reflect this recently issued regulatory guidance. It is patently unfair and extremely burdensome for the SEC now to rewrite the very rules that have serve as the framework for ***all*** bank referral programs, especially as the Congress never prescribed these revisions.

We list below many of the significant requirements the SEC has added by way of the interim final rules to bank referral fee programs that will take considerable time and money to implement, including:

- Calculating a flat dollar amount for each employee based on their gross hourly wages;
- For salaried employees, calculating their hourly wage and setting an appropriate referral fee based on that wage;
- Tracking of salaries and gross hourly wages of all employees eligible for referral fee programs;
- Revising point programs to ensure that points paid for brokerage referrals received the lowest point referrals for all products included in the point program, including points awarded for safety deposit boxes, savings accounts, checking accounts, etc., and

- Reviewing all referral fee programs to ensure that the value of the securities account, the value of the customer's bank account, or the customer's financial status are not included in any established referral fee programs.

Banks ability to continue sweeping deposits into money market mutual funds under the sweep exception.

Title II provides an exception from push-out for those banks that sweep on a nightly basis demand deposit balances out of the bank and into no-load money market mutual funds; the next day, the balances are swept back into the customer's deposit account to meet daily transactional requirements. These sweep accounts offer both commercial and retail customers the ability to make cash deposits productive and allow banks offering these services to compete against other financial services providers offering corporate cash management accounts that look and feel like checking accounts, but pay market rates of interest. Of course, banks are legally prohibited from paying interest on corporate demand deposit accounts, although H.R. 974 recently approved by the House would eliminate this prohibition.

The SEC has taken the position that a "no-load" money market mutual fund is a fund that is not subject to either a front-end or back-end load and the fund's total charges against net assets to provide for sales related expenses and/or service fees do *not* exceed 25 basis points. We agree that no-load is generally understood to mean no front-end or back-end sales charges. We do not agree with the SEC's determination that no-load also means that sales related expenses and/or service fees cannot exceed 25 basis points.

Nothing in the legislative history supports the SEC's conclusion. Indeed, former-Chairmen Leach and Gramm have recently indicated to the SEC that, in approving the sweep exception, the Congress did not intend to disturb existing bank sweep activities.

Moreover, the SEC's interpretation ignores the reality of the situation. These accounts are marketed and sold as deposit accounts with sweep services being merely incidental to the account itself. Interest earned on the sweep is posted to the deposit account and disclosed to the customer on the monthly account statement. To the consumer, the account looks and feels like a deposit account and should be treated as such under the push-out provisions.

Finally, ABA and ABASA would suggest that before any action is taken by the SEC that might encourage consumers to move their sweep accounts to broker-dealer firms, consideration should be given as to what impact, if any, such a movement would have on the availability of deposits to fund loans in local communities. Many banks offers sweep services that only sweep amounts in excess of a target amount, for example, \$50,000. Amounts below that target amount are then made available with other deposit account balances to fund loans. It would be prudent for the SEC and the bank regulators to consider this issue jointly before any regulatory action is taken that could cause significant disintermediation of bank deposits.

Conclusion

In conclusion, the ABA and ABASA appreciate the opportunity to share with you our views regarding the SEC's interim final rules and their impact on the banking industry. While we continue to oppose the rules on the grounds that they do not comport with Congressional intent and impose huge and unnecessary regulatory burdens on our members, we pledge to work with the SEC and the banking regulators to develop final rules that are workable and, most importantly, reflect Congressional intent.

Robert M. Kurucza
General Counsel, Bank Securities Association
Partner, Morrison & Foerster LLP

Oral Testimony before the Joint Hearing of the Subcommittee on Financial Institutions and Consumer Credit and Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services

U.S. House of Representatives
One Hundred Seventh Congress
August 2, 2001

Good morning Chairman Bachus, Chairman Baker and other members of the Sub-Committees. My name is Bob Kurucza. I am a partner in the law firm of Morrison & Foerster and serve as General Counsel for the Bank Securities Association. Prior to joining Morrison & Foerster, I served as Director of the Securities and Corporate Practices Division at the OCC, and as an Assistant Director in the Division of Investment Management at the SEC. Accordingly, I have been involved in bank securities matters for over 20 years—both as a regulator and as a private practitioner.

I am pleased to have the opportunity to appear today to discuss the SEC's "push-out" Rules. As you know, these Rules relate to the bank broker-dealer exceptions in Title II of the Gramm-Leach Bliley Act—the so-called Title II Exceptions. This is a vitally important matter for the banking industry, and we commend your leadership in holding this hearing. We clearly need your help.

The Gramm-Leach-Bliley Act was intended to modernize the regulatory scheme for the financial services industry. There is no question that functional regulation is a key component of the new regulatory regime. However, Congress recognized the limits of functional regulation. This is why it provided the Title II Exceptions. There was no need to subject activities that had been conducted safely and soundly by banks—in many cases for over 100 years (such as trust, fiduciary and sweep account services)—to redundant broker-dealer regulation. These activities have, and continue to be, effectively regulated by federal and state banking authorities without any history of significant problems.

The Title II Exceptions were clearly intended to allow banks to continue to conduct traditional securities-related activities undisturbed, without having to register as broker-dealers. The SEC seems to have missed this fundamental point.

It is not surprising that the push-out Rules, which in effect nullify many of the Title II Exceptions, have met with almost universal criticism. The BSA has been a loud voice in this "chorus of critics." It believes that the Rules are fundamentally flawed from both a procedural and substantive perspective.

As to process, the BSA believes that a substantial doubt exists, from a legal standpoint, as to whether the SEC, in issuing the Rules as "final rules," has met the stringent standards imposed under the Administrative Procedures Act. There clearly was no urgent need to adopt definitive rules. The only thing that had to happen immediately was the deferral of the May 12th effective date.

By issuing final rules without providing prior notice or the opportunity for public comment, the SEC placed banks in a Catch-22 position. To its credit, the SEC recognized the quandary in which it had put banks, and recently extended the Title II compliance dates until May of next year. This is a welcome first step in the right direction; however, no amount of time delay will cure the substantive defects in the Rules.

In this regard, the BSA believes that many of the Rules will greatly diminish the ability of banks to provide longstanding services to their customers. Accordingly, they clearly contravene Congressional intent and reflect a basic lack of understanding as to the nature, structure and pricing of these services. The Rules are replete with departures from Congressional intent. This is the case with almost all of the Title II Exceptions. Even in cases where the SEC ostensibly is attempting to provide relief or flexibility, it conditions the availability of the relief on such onerous and unworkable conditions that it is rendered meaningless.

As the SEC has acknowledged, banks now conduct most of their "core" securities activities—such as full service brokerage—through registered broker-dealers. Nonetheless, the SEC somehow believes that banks will use the Title II Exceptions to evade broker-dealer regulation. This is pure sophistry. Banks have been conducting most of their securities activities through registered broker-dealers for many years. They have done so voluntarily even though a blanket exemption from regulation was available.

Where does this leave us? There is no question that the Rules must be rebuilt from the ground up. We would hope that the SEC would heed the concerns expressed by your Sub-committees and other interested parties. Based on this input, we would urge the SEC to "start a fresh" and re-publish the Rules as proposed rules that better follow Congress's mandate and conform to a normal rulemaking process.

Thank you again for the opportunity to appear. I would be happy to answer any questions that you may have.

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July 17, 2001

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By Messenger

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

Re: Comments of the Bank Securities Association to Interim Final Rules Relating to Definitions of Terms in, and Specific Exemptions for Banks Under, Section 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934; File No. S7-12-01

Dear Mr. Katz:

As you are aware, on May 18, 2001, the Securities and Exchange Commission ("Commission") published in the Federal Register interim final rules with a request for comments relating to definitions of terms in, and specific exemptions for banks, savings associations and savings banks under, Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 (the "Exchange Act") (SEC File No. S7-12-01) (the "Interim Final Rules").[1] This letter, which is being filed on behalf of the Bank Securities Association ("BSA"),[2] is the response of such association to the Interim Final Rules.

I. Summary of BSA's Position

As a threshold matter, the BSA appreciates the opportunity to comment on the Interim Final Rules and hopes that this letter will be of benefit to the Commission as it considers what further action is appropriate. The BSA generally applauds the Commission's efforts to attempt to provide financial institutions with guidance on the application and scope of the various broker-dealer exceptions contained in Title II of the Gramm-Leach-Bliley Act (the "GLB Act") (together, the "Title II Exceptions"). The

[1] 66 Fed. Reg. 27,760 (May 18, 2001).

[2] The BSA is the nation's leading membership-based not-for-profit trade association dedicated exclusively to representing the interests of banks and other financial institutions in connection with the offering of securities and investment products and services. The membership of the BSA includes commercial banks, thrift institutions, securities firms, investment companies and other organizations in the financial services industry. The members of the BSA range from some of the largest financial institutions in the country to smaller community banks and savings institutions.

BSA also wants to acknowledge the wisdom of the Commission in delaying the effectiveness of the Title II Exceptions beyond the May 12th statutory date, which clearly was appropriate under the circumstances. Unfortunately, however, we must regrettably conclude that the Interim Final Rules are in many respects fatally flawed from both a procedural and substantive perspective.

With respect to process, for the reasons discussed below, the BSA believes that a substantial doubt exists, from a legal standpoint, as to whether the Commission, in promulgating the Interim Final Rules as "final rules," has met the stringent standards imposed under Section 553 of the Administrative Procedures Act (the "APA"). In this regard, the BSA is at a loss to understand why the Commission felt compelled to publish the Interim Final Rules without the provision of prior notice and opportunity to comment, which are critical elements of any normal rulemaking. There clearly was no urgent need to adopt definitive rules relating to the Title II Exceptions. The only thing that had to happen immediately was the delay of the May 12th effective date.

As the Commission acknowledged in the adopting release for the Interim Final Rules, over 90% of banks already use registered broker-dealers that are subject to Commission and National Association of Securities Dealers Regulation, Inc. ("NASDR") regulation to effect securities transactions. Accordingly, the traditional bank activities covered by the Title II Exceptions represent a relatively small percentage of overall bank securities-related activities, albeit very important activities for banks and their customers. It also is important for the Commission to keep in mind that until now banks were generally not required to register as broker-dealers in order to engage in these activities. Nevertheless, many banks have for some time elected to *voluntarily* conduct their "core" securities activities, such as retail full-service brokerage operations, through a regulated broker-dealer. This fact should tell the Commission that when banks recognize the appropriateness of functional regulation for a "true" securities activity, they submit to it even though not required. On the other hand, when, as is the case under the Interim Final Rules, long-standing banking activities, such as trust and fiduciary and cash sweep account services, are being subjected to inappropriate and unnecessary broker-dealer regulation through regulatory fiat, banks are going to protest vociferously. This should not be a surprise to the Commission.

To our knowledge, there has been no indication of any significant problems with respect to any of the traditional bank activities covered by the Title II Exceptions. Moreover, these traditional bank securities-related activities are not conducted in a regulatory vacuum; the respective federal banking agencies, as well as state banking authorities, continue to regulate these activities, as they have, in many cases, for over one hundred years. Despite the Commission's attempt to offer a basis supporting the adoption of the Interim Final Rules as final rules, the proffered reasons are "thin reeds" at best.[3] Against this backdrop, it is hard to imagine a compelling regulatory reason, let alone sufficient legal basis for APA purposes, warranting the Commission's action in adopting the Interim Final Rules as final rules, or attempting to take the positions that it has under these rules.

With regard to substance, the BSA believes that many of the Interim Final Rules improperly erect barriers that will prevent or greatly diminish the ability of banks to engage in traditional securities-related activities. Accordingly, they clearly are contrary to Congressional intent and reflect a basic lack of understanding as to the nature, structure and pricing of the activities covered by the Title II Exceptions. Even in cases where the Commission ostensibly is attempting to provide relief or flexibility, it conditions the availability of the relief on such onerous and unworkable conditions that the relief is rendered meaningless.

As the Commission is well aware, the Interim Final Rules have already been universally condemned by various banking industry groups, including the BSA, and most significantly, by the federal bank regulatory agencies and various Congressional quarters. We expect that this sentiment will be echoed in the comments received by the Commission in response to its request for comments on the Interim Final Rules.

Some quarters of the banking industry and Capitol Hill have strongly advocated that the Commission withdraw the Interim Final Rules, citing the numerous departures from Congressional intent[4] and other fundamental flaws in the Interim Final Rules. As a general matter, the BSA agrees with the underlying objections to the Interim Final Rules made by the withdrawal advocates; however, we would suggest a somewhat more pragmatic approach at this juncture. By the time this letter is filed with the Commission, the comment period on the Interim Final Rules will have ended. While we doubt that the Commission will receive the type of detailed, thoughtful comments typical in a normal rulemaking process given the basic objections of the banking industry to the Interim Final Rules, it nonetheless will receive some valuable input. We hope this input will be considered seriously.

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[3] It is telling that the Interim Final Rules, which are replete with requests for comments not only on specific provisions, but also on basic approaches, read in many ways more like an advanced notice of proposed rulemaking rather than even a proposed rulemaking.

[4] Although Congress issued no formal report in connection with the passage of the GLB Act, the Conference Committee did issue a Joint Explanatory Statement. It states: "The Conferees retained certain limited exemptions to *facilitate* certain activities in which banks have traditionally engaged (emphasis added)." It goes on to note, with respect to the trust and fiduciary exception, "[t]he Conferees expect that the Commission will not disturb traditional bank trust activities under this provision."

We would respectfully urge the Commission to issue, after evaluation of the comments by the staff and consideration by the Commission at an open meeting (as opposed to a seriatim procedure), a revised set of rules for public comment. After the proposed rules (which hopefully will be fashioned in a manner more consistent with Congressional intent and the limited and relatively innocuous nature of these traditional bank securities-related activities) have been properly vetted with the public in accordance with the procedures mandated by the APA, then the Commission will be in an appropriate position to proceed with adopting final rules regarding the Title II Exceptions.

After any final rules are adopted by the Commission, it will be critical to allow a realistic period of time for compliance. In this regard, it is important to keep in mind that depending on the final form of the definitive rules, many smaller community banks, for example, will be subjected to broker-dealer regulatory requirements for the first time, and some long-standing bank operations and practices may need to be recast. The banking agencies in their joint comment on the Interim Final Rules[5] suggested a one year delayed effective period after the adoption of any final rules. The BSA generally agrees with this position since it will allow the next step of functional regulation to take place in the orderly fashion that Congress envisioned.

The following sets forth the detailed comments of the BSA regarding the promulgation of the Interim Final Rules under the APA and specific provisions of such rules.

II. Process Under the APA

The Interim Final Rules were adopted under Section 553(b) of the APA which, under certain limited conditions, permits an agency to issue rules that bypass the usual public rulemaking process. Specifically, the APA provides that prior notice and comment is not required "(A) [for] interpretive rules, general statements of policy, procedure, or practice; or (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefore in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."[6]

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[5] Joint Comment Letter from the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency, dated June 29, 2001 (the "Banking Agencies Letter").

[6] 5 U.S.C. § 553(b)(B).

A. The "Interpretive Rule" Exception

The Commission does not state whether it has adopted, in whole or in part, the Interim Final Rules pursuant to the so-called "interpretive rule" exception or "good cause" exception. However, because the Commission provides a statement of good cause, we have assumed that the Interim Final Rules were intended to be adopted under the "good cause" exception.

The Commission (contrary to what we believe to be the case) does note that the Interim Final Rules "do not impose any new obligations in addition to those created by the GLB Act, but rather provide guidance as to the meaning of certain provisions of that statute or provide exemptive relief consistent with those provisions."[7] Accordingly, the Commission could attempt to categorize at least some of the Interim Final Rules as promulgated under the "interpretive rule" exception. However, there is ample judicial precedent to suggest that the Interim Final Rules have "legal effect" and, unlike no-action letters, are not merely procedural or interpretive but rather legislative in nature, thereby making the "interpretive rule" exception unavailable.[8]

B. The "Good Cause" Exception

As to the "good cause" exception, the legislative history of the APA indicates that Congress intended the exception in §553(b)(B) to be narrow[9] and reluctantly countenanced. When citing the "good cause" exception as a basis for promulgating a rule, an agency must *in fact* find good cause and not merely recite that good cause exists. There are three enumerated grounds in §553(b)(B) for finding good cause: notice and comment would be "impracticable, unnecessary, or contrary to the public interest."[10] The Commission did not state on which of the three bases it was relying, so we address each.

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[7] Interim Final Rules, 66 Fed. Reg. at 27,789.

[8] *See* American Mining Congress v. Mine Safety & Health Admin., 995 F.2d 1106, 1112 (D.C. Cir. 1993); Megia-Ruiz v. INS, 51 F.3d 358 (2nd Cir. 1995); and Metro. Sch. Dist. of Wayne Township v. Davila, 969 F.2d 485 (7th Cir. 1992), *cert. denied*, 113 S.Ct. 1360 (1993).

[9] National Nutritional Foods Ass'n v. Kennedy, 572 F.2d 377, 384 (2d Cir. 1978) ("*National Nutritional Foods*"); Methodist Hosp. of Sacramento v. Shalala, 38 F.3d 1225, 1236 (D.C. Cir. 1994).

[10] The Senate Report on the APA states: "The exemption of situations of emergency or necessity is not an escape clause in the sense that any agency has discretion to disregard it terms or the facts. A true and supported or supportable finding of necessity or emergency must be made and published. 'Impracticable' means a situation in which the due and required execution of the agency functions would be unavoidably prevented by its undertaking public rule-making proceedings. 'Unnecessary' means unnecessary so far as the public is concerned, as would be the case if a minor or merely technical amendment in which the public is not particularly interested were involved. 'Public interest' supplements the term 'impracticable' or 'unnecessary'; it requires that public rule-making procedures shall not prevent an agency from operating and that, on the other hand, lack of public interest in rule making warrants an

With respect to the "impracticable" ground, the Attorney General's Manual[11] explains that "a situation is 'impracticable' when an agency finds that due and timely execution of its functions would be impeded by the notice otherwise required..., as when a safety investigation shows that a new safety rule must be put in place immediately." This ground for finding good cause cannot possibly apply here. It would *not* have been impracticable for the Commission to have proposed rules well before (or even after, for the reasons discussed herein) the May 12th effective date of the Title II Exceptions.

The Commission states as a basis for finding good cause the "short time available between the time members of the banking community requested specific guidance as to the meaning of certain provisions of the GLB [Act] and the date on which those provisions bec[a]me effective." The BSA finds it difficult to believe that the Commission was not aware that it was going to be necessary to issue guidance, in some form, relating to the Title II Exceptions. Particularly given the heavily "negotiated" nature of the Title II Exceptions from a legislative perspective, a number of these provisions are unclear or ambiguous in many cases. Moreover, there were 18 months between the date of enactment of the GLB Act and the date on which Title II became effective. In any event, contrary to the Commission's assertion, the period between the time that some members of the banking industry requested guidance and the effective date of Title II was relatively short because the Commission had not issued any guidance during that period. That is to say, the banking industry at large had been waiting for guidance to which it could react, and when by early 2001 the industry had not received any guidance, a growing number of members of the industry understandably began asking more questions given the approaching May 12th effective date. To suggest now that this short period in some way should serve as a showing of good cause is pure sophistry.

Moreover, a desire to provide immediate guidance, no matter how well-intended, does not amount to good cause.[12] If "conclusory statement[s] that normal procedures were not followed because of the need to provide immediate guidance and information... constituted 'good cause,' then an exception to the notice and comment requirement would be created that would swallow the rule."[13]

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agency to dispense with public procedure." *National Nutritional Foods*, 572 F.2d at 385 (citing S. REP. NO. 79-752 (1945)).

[11] UNITED STATES DEPARTMENT OF JUSTICE, ATTORNEY GENERAL'S MANUAL ON THE ADMINISTRATIVE PROCEDURE ACT 30-31 (1947) ("ATTORNEY GENERAL'S MANUAL").

[12] Mobil Oil Corp. v. Department of Energy, 610 F.2d 796, 803 (Temp. Emer. Ct. App.), *cert. denied*, 446 U.S. 937 (1979).

[13] Nader v. Sawhill, 514 F.2d 1064, 1068 (Temp. Emer. Ct. App.) (1975).

In adopting the Interim Final Rules, the Commission also notes that it has taken its lead from the banking agencies, which adopted interim final rules in connection with certain provisions of the GLB Act.[14] However, the Commission's "good for the goose, good for the gander" attempt at justifying its action is inapposite. The banking agencies in many respects were charged with actually *implementing* parts of Title I of the GLB Act—that is to say, those provisions allowing banks and other institutions to take advantage of the affiliation provisions of the statute would not have taken effect absent rulemaking by the banking agencies. Moreover, the banking agencies had a significantly shorter period of time in which to issue rules. For example, Title I became effective March 11, 2000, and Title V (Privacy) became effective on November 12, 2000. Title II became effective a full 18 months after enactment of the GLB Act. And unlike the need for the banking agencies to adopt rules to implement particular provisions of the GLB Act, the Commission was not charged with specifically implementing any part of Title II of the GLB Act. Basically, the Title II Exceptions self-executed and would have done so notwithstanding the Interim Final Rules, although some type of guidance from the Commission was obviously necessary.

Accordingly, while it may have been impracticable for the banking agencies to propose a rule with prior notice and opportunity for public comment, it appears to us that it would not have been "impracticable" for the Commission to have done so with respect to the Title II Exceptions well before, or even after, May 12, 2001, once it took the necessary step of delaying the compliance date.

With regard to the "unnecessary" ground, it cannot be maintained that notice and comment were "unnecessary," because the Interim Final Rules can hardly be classified as "a minor or merely technical amendment."[15] In the Interim Final Rules, the Commission proffers a conclusory statement that the amount of input it already had received from the banking industry was sufficient, and thus presumably made further comments "unnecessary." Clearly, that is not enough under the standard. One court has ruled that notice and comment might not be necessary when the "rule is a routine determination, insignificant in nature and impact, and inconsequential to the industry and to the public."[16] This formulation comports with the explanation in the Attorney General's Manual that "'[u]nnecessary' refers to the issuance of a minor rule in which the public is not particularly interested."[17] The Commission's issuance of the Interim Final Rules clearly does not fit that mold. At the risk of a gross understatement, the Interim Final

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[14] The Commission states, "as the banking regulators found with respect to certain of their regulations under the GLBA, we find good cause...." Interim Final Rules, 66 Fed. Reg. at 27789.

[15] *See supra* note 10.

[16] South Carolina v. Block, 558 F. Supp. 1004, 1016 (D.S.C. 1983).

[17] ATTORNEY GENERAL'S MANUAL at 31.

Rules are something about which many members of Congress, the banking agencies and the banking industry, are vitally interested and concerned.[18]

As to the "public interest" ground for finding good cause, the Attorney General's Manual states that this "connotes a situation in which the interest of the public would be defeated by any requirement of advance notice," as when the announcement of a rule would enable the sort of financial manipulation the rule sought to prevent.[19] Nothing of the sort is present here and nothing that the Commission has cited as a reason constituting good cause suggests that it needed to forego notice and comment in order to prevent a public harm resulting from a delay in the effective date of the Title II Exceptions.

The Commission further attempts to finesse the good cause requirement by noting the "interim nature of the rules...which invite further comment, with possible revision of the rules in light of those comments." It appears that the Commission believes that a "volunteered" request for comments should somehow alleviate any concern that the Interim Final Rules precluded the opportunity for interested parties to comment in the usual manner in a typical public rulemaking under the APA. However, because the Interim Final Rules became effective on May 11, 2001 (with delayed compliance until October 1, 2001, and, in certain cases, January 1, 2002), financial institutions are placed in the untenable position of having to make preparations to comply with the Interim Final Rules *as written* or face the legal risk of not being in compliance by those dates, or to "roll the dice" and speculate as to how the Interim Final Rules might change or be further delayed. Accordingly, the possibility that the Interim Final Rules will be re-written or modified only exacerbates the conundrum of the banking industry. It underscores why the "good cause" exception should be rarely used and sparingly sanctioned, and why it cannot be found here.

For the reasons set forth above, the BSA believes that substantial legal doubt exists as to whether Interim Final Rules were properly promulgated under the APA. Accordingly, to avoid any question in this regard, and as an act of fundamental fairness by a regulatory agency, the BSA strongly urges the Commission to follow the procedural approach outlined in the beginning of this letter.

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[18] *See* Interim Final Rules, 66 Fed. Reg. at 27,789, notes 258-263 (citing at least some of the letters from various members of the public expressing interest in the way in which the Commission might issue guidance on the Title II Exceptions, even before the Commission issued the Interim Final Rules).

[19] *See* ATTORNEY GENERAL'S MANUAL at 31; *see also* Utility Solid Waste Activities Group v. E.P.A., 236 F.3d 749, 755 (D.C. Cir. 2001).

III. Substantive Issues

As a whole, the BSA finds the Interim Final Rules to be the product of an overly narrow interpretation of the Title II Exceptions that is not at all reflective of Congressional intent. As noted above, Congress adopted the Title II Exceptions in order to preserve and facilitate the conduct of the activities covered by these exceptions that banks have conducted safely and soundly without broker-dealer regulation for many years. The Interim Final Rules neither preserve nor facilitate the continued conduct of these activities by banks. To the contrary, they will ensure that banks will either be forced to incur the substantial costs, direct and indirect, of pushing-out these activities to registered broker-dealers or be forced to stop offering increasingly demanded securities-related products and services to their customers. Banks, large and small, and their customers will be negatively affected. However, smaller community banks and their customers will undoubtedly suffer the greatest adverse effects. We hope that the Commission will keep in mind that, in many cases, these smaller community banks and branches of larger banks in small communities are the only source of these securities-related products and services for their customers. No other financial intermediary is generally interested in serving these customers.

The BSA believes that the Commission should and need not have chosen the cumbersome regulatory path that it has in formulating the Interim Final Rules. This is true particularly in light of the relatively few activities, both in number and scope, that the Title II Exceptions cover. Moreover, as noted above, banks already conduct the vast majority of their securities activities through registered broker-dealers. Many securities-related activities conducted internally within a bank (such as trust and custody activities) are already subject to an extensive bank regulatory scheme, including scrutiny under the highest fiduciary standards. It is ironic that, in many instances, these bank regulatory standards are far more stringent than the broker-dealer standards that the Commission would wish to substitute. We fail to see how this result will benefit consumers or protect investors.

The following sets forth our comments on certain specific definitions and exemptions outlined in the Interim Final Rules. As you will note, the order of the BSA's comments do not necessarily track the order of the Title II Exceptions; rather they follow the priority of interests of BSA members. They also reflect an informal "sharing" arrangement as to specific issues among the bank industry trade associations.[20]

[20] In many cases, you will find that the BSA has largely adopted the positions set forth in the Banking Agencies Letter with respect to particular issues, and has not always developed separate or amplified analyses on these points when we believe that the Banking Agencies Letter has effectively addressed these issues. We have done this, in part, to avoid unnecessarily burdening the Commission staff with analyzing comment letters which are, in effect, making the same fundamental points.

A. Definitions of Broker and Dealer

Before providing our views on the specific aspects of the Title II Exceptions and Interim Final Rules, we thought it important to emphasize that the Title II Exceptions are in fact exceptions, which need only be considered if a bank, as a threshold matter, comes within the definition of either "broker" or "dealer" under the Exchange Act. Stated another way, if a particular bank securities-related activity (*e.g.*, a trust or custody activity) does not cause a bank to fall within these definitions, the Title II Exceptions are never reached. We understand that this may be an obvious statement. However, we believe that it would be very helpful for the banking industry to receive confirmation from the Commission as to this point. It may help resolve some of the questions and concerns that banks have in connection with particular activities, such as trust activities. We believe that a clear articulation of this position will be particularly helpful in light of the absence of any discussion on this point in the adopting release for the Interim Final Rules and also the language in certain of the Interim Final Rules (which may have unintentionally given the impression that an activity discussed in a specific Interim Final Rule caused a bank to be deemed a "broker" or "dealer").

In this regard, Section 3(a)(4) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." Section 3(a)(5) defines a "dealer" as "any person engaged in the business of buying and selling securities for his own account through a broker or otherwise." These definitions have been interpreted by the Commission in numerous no-action letters.[21] One such context that the Commission has addressed is whether registered investment advisers must also register as broker-dealers when they place trades for managed accounts (*i.e.*, exercising brokerage placement as part of their duties). In this connection, the Commission staff has taken the position that these investment advisers do not have to register as broker-dealers under the Exchange Act if they do not receive commissions or other transaction-based compensation, and they otherwise do not fall within the definition of "broker" or "dealer."[22]

As the Commission is well aware, in many instances, banks acting in a fiduciary or trustee capacity provide functionally equivalent services to those of registered investment advisers. For example, both offer discretionarily-managed accounts in which they exercise brokerage placement authority. Presumably, since the exercise of brokerage placement authority does not trigger the need for broker-dealer registration for registered investment advisers, the same would hold true for a bank. The underlying

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[21] *See, e.g.*, First Atlantic Investment Advisory Corp., SEC No-Action Letter (Feb. 20, 1974); ICU Services Corporation, SEC No-Action Letter (Sept. 22, 1974); and Invescap of Florida, Inc., SEC No-Action Letter (Mar. 28, 1975).

[22] *See* 1st Global, Inc., No-Action Letter (May 7, 2001).

basis for reaching this conclusion is that brokerage placement in and of itself does not cause an entity to be in the "business of effecting transactions in securities."[23]

The confirmation of this point, as well as similar issues regarding the treatment of particular activities under the definitions of "broker" and "dealer," would be very useful, and may serve to eliminate some unnecessary concerns.

B. The Sweep Account Exception

Section 201 of the GLB Act, as it amends 3(a)(4)(B)(v) of the Exchange Act, allows banks to "[effect] transactions as part of a program for the investment. . . of deposit funds into any no-load, open-end management investment company registered under the [Investment Company Act of 1940, as amended (the "1940 Act")] that holds itself out as a money market fund" (the "Sweep Exception"). Accordingly, a bank may engage in the offer and sale of money market mutual funds involved with a sweep program without registering as a broker-dealer and, in turn, have its employees register as representatives as long as the fund is a "no-load" money market fund. The GLB Act, however, does not define the term "no-load."

In arriving at a definition of "no-load" for purposes of the Sweep Exception, the Commission apparently has been guided by the NASDR interpretation of the term "no-load," as reflected in National Association of Securities Dealers, Inc. ("NASD") Conduct Rule 2830.[24] In this regard, the NASDR determined in 1993 that, for disclosure purposes, a "no-load" fund is one that does not have any front-end or contingent deferred sales charge, or one whose "total charges against net assets to provide for sales related expenses and/or service fees [do not] exceed .25 of 1% of average net assets per annum."[25]

[23] Exchange Act Section 3(a)(4)(A). This position was confirmed by Commission staff at the BSA Legislative and Regulatory Symposium (June 4-5, 2001).

[24] Memorandum from Annette L. Nazareth to Chairman Levitt re: Section 201 of the Gramm-Leach-Bliley Act: Interpretation of the Money Market Fund Exception from Broker-Dealer Registration, dated Jan. 25, 2001, which accompanied a letter dated January 29, 2001 from Chairman Levitt to former Chairman Leach (the "Levitt Memorandum").

[25] *See* Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Publication of Clarification of Issues Relating to NASD Rule Governing Asset-Based Sales Charges in the Sale of Mutual Fund Shares, 58 Fed. Reg. 19,505 (Apr. 8, 1993). In 1994, the Commission staff adopted, also for disclosure purposes, the NASD definition of "no-load" stating that it applied to mutual funds regardless of whether a fund is associated with an NASD member or not. Letter from Barry P. Barbash, Director, Division of Investment Management to Paul Schott Stevens, General Counsel, Investment Company Institute (Aug. 22, 1994) (the "1994 Letter").

Unfortunately, in the Interim Final Rules, the Commission elected to adopt the NASDR definition as the operative definition of "no-load." In so doing, the Commission erred because this definition of "no-load" is contrary to Congressional understanding and intent, and also contrary to the unambiguous purposes that underlie the Sweep Exception, as well as all of the other provisions of Title II—to leave long-standing traditional bank securities-related activities undisturbed and free from broker-dealer regulation.

Contrary to Congressional Intent

The essential language of the Sweep Exception has existed in many prior iterations of financial services modernization legislation, going back at least as far as the important Proxmire Financial Services Modernization Act of 1988.[26] In the 1980s when the Proxmire Bill was under consideration by Congress, the term "no-load" was commonly understood to mean either front-end or contingent deferred sales charges; it was not understood to encompass any recurring asset-based fees. It was not until April 1993, when the NASD amended Section 26 of the NASD Rules of Fair Practice (the predecessor to NASD Conduct Rule 2830)[27] that it adopted its now-current position on the definition of "no-load" for disclosure purposes. This was <u>five</u> years <u>after</u> the Proxmire Bill.

Ms. Nazareth, in the Levitt Memorandum, advocates a first-in-time approach to interpretation. In support of the fact that the NASDR adoption of its position in April 1993 and the 1994 Letter were first-in-time and, therefore, should control the GLB Act definition, she states: "The letter from the Division of Investment Management [*i.e.*, the 1994 Letter] was issued publicly several years before Gramm-Leach-Bliley was enacted." Under this theory, however, should not the definition that is truly first-in-time (*i.e.*, the understanding at the time of the Proxmire Bill) control? The Commission staff has apparently ignored the fact that the term "no-load" appeared in proposed legislation that *preceded* the adoption of the NASDR position in April 1993 and the 1994 Letter.

[26] The Proxmire Financial Services Modernization Act, 100th Cong. 2nd Sess. 1988 (the "Proxmire Bill") excepts from registration "(vi) [banks that effect] transactions as part of a program for the investment or reinvestment of bank deposit funds into any no-load open-end investment company registered pursuant to the Investment Company Act of 1940 that attempts to maintain a constant net asset value...."

An even earlier use of the "no-load" Sweep Exception language appeared in the ill-fated Rule 3b-9 issued by the Commission in 1985, which was struck down in court (*see* American Bankers Association v. SEC, 804 F.2d 739 (D.C. Cir. 1986)) on the grounds that the Commission did not have the legal authority under the Exchange Act to adopt it in light of the general bank exclusion. The Rule 3b-9 sweep account language, in fact, served as a language template for later financial modernization efforts. Clearly, the Commission staff would not maintain that the commonly understood meaning of "no-load" in 1985 included recurring asset-based charges.

[27] *See* supra note 26.

Clearly, the term "no-load" that appeared in the Proxmire Bill is the same term (surrounded by essentially the same language) that appears in the GLB Act. To suggest that, under the GLB Act and its progeny, Congress intended the term "no-load," as it appears in the Sweep Exception, to mean what the NASDR and Commission staff later deemed it to be in an unrelated context is clearly not compelling.

In 1988 (and before), a "no-load" money market fund was commonly understood to mean a money market fund without a front-end or back-end sales load, irrespective of the existence of any recurring asset-based fees. This is the only position that Congress could have reasonably understood and intended "no-load" to mean in 1988, and this is what Congress understood and intended "no-load" to mean in 1999 in the Sweep Exception. As the Commission is well aware, as one of the major regulatory participants in the over decade-long debate over financial modernization, there is a clear reason why the meaning of the term "no-load" in the Sweep Exception should be read to have the same meaning as that term in the Proxmire Bill in 1988. The issue of bank sweep accounts was debated and settled in 1988. No one dared thereafter to change the language or intended meaning of the sweep account exception in any way, since it could disrupt the very delicate compromise reached by interested parties—both regulators and industry groups—on this provision. This obviously was the case with the other Title II Exceptions as well. Stated simply, the deal was struck as to the bank sweep exception language in 1988, "no-load" could only mean no front-end or back-end sales load (and not include any recurring asset-based fees). The issue was not revisited or changed thereafter. Now, the Commission in the Interim Final Rules is trying to alter the deal that Congress struck, and on which the banking industry has relied.[28]

Our view is strongly supported by two letters[29] from named sponsors of the GLB Act. Congressman James Leach, Chairman Emeritus of the House Committee on Financial Services, and Senator Phil Gramm, Ranking Member of the Committee on Banking, Housing, and Urban Affairs, both wrote to former Chairman Arthur Levitt noting in substance that the Commission's definition of "no-load," insofar as it applied to the Sweep Exception, is not supportable. Senator Gramm notes that "[i]n enacting the broker-dealer exemptions in Title II...Congress intended to permit banks to continue to engage in certain activities, such as sweep accounts, that they have been conducting in a safe and sound manner for many years....Congress did not intend that [Commission] rules, definitions or interpretations would be changed in a way that would limit the

[28] It is telling that, to our knowledge, there is nothing in the legislative history regarding the GLB Act that suggests that Congress intended that "no-load" should mean what the Commission has determined by fiat that it now means.

[29] Letter from Congressman James A. Leach, Chairman of the House Committee on Banking and Financial Services, to Chairman Arthur A. Levitt (Jan. 2, 2001); and Letter from Senator Phil Gramm, Chairman of the Committee on Banking, Housing, and Urban Affairs, to Arthur A. Levitt (Feb. 6, 2001).

current activities preserved by the exemptions." We cannot imagine a stronger statement in support of our position.

In any event, even if Congress were somehow put "on notice" that the term "no-load" had different meanings in different contexts that it should have been aware of, such as in the NASDR definition, it seems unlikely that Congress would have meant to embrace the NASDR definition for purposes of the Sweep Exception. We believe that a far more relevant and recognized definition of "load/no-load" appears in Form N-1A, the integrated form that mutual funds, including money market funds, use to register under the 1940 Act and the Securities Act of 1933.[30]

Although Form N-1A was recently overhauled and modernized by the Commission, one prospectus disclosure requirement in that Form that was not substantially revised was the fee table required by Item 3. This item requires every mutual fund to set forth in a table early in its prospectus, both the shareholder fees (fees paid directly from a shareholder's investment) and annual fund operating expenses (expenses that are deducted from fund assets) that it charges. As a general matter, mutual funds may not vary the table from the format proscribed by Form N-1A. Under the heading "Shareholder Fees," the Form calls for the "maximum sales charge (load) imposed on purchases, maximum deferred sales charge (load), and maximum sales charge (load) imposed on reinvested dividends." Under the separate heading "Annual Fund Operating Expenses," the Form calls for "management fees, distribution [and/or service](12b-1) fees, and other expenses." Form N-1A treats loads as those charges which are front-end, contingent deferred or charges on reinvestment of dividends. In the Form, distribution and service fees are not treated as items to be included with the "load" items in the table. The treatment in Form N-1A of what are "loads" and what are not "loads" leads to precisely the interpretation of "no-load" that we believe Congress intended in the Sweep Exception.

The 1940 Act also provides a definition of "sales load"[31] that supports this approach. The 1940 Act definition plainly states that a sales load is the difference between the price of a mutual fund's shares and the net amount invested less any non-

[30] Indeed, to the extent the Commission somehow believes that it has the absolute authority to interpret the term "no-load" in the Sweep Exception, it is inexplicable as to why it would have ignored the Form N-1A differential approach, which is at least as logical a definition/usage of load as the NASD position.

[31] Investment Company Act of 1940, 15 U.S.C. § 80a-2(35), provides in pertinent part: "Sales Load means the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer...less any portion of such difference deducted for trustee's or custodian's fees, insurance premiums, issue taxes, or administrative expenses or fees which are not properly chargeable to sales or promotional activities."

sales related component of this differential. In lay terms, this means front-end and back-end sales charges, and not any recurring asset-based fees.

If the Commission, in adopting the NASDR definition, seeks definitional consistency across the federal securities laws, it would appear to us that the meaning of "load" (which, of course, is the reciprocal of "no-load") provided in Form N-1A or the 1940 Act is at least as logical a choice as the NASDR definition. If the Commission is truly interested in determining what Congress intended, it is far more likely that the Senators and Representatives who voted on the GLB Act understood what was a "load" and what was not a "load" from reading a money market prospectus (which shows "load" as not including any recurring asset-based fees), as opposed to being aware of a relatively obscure NASD rule.

Contrary to the Underlying Purposes of Title II

As noted above, in the Interim Final Rules, the Commission largely chose to ignore the compelling arguments put forth earlier by Congressman Leach, Senator Gramm and the BSA, ostensibly for the sake of achieving a consistent definition. That is to say, because the Commission staff, borrowing the NASDR position, had defined "no-load" once in the context of disclosure (*i.e.*, whether a fund could hold itself out to the public as a "no-load" fund), it believed that the term should be defined consistently in other contexts, no matter how different. This approach may be sound when the contexts have similar purposes. However, as we note below, there is no need for consistency in this case because there is no real regulatory similarity between a disclosure context and an activity threshold for broker-dealer registration.

The underlying purposes of the Title II Exceptions contemplate that banks will be allowed to continue to engage in traditional securities-related activities. However, unlike securities underwriting and dealing activities, for example, one has to ask whether there is any meaningful public policy served by requiring banks and their personnel to register as broker-dealers and representatives merely because a money market fund may not be "no-load" as the Commission would define such term.

In the Interim Final Rules, the Commission notes that public policy may be served because "payments by investment companies of asset-based fees to distributors...create a conflict of interest for the brokers and banks that are distributing these shares." This view reveals two things: (i) that the Commission, which we believe is being somewhat disingenuous given its stringent and quite effective regulatory requirements applicable to money market funds, overstates the riskiness of money market funds and the role of a registered representative in selling them; and (ii) that the Commission staff may not, at this point, fully appreciate how bank sweep accounts are structured.

First, although the Commission acknowledges the "limited risks to bank customers because of the constant net asset value of [a money market fund]," it nevertheless seems to believe that abuses may occur absent broker-dealer registration. Presumably, the Commission thinks that it is important that the full panoply of customer protection rules afforded by broker-dealer registration should apply to the offering of bank sweep accounts. It is telling that even if the Commission has its way on the definition of "no-load," this will not be the case.

Quite significantly, the NASD's suitability rule, which is one of the primary customer protection rules in the securities arena, exclude transactions with customers where investments are limited to "money market mutual funds."[32] Clearly, the NASDR has recognized that, in light of the limited risks presented by money market funds and the relatively minor variability of their performance, there really is no need to subject the sale of any money market fund, whether or not it has a load under the NASDR definition, to the suitability rule. We believe that it is anomalous and disingenuous for the Commission to maintain, in the face of this exclusion (which we believe is clearly appropriate) that somehow it is necessary to subject bank sweep accounts to broker-dealer registration simply because the money market fund involved does not meet the NASDR's definition of "no-load."

Second, we are very concerned that the Commission staff may not fully appreciate how these products are structured and priced. As a general matter, in a bank sweep account arrangement, a bank transaction account is linked with a very limited number (frequently a single fund) of money market funds.[33] These money market funds can be provided by third-party mutual fund complexes or they can be part of a bank proprietary fund complex. The sweep account product is offered as an integrated/linked product that generally cannot be unbundled. To provide otherwise would be operationally unworkable and would result in costs that would make the product economically not viable.

Cash sweep accounts are offered to a variety of different bank customer segments, including business, institutional and retail customers. Not surprisingly, given the different types of bank customers using sweep accounts, there are numerous permutations of pricing for these "linked" products to give customers flexibility as to how they pay for the sweep account. Some accounts are priced exclusively at the account level, others are priced solely on the basis of fund level fees, and others are priced on a combination of account level and fund level fees. These different pricing options are intended to give

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[32] *See* Notice to Members 90-12 (April 5, 1990).

[33] A sweep account customer generally does not have the ability to choose any money market fund. The choices are limited to those money market funds that are included in the arrangement.

customers a range of options as to how they pay for cash management services. In some cases the pricing options available to a specific customer base may be dictated or limited by regulatory requirements (*e.g.*, ERISA).[34]

We would strongly urge the Commission to keep these facts in mind as it gives further consideration to the Sweep Exception.

Consequences of the Commission's "No-Load" Definition

For many banks that offer sweep products, the money market fund that serves as the investment vehicle has sales-related and shareholder servicing fees that exceed 25 basis points and therefore do not meet the "no-load" definition in the Sweep Exception. If these money market funds are not deemed to be "no-load" funds for purposes of the Sweep Exception, bank personnel involved in offering the sweep product (*e.g.*, corporate cash management personnel who offer a variety of other non-securities products) will have to be qualified registered representatives of a broker-dealer in order to continue to offer the sweep product. This would require, for example, that such bank personnel be "dually employed" by a registered broker-dealer affiliate (if one exists), or that a broker-dealer be created if none exists and no other exemption from broker-dealer registration is available. This will, of course, dramatically increase the costs for a bank offering a sweep product. In many cases, this will make the product economically not viable, and thereby deny many customers access to these products

We emphasize that this issue affects not only bank-advised mutual funds. Many sweep programs are structured whereby a third-party mutual fund serves as the sweep vehicle for the bank's customers. The bank's personnel are typically involved in selling the sweep product, and thereby the mutual fund's shares, to its customers. Again, if banks and their personnel are required to register as broker-dealers and representatives, the program may not be economically feasible. Accordingly, mutual fund providers who serve the bank marketplace will be adversely affected as well.

In summary, we urge the Commission to adopt a definition of "no-load" that reflects Congressional intent and the purposes behind the Sweep Exception. In short, for the compelling reasons set forth above, we believe that the definition of "no-load" should encompass only front-end and back-end sales charges and not recurring asset-based

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[34] The Commission has indicated that it not would assert broker-dealer regulation over a bank sweep account that was priced exclusively at the account level. We believe that this is the correct legal position for the Commission to adopt, but we also believe that it is the correct legal position for <u>all</u> bank sweep accounts, irrespective of how they are priced. Given the context, there is no real regulatory reason for the Commission to strain to regulate any bank sweep account as an activity requiring broker-dealer registration.

fees.[35] Importantly, no customer protections will be compromised if the Commission proceeds on this basis. In fact, it will likely preserve access to sweep account products for businesses, institutions and individuals, who would otherwise lose access to these products.

C. The Networking Exception

Section 201 of the GLB Act, as it amends 3(a)(4)(B)(i) of the Exchange Act, provides an exception from the definition of "broker" for banks that enter into third-party brokerage or "networking" arrangements (the "Networking Exception"). Accordingly, a bank will not be considered a broker-dealer if it "enters into a contractual or other written arrangement" with a registered broker/dealer through which the broker-dealer "offers brokerage services on or off the premises of the bank."

The Networking Exception has a list of statutorily imposed conditions, such as the separation of brokerage and banking services and compliance with advertising conditions. In particular, one condition prohibits unregistered bank employees from receiving "incentive compensation...for the referral of any customer...except 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."[36]

This language is not new for banks in that this restriction has, in effect, applied to banks since 1984 under guidelines set forth under the Interagency Statement on Retail Sales of Nondeposit Investment Products ("Interagency Statement"). What is new, however, is that the Commission has chosen to narrowly interpret the term "nominal one-time cash fee of a fixed dollar amount."

Under new Rule 3b-17(g) under the Exchange Act, the Commission has interpreted the term to be limited to only payments that do not exceed one hour of the gross cash wages of the bank employee making the referral, or points in a system that cover a range of bank products and non-securities related services where the points count toward a bonus that is cash or non-cash if the points (and their value) awarded for referrals involving securities are not greater than the points (and their value) awarded for activities not involving securities. In addition, the Commission states that the referral fees cannot be paid in the form of bonuses.

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[35] Assuming *arguendo*, that the Commission's definition of "no-load" prevails, we believe that, for all the reasons discussed above, the Commission should exercise its authority to exempt, without any other conditions or qualifications, all activities involving bank sweep accounts from broker-dealer regulation, so long as the sweep account involves a money market fund.

[36] Exchange Act, Section 3(a)(4)(B)(i)(VI).

The BSA appreciates that the Commission, by recognizing that some banks use "point" systems, wishes to provide banks some flexibility as to the form of referral payment that they may make to bank employees. However, the Commission definition imposes unnecessary limitations on the securities referral programs of banks that are not required by statute and creates administrative burdens that seemingly are inconsistent with the Commission's own policies.

Specifically, we believe that the Commission's definition places severe and unworkable limits on the payment of referral fees. The Commission's scheme clearly is intended to reduce a perceived "salesman stake" in the sale of securities of an unregistered bank employee. However, this fear is grossly misplaced. Under the Networking Exception, a bank employee can only refer a customer to a registered representative of a broker-dealer. That registered representative must then qualify and otherwise interface with the customer consistent with all applicable NASD rules. Quite frankly, the potential for abuse in this context is largely overstated.[37]

With regard to amounts, the Commission has long taken the position that registration requirements are not triggered under the Exchange Act by networking arrangements in which a bank employee receives a "nominal fee" for referrals to a broker-dealer.[38] And, in fact, as the Commission notes in the Interim Final Rules, it is this position that served as the basis for the Networking Exception. However, in none of these precedents, has the Commission provided a definition of "nominal." Why the Commission chooses now to define the term in the Interim Final Rules is perplexing to us. Under the Interim Final Rules, bank employees might be paid a referral fee, before taxes, that could be at the rate of minimum wage of $5.15. We believe that this threshold is far too low and that amounts permitted under the Interagency Statement are a more appropriate measure.

The methodology for determining "nominal" under the Interim Final Rules is impractical and unworkable. Banks typically offer all of their employees, from private bankers to tellers, the same nominal amount value for referring securities customers. Under the methodology in the Interim Final Rules, banks will be forced to incur a significant administrative burden because a separate "permissible referral fee" calculation will be required for each employee. This calculation is further complicated by the fact that some employees' compensation is not based on an hourly wage. The Commission

[37] While we understand that the term "nominal amount" is statutory, we have trouble understanding how the payment of even a moderate amount of compensation would create an environment for potential abuse. It is important to keep in mind that in all cases the customer is being referred to a registered representative who is subject to all applicable NASD rules and who will be the only party making recommendations as to securities transactions for the customer.

[38] *See* Chubb Securities Corp., SEC No-Action Letter (Nov. 24, 1993).

notes in the Interim Final Rules that translating yearly salaries into hourly wages should be a simple task. This may be the case, but wages can often be tied to variable factors such as bonuses, incentive payments or the value of stock or stock options. Providing an accurate translation of that compensation into an hourly figure is not simple. In any event, to impose such an administrative burden on banks in this context is entirely unnecessary and inappropriate.

While the BSA again appreciates the Commission's effort to provide flexibility by permitting a point system, the Commission's determination that the system must cover a range of bank products and non-securities-related services and that referral points for securities services and products have a value that is no greater than the points received under the system for any other product or service, is unjustifiable. There is absolutely no requirement in the statute with regard to these restrictions, only that the payment be "nominal." Again, in this regard, we believe that the Commission has exceeded its authority under the GLB Act in interpreting these terms.

The BSA also objects to the Commission's prohibition on the payment of referral fees in the form of bonuses. In this regard, the Commission appears again to have gone beyond the mandate of the statute. The GLB Act does not prohibit payment in this manner. In fact, allowing year-end bonuses could further the goals of the Interim Final Rules (*i.e.*, reducing a salesman's stake in an excepted activity). Separating the time between the actual referral and the time that a referral fee is paid would seem to reduce the salesman's stake.

The BSA does not believe that it is appropriate or necessary for the Commission to change its practice regarding referral fees or to define the upper limits of permissible fees. The Commission should instead allow, as under current practice, banks to structure the corporate aspects of these referral fee programs in a manner consistent with the standards applicable under the Interagency Statement.

The BSA also is extremely concerned that any attempt by the Commission to regulate the total amount of referral fees paid to an individual would be inconsistent with the GLB Act, which does not provide any basis for imposing aggregate compensation limits. To the contrary, the law specifically allows a bank employee to be paid "a nominal one-time cash fee" for <u>each</u> referral, without regard to total referral compensation paid.

D. The Trust and Fiduciary Exception

Section 201 of the GLB Act, as it amends 3(a)(4)(B)(ii) of the Exchange Act, allows a bank to act as a trustee or fiduciary without having to register as a broker-dealer if it meets certain conditions, including that the bank be "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 such securities transactions or any combination of such fees" (the "Trust and Fiduciary Exception").

Of great concern to the BSA are those provisions in the Interim Final Rules that "interpret" the Trust and Fiduciary Exception in a manner which we believe is inconsistent with Congressional intent. This exception was designed to allow banks to continue to engage in trust and fiduciary activities without having to register as broker-dealers.[39] These types of activities have been a key component of the business of banking for many years and have long been offered to the public without significant problems or abuses. Moreover, as discussed above, these activities are regulated extensively, and effectively, by federal and state bank regulators.[40] Congress determined that pushing-out such activities was unwarranted in light of the effective regulation of bank trust and fiduciary activities by federal and state regulators, even though they may have certain securities-related aspects. The Interim Final Rules relating to the Trust and Fiduciary Exception diverge substantially from this Congressional mandate and would severely disrupt and hamper these traditional activities.

The Interim Final Rules also impose unworkable requirements that have no support in the Trust and Fiduciary Exception, making the exception (and related exemptions offered by the Interim Final Rules), in practical terms, unavailable to most banks. Moreover, the Interim Final Rules suggest a lack of fundamental understanding of the ways in which banks provide services as fiduciaries and trustees under federal and state law.

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[39] "Banks have historically provided securities-related services largely through their trust departments, or as an accommodation to certain customers. Banks are uniquely qualified to provide these services and have done so without any problems for years. Banks provided trust services under the strict mandates of State trust and fiduciary law without problems long before Glass-Steagall was enacted; there is no compelling reason for changing Federal regulation of bank trust departments, solely because Glass-Steagall is being modified. S. REP. NO. 106-44, at 10 (1999). *See also, supra* note 4.

[40] The federal banking agencies' examiners regularly examine the trust departments of banks, as well as other departments that conduct fiduciary activities (such as private client banking and asset management departments). Among other things, these agencies review: the processes and controls used by banks to recommend investments; the effectiveness of a bank's policies and procedures for preventing self-dealing and other conflicts of interest; the qualification of bank employees; a bank's operational and procedural controls; and compliance with applicable securities-related rules. See the Federal Reserve Board's *Trust Examination Manual* (www.federalreserve.gov/boarddocs/supmanual), the Federal Deposit Insurance Corporation's *Trust Examination Manual* (www.fdic.gov/regulations/trust/trust/secaa.html) and the Office of the Comptroller of the Currency's *Comptroller's Handbook for Fiduciary Activities* (www.occ.treas.gov/pubscrpt.htm).

We generally agree with the positions set forth in the Banking Agencies Letter regarding the Trust and Fiduciary Exception, and accordingly, see little reason to repeat the substance of those comments. Nonetheless, we have highlighted below those issues that are of paramount concern to us.

Account-By-Account Calculation of Compensation

In defining what "chiefly compensated" means, the Commission has determined that the compensation received for each trust or fiduciary account must be separately calculated, rather than calculated on a department- or bank-wide basis. The Interim Final Rules provide that the "relationship" compensation received from each trust and fiduciary account during a year must not exceed the "sales" compensation from the account—that is to say, "relationship" compensation must equal more than 50% of total compensation.

As a general matter, we believe that the Commission has come to a reasonable judgment in defining the term "chiefly" to mean more than 50%. However, we believe that the Interim Final Rules improperly and unnecessarily require an account-by-account calculation of compensation. The House Report on the GLB Act notes that: "[a] bank must be chiefly compensated for *its* trust and fiduciary activities"[41] on the basis set forth in the GLB Act. Contrary to the Commission's conclusion that the phrase "chiefly compensated for such transactions" compels a reading that Congress intended account-by-account calculations, the above excerpt suggests that "such transactions" refer to all of the transactions effected by a bank in a trustee or fiduciary capacity. There is no reference in this exception to individual accounts. Moreover, common sense and the lack of any compelling regulatory imperative to the contrary, would strongly support the conclusion that a bank-wide calculation is the only appropriate standard to adopt here.

From a regulatory policy perspective, imposing the "chiefly compensated" requirement on each account will interfere with traditional bank trust and fiduciary activities. Under the Interim Final Rules, a bank at the end of a year, after engaging in the muddled calculation methodology required, could find that a single account has jeopardized its status under the Exchange Act and potentially subjected it to enforcement action by the Commission and private law suits, including recission demands. Particularly in a bear market, we believe this scenario is more than merely a speculative possibility. In any event, there is no reason why banks should be subjected to <u>any</u> risk in this regard, no matter how remote.

The requirement in the Interim Final Rules that banks track the compensation received from all trust and fiduciary accounts on an account-by-account basis will impose unfathomable administrative burdens and costs (which likely will be passed on to

[41] H.R. Rep. 106-74, at 164 (1999).

customers in the form of higher fees). As a result, banks may be forced to decide that attempting to satisfy the conditions necessary to obtain exemptive relief are too onerous and have to push-out these activities to a broker-dealer. In this case, the Interim Final Rules, if left unchanged, will cause the disruption and fragmentation of long-established relationships between a bank trustee and its customer by requiring the unnecessary and cumbersome involvement of a broker-dealer for part of the relationship. This will undoubtedly result in additional costs that are unnecessary in light of the strong protections already afforded customers under existing federal and state banking laws. It also will be a result totally at odds with the intentions of Congress.

The Exemption from an Account-By-Account Calculation of Compensation

The Commission correctly acknowledges that its interpretation of the Trust and Fiduciary Exception's "chiefly compensated" requirement will result in increased costs and burdens.[42] In light of this recognition, the Commission has offered an exemption (embodied in Rule 3a4-2) that allows a bank to avoid calculating on an account-by-account basis if it:

- demonstrates that the total sales compensation received from its trust and fiduciary accounts during the year does not exceed 10% of the relationship compensation received from such accounts during the year;
- maintains procedures reasonably designed to ensure that each trust and fiduciary account is chiefly compensated from relationship compensation (i) when each account is opened; (ii) when the compensation arrangements for the account are changed; and (iii) when sales compensation received from the account is reviewed by the bank for purposes of determining any employee's compensation; and
- complies with the GLB Act's limitations on the public solicitation of brokerage business for trust and fiduciary accounts.

We concur with the Commission's assessment that relief from the account-by-account calculation requirement is needed. However, we do not believe that Rule 3a4-2 accomplishes this goal. The requirement that each trust and fiduciary account must be "chiefly compensated" in order to take advantage of the 10% exemption essentially nullifies the exemption—calculations must still be made on an account-by-account basis when any account is opened or a compensation arrangement is changed. This is a regulatory "sleight of hand" if there ever was one.

[42] Interim Final Rules, 66 Fed. Reg. at 27,776 ("[The exemption] should minimize the costs and regulatory burdens on banks arising from the GLBA requirements relating to the trust and fiduciary compensation computations....").

Furthermore, even if the Commission modified the exemption to address these concerns, a bank relying on the exemption would have to ensure that during any year, the sales compensation received from all of its trust and fiduciary accounts did not exceed 10% of the "relationship" compensation received from such accounts. Accordingly, a bank could still be "chiefly" (*i.e.*, more than 50%) compensated from "relationship" compensation on a department- or bank-wide basis, but the exemption would not be available because the Commission has set the "real" bar at 10%.

Together, these requirements make the exemption virtually unattainable and fail to relieve the regulatory burdens imposed by the Commission's definition of "chiefly compensated." The approach adopted by the Commission, while welcomed in concept, needs fundamental reworking to be of any meaningful use.

Scope of "Fiduciary Capacity"—Investment Advisory Services

The Trust and Fiduciary Exception specifically excepts a bank from the definition of "broker" when it acts in a "fiduciary capacity," which includes acting "as an investment adviser if the bank receives a fee for its investment advice."

The BSA is concerned about various aspects of the Commission's interpretation of the term "fiduciary capacity" generally in the Interim Final Rules. In this regard, we believe that the well-settled understanding as to the meanings and scope of the terms "trustee capacity" and "fiduciary capacity" should be observed by the Commission, as opposed to reducing their historical scope, as the Commission appears to be doing in the Interim Final Rules. This is clearly what Congress envisioned in enacting the Trust and Fiduciary Exception.

The BSA is particularly concerned with the way that the Commission has interpreted "acting as an investment adviser if the bank receives a fee for its investment advice." The Interim Final Rules provide that a bank will be deemed to be acting in an investment advisory capacity for purposes of the fiduciary exception only if the bank provides continuous and regular "investment advice" to the customer's account that is based upon the individual needs of the customer; and owes a duty of loyalty to the customer (arising out of state or federal law, contract, or customer agreement).[43]

The definition of the term "fiduciary capacity" comes largely from Part 9 of the Office of the Comptroller of the Currency's fiduciary regulations.[44] However, neither

[43] As discussed *infra*, we have assumed a bank would only need to consider whether the Trust and Fiduciary Exception is available if it, as a threshold matter, comes within the definition of "broker."

[44] 12 C.F.R. § 9.101(a) (2001). Under Part 9, a national bank provides investment advice for a fee only if the bank provides advice or recommendations concerning the purchase or sale of specific securities.

Part 9 nor any language in the Trust and Fiduciary Exception provides that a bank acts in a "fiduciary capacity" only when the bank provides "continuous and regular" investment advice. The BSA does not believe that there is any basis for this Commission-imposed requirement. The Trust and Fiduciary Exception only requires that a bank receive a fee for the investment advice that it provides. This requirement is included in the Trust and Fiduciary Exception to distinguish situations when a bank provides investment advice only as an incident to, for example, securities brokerage activities without separate compensation (*i.e.*, acts as a full-service broker).

By imposing a "continuous and regular" requirement, the Commission has again exceeded its mandate. The BSA believes that this requirement could, on its face, prevent banks from relying on the Trust and Fiduciary Exception even in clearly non-securities brokerage-related circumstances. Under the Interim Final Rules, a bank, for example, should not be considered to be acting in a "fiduciary capacity" if the bank, in return for a fee, provides a one-time account review for a new customer. This clearly is a permitted activity under bank regulatory rules and does not involve a securities brokerage activity.[45]

E. The Safekeeping and Custody Activities Exception

Section 201 of the GLB Act, as it amends 3(a)(4)(B)(viii) of the Exchange Act, allows banks to act in a variety of custodial and safekeeping-related activities as part of its customary banking activities (the "Custody Exception"). This exception permits a bank to: provid[e] safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers; and serv[e] 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.

The Custody Exception generally was intended to allow banks to engage in all activities which are part of their customary safekeeping and custody operations, such as facilitating the transfer of customer funds or securities. Like the Trust and Fiduciary Exception, Congress intended the Custody Exception in the GLB Act to allow banks to continue traditional custody and related activities without having to register as broker-dealers, even if such activities had certain securities-related aspects.

In the Interim Final Rules, however, the Commission again appears to have exceeded its authority under the GLB Act. By asserting that the Custody Exception does not permit banks to handle securities orders for their custodial IRA customers, for 401(k) and benefit plans that receive custodial and administrative services from the bank or as an

[45] As noted above, we do not believe that this activity meets the definition of "broker" under the Exchange Act. Accordingly, there should be no need for a bank to consider this exception. As mentioned above, clarification from the Commission regarding this and similar points would be most helpful.

accommodation to custodial customers, the Commission has ignored Congressional intent and the very reason that the Custody Exception was included in the GLB Act in the first place.

The GLB Act assumes that banks will execute securities transactions in connection with their customary custodial duties. To assume, as the Commission has, that these activities are not covered by the Custody Exception makes the Custody Exception superfluous. In enacting the Custody Exception, Congress recognized that "bank safekeeping and custody services may involve effecting transactions for bank customers."[46] Curiously, the Commission staff, in at least two no-action letters, has generally recognized that banks provide a broad range of related services, including securities execution services, as part of providing custodial services.[47]

The Interim Final Rules do include two exemptions for custodial-related transactions that, but for the Commission's tortured view of the Custody Exception, would be unnecessary. In any event, as is discussed below, the Commission has all but ensured that these exemptions will be of little utility given the numerous and burdensome conditions it has imposed.

Typical Custodial, Order-Taking Functions of Banks

Banks acting as custodians have long-provided securities-related execution to self-directed IRA accounts. In this regard, the Internal Revenue Service ("IRS") generally requires that a bank serve as a trustee or custodian for an IRA.[48] These services are subject not only to strict regulation by the IRS but also by the federal banking agencies and have been offered for years without creating concerns. With banks acting in this capacity, customers are able to avoid the unnecessary expense and administrative complexity associated with establishing a separate brokerage account. Banks serving as a custodian or trustee for a self-directed IRA account, transmit all securities transactions to a registered broker-dealer for execution and would be required to continue to do so under the GLB Act.

Banks also provide custodial and safekeeping services for 401(k) and other retirement and benefit plans. Frequently, banks will bundle custodial services with other recordkeeping, reporting, tax-preparation and administrative services. In this regard, the custodial bank will perform order-taking and order-execution functions pursuant to the direction of a plan fiduciary. These bank-offered services allow plan administrators to

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[46] H. REP. No. 106-74, at 158 (1999).

[47] *See* Provident National Bank, SEC No-Action Letter (Oct. 6, 1982) and Universal Pensions, Inc., SEC No-Action Letter (Jan. 30, 1998).

[48] 26 C.F.R. § 1.408-2(b)(2)(i) and (d) (2001).

obtain securities execution and other administrative services in a cost-effective manner, thereby reducing plan expenses. The Commission has improperly interpreted the Custody Exception in a manner that would disrupt the efficient delivery of these services without any corresponding benefit to consumers.

The Commission has stated that it adopted its restrictive approach in light of the Congressional intent that the Custody Exception was not meant to allow banks to engage in broader securities activities. By eliminating the ability of banks to accept orders from customers to purchase or sell securities (other than in the very circumscribed manner permitted in the Custody Exception), the Commission has gone overboard. The Custody Exception excepts custody and safekeeping and related activities only; it is not "open-ended" and would not, as the Commission fears, allow banks to somehow generally offer brokerage services to the public.[49] In any event, the GLB Act's restrictions on a bank's ability to publicly advertise these services should address these unfounded fears.

The Custody Exemptions

Again, rather than interpreting a Title II Exception in a responsible and useful manner, the Commission has chosen to narrowly interpret a Title II Exception and then, recognizing that its interpretation will disrupt traditional bank securities-related activities, the Commission offers an exemption in an attempt to justify its initial unsupportable position. In this case the Commission has offered Rule 3a4-4 and Rule 3a4-5, which permit banks to accept orders from their custody customers. While we again support the Commission's desire to provide flexibility to banks with regard to the Custody Exception, we believe that these exemptions ultimately provide little, and establish conditions inconsistent with Congressional intent and any fair reading of the Custody Exception.

In Rule 3a4-4, a bank may effect securities transactions for a custodial client subject to an almost absurd number of conditions.[50] In addition, the exemption under

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[49] Again, we continue to be amazed that the Commission believes that banks are somehow intent on avoiding broker-dealer regulation when the record shows that banks have embraced broker-dealer regulation for securities activities, like full service brokerage, that justify such regulation.

[50] These conditions include that the bank must have had less than $100 million in assets as of Dec. 31st of both of the two prior calendar years; the bank is not, since Dec. 31st of the 3rd prior calendar year, affiliated with a bank holding company that as of Dec. 31st of the prior two calendar years had consolidated assets of more than $1 billion; the bank is not associated with a broker-dealer; the bank does not have a networking arrangement with a broker-dealer as expressly permitted under the Networking Exception; the bank may accept orders only for custodial IRA accounts and other specified types of tax deferred accounts (but not 401(k) accounts) for which the bank acts as custodian; the bank may accept orders from such accounts only for the purchase and sale of Commission-registered mutual funds; if the bank makes available shares of an affiliated mutual fund, the bank must also make available shares of an unaffiliated mutual fund that has "similar characteristics"; the total compensation received by the bank for effecting

Rule 3a4-5 provides that a bank may effect transactions for its custodial customers only if the bank does not, directly or indirectly, receive any compensation.

Needless to say, we cannot imagine very many scenarios where banks will be able to take advantage of these exemptions, even assuming that it is possible to devise a system adequate to ensure compliance with the exemption's conditions in a cost-effective manner. Once again, the Commission has fashioned exemptions that are largely nugatory.

In sum, neither the GLB Act nor its legislative history provides any justification for prohibiting banks from charging fees for their customary custody and safekeeping activities, including providing related securities processing services. Moreover, the two exemptions offered by the Commission provide very little real relief.

F. Cure Provisions and Extensions of Time

Cure Provisions

The Interim Final Rules do not address the prospect that, particularly given how many of the Interim Final Rules are structured, a bank will only be able to determine whether or not the conduct of a particular activity qualifies for a Title II Exception on a retrospective basis. Therefore, a bank may only find after the fact that it needed to have been registered as a broker-dealer. As a result, for even a small technical violation, a bank could be subject to enforcement by the Commission, civil suits or and other draconian consequences.

At a minimum, the Commission should offer banks a reasonable period of time with which they could bring their operations into compliance in these circumstances. In this regard, a useful analogy can be made to Rule 3a-2 under the 1940 Act, which allows inadvertent investment companies a one year period to come into compliance with the 1940 Act.[51]

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securities transactions under the Custody Exception (including any 12b-1 fees received from the mutual funds in which the customer invests) may not exceed 3% of the bank's annual net interest and noninterest income; the bank does not advertise that it effects any kind of securities transactions and must otherwise limit its securities advertising activities; the bank's employees effecting these transactions must not be associated with a broker-dealer, must primarily perform duties for the bank other than effecting securities transactions for customers and must not receive compensation for effecting securities transactions under the exemption from the bank, the executing broker-dealer or any other person related to (i) the size, value, or completion of any securities transaction; (ii) the amount of securities-related assets gathered; or (iii) the size or value of any customer's securities account; and the bank must direct trades to a broker-dealer.

[51] Exchange Act Rule 3a-2(a) states: "[A]n issuer is deemed not to be engaged in the business of investing, reinvesting, owning, holding, or trading in securities during a period of time not to exceed one

Extensions of Time

The BSA applauds the Commission's efforts with regard to providing banks additional time with which to comply with the Title II Exceptions, and to delay the ability of private parties to bring a cause of action against banks under Section 29(b) of the Exchange Act on the basis that the bank is not in compliance with the broker-dealer registration provisions of the Exchange Act.

However, as discussed earlier, the BSA believes that a substantial question exists as to whether the Interim Final Rules were properly adopted under the APA and that, in any event, significant and material revisions need to be made to these rules. In this regard, in order be in compliance with the Title II Exceptions and the Interim Final Rules by October 1, 2001 (or January 1, 2002), banks would already have had to start making arrangements to recast their operations. Yet, banking organizations and industry trade associations (as well as the Commission staff) expect that the Interim Final Rules will be changed in some fashion before they are truly finalized. Accordingly, the banking industry is in a paradox. On the one hand, it must begin (or have already begun) the costly initiative to come into compliance with the Interim Final Rules as written or face the possibility of violating the law. On the other hand, if it does begin (or has begun) this undertaking, banks face the possibility of having to further modify their operations after the "final" version of the Interim Final Rules is published.

Given this "Catch-22" dynamic, we believe that the Commission should set new compliance deadlines, irrespective of how the Interim Final Rules proceed, and that the new compliance deadlines should be set as one year from the date of issuance of definitive rules. In the meantime, we would strongly urge the Commission to promptly issue a statement that the October 1st and January 1st deadlines are being deferred, pending final resolution of the Interim Final Rules by the Commission. This would relieve some of the angst within the banking industry.

IV. Conclusion

As discussed above, the BSA believes that the Interim Final Rules should be re-published under normal APA public rulemaking procedures as proposed rules and revised in accordance with our comments and the Banking Agencies Letter. To do otherwise will cause great disruption to banks and the long-standing services that they have provided their customers, with no corresponding benefit to the public. This certainly is not what Congress intended when they enacted Title II of the GLB Act.

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year; provided, that the issuer has a bona fide intent to be engaged primarily, as soon as is reasonably possible (in any event by the termination of such period of time)...."

If you have questions regarding this letter, please do not hesitate to call the undersigned at (202) 887-1515.

Very truly yours,

Robert M. Kurucza
General Counsel, Bank Securities Association

Partner
Morrison & Foerster LLP

Testimony of

K. REID POLLARD

PRESIDENT & CEO
RANDOLPH BANK & TRUST
ASHEBORO, NORTH CAROLINA

On behalf of the

INDEPENDENT COMMUNITY BANKERS OF AMERICA

Before the

HOUSE FINANCIAL SERVICES COMMITTEE

Washington, D.C.
August 2, 2001

Chairman Bachus, Chairman Baker, Ranking Member Waters, Ranking Member Kanjorski, members of the Committee, it is a privilege to be here to present the views of our nation's independent community banks on the SEC's interim final rule to implement Title II of the Gramm-Leach-Bliley Act. Title II addresses exceptions for banks from being defined as brokers or dealers. My name is K. Reid Pollard, and I am president and CEO of Randolph Bank and Trust Company, a $186 million community bank located in Asheboro, North Carolina. I serve on the Federal Legislation Committee of the Independent Community Bankers of America (ICBA)[1], on whose behalf I appear today.

Mr. Chairman, we wish to thank you for holding this hearing to examine one of the more controversial rulemaking proposals pursuant to the Gramm-Leach-Bliley Act. We believe the rule in its present form is incompatible with congressional intent and would impose unworkable and burdensome requirements that would disrupt many of the activities traditionally conducted in banks that involve securities transactions, such as trust, fiduciary and custodial activities

Many of our concerns are shared by Members of Congress and representatives of the federal banking agencies who were instrumentally involved in the negotiations and drafting of the Title II provisions. Notable among those expressions of concern, Mr. Chairman, is your letter of July 19, co-signed by Chairman Oxley and the chairman of every Subcommittee of this Committee.

It is importantly to remember that, as the House Banking Committee in the last Congress, this committee had primary jurisdiction over the Gramm-Leach-Bliley Act. Clearly, this committee knows what Congress intended when it passed the Gramm-Leach-Bliley Act.

In addition, on June 29, a joint comment letter was filed by the Federal Reserve Board, the FDIC and the OCC, similarly critical of the SEC's rulemaking.

SEC Response

Like you, Mr. Chairman, we very much welcome and appreciate the SEC's announcement on July 17 that the compliance date and comment period for this rule would be extended and that amendments to the rule would be made. We would ask the SEC to take it one step farther, however, and issue a substantially revised rule for another round of public comment. We believe that it would be an error for the SEC to try to fix this rule and proceed immediately to a final rule based on comments it has received on the existing interim final rule. Rather, a new proposal is needed based on the input the agency has received and with an opportunity for the public to provide input on a new proposal. The ICBA also believes that it is critical that the SEC should defer compliance

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[1] ICBA is the primary voice for the nation's community banks, representing 5,500 institutions at nearly 16,700 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business, agricultural and consumer lending. ICBA's members hold more than $491 billion in insured deposits, $589 billion in assets and more than $344 billion in loans for consumers, small businesses and farms. They employ nearly 232,000 citizens in the communities they serve. For more information, visit www.icba.org.

for at least 12 months after a final rule is published to allow banks the time to adapt systems, procedures and products and services.

Summary of Concerns

On July 17, the ICBA filed an extensive comment letter on the interim final rule, which is attached to this testimony for the permanent hearing record. The ICBA comment letter describes the concerns of independent community bankers in substantial detail. For the sake of brevity, I will summarize several of our principal concerns in this testimony, and urge Members to review our entire comment letter.

Exceptions Critical to Community Banks

Prior to enactment of the Gramm-Leach-Bliley Act, banks enjoyed a blanket exemption from registration as brokers or dealers under the 1934 Securities and Exchange Act. Gramm-Leach-Bliley removed the blanket exemption, but recognizing that banks have long offered customers certain securities services without problem, instituted a series of exceptions for certain traditional banking activities, such as trust and fiduciary activities.

These statutory exceptions are extremely important for community banks and our customers. Registering as brokers or dealers or establishing a broker-dealer affiliate is simply not an option for most small banks. The capital required and the compliance and reporting systems that small banks would have to implement to register as broker-dealers are not commensurate with the potential income streams for these banks. The business case would not justify registration.

Furthermore, many community banks operate in rural areas where it would be difficult to recruit and retain experienced licensed personnel to staff such an operation. Therefore, practical and useful applications of the statutory exceptions are critical to continue to provide these services and to make them available to investors. In fact, without these exceptions, in some rural areas, customers might not have personal access to any financial institution that offers these services if their local bank discontinues them.

Rule is Incompatible with Congressional Intent, Would Add to Regulatory Burden

Title II of the Gramm-Leach-Bliley Act was designed to ensure that traditional banking activities involving securities transactions, such as fiduciary activities and custodial functions, are not disturbed, and that banks are able to continue to provide services to customers as they have for many years. However, the rule as written would impose unworkable and burdensome requirements that would, in fact, disrupt trust and fiduciary activities, and essentially nullify the congressional exceptions. The rule fails to take into account the extensive fiduciary requirements that other laws impose on bank trust and fiduciary activities and overlooks the existing supervisory framework that the federal banking agencies have established to supervise these activities.

For example, the SEC interim final rule would allow the SEC to assess what constitutes acting as a fiduciary. This is unnecessary and would lead to confusion and uncertainty. Many states have adopted laws that govern the activities and responsibilities of banks acting as fiduciary. In addition, the common law in most states further defines these responsibilities. There is no need for the SEC to evaluate what constitutes acting as a fiduciary when state law already establishes this.

Furthermore, the banking agencies have extensive examination procedures that closely review bank fiduciary activities, including the appropriateness of investments, whether they are compatible with law and the governing instrument, and so forth. It is unnecessary for the SEC to institute additional controls.

"Push Out" Would be Costly to Customers

The interim final rule will disrupt long-standing fiduciary and trustee activities, and increase costs and impose burden and inconvenience on bank customers. For example, if a bank is required to "push-out" the securities activities of a trust account to a registered broker-dealer, customers will be forced to have one account with a bank and a separate brokerage account with a broker-dealer to conduct securities transactions. State laws govern what entities may serve as trustee and while banks may generally serve as a corporate trustee, a broker-dealer may not, mandating this dual account situation and unnecessarily driving up costs for trust customers.

Chiefly Compensated Definition Flawed

To prevent banks from using trust services to engage in a full-brokerage operation, the Gramm-Leach-Bliley Act requires that banks be "chiefly compensated" for trust and fiduciary activities on the basis of non-brokerage related fees. However, the SEC interpretation creates a complex and unworkable definition of compensation, and inappropriately requires the bank to monitor and analyze each individual trust account in order to comply with the rule. This would require unworkable and unduly burdensome calculations. The alternative "safe harbor" proposed by the SEC to allow banks to avoid the account-by-account calculation is also unworkable and therefore useless. The ICBA believes that the analysis should be done on the entire trust operations of the bank and not on each individual account.

Safekeeping and Custodial Functions Jeopardized

The interim final rule also would severely disrupt bank safekeeping and custody arrangements by taking an overly narrow view of what activities are acceptable and by determining that securities transactions are generally impermissible. For example, the interim final rule would not allow a bank to accept orders to purchase and sell securities when serving as custodian. This interpretation makes little sense and defeats the purpose of the statutory exception. If a bank cannot accept orders from a customer on the disposition of securities the bank holds as custodian, including orders to purchase and sell, then there is little reason for a bank to serve as custodian. The SEC interpretation makes the bank custodial role little more than one of corporate safety deposit box.

The Gramm-Leach-Bliley Act clearly intended that these activities be allowed to continue, but the interim final rule would make it virtually impossible for banks to continue to serve customers as they have for many years.

Exemptions

Perhaps recognizing this, the SEC has proposed two special exemptions to the limitation, for small banks and accommodation trades. But the exemptions are so complex and restrictive as to be of negligible value.

The first exemption would be for small banks. To qualify for the small bank exemption, the interim final rule would require that a bank have less than $100 million in assets and not be affiliated with a holding company with more than $1 billion in consolidated assets. This cap is much too low. The ICBA believes a higher figure would be much more appropriate for this exemption, and there are precedents for a higher figure. For example, the federal banking agencies have streamlined CRA examination procedures for "small banks," defined as having less than $250 million in assets. And the Gramm-Leach-Bliley Act permits "small banks" of under $500 million in assets unqualified eligibility for membership in the Federal Home Loan Bank System.

If this exemption is retained (we believe it would be unnecessary under a proper interpretation of the statute), we recommend that the SEC revise the definition of small bank at least to one with $250 million in assets, and perhaps even higher, to be more in keeping with existing banking industry guidelines and the realities of the present world of mergers and consolidations.

A second exemption, "the accommodation exemption," would allow banks to engage in certain securities transactions on behalf of a restricted category of safekeeping and custody customers, such as those with self-directed IRAs and other tax-deferred accounts. Currently, banks can offer a full range of investment products to their self-directed IRA customers, from CDs to stocks and bonds. However, under the SEC's interim final rule, banks would be limited to offering investments strictly in SEC-registered mutual funds. This restriction would put banks at an unfair competitive advantage in relation to other financial service providers. Since this restriction is not mandated under the Gramm-Leach-Bliley Act, it should be eliminated.

If the agency had simply followed the plain language of the statute to exempt custody and safekeeping activities, these two special exemptions would be unnecessary. Therefore, the ICBA recommends the agency adopt a much broader interpretation of what is permissible under the custody and safekeeping exception, one more in keeping with the Gramm-Leach-Bliley Act.

Networking Arrangements Restricted, Referral Fee Caps Unrealistic

Many community banks rely on networking arrangements with third-party broker-dealers to serve their customers. Under the Gramm-Leach-Bliley Act, if a bank contracts with a third-party to offer brokerage services to the bank's customers, the bank will not be considered a broker subject to SEC broker registration requirements and regulation. Under this "networking" exception, bank employees may not receive incentive compensation for any brokerage transaction, although the statute provides that they may receive referral fees that are nominal one-time cash payments of a fixed dollar amount that is not contingent on whether the referral results in a sale.

The interim final rule would impose new and unrealistic restrictions on referral fees, inappropriately interjecting the SEC into bank employee compensation programs. For example, the gross hourly wage cap that the interim final rule imposes is unrealistic and implementation of this restriction raises employee privacy concerns. Because of the impracticalities and burdens of using an hourly wage level as a cap for the referral fee, the ICBA strongly opposes its use. We believe that bank compensation is a matter more appropriately supervised by banking regulators.

***De Minimis* Exception Important to Small Banks**

The Gramm-Leach-Bliley Act contains an important exception from registration for a bank that conducts no more than 500 securities transactions in a calendar year. Under this provision, transactions excepted under one of the other Gramm-Leach-Bliley Act provisions (e.g., trust and fiduciary activities, safekeeping and custodial transactions, etc.) are not included when calculating the 500 transaction limit.

This *de minimis* exception is extremely important to small banks. The statutory language is plain and straightforward on this exception. However, the interim final rule contains a provision that confuses the plain meaning of the statute. The SEC interim final rule would count certain transactions twice – once as a sale and once as a purchase. This double counting is illogical and incompatible with plain English. We urge the SEC to define a transaction solely as the transfer of a security from one owner to a new owner and only counted once.

Asset Securitization Limited

The interim final rule also proposes unrealistic and unworkable rules for a bank to qualify for an exception from dealer requirements for asset securitization. Under the Gramm-Leach-Bliley Act, banks can underwrite and sell asset-backed securities if the underlying obligations were primarily originated by the bank, an affiliate, or through a syndicate of which the bank is a member.

However, in order for a bank to qualify for this exception under the SEC's interim final rule, "predominantly"means that at least 85 percent of the value of the obligations in the pool must have been originated by the bank, one of its non-broker dealer affiliates, or a syndicate of which the bank is more than an insignificant member. The rule also says that to be considered as having originated the underlying obligations, the bank must have initially made and funded the obligation.

The ICBA believes that the 85 percent threshold set by the SEC is too high. While smaller community banks are unlikely to take the lead in putting together the pool of assets that are securitized, for many small banks, the ability to sell loans into the market is critical for liquidity and to be able to meet credit needs by funding new loans. Sales of loans to institutions that securitize them is one way that small banks obtain new funding. However, by making it difficult for larger banks to incorporate loans that they themselves do not originate, the SEC erects a barrier to small banks selling these loans into the market. We believe the 85 percent threshold should be dropped. A simple majority – 51 percent – would be sufficient to carry out the intent of Congress. And, it would ensure that securitizations continue to serve as a source of funding for banks.

Second, the SEC definition of a syndicate will make many existing arrangements ineligible for the securitization exception. Because the interim final rule's interpretation is so narrow, many syndications will no longer qualify, making it more difficult for banks to use this successful tool to continue to serve low- and moderate-income borrowers.

Need for a Cure Mechanism

One of the points raised by the federal banking agencies with which the ICBA strongly concurs is the need for a cure mechanism for inadvertent errors. If a bank is operating in good faith and making reasonable efforts to comply with the requirements, yet inadvertently falls out of compliance, the bank should be able to rectify the error without having to suddenly register as a broker-dealer or without allowing customers to void transactions, as would be possible if the bank were defined as a broker-dealer that had not registered. The ICBA believes that any final rule should include a cure mechanism to address this issue.

Conclusion

We believe that the SEC's interpretations in the interim final rule governing the Gramm-Leach-Bliley Act exceptions from the definition of broker and dealer are unduly and unnecessarily narrow, complicated and qualified. The net effect of the restrictions and conditions is to nullify the statutory exceptions. This is neither in keeping with the spirit nor the express language of the Gramm-Leach-Bliley Act.

Congress clearly intended that banks continue to be able to provide services to their customers that they have offered successfully for many years. Banks have offered these services, including securities transactions, as part of their traditional banking activities without problem. These activities are subject to strict fiduciary standards and closely supervised by the various banking agencies. Congress recognized all this when it established the exceptions under Title II of the Gramm-Leach-Bliley Act. Banks should be allowed to continue providing traditional services to their customers without sustaining or passing on to their customers prohibitive costs to comply.

Therefore, the ICBA has urged the SEC to substantially revise and reissue for public comment a proposed rule that gives effect to Congress' intent and that addresses all the exceptions provided in the statute.

Thank you for this opportunity to testify.

Enclosure

ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA

July 17, 2001

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

Re: File No. 27-12-01, 17 CRF Parts 200 and 240, Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934

Dear Mr. Katz:

The Independent Community Bankers of America (ICBA)[1] has reviewed the interim final rule issued by the Securities and Exchange Commission (SEC) to implement Title II of the Gramm-Leach-Bliley Act of 1999 (GLBA) and wishes to offer the following comments.

Prior to GLBA, banks enjoyed a blanket exemption from registration as brokers or dealers under the 1934 Securities and Exchange Act. GLBA removed the blanket exemption, but recognizing that banks have long offered customers certain securities services without problem, instituted a series of exceptions for certain traditional banking activities, such as trust and fiduciary activities. Theoretically, the interim final rule is designed to implement those provisions.

However, the ICBA finds that the interim final rule is incompatible with both the plain language of GLBA and Congressional intent. Title II of GLBA was designed to ensure that traditional banking activities involving securities transactions, such as fiduciary activities and custodial functions, not be disturbed and that banks be able to

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[1] ICBA is the primary voice for the nation's community banks, representing 5,000 institutions at nearly 17,000 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business, agricultural and consumer lending. ICBA's members hold more than $486 billion in insured deposits, $592 billion in assets and more than $355 billion in loans for consumers, small businesses and farms.

continue to provide services to customers as they have for many years. The interim final rule, though, would make it difficult – if not impossible – for banks to continue those activities undisturbed. In its current state, the interim final rule is extremely burdensome, unnecessarily complicated and restrictive, and will prove so costly for banks to implement that it essentially nullifies the statutory exceptions, defeating the Congressional intent that banks be allowed to continue to function as they have. Without substantial revision, the interim final rules will force many banks – especially smaller banks – to discontinue existing services to the detriment of their customers. Those banks that continue to offer the same services will face substantially increased costs due to compliance with the interim final rule's complexity. Of particular concern for ICBA members are the potential impact the interim final rule will have on trust and fiduciary services, safekeeping and custody arrangements and networking arrangements with third-party broker-dealers.

The statutory exceptions in Title II of GLBA are extremely important for community banks and their customers. Registering as brokers or dealers or establishing a broker-dealer affiliate is simply not an option for small banks. The capital required and the compliance and reporting systems that small banks would have to implement to register as broker-dealers are not commensurate with the potential income streams for these banks. The business case would not justify registration. Furthermore, many community banks operate in rural areas where attracting qualified personnel to staff such an operation is not feasible. Therefore, practical and useful applications of the statutory exceptions are critical to continue to provide these services and to make them available to investors.

The ICBA also questions the manner in which the interim final rule was issued. Because the SEC had not issued *any* guidance on these exceptions and because the statutory effective date was approaching, the agency was asked to defer the effective date of the requirements while seeking comments on proposed guidance. Instead, without any input from the banking industry or the public, the SEC issued an interim final rule. This interim final rule places banks in an untenable position. While the SEC did establish a deferred date for compliance, the transition period is extremely short given the complexities of the rule. And, before a final rule has been issued, banks will be compelled to revise their systems and procedures based on the interim final rule in order to begin to prepare for compliance by the deadline.[2] The ICBA objects to the fundamental unfairness of expecting banks to proceed on the basis of a rule that was issued without following standard administrative procedures and without knowing how the rules will be changed, especially given the serious impact the rule will have on bank services and customer relationships.

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[2] While the statute has existed since November 1999, the length and extent to which the SEC goes to explain its rationale on portions of the interim final rule demonstrates the complexities of these issues and the difficulty the industry would have in complying without regulatory guidance.

Therefore, the ICBA believes that a substantially revised rule should be issued for public comment. The ICBA especially urges the SEC to work with the agencies charged with supervising the entities which this rule impacts.[3] To allow adequate time for banks to revise systems and procedures in accordance with a revised rule, compliance should be deferred until at least twelve months after a final rule is published. Finally, to avoid further disruption of customer service by banks, the ICBA also strongly urges the SEC to immediately announce the suspension of the interim final rule's requirements until a final rule can be issued.

Overview

Congress adopted the exceptions to broker-dealer registration in GLBA because banks have provided these products and services for years, making banks uniquely qualified to continue to engage in certain securities activities.

The interim final rule would impose unworkable and burdensome requirements that would disrupt trust and fiduciary activities. The rule fails to take into account the extensive fiduciary requirements that other laws impose on bank trust and fiduciary activities and overlooks the existing supervisory framework that the federal banking agencies have established to supervise these activities. Furthermore, the interim final rule would call into question the legitimacy of the trustee function and unnecessarily create uncertainty and ambiguity.

To prevent banks from using trust services to engage in a full-brokerage operation, GLBA requires that banks be "chiefly compensated" for trust and fiduciary activities on the basis of non-brokerage related fees, but the SEC interpretation creates a complex and unworkable definition of compensation. Furthermore, the interim final rule would apply the analysis on an account-by-account basis instead of an aggregate basis, a step that is extremely burdensome and incompatible with Congressional intent.

The interim final rule would also severely disrupt safekeeping and custody arrangements by taking an overly narrow view of what activities are acceptable. The GLBA clearly intended that these activities be allowed to continue, but the interim final rule would make it virtually impossible for banks to continue to serve customers. Perhaps recognizing this, the SEC has adopted two special exemptions to the limitation, but the exemptions are so complex and restrictive as to be of negligible value. If the agency followed the plain language of the statute to exempt custody and safekeeping activities, these two special exemptions would be unnecessary.

Especially important to the ability of community banks to serve their customers are networking arrangements with third-party broker-dealers. Here, the interim final rule would impose new and unrealistic restrictions on referral fees, making it difficult for banks to continue to offer these types of programs.

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[3] The ICBA fully supports the comments on the interim final rule filed June 29, 2001 by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.

In addition, a number of other areas in the interim final rule need to be addressed or revised, such as sweep accounts, securitizations, a safe harbor that allows banks to cure inadvertent errors and an extension of time for compliance. Following are ICBA's comments on the specifics of the rule, but we wish to reiterate that we urge the SEC in the strongest possible terms to propose for comment a substantially revised rule that is compatible with Congressional intent and the plain terms of the statute.

Trust and Fiduciary Activities

For many years, banks have offered customers trust and fiduciary services that involve securities transactions. These activities are a mainstay of the business of banking, have been delivered to customers without serious problems, and are subject to state laws on fiduciary activities and supervision by banking agencies. Recognizing this longstanding tradition, Congress included an exception in GLBA that allows banks to continue to provide securities transactions for their trust and fiduciary customers as they have for many years. To prevent banks from conducting a full-scale brokerage operation in the guise of trust department activities, GLBA placed some qualifications on this exception: the statute requires a bank to be "chiefly compensated" for trust and fiduciary services on the basis of non-brokerage related fees and prevents the bank from advertising its securities services, except in connection with general trust services. However, Congress clearly intended that existing services to bank customers through trust and fiduciary activities – including securities services – be allowed to continue.[4]

In addressing these activities, the interim final rule goes too far and will disrupt long standing fiduciary and trustee activities, contrary to Congressional intent. The ICBA also is concerned that the existing SEC approach to trust and fiduciary activities will increase costs and impose burden and inconvenience on bank customers. If a bank is required to "push-out" the securities activities of an account to a registered broker-dealer, the customer will be forced to have one account with a bank and a separate brokerage account with a broker-dealer to conduct securities transactions. State law governs what entities may serve as trustee. Generally, banks may serve as a corporate trustee while a broker-dealer may not, mandating a dual account situation, a costly enterprise for trust customers.

Acting in a Fiduciary Capacity. GLBA specifies that a bank is acting in a fiduciary capacity, and hence exempt from the definition of broker-dealer, when acting as "trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gift to minors act." In

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[4] See, e.g., H.R. Rep. No. 106-74, pt.3, 164: GLBA "provides an exception for bank trust activities, recognizing the traditional role banks have played in executing securities transactions in connection with their trust accounts."

addition, the statute clearly states that a bank is not defined as a broker-dealer if it "effects transactions in a trustee capacity."[5]

The terms of the statute are unambiguous, but the SEC states that it will assess the activities as well as the label to determine whether a bank is truly acting in a fiduciary capacity. By asserting a necessity to "clarify" what needs no clarification, the interim final rule creates confusion and an invitation to litigation. It also suggests that the SEC has the authority to review and interpret fiduciary law, an authority not conferred by GLBA.

By bringing into question when a trustee is truly a trustee, the SEC is compelled to address three areas: indentured trustees, ERISA and similar trustees and IRA trustees. For these particular relationships, the SEC specifies that a bank acting in these capacities qualifies for the broker registration exception, but only as long as the securities transactions are conducted in the trust department or other area of the bank that is regularly examined for compliance with fiduciary standards.

There is no reason for the creation of this ambiguity or additional restrictions on the scope of trustee or fiduciary capacity. The SEC's calling into question what constitutes a trustee serves neither public policy nor Congressional intent. The ICBA strongly recommends that this interpretation be eliminated from the final rule. This would obviate the need to create special exemptions for indentured trustees or ERISA and IRA trustees. Rather, the SEC should accept the plain meaning of the term without qualification and acknowledge that Congress has excepted a bank acting in a trustee or fiduciary capacity under applicable law from the definition of broker-dealer.

Trustees and Fiduciaries are Subject to Existing Law and Banking Agency Supervision. It is critically important that the SEC recognize that whenever a bank is acting in a fiduciary capacity, it becomes subject to both existing state laws on fiduciary conduct and regular bank supervision.

First, well-established state laws and regulations on fiduciary conduct apply to any transactions that the bank conducts in its trustee or fiduciary capacity. For example, the National Conference of Commissioners on Uniform State Laws has drafted uniform statutes that many states have adopted to govern the activities and responsibilities of banks acting as fiduciary. In addition, the common law in most states further defines these responsibilities – including the responsibilities of a fiduciary when managing and investing trust assets. Many of these laws are codifications of practices that go back centuries. There is no need for the SEC to impose itself in evaluating what constitutes acting as a fiduciary when state law readily establishes this. Rather, if a bank is acting in a manner that is accepted by state law as acting in a fiduciary capacity, that should be sufficient under Title II of GLBA.

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[5] GLBA, Section 201, amending section 3(a)(4)(B)(ii) of the Securities Exchange Act of 1934.

Second, examiners from the federal banking agencies regularly review these activities through long-established examination procedures. During these examinations, the examiners consider the procedures that the bank uses to develop investment recommendations and whether investments are consistent with the terms of the governing trust instrument. The examiners also investigate the bank's policies and procedures to ensure the investments are made in accordance with existing laws and regulations, including compliance with applicable securities rules. And, special examiners trained in trust and fiduciary matters conduct these examinations.[6]

Both the existence of state fiduciary laws and the supervision by bank regulators offer protection for the grantors and beneficiaries of these trusts, including protection regarding any securities transactions that may occur. Congress recognized this in creating the exception under Title II of GLBA. SEC overlay of additional regulatory restrictions is both burdensome and unwarranted.

Chiefly Compensated. As noted above, one of the conditions in GLBA for a bank to qualify for the trust and fiduciary exception is that it must be "chiefly compensated" on the basis of activities unrelated to securities transactions. The purpose is to ensure that banks do not engage in a full-service brokerage operation under the auspices of the trust department.

The SEC interim final rule provides lengthy, complex and burdensome specifications on whether a bank has met the qualification of being "chiefly compensated." The rule requires the bank to make the assessment annually for each individual account. The ICBA disagrees with this interpretation and believes the analysis should be on an aggregate basis. This would be consistent with Congressional intent to ensure that a full-brokerage business is not conducted through the trust department of the bank.

Trust departments often conduct securities transactions in individual trusts for many reasons, but to require analysis on individual accounts could mean that some fail to meet the test merely because they are carrying out normal trust obligations. For example, when an account is first opened in a trust department, investment policy of the bank and the governing trust instrument may require the trust department to engage in a significant number of securities transactions at the outset. Bank trust departments also engage in a high volume of securities transactions near year-end for tax purposes or to comply with the terms of the governing instrument. These transactions are designed for purposes other than conducting a brokerage business, but they could prevent the accounts from qualifying under the SEC proposed interim final rule.

It is not necessary to evaluate the trust department account-by-account to ensure that the bank does not conduct a full-scale brokerage business in the trust department.

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[6] The Federal Financial Institutions Examination Council (FFIEC) has developed the Uniform Interagency Trust Rating System (UITRS) that is designed specifically to evaluate and rate the trust and fiduciary activities of banks.

An aggregate analysis to determine how the department is chiefly compensated is sufficient to provide this information. A costly account-by-account analysis runs contrary to Congressional intent that long-established trust and fiduciary operations not be disrupted by GLBA.

Second, the interim final rule would require trust departments to classify trust department compensation into one of three categories: relationship compensation, sales compensation or unrelated compensation. Trust departments currently do not have systems in place that make these evaluations. To construct such systems will be a time consuming and expensive undertaking with costs likely to be passed on to trust customers. For smaller banks, this accounting exercise alone is likely to substantially erode any trust department income.

The ICBA strongly urges the SEC to revise the interim final rule's approach and allow banks to conduct an analysis of whether or not the bank meets the "chiefly compensated" test on an aggregate departmental basis. The ICBA also urges the SEC to clearly specify in the final rule that "chiefly compensated" is accepted as meaning that relationship compensation only need be a simple majority, i.e., 51 percent, of sales and relationship compensation.

Special Exception. The SEC has provided a safe harbor intended to allow a bank to avoid the account-by-account calculation to determine whether it is "chiefly compensated" on a relationship basis if most of the trust department income is from relationship-based fees. The ICBA appreciates the fact that the SEC recognizes that a safe harbor is needed if the rule requires an account-by-account analysis. However, as designed in the interim final rule, the safe harbor is insufficient and does not reach its intended goal.

Under the interim final rule, if the bank can demonstrate that sales compensation is less than 10 percent of its income for all fiduciary activities, it may avoid the account-by-account calculation. However, the bank must nonetheless maintain procedures to assess compliance with the "chiefly compensated" provisions on an account-by-account basis when an account is opened, when compensation arrangements change or when sales compensation is reviewed in connection with employee compensation. In making the 10 percent assessment, the bank would not consider any accounts that do not include securities trading activities.

The qualifications that the SEC has imposed on the safe harbor make it virtually meaningless. The procedures that require assessments account-by-account when an account is opened, when compensation arrangements change or when sales compensation is reviewed in connection with employee compensation essentially re-institute the account-by-account analysis that the safe harbor is meant to avoid.

Second, 10 percent is much too low. The statute speaks in terms of "chiefly compensated" by income from securities transactions. Nothing in the statute or legislative history indicates that this should be other than an analysis to determine that over fifty percent of the bank's compensation is from relationship compensation. Accordingly, ten percent is much too low.

However, since the ICBA also firmly believes that it would be more appropriate to use an aggregate analysis when determining whether a bank trust department meets the "chiefly compensated" test, this special safe harbor should be unnecessary.

Relationship Compensation. As defined in the interim final rule, relationship compensation is fees based on the account relationship received directly from the customer or beneficiary, or directly from the assets of the trust or fiduciary account. The ICBA believes that this is too narrow. GLBA does not place restrictions on the source of fees for these services, and the ICBA does not believe there is any justification or need to create such restrictions. Bank trust departments often structure fee arrangements to meet a variety of needs (such s for a series of related trusts) and should be able to continue to do so. The source of the fees is irrelevant to whether the compensation is securities transactions or based on the trust relationship. Therefore, this restriction should be eliminated from the final rule.

The interim final rule provides that one example of a relationship fee would be per order processing fees, provided the fees are limited to the cost assessed by the third party broker-dealer, plus any reasonable overhead incurred by the bank in connection with the transaction that is represented by bank resources devoted solely to securities order processing. The language of GLBA is not so restrictive, and would allow the bank to be compensated for any costs associated with order processing. Banks structure their activities in a variety of ways to make the most efficient use of their resources. Especially in smaller banks, individuals may perform more than one function and not be exclusively devoted to securities transaction processing. Alternatively, the bank may outsource these responsibilities to make more efficient use of existing resources. It does not make sense to deny the bank the ability to recover the costs of those activities merely because the individual involved is not exclusively devoted to securities order processing. Since the GLBA does not place this restriction on the ability of a bank to recover its costs, it is inappropriate for the SEC to add such a qualification. Therefore, the final rule should allow banks to recover any reasonable costs associated with the per order processing and characterize that expense as a relationship fee.

The interim final rule requires that all aspects of securities transactions conducted for trust and fiduciary customers be conducted solely in the trust department or other part of the bank subject to regular fiduciary examinations in order to qualify for the exemption. However, as noted, many banks –particularly smaller banks – may outsource related duties such as order processing, settlement and other back office functions or delegate them to other areas of the bank to make the most efficient use of resources. While these activities may not be subject to trust examinations, that does not mean they are not examined or reviewed by banking supervisors. On the contrary, all activities of the bank are regularly examined for compliance with applicable laws and regulations. The interim final rule would place an artificial constraint on normal business activities and force banks to structure activities in inefficient and costly ways. Therefore, the rule should be revised to allow banks to perform these ancillary activities outside the trust department.

Sales Compensation, as defined by the interim final rule, would include fees that are not capped or based on what the bank was charged for the transaction by a broker-dealer. As noted above, GLBA allows the bank to recover its costs, and therefore any recovery of bank costs should not be defined as sales compensation.

Under the interim final rule, sales compensation would also include "service fees" paid by an investment company for personal service or the maintenance of shareholder accounts, also sometimes referred to as Rule 12b-1 fees. The ICBA disagrees with this interpretation, and urges these fees be designated as relationship compensation when law or the governing agreement requires these fees be used to benefit the account. For example, under ERISA, the bank is required to use these fees either to directly benefit the pension plan or to reduce by an equal amount other compensation it receives. It would be unfair under those circumstances to designate the fees as sales compensation.

Another reason not to define Rule 12b-1 fees as sales compensation is that it will make it extremely difficult – if not impossible – for many banks to serve as trustee for a pension plans for small employers. Many of these plans are compensated using Rule 12b-1 fees to hold down costs. If these fees are defined as sales compensation, many of these pension trusts will fail to qualify as "chiefly compensated" by relationship compensation. In turn, this will cause the costs for administering these plans to increase to the point that many small employers will decide it is uneconomical to continue the pension trust.

Finally, redefining Rule 12b-1 fees as sales compensation goes against existing SEC interpretations. The agency has consistently agreed that such fees are for administration and servicing, i.e., relationship compensation.

Other Trust and Fiduciary Activities

Investment Adviser When the Bank Receives a Fee for Investment Advice. The GLBA specifies that a bank is acting in a fiduciary capacity, and therefore exempt from the definition of a broker, when it acts "as an investment adviser if the bank receives a fee for its investment advice." However, where the statute offers no qualifications to this provision, the interim final rule restricts the ability of a bank to qualify for the exception. The ICBA believes that these qualifications are unnecessary and should be eliminated. If a bank is offering investment advice for a fee, by the very terms of the statute the bank is acting in a fiduciary capacity and therefore qualifies for the exception. If for some reason the SEC believes that the bank is abusing the exception, it has the ability to refer the problem to the appropriate banking supervisor for further investigation.

In addition to believing that no qualifications are necessary, the ICBA finds the two qualifications inappropriate. First, the rule requires the bank to provide "continuous and regular investment advice based on the customer's investment needs." The advice must be ongoing rather than episodic and impersonal advice, such as advice provided through a newsletter designed for general circulation, in response to a market event, or that is not tailored to a specific customer's needs. However, the underlying intent of the interim final rule's requirement seems to be to ensure that the bank has met with and assessed the financial needs of the customer, and the ICBA agrees that is a fair requirement. However, intent to ensure that the investment advice is tailored to a particular customer is not commensurate with requiring that it be ongoing.[7] For some customers, a one-time portfolio review may be all the investment advice the customer wants or needs. As long as the advice proffered is specific to a particular customer, that should be sufficient. Furthermore, the interim final rule's requirement does not provide clear guidance for compliance, since it is not readily ascertainable what qualifies as "continuous and regular." Therefore, the ICBA believes the requirement should be eliminated.

Second, the rule requires the bank to be under an obligation, through law or contract, "to make full and fair disclosure to the customer of all material facts relating to conflicts." The ICBA believes that this requirement is unnecessary and redundant, given existing standards that govern bank fiduciary duties in their customer relationships.

Since Congress did not impose qualifications, and since the interim final rule's qualifications are unworkable and unnecessary, the ICBA recommends they be deleted.

Transfer Agent. According to the SEC, the fiduciary relationship of a bank acting as a transfer agent is between the bank and the issuer, not the purchaser of the security. Therefore, the exception is limited to transactions conducted on behalf of the issuer. The bank must rely on another exception for securities transactions conducted on behalf of shareholders in order to be exempt from registration for those activities.

The ICBA does not believe that this is logical. By defining the fiduciary relationship as only between the bank and the issuer, the SEC eliminates a great portion of the transfer agency function. The more appropriate view would to see the transfer agency as an intermediary that owes a fiduciary duty to both the issuer and the purchaser. If a bank transfer agent cannot conduct transactions in an issuer's stock on behalf of purchasers or holders of that stock, the bank cannot function effectively as a transfer agent. Because of this extreme limitation, no issuer would want to engage the services of a bank as transfer agent, and no bank will be able to function as transfer agent without registering as a broker-dealer. Banks have engaged in transfer agency activities for many years without problem and Congress recognized this is granting this

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[7] The ICBA questions whether many broker-dealers meet the qualifications that the SEC is seeking to impose on banks.

exception in GLBA. The SEC's interpretation in the interim final rule flies in the face of this longstanding tradition and experience – and denies effect to Congressional intent.

Safekeeping and Custody Activities

Another significant exception from the definition of broker under GLBA allows a bank to serve in the capacity of safekeeping or custodian for a customer's securities. Under this provision, the bank can hold customer securities, exercise warrants, facilitate the transfer of funds in connection with clearance and settlement of securities transactions, and effect securities lending and borrowing on behalf of a customer. However, the bank cannot act as a carrying broker.

Safekeeping and custody activities, like trust and fiduciary activities, have long been a part of the business of banking. This exception provides a means for banks to continue offering without disruption these products and services that they have offered for many years.

Generally, the SEC defines this exception as one where the bank functions in a "clerical or ministerial" role and does not engage in "broader securities activities." For example, according to the SEC, safekeeping and custody does *not* allow a bank to accept orders to purchase and sell securities. The agency believes that this kind of communication with customers "implicates concerns traditionally covered by the federal securities laws."

The ICBA believes that the SEC has taken an unduly narrow interpretation of what is permissible under GLBA for safekeeping and custody activities. The interim final rule would not allow a bank to accept orders to purchase and sell securities when serving as a custodian. However, such an interpretation makes little sense and defeats the purpose of the statutory exception. If a bank cannot accept orders from a customer on the disposition of securities the bank holds as custodian, including orders to purchase and sell, then there is little reason for a bank to serve as a custodian. The SEC interpretation makes the bank custodial role little more than one of corporate safety deposit box.

GLBA gives banks the ability to "facilitate the transfer of funds or securities, as a custodian or a clearing agency, in connection with the clearance and settlement of its customers' transactions in securities."[8] Congress qualified this exception from the definition of broker by requiring that banks execute such transactions through a registered broker-dealer. The SEC interpretation fails to give full effect to the logical statutory interpretation that banks be allowed to accept orders for securities sales and purchases from customers as part of their custodial function. The bank is merely

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[8] Section 3(a)(4)(B)(viii)(I)(bb) of the Securities Exchange Act of 1934 as amended by GLBA.

facilitating the investment decision made by the customer, and as long as the transaction is executed by a registered broker-dealer, that should be sufficient.

The SEC interpretation of the safekeeping and custody exception will force banks to restructure and realign many business arrangements. The SEC has gone so far as to interpret this restriction to apply to custodial IRA accounts and other retirement plans, leading it to institute two special exemptions. The exemptions, though, are so overly complex, burdensome and restrictive as to be unworkable and meaningless. However, the ICBA believes that these exemptions would be unnecessary under a proper interpretation of the safekeeping and custody exception that gives full effect to Congressional intent and allows banks to conduct securities transactions on behalf of their safekeeping and custody customers.

Small Bank Exemption. This SEC-created exemption is primarily designed to allow small banks to continue to conduct securities transactions for a customer's IRA, and solely as an accommodation to customers. However, the qualifications and long list of conditions that the SEC imposes under the interim final rule render this first special exemption essentially useless.

To qualify for the small bank exemption under the interim final rule, a bank must have had less than $100 million in assets as of December 31 of the two previous years and may not be affiliated with a holding company with over $1 billion in consolidated assets in the two prior years. The ICBA believes that this figure is much too low. For example, for purposes of the Community Reinvestment Act (CRA), the federal banking agencies define a small bank as one with less than $250 million in assets. The ICBA strongly recommends that the SEC revise the definition of small bank ***at least*** to one with $250 million in assets, to be in keeping with existing banking industry guidelines.

Once a bank satisfies the size threshold, the interim final rule would permit the bank to conduct transactions, subject to a litany of unnecessary qualifications that severely limits its usefulness. Transactions would be permitted, but only for custodial IRA accounts and other specified tax-deferred accounts (not 401(k) accounts) and only for the purchase of SEC-registered mutual funds. Bank compensation related to effecting transactions under this exemption would be limited by the interim final rule to less than 3 percent of annual revenue. The bank must not have a broker-dealer affiliate or a networking arrangement with a third party broker-dealer to effect securities transactions for the bank's customers. Any bank employee involved must primarily have duties other than conducting securities transactions and must not receive incentive compensation for the transactions.

The artificial constraints required under the small bank exemption would disrupt the traditional banking services that Congress intended to protect by creating the safekeeping and custody exception. These restrictions would place banks at a competitive disadvantage to other financial service providers that offer custodial IRA accounts. Specifically, denying banks the ability to have arrangements with third-party broker-dealers in order to qualify for the small bank exemption makes no sense, since it would allow the bank to offer a service to its customers (the networking arrangement) while still allowing the bank to conduct some transactions in-house. This restriction would merely penalize small banks without any commensurate benefit.

Similarly, the restrictions on bank compensation, more fully discussed below, are inappropriate and contrary to the intent of GLBA. These provisions would institute restrictions that are not contemplated in GLBA, and again serve merely to penalize banks that wish to take advantage of the small bank exemption.

Overall, the ICBA believes that substantial revisions to the interim final rule's general interpretations regarding the safekeeping and custody exception are necessary. However, absent those changes, a small bank exemption would still be vitally important. The ICBA recommends, though, that the qualifications that the SEC has added to the statutory language be deleted, and that banks be allowed to conduct securities transactions through any registered broker-dealer on behalf of their safekeeping and custodial account customers without other constraint, as intended by Congress.

Self-directed IRAs and Other Tax-Deferred Accounts. The second special exemption that the SEC creates is the "accommodation exemption" that allows banks to engage in certain securities transactions on behalf of a restricted category of safekeeping and custody customers, such as self-directed IRAs and other tax-deferred accounts.

Banks often serve as custodians to self-directed IRAs.[9] While the Internal Revenue Code allows other entities to act as custodians, they must be qualified to do so by the Internal Revenue Service.[10] Many banks offer their customers this service and have done so successfully for years without problem. These services are subject to the requirements of the Internal Revenue Code and the supervision of bank examiners as well as being subject to state fiduciary laws.

Currently, banks can offer a full range of investment products, from certificates of deposit to stocks and bonds, to their self-directed IRA customers. Since a bank must serve as trustee or custodian, allowing banks to continue to offer securities transactions to these customers means that individual investors do not have to establish separate accounts with a broker-dealer to execute securities transactions. Instead, banks can and do conduct these transactions on behalf of customers through a broker-dealer. The interim final rule creates a second special exemption for tax-deferred accounts to permit these activities to continue.

However, under the interim final rule, the bank is limited to offering investments strictly in SEC-registered mutual funds. This restriction on the investment options that banks may offer their custodial customers puts them at an unfair competitive advantage

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[9] This discussion focuses on those situations where the bank does not offer investment advice or make investment decisions for the accountholder.
[10] 26 CFR 1.408-2(b)(i) and (d).

in relation to other financial service providers. Since it is not mandated by GLBA, this restriction should be eliminated.

The interim final rule also severely restricts the income a bank may receive from these activities by limiting fees to charges to those directly assessed by the broker-dealer, plus direct overhead. In order to recover any costs for employee activities, the employee must be engaged in securities activities full-time. For many smaller banks with fewer employees, this is completely unrealistic as each member of the staff is likely to serve more than one role. As a result, the bank will be unable to recoup its costs for employee services associated with these activities. The restrictions also will make it difficult for banks to recover any other overhead associated with these services. Therefore, the impact of the SEC interim final rule would be to allow the bank only to pass along direct charges from the broker-dealer. Any other expenses will have to be absorbed by the bank. This essentially means that the bank would be offering these services at a loss. No useful public policy is served by not allowing banks to charge for their services. As a result, the interim final rule would cause banks to discontinue offering these services, contrary to Congressional intent. This restriction should be eliminated.

Overall, the ICBA believes that the restrictions imposed by the interim final rule on safekeeping and custody activities would disrupt existing bank services. Bank supervision and other laws and regulations offer protections for any securities transactions conducted in this area, and the ICBA recommends that the interim final rule's restrictions be eliminated. At a minimum, banks must be allowed to continue to accept purchase and sell orders for securities transactions for their customers' safekeeping and custodial accounts.

Third Party Brokerage Arrangements

One of the most important exceptions from the definition of broker under GLBA for ICBA members is the third party brokerage arrangements exception (referred to by the SEC as the networking exception). If the bank contracts with a third-party to offer brokerage services to the bank's customers, the bank will not be considered a broker subject to SEC broker registration requirements and regulation.

Under the networking exception of GLBA, bank employees may not receive incentive compensation for any brokerage transaction, although they may receive referral fees that are a nominal one-time cash payment of a fixed dollar amount that is not contingent on whether the referral results in a sale.

Referral Fees. The SEC interim final rule places a number of restrictions on referral fees. According to the rule, the referral fee may be made only for the *first* introduction between a customer and the broker. Second, the rule establishes two alternative definitions for what constitutes one-time nominal cash payments. Under the first alternative, the amount cannot exceed one hour of the gross cash wages of the employee making the referral. Ostensibly, the use of the hourly wage is to adjust for regional variations in compensation packages, but it demonstrates the SEC's lack of understanding of the banking industry and how bank employees are compensated.

In many instances, these referral fees are paid to tellers or customer service representatives for referring customers. In a recent study of bank compensation,[11] the ICBA found that the median salary for customer service representatives ranged between a low of $19,469 in Minneapolis and a high of $27,660 in San Francisco, with the mid range around $22,500. For customer service representatives, therefore, the gross hourly wage cap for referral fees would range between just over $9 and slightly more than $13 (based on a 40-hour week). For tellers, salary ranged between a mean of $15,387 and $20,499, placing a cap on referral fees under the SEC rule between just over $7 and just under $10. Basing referral fees on these salary levels greatly diminishes their utility and is not necessary under the statute.

Even if one accepts it is appropriate for the SEC to develop regulations affecting bank employee compensation, an area over which it has no jurisdiction, the gross hourly wage cap that the interim final rule imposes is unrealistic. Different employees in the same bank would eligible for different levels of referral fees, a result not conducive to the teamwork among employees that banks strive to achieve. Furthermore, requiring banks to regularly adjust payment of referral fees based on salary levels is an unnecessary administrative burden. The bank could set the cap using the lowest common denominator, but that would diminish the value of referral fees for many bank employees, essentially obviating the bank's ability to use a form of compensation specifically sanctioned by GLBA.

Use of an employee's hourly wage also raises issues of employee privacy. The member of the bank staff that administers any referral fee plans may not be the same person that administers payroll records. By using the hourly wage cap, though, the referral fee administrator will have to be privy to employee payroll records, an invasion of employee privacy. Others, such as auditors and compliance officers will also have to confirm this information, further invading the privacy of employees eligible for referral fees.

Because of the impracticalities and burdens of using an hourly wage level as a cap for the referral fee, the ICBA strongly opposes its use.

As an alternative, the interim final rule would allow referral fees as part of a points system that covers a range of products or services. However, the points awarded for securities referrals may not be greater than points awarded for other products. The ICBA believes that this approach is equally impractical. First, it discourages securities referrals, since all other products must be given equal or higher priority in order to ensure the SEC restrictions are satisfied. Second, bonuses based in whole or in part on

[11] *Community Bank Compensation & Benefits Survey Report 2001,* conducted for ICBA by Association Research, Inc. The survey was conducted in the fall of 2000.

referrals would be prohibited, even if the bonus were based on the securities activity of a department or branch, a requirement that would make it impossible for a bank to award a bonus to a department or branch manager based on the performance of the department as a whole.

The ICBA disagrees with the SEC alternative approach. Nothing in the statute requires these restrictions, but they would disrupt existing bank compensation programs. Therefore, the ICBA opposes the use of the alternative.

Finally, the SEC asks whether it should impose an aggregate cap on such referral fees. The ICBA believes that this would be particularly inappropriate. If each fee is "nominal," there is no reason to place any further constraints, and an aggregate cap would be totally inappropriate.

The interim final rule would also specify that referral fees may not be based on the size, value or completion of the transaction; the amount of securities-related assets gathered; the size or value of any customer's bank or securities account; or the customer's financial status. The ICBA does not believe that these additional restrictions are necessary, and therefore they should be eliminated from the rule.

It is important for the SEC to recognize that the fee is based on customer referral, not completion of any transactions. Especially disappointing is the failure of the SEC to recognize the success of the current system. Over the past decade, the banking and securities regulators have, through extensive review and debate, settled upon a referral payment methodology that works well and has not evidenced any conflict of interest or steering.[12] Therefore, the ICBA urges the agency to eliminate the restrictions on referral fees that are placed in the interim final rule. Since bank compensation programs are reviewed by bank examiners, the banking agencies are capable of ensuring that any compensation – including referral fees – are appropriate and comply with laws and regulations, including the GLBA restrictions.

Other Exceptions

***De Minimis* Exception**

GLBA provides an exception from registration for a bank that conducts no more than 500 securities transactions in a calendar year. Under the statute, transactions excepted under one of the other provisions of GLBA (e.g., trust and fiduciary activities, safekeeping and custody transactions, etc.) are not included when calculating the 500 limit.

This *de minimis* exception is an extremely important exception for smaller banks. The statutory exception is straightforward, and the ICBA encourages the SEC not to

[12] See, e.g., *Interagency Statement on Retail Sales of Nondeposit Investment Products*, issued by the four federal banking regulators in February 1994.

establish qualifications that confuse Congress' plain meaning. For example, the SEC interim final rule would count certain transactions twice: once as a sale and once as a purchase. This double counting is illogical and incompatible with plain English. Rather, a transaction should be defined solely as the transfer of a security from one owner to a new owner and only counted once.

Sweep Accounts

GLBA also creates an exception from the definition of broker if a bank "effects transactions as part of a program for the investment or reinvestment of 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."

Historically, a no-load fund is a fund where neither investors nor the fund bears any costs for distribution of fund shares. In 1980, the SEC adopted Rule 12b-1 under the Investment Company Act that allows fund assets to be used to pay distribution costs.

The National Association of Securities Dealers (NASD) has also adopted a rule defining a no-load fund as one that does not have a front-end or deferred sales charge. In addition, to qualify as a no-load fund, the NASD rule restricts sales related expenses to no more than 0.25 percent of the fund's average net assets per year. The SEC intends to use the NASD rule to define a no-load fund, but the ICBA believes this additional restriction is inappropriate.

The ICBA believes that the SEC has misplaced reliance on the NASD rule. The NASD rule was developed in connection with advertising and disclosure to be sure that customers are informed about the fees and charges levied by a fund. Converting an advertising rule to a registration exemption completely ignores the economic reality of providing the service. The concerns that militate disclosure are very different from those that trigger whether or not a fund qualifies for investments under the Congressional exception that allows banks to make these investments on behalf of customers.

For smaller banks, use of the NASD limitation on what constitutes a no-load fund will cause many to discontinue current business arrangements and services they offer customers. Even at 60 to 75 basis points, these banks barely generate enough volume to make their sweep programs profitable. Administrative costs of implementation and servicing of sweep accounts is significant, especially for small banks that have lower aggregate account balances and fewer customers involved in the sweep function. A 25 basis point cap is not an exemption for small banks – it is an economic prohibition. Implementation of the highly restrictive NASD definition will defeat these programs and violate the Congressional prescription against disrupting banking services.

Furthermore, the ICBA believes that the restrictions imposed by the SEC on the types of investment that can be made using sweep accounts unfairly restricts the types of investments that banks can offer customers. The ICBA urges the final rule to eliminate the qualifications of the NASD rule. Rather, a no load fund should be defined without the restrictions of the NASD rule. Otherwise, banks will be unable to continue to offer the kinds of sweep accounts that they have offered for years and the GLBA intended to allow them to continue to offer.

Affiliate Transactions

The GLBA also grants an exception for affiliate transactions that allows a bank to effect securities transactions for an affiliate, provided the affiliate is not a broker-dealer nor engaged in merchant banking. The SEC has determined that this does not extend to a trade with a non-affiliated customer, even if that transaction is part of a trade involving an affiliate.

The ICBA believes that the restriction that limits these transactions to only those involving two bank affiliates defeats the purpose of the Congressional exception. There are likely to be very few instances when a transaction does not involve at least one non-affiliate of the bank. The focus should be on the entire transaction, not splitting a transaction into separate components of purchase and sale. As long as one of the parties involved in the transaction is an affiliate of the bank, that should be sufficient to meet the requirements of GLBA. Otherwise, the exception becomes useless and the provision in the statute meaningless, contrary to normal tenets of statutory construction, which is to interpret statutory language so that it has meaning.

Asset-Backed Products

GLBA creates four exceptions from the definition of dealer for banks, but the only provision that the SEC addresses in the interim final rule is asset securitization activities. Under this exception, banks can underwrite and sell asset-backed securities if the underlying obligations were primarily originated by the bank, an affiliate or through a syndicate of which the bank is a member.

According to the SEC, Congressional intent to create a narrow exception is clear. Therefore, while the interim final rule allows a bank to use the exception to originate and distribute asset-backed securities, it does not allow a bank to repurchase and re-sell such securities (although a bank is allowed to repurchase the securities for its own investment portfolio).

The SEC rule also defines several terms. For a bank to use the exception, it must "predominantly" originate the obligations underlying the security. According to the interim final rule, this means that at least 85 percent of the value of the obligations in the pool must have been originated by the bank, one of its non-broker dealer affiliates, or a syndicate of which the bank is more than an insignificant member. The interim final rule also states that to be considered as having originated the underlying obligations, the bank must have initially made and funded the obligation. The interim final rule also restricts the purchase of such obligations to "qualified investors" as that term is defined elsewhere in the rules under the Securities and Exchange Act of 1934, but essentially, sales are restricted to "a more sophisticated group."

The ICBA is very concerned that the level that the SEC sets for the exception – 85 percent – is too high. While smaller community banks are unlikely to take the lead in putting together the pool of assets that are securitized, for many small banks, the ability to sell loans into the market is critical for liquidity and to be able to meet credit needs by funding new loans. Sales of loans to institutions that securitize them is one way that smaller banks obtain new funding. However, by making it difficult for larger banks to incorporate loans that they themselves do not originate, the SEC erects a barrier to small banks selling these loans into the market. Not all small banks are able, for a variety of reasons, to use government sponsored enterprises such as Fannie Mae and Freddie Mac for this purpose, and so the SEC interim final rule will cut many of them off from the secondary market. Therefore, the ICBA strongly urges the SEC to drop this high percentage. In fact, we believe that a simple majority – 51 percent – would be sufficient to carry out Congress' intent.

In addition, the definition of a syndicate that qualifies for meeting the origination test is unduly restrictive. Banks have formed many types of coalitions with other banks to make loans, especially to low- and moderate-income borrowers. In some instances, the coalition will refer a given borrower to one of the banks to originate and underwrite the loan. However, these types of arrangements would be ineligible under the SEC interim final rule. The ICBA believes that the definition of "syndicate" needs to be revised and expanded to better reflect existing banking practices and to take into account many of the existing arrangements that banks use to meet the needs of low- and moderate-income borrowers.

Additional Comments

<u>Where Activities Are Conducted</u>

To qualify for the trust and fiduciary exception, the interim final rule requires that the activities be conducted in the bank's trust department and be subject to examinations for "compliance with fiduciary principles and standards." While GLBA requires that activities conducted in a fiduciary capacity be conducted in the trust department and subject to such examinations,[13] the statute does not place the same restrictions on activities conducted as a trustee.

It is important that the SEC recognize that banks, especially smaller banks, may conduct certain activities that would otherwise qualify for an exception outside of the trust department. For example, a bank may offer self-directed IRAs through its normal retail branch activities. These activities are still subject to regular review by bank examiners. However, the interim final rule must take into account that it is the activity that Congress intended to allow to continue, without creating new constraints on where that activity takes place. To require activities to be conducted only in a trust department will create an unnecessary restriction that will force banks to realign products and

[13] Securities and Exchange Act of 1934, section 3(a)(4)(b)(ii) as amended by GLBA Section 201.

programs in possibly inefficient ways at unnecessary cost to both the bank and its customers. For smaller banks that do not have trust departments, this will serve as a ban on these activities.

Since GLBA provides the exception for activities as a trustee without the qualifications that the activities be conducted in the trust department, the ICBA opposes the creation of a qualification that is not in the statute. Furthermore, we urge the SEC to clarify that it is the activity that will qualify for the exception – not where the activity is conducted.

Execution of Transactions

Many of the exceptions in the interim final rule seem to require that even though the bank qualifies for the exception, the actual transaction must be conducted through a registered-broker dealer. The ICBA finds this much too restrictive. In some instances, smaller banks execute transactions on behalf of their customers directly with a mutual fund company. Requiring the bank to divert the trade through a broker-dealer will merely add expense and burden for the bank and its customers. Unless GLBA specifically requires securities transactions to be conducted through a registered broker-dealer, the ICBA urges the SEC to allow banks that qualify for an exception to trade directly with investment companies. This clarification is especially important for self-directed IRAs.

Need for A Cure Mechanism

The interim final rule does not allow a bank to meet these standards in good faith, but instead would impose a rigid all or nothing scheme. The absence of a cure mechanism exposes banks to considerable risks – possibly even to the safety and soundness of the institution – in the event of a single error. The imposition of an all or nothing approach to the rules imposes for small financial institutions a significant capital risk resulting from inadvertent and unintended securities law violations.

Many banks, in the process of serving their customers, execute transactions in trust accounts during the closing days of the year, usually to address federal tax concerns. As a result, while the bank might be making every effort to meet the requirements of the SEC's interim final rule, it might find that it inadvertently dropped out of compliance. For example, as the interim final rule is currently structured, a trust department might find that some of its accounts had over 50 percent of compensation from securities transactions due to year-end transactions, despite the fact that the department had made every effort to meet SEC constraints. This would require the bank to completely restructure its programs and register as a broker-dealer in only twenty-four hours.

The ramifications for not doing so would be draconian. For example, if the bank were found to be an unregistered broker-dealer, the customer could later void the transaction at any time (once the interim final rule takes full effect). Customers would be able to take advantage of this situation in a falling market and choose to void a transaction at the expense of the bank, regardless of its propriety when entered. This danger alone might be sufficient to steer many banks away from activities that Congress deemed appropriate.

Therefore, the ICBA believes that it is appropriate and necessary to incorporate a provision that allows a bank operating in good faith to comply with the rules to "cure" any inadvertent errors within a reasonable period of time.

Extension of Time for Compliance

Many banks had expressed concern about the ability to meet the statutory deadline for compliance (May 12, 2001). In fact, the original requests to the SEC were primarily to extend the deadline, leading the SEC to conclude that an interim final rule was appropriate.

The interim final rule institutes two additional exemptions for banks that allow additional time for compliance. First, banks are given until October 1, 2001 to adapt their securities activities to the new requirements, either by structuring them to meet one of the exceptions, by moving them to a registered broker-dealer, or by registering as a broker-dealer. Second, banks have until January 1, 2002 to conform any compensation arrangements to meet the conditions outlined in the interim final rule.

Under existing SEC rules, if an entity sells a security when it should have been registered but was not, that sale can be voided. Accordingly, if a bank did not meet the conditions of one of the exceptions in the interim final rule and had not registered as a broker-dealer by the deadline, a customer could void that sale at any time. In a declining market, a customer would merely have to make such a claim and the bank would bear the loss. Therefore, the interim final rule has an additional provision that precludes contracts executed before January 1, 2003 from being voidable.

The ICBA applauds the SEC for recognizing the need to allow banks additional time to comply with the new rules. Clearly, the SEC recognizes the difficulties inherent in applying some of these provisions, based on the length and depth the agency goes to in explaining its rationale for some aspects of the interim final rule. However, this same complexity also mandates a longer transition period before the rule takes effect. The interim final rule allows just over four months to comply with a rule that has yet to be finalized, meaning that banks must begin to comply with the interim final rule without knowing what changes may be made when it is finalized. Furthermore, software programs have not yet been developed to take into account the analysis needed for assessing whether the bank meets the "chiefly compensated" test for trust and fiduciary activities, and it will take much longer than the next six months to develop, test and install such programs. For smaller institutions that lack the resources and personnel and must rely on vendors to develop these programs, six months is clearly an insufficient amount of time. Therefore, the ICBA strongly recommends that the SEC further extend the dates for mandatory compliance by an additional twelve months at the very least. In all fairness, the date for final compliance should not be established until a final rule is issued, with the compliance date twelve months *after* that rule is issued.

Recordkeeping Requirements

The interim final rule does not impose recordkeeping requirements to verify compliance with any of the conditions specified, based on the presumption that banks will maintain such records in the ordinary course of business. While it is likely that the federal banking agencies will adopt such requirements, as required by GLBA, the SEC also asks whether it should institute parallel recordkeeping requirements to ensure compliance.

The ICBA believes it would be inappropriate for the SEC to impose recordkeeping requirements on banks. The recordkeeping requirements of banks is an area uniquely suited to the federal banking agencies. Congress recognized this in section 204 of GLBA, which confers this authority on the banking agencies. The statute does not grant the SEC similar authority. Therefore, the ICBA does not believe the SEC should institute such requirements. If the SEC has concerns about the types of records that banks should maintain, it should express those views to the banking agencies which can, as Congress specified in section 204, take the SEC's concerns into consideration in developing such requirements.

Savings Associations

Prior to GLBA, only banks and not savings associations were exempt from broker-dealer registration requirements. The interim final rule extends the new exceptions from registration to savings associations as well, placing them on the same footing as banks. The ICBA believes that this is an appropriate step and supports this aspect of the rule.

Plain Language

Section 722 of GLBA mandates that federal banking agencies use plain language in all rulemakings. Although this same requirement was not applied to the SEC, the ICBA believes that the agency should make every effort to comply with the spirit of the law in requiring bank regulations to be written in understandable language. The cross-referencing and structure of the interim final rule is very complicated and likely to require legal expertise to interpret. For smaller banks, this alone present an additional barrier to reliance on the exceptions, since few have in-house counsel to interpret these rules, and many in rural areas do not have ready access to attorneys expert in the finer aspects of securities law and regulation. To make these exceptions useful for small community banks with limited resources, the ICBA strongly urges the SEC to issue a final rule that is in plain language and readily comprehensible.

Statutory Exceptions Not Addressed in the Interim Final Rule

There are a number of additional exceptions in the statute, such as engaging in permissible securities activities or private securities offerings, that are not addressed in the interim final rule. These are statutory exceptions adopted by Congress to allow banks to continue to engage in certain bank permissible securities transactions without being required to register as brokers or dealers. However, based on the restrictive nature of the SEC interpretation of the exceptions that are covered in the interim final rule, the ICBA is extremely concerned about the restrictions that the agency might place on these exceptions as well. The ICBA firmly believes that before the SEC takes any action on any of these exceptions, either through no-action letter or otherwise, it should take the appropriate rulemaking steps mandated by the Administrative Procedures Act and issue a proposed rule with an opportunity for public comment. This is critically important to provide the SEC with the information that it needs to understand the functioning of the banking industry, existing protections under current laws and banking agency supervision, and the ramifications of any decision the SEC might make.

Conclusion

In the ICBA's view, the SEC's interpretations in the interim final rule of the GLBA exceptions from the definition of broker and dealer are unduly and unnecessarily narrow, complicated and qualified. The net effect of the restrictions and conditions contained in the interim final rule is to nullify the statutory exceptions. This is neither in keeping with the spirit nor the express language of GLBA.

The vast majority of the thousands of community based financial institutions must place complete reliance on the exemptions from registration to continue to offer the services they provide their customers today. To these small financial institutions, registration is neither a practical or economic alternative. These small banks and thrifts do not have the capital to build and staff a broker-dealer operation that can effectively meet the highly complex record keeping and supervisory requirements of the SEC. Even if they could afford to do so, community banks located in rural areas would find it very difficult to recruit and retain experienced personnel to staff such an operation. While the SEC maintains that its primary goal is protection of investors, the ICBA is seriously concerned that for many customers of smaller banks in rural markets, building a regulatory structure that is impractical denies thousands of small rural financial institutions the preexisting authority to offer these services for their customers, resulting in "investor exclusion" instead of "investor protection."

The SEC summarizes the 'more than thirty years of Congressional efforts' that culminated in GLBA. After such extensive discussion, it is inconceivable that Congress intended a redefinition of standard terms such as trustee and fiduciary – terms that have been widely used and accepted for many years – but then did not grant specific authority to do so. On the contrary, the express intent of Congress, after three decades of discussion and debate, was to exempt certain well-known and understood traditional banking activities that involve related securities transactions. There was no intent to allow a new regulatory scheme to redefine banking.

It is inappropriate to qualify the ability of banks to offer trust and fiduciary services. The SEC interpretations and qualifications of what constitutes "chiefly compensated" are overly burdensome, complex and unnecessarily confusing for banks.

The qualifications the interim final rule would place on safekeeping and custody arrangements would force banks to greatly curtail existing activities, contrary to Congressional intent. And, the restrictions on referral fees for networking arrangements are unduly restrictive as are the restrictions on the types of investments permissible through sweep arrangements.

Congress clearly intended that banks continue to be able to provide the services that they have offered successfully for many years. Banks have offered these services, including securities transactions, as part of their traditional banking activities without problem. These activities are subject to strict fiduciary standards and closely supervised by the various banking agencies. Congress recognized all of this when it established the exceptions under Title II of GLBA. Banks should be allowed to continue providing traditional services to their customers without sustaining prohibitive costs to comply.

Therefore, the ICBA urges the SEC to substantially revise and reissue for public comment a proposed rule that gives effect to Congress' intent.

Thank you for the opportunity to comment. Should you have any questions or need additional information, please contact ICBA's regulatory counsel, Robert Rowe, at 202-659-8111 or robert_rowe@icba.org.

Sincerely,

Robert I. Gulledge
Chairman

Testimony of

Eugene F. Maloney

Executive Vice President and Corporate Counsel

Federated Investors, Inc.

Before a Joint Hearing of the

Subcommittee on Financial Institutions and Consumer Credit

and the

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Pushing Back the Pushouts:

The SEC's Broker-Dealer Rules"

August 2, 2001

Committee on Financial Services
U.S. House of Representatives
Washington, D.C.

Testimony of Eugene F. Maloney
Executive Vice President and Corporate Counsel
Federated Investors, Inc.

Mr. Chairman and Members of the Committee, I am Eugene F. Maloney, Executive Vice President and Corporate Counsel of Federated Investors, Inc., Pittsburgh, Pennsylvania, and a faculty member at Boston University Law School where I teach a course on Trust and Securities Activities of Banks.

My company is the sponsor and distributor of the Federated family of mutual funds with approximately $160 billion in total assets under management. Many of Federated's mutual funds are made available through bank trust departments to personal trust accounts, managed investment accounts, 401(k) plan accounts, individual retirement accounts ("IRAs"), corporate trust and escrow accounts, and other fiduciary relationships. Federated does business with approximately 1400 bank trust departments and approximately one-half of our assets under management come through banks.

Because of the importance we attach to our banking relationships, we have structured many of our investment products in accordance with the legal framework that governs the banking industry and have devoted substantial corporate resources to helping our bank clients comply with applicable banking, securities and trust laws when they use the Federated mutual funds as investment vehicles.

We have a substantial interest in the applicability to bank trust departments of Title II of the Gramm-Leach-Bliley Act and the Interim Rules issued by the Securities and Exchange Commission thereunder. The compliance obligations imposed on banks by Title II and the Interim Rules will affect how we structure our relationships with banks and how we will make the Federated funds available as fiduciary investments going forward.

In my testimony today, I would like to share with you some of Federated's concerns about the Interim Rules as well as some observations as to the compliance issues that we see facing our bank clients.

Federated's Experience with the SEC

As a preliminary matter, I would first like to note that Federated has had a very positive experience in interacting with the Commission's staff on the scope of the Title II exemptions for banks. We approached the staff earlier this year with three areas of concern in particular—corporate trust, investment management, and employee retirement accounts. We were invited to submit formal requests for guidance and relief in each area, which we did. The Commission substantially granted the relief we requested in its Interim Rules and, we believe, thereby demonstrated a willingness to work with the industry in developing a workable approach to functional regulation.

While it is regrettable that the Interim Rules were issued without the benefit of public comment and include provisions that appear to be unnecessarily burdensome, our experience gives us reason to be optimistic that the Commission will continue to work with the industry in developing a workable framework to implement the Title II provisions. The Commission's solicitation of public comments, its announcement that the Rules will be changed in response to the public comments, and its decision to further postpone the Rules' effective date all signify that the Commission is prepared to work constructively with the industry.

We have urged the Commission to pursue a progressive process aimed at maximizing compliance with Title II over time based on a mutual understanding with the industry as to how the investor protection concerns of the securities laws can best be effectuated in the banking context with minimal disruption to long-term fiduciary relationships and practices. In order to be effective, an ongoing compliance process will require a continuing dialogue with candor on both sides, including frequent communication with the federal banking regulators to ensure interagency coordination and cooperation. We also believe that Congressional oversight is appropriate given the structural implications of the SEC's Rules for bank trust departments and their customers and questions as to whether the Rules are consistent with Congressional intent.

I would like to make several points that we feel are crucial to understanding the impact of the Commission's Rules on bank trust departments and then offer some comments on specific provisions in the Rules.

The "Push-Out" Has Already Occurred

We feel it is important to recognize that "functional regulation" was a *fait accompli* long before Title II was enacted. Banks began to "push-out" their core retail securities brokerage activities almost as soon as they got into the business. The SEC's Rule 3b-9, issued in 1985, required banks to conduct their brokerage operations through registered broker-dealers. Even though the SEC's rule was overturned in the courts, most major banks formed separate registered broker-dealers to handle their retail brokerage activities both as a matter of institutional preference and in anticipation of Congressional codification of Rule 3b-9. Smaller banks entered into so-called "networking" arrangements by which third party broker-dealers made securities available to bank customers on the banks' premises. Even prior to enactment of GLBA, it was estimated that over 90 percent of all retail sales of securities on bank premises were conducted by registered broker-dealers. GLBA essentially codified the SEC's Rule 3b-9, as the SEC had long advocated, and ratified what had already occurred in the marketplace while making clear that certain traditional bank activities were not to be disturbed.

With the "push out" of retail bank brokerage activities complete, the Commission's exercise of its regulatory jurisdiction over bank securities activities has focused on the exemptions from broker-dealer regulation. The consequence, we believe, has been excessive regulatory treatment of the exemptions, resulting in unnecessary regulatory complexity and compliance burdens that are inappropriate for exempt activities.

Among other things, the Commission's approach of providing exemptive relief, as opposed to interpretive guidance, has created confusion as to whether certain trust activities that are not encompassed by the regulatory exemptions would require a separate exemption. While Federated and its bank clients have been the beneficiaries of these exemptions and we are grateful for the Commission's attention to the areas of concern that we raised, we believe it would be less burdensome if the Commission were to adopt a regulatory presumption that any activity performed by a bank in the capacity of "trustee" is covered by the trust exemption unless expressly found otherwise by the Commission. A bank acting as trustee should be presumed to be covered by the exemption unless it is clearly engaged in a commission-based brokerage business in contravention of the intent of Congress.

The Fiduciary Context Affords Significant Investor Protections

In our comment letter, we urged the Commission, in interpreting the trust exemption, to take into consideration the fiduciary law context in which bank trust departments operate. Banks are subject to standards of prudence and a strict duty of loyalty under the Uniform Prudent Investor Act—which has been adopted by nearly all of the states. In addition, banks that provide services to employee benefit plan accounts are subject to strict fiduciary duties under the Employee Retirement Income Security Act ("ERISA"). These safeguards generally are not available from a registered broker-dealer.

The applicable fiduciary law framework has resulted in a conservative investment culture that customers have come to rely on in seeking investment services from bank trust departments. Many customers have chosen bank trust departments rather than registered broker-dealers for investment services because of the fiduciary culture and their belief that trust law affords greater protection than the securities laws. Indeed, the investor protection scheme of the securities laws—based primarily on the principle of "disclosure" rather than substantive standards of prudence and reasonableness—is viewed by many bank customers as affording little meaningful protection. Although the securities laws impose suitability requirements and training and testing qualifications on securities sales personnel, the commission-based sales culture of a broker-dealer is very different from that of a bank trust department governed by strict fiduciary duties.

Many bank trust customers would strenuously object to having their accounts transferred to a registered broker-dealer for these reasons, in addition to the fact that the fees charged by broker-dealers generally are higher than those charged by bank trust departments. The system of banking supervision and regulation also provides a measure of security not available from broker-dealers and is an important factor in the selection of bank trust departments as money managers.

The "Chiefly Compensated" Test Will Disrupt Carefully Established Mutual Fund Fee Arrangements with Bank Trustees

Federated's principal concern regarding the Interim Rules is the Commission's interpretation of the "chiefly compensated" test in the trust exemption to exclude fees received by bank trust departments from mutual funds. Under the Interim Rules, fees received by a bank from a mutual fund in which the bank invests fiduciary assets are treated either as "sales compensation" in the case of 12b-1 fees or "unrelated compensation" in the case of administrative or subaccounting fees. Such fees thus either are counted against a bank's qualifying "relationship compensation" or are neutral in calculating whether a bank trustee meets the "chiefly compensated" test.

Federated believes that the SEC's dichotomy between "relationship compensation" and "sales compensation" fails to take into consideration the fiduciary law context governing bank trustee compensation and penalizes legitimate compensation arrangements that are an integral part of the fiduciary services offered by bank trust departments.

As a mutual fund sponsor and administrator, Federated pays to bank trust departments fees for performing shareholder accounting and administrative services in connection with the investment of fiduciary assets in Federated's mutual funds. These fees have enabled bank trust departments to avoid increasing their account level fees and to offer fiduciary services at less cost than a customer would pay to a broker-dealer for the same services but without the fiduciary law protections that arise in a bank trust department setting.

Federated's arrangements with bank trust departments have been instituted after extensive review and analysis of applicable fiduciary law and relevant trust documents; amendment of trust law by state legislators to address such arrangements; issuance of supervisory guidance by federal banking regulators; adoption of policies and procedures designed to ensure that the fee arrangements are reasonable and otherwise comply with applicable trust law; amendment of trust instruments, fund prospectuses, and other documents; and disclosure to trust beneficiaries.

We are concerned that the Interim Rules will disrupt these carefully established fee arrangements. If bank trust departments cannot rely on fees paid by Federated as a source of qualifying compensation for the "chiefly compensated" test, they may be forced in many cases to restructure the pricing of their trust services by increasing their trustee fees. This result may occur in the case of certain 401(k) plan accounts, for example, where some bank trustees have chosen to not charge fees at the account level but receive all of their compensation in the form of mutual fund servicing fees. Federated also is considering whether it and/or the Federated Funds will need to establish new fee arrangements with banks and take other measures if the "chiefly compensated" test remains unchanged.

As noted in our comment letter to the Commission, the treatment of mutual fund fees under the Interim Rules appears to be based on a misunderstanding of the law governing bank fiduciary compensation and a reading of the "chiefly compensated" test in the statute to suggest that bank trust departments are paid sales commissions. Under trust law, bank trustees are not permitted to receive sales commissions or other compensation for "selling" investments or other services to their trust accounts. State trust law specifically addresses the types of compensation that bank trustees may permissibly receive from mutual funds and does not permit bank trust departments to receive "sales commissions" or other rewards designed to compensate them for promoting particular products and services.

In nearly all of the states, trust law permits bank trustees to receive fees for the performance of services in connection with investments of fiduciary assets in mutual funds. The fees that Federated pays to bank trust departments are pursuant to service contracts designed to comply with state trust law. Federated has obtained legal opinions from local trust counsel in nearly every state addressing the permissibility of the fees it pays to bank trust departments and in each case local counsel has opined that the fees are permissible service fees—not sales compensation—under applicable trust law.

Banks similarly are restricted in the type of compensation they may receive from mutual funds under ERISA. The Department of Labor, in various interpretive letters and class exemptions, has permitted banks acting as ERISA trustees to receive service fees from mutual funds while prohibiting them from receiving sales commissions.[1]

In our comment letter, we urged the Commission to reconsider the dichotomy it has drawn between "sales compensation" and "relationship

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[1] *See, e.g.,* Department of Labor, Prohibited Transaction Class Exemption (PTCE) 77-4, 42 Fed. Reg. 18,732 (April 8, 1977), exempting the investment of ERISA plan assets in proprietary mutual funds subject to certain conditions, including that the plan not pay a sales commission in connection with the investment.

compensation" and instead focus on the fiduciary principles and standards that apply to fiduciary compensation. Only in cases where a bank trust department receives sales commissions for effecting securities transactions for trust accounts should the chiefly compensated test become an issue. In such a case, the trust department likely will be in violation of applicable trust law.

The "Chiefly Compensated" Test Is Excessively Burdensome

Many of Federated's clients have expressed concern that it would be excessively burdensome to comply with the "chiefly compensated" test on an account-by-account basis as required by the Interim Rules. Although banks typically maintain fixed fee schedules, generally based on assets under management, many banks vary their prices by offering discounted fee arrangements on a customer-by-customer basis in order to take into account the bank's relationship with the trust customer, the size of the trust account or other factors, resulting in a wide range of fee variations. Bank trust departments also may grant fee waivers, rebates or credits with respect to accounts that are invested in mutual funds that pay fees to the bank or its affiliates. A bank may offset 12b-1 fees against trustee fees in order to comply with Department of Labor interpretations under ERISA, for example.

The Interim Rules do not address how such fee discounts, waivers, rebates, credits, or offsets are treated for purposes of the "chiefly compensated" test. In particular, the Rules do not indicate whether such fee concessions should be subtracted from a bank's compensation and, if so, whether the deduction should be made from "relationship compensation" or "sales compensation."

How a fee concession is characterized could determine whether a bank satisfies the chiefly compensated test or not. Assume, for example, that a bank receives $1000 in trustee fees from a trust account and $500 in 12b-1 service fees from a mutual fund in which the trust account has invested. Assume further that the bank credits the trust account with the $500 to offset the 12b-1 fees. If the definition of sales compensation in the Interim Rules remains unchanged, the bank will fail the chiefly compensated test because its relationship compensation will not exceed its "sales compensation." On the other hand, if the bank does not reduce its trust account fee but instead waives the $500 in 12b-1 fees, the bank will satisfy the "chiefly compensated" test because all of its compensation will be in the form of relationship compensation. In both cases, the bank is receiving, and the customer is paying, $1000 in fees.

This anomaly demonstrates the complexity of the chiefly compensated test and its uncertain implications for the structuring of trustee compensation arrangements. The chiefly compensated test should not become a determinative factor in how banks structure their trustee fees and we have urged the

Commission to consider whether the chiefly compensated test in the Interim Rules can be simplified to avoid this result.

The chiefly compensated test appears to have been included in the trust exemption in order to prevent banks from conducting a commission-based securities brokerage operation in the trust department. We believe there is little danger of such an evasion and would urge the Commission to apply the chiefly compensated test in those situations where such an evasion is evident without imposing a major compliance burden on the rest of the industry.

Other Concerns

In our comment letter filed with the Commission, Federated expressed concerns about other aspects of the Interim Rules, including the 10 percent safe harbor provision, the treatment of custodial accounts, and the conditions attached to the exemption for investment management accounts. Rather than repeat our concerns in my limited time here, I have attached our comment letter as an appendix to my testimony. I would be happy to amplify my testimony or respond to any questions you may have.

Federated appreciated this opportunity to present its views to the Subcommittee Members. Thank you, Mr. Chairman.

Appendices to Testimony of

Eugene F. Maloney

Federated Investors, Inc.

August 2, 2001

APPENDIX A

EUGENE F. MALONEY

Federated Investors, Inc.
Pittsburgh, PA

Executive Vice President and Corporate Counsel

Mr. Maloney is Director, Executive Vice President and Corporate Counsel of Federated Investors, Inc. and has been employed by the firm for twenty-nine years.

He also is an instructor in trust and securities law at Boston University School of Law, has been a visiting instructor at the Federal Financial Institutions Examination Council and the American Bankers Association's National Graduate Trust School at Northwestern University, and participates in programs leading to the designation of Certified Trust and Financial Advisor. Mr. Maloney has also served as an expert witness in both judicial and legislative settings on matters relating to fiduciary compensation, will construction, and prudent investing.

Mr. Maloney has appeared as a speaker at American Bankers Association gatherings and is a frequent speaker at State Bankers Association meetings on the following subjects: the Gramm-Leach-Bliley Act, the deregulation of the financial services industry, the Uniform Prudent Investor Act and the investment management process it contemplates, fiduciary compensation, and asset allocation as a means of optimizing return and minimizing risk.

Mr. Maloney has authored and co-authored a number of articles appearing in various financial and legal publications regarding the investment responsibilities of corporate fiduciaries. He has also been the architect of various educational videos and memoranda having to do with the Uniform Prudent Investor Act, the implications for trust banks of functional regulation under the Gramm-Leach-Bliley Act, asset allocation in a trust context, the prudence of international investing, fiduciary compensation, and the propriety of a corporate fiduciary utilizing a mutual fund to which it provides discrete services.

Mr. Maloney received his B.A. from Holy Cross College in Worcester, Massachusetts, and his J.D. from Fordham Law School in New York City. He attended Wharton School of the University of Pennsylvania focusing on the financial management of commercial banks. He was an officer in the United States Army from 1969 to 1972 and served as an infantry officer for one year in the Republic of Vietnam.

APPENDIX B

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July 2, 2001

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

RE: Interim Final Regulations Implementing the Gramm-Leach-Bliley Act, Title II, Release No. 34-44291; File No. S7-12-01; RIN 3235-AI19

Dear Mr. Katz:

This comment letter is filed on behalf of my client, Federated Investors, Inc., in response to the Commission's request for comment on the Interim Rules implementing the exemptions from broker-dealer regulation for banks in Title II of the Gramm-Leach-Bliley Act ("GLBA").

Federated is the sponsor and distributor of the Federated family of mutual funds registered under the Investment Company Act of 1940 with approximately $130 billion in total assets under management. Many of Federated's mutual funds are made available through bank trust departments acting in various fiduciary capacities, including as trustee and/or custodian for personal trust accounts, managed asset accounts, 401(k) plan and individual retirement accounts ("IRAs"), and trust indentures. Federated thus has a substantial interest in the applicability of the federal securities laws to such services offered by banks.

Federated appreciates this opportunity to address the specific issues on which the Commission has invited comment. In addition, we offer several suggestions for ways in which the Interim Rules might be clarified or modified to take into consideration the fiduciary context applicable to brokerage activities conducted by bank trust departments and the ways in which bank trustees are compensated for their services.

General Comments

Federated believes that, on the whole, the Interim Rules provide useful guidance to banks as to the scope of the exemptions and afford meaningful relief in areas where investor protection concerns are minimal or are addressed under applicable fiduciary law. In particular, Federated supports the exemptions for indenture trustees, trustees of 401(k) plan accounts and individual retirement accounts, and investment advisory accounts. Federated requested relief in these three areas in letters addressed to the Commission's staff earlier this year and is pleased that the Commission acted quickly to provide exemptive relief. These exemptions will enable bank trust departments to continue to offer traditional banking services, avoid disrupting established fiduciary relationships consistent with the intent of Congress, and reduce uncertainty as to the scope of the trust exemption. Federated's letters are attached hereto for the record.

The Commission's approach of providing exemptive relief as opposed to interpretive guidance, however, has created some confusion as to whether certain trust activities that are not encompassed by the regulatory exemptions would require a separate exemption. To eliminate this confusion, we would urge the Commission to adopt a regulatory presumption that any activity performed by a bank in the capacity of "trustee" is covered by the trust exemption unless expressly found otherwise by the Commission.

Need for Progressive Compliance Process

In any case, we would urge the Commission to remain open-minded in continuing to work with the banking industry to clarify the scope of the GLBA exemptions. We urge the Commission to maintain a dialogue with individual banks and the industry as a whole in a progressive process aimed at maximizing compliance with the Interim Rules over time based on a mutual understanding as to how the investor protection concerns of the securities laws can best be effectuated in the banking context with minimal disruption to long-term fiduciary relationships and practices. In order to be effective, an ongoing compliance process will require a continuing dialogue with candor on both sides. We would hope that this process would include frequent communication with the federal banking regulators in developing a cooperative approach to ensuring compliance with the Interim Rules.

Fiduciary Law Context of Bank Trust Activities

In interpreting the bank trust exemption, we urge the Commission take into consideration the fiduciary law context in which bank trust departments operate. Banks are subject to standards of prudence and a strict duty of loyalty under the Uniform Prudent Investor Act, which has been adopted by nearly all of the states. The few states that have not adopted the uniform Act have trust laws that impose similar fiduciary standards and duties upon trustees. In addition, banks that provide services to employee benefit plan accounts are subject to strict fiduciary duties under the Employee Retirement Income Security Act ("ERISA").

The applicable fiduciary law framework has resulted in a conservative investment culture that customers have come to rely on in seeking investment services from bank trust departments. Many bank customers have chosen bank trust departments rather than registered broker-dealers for investment services because of the fiduciary culture and their belief that trust law affords greater protection than the securities laws. Indeed, the investor protection scheme of the securities laws—based primarily on the principle of "disclosure" rather than substantive standards of prudence and reasonableness—is viewed by many bank customers as affording insubstantial protection. The system of banking supervision and regulation also provides a measure of security not available from broker-dealers and is an important factor in the selection of bank trust departments as money managers. Many bank trust customers would object to having their accounts transferred to a registered broker-dealer for these reasons, in addition to the fact that the fees charged by broker-dealers generally are higher than those charged by bank trust departments.

Treatment of Mutual Fund Fees

Federated's principal concern regarding the Commission's interpretation of the "chiefly compensated" test in the trust exemption under GLBA is the treatment of fees received by bank trust departments from mutual funds. Under the chiefly compensated test set forth in the Interim Rules, fees received by a bank from a mutual fund in which the bank invests fiduciary assets are treated either as "sales compensation" in the case of 12b-1 fees or "unrelated compensation" in the case of administrative or subaccounting fees. Such fees thus either are counted against a bank's qualifying "relationship compensation" or are neutral in calculating whether a bank trustee meets the "chiefly compensated" test.

Federated believes that the dichotomy between "relationship compensation" and "sales compensation" fails to take into consideration the fiduciary law context governing bank trustee compensation and penalizes legitimate compensation arrangements that are an integral part of the fiduciary services offered by bank trust departments.

As a mutual fund sponsor and administrator, Federated pays to bank trust departments fees for performing shareholder accounting and administrative services in connection with the investment of fiduciary assets in Federated's mutual funds. These fees have enabled bank trust departments to avoid increasing their account level fees and to offer fiduciary services at less cost than a customer would pay to a broker-dealer for the same services but without the fiduciary law protections that arise in a bank trust department setting.

Federated's arrangements with bank trust departments have been instituted after extensive review and analysis of applicable fiduciary law and relevant trust documents; amendment of trust law by state legislators to address such arrangements; issuance of supervisory guidance by federal banking regulators; adoption of policies and procedures designed to ensure that the fee arrangements are reasonable and otherwise comply with applicable trust law; amendment of trust instruments, fund prospectuses, and other documents; and disclosure to trust beneficiaries.

We are concerned that the Interim Rules will disrupt these carefully established fee arrangements. If bank trust departments cannot rely on fees paid by Federated as a source of qualifying compensation for the "chiefly compensated" test, they may be forced in many cases to restructure the pricing of their trust services by increasing their trustee fees. This result may occur in the case of certain 401(k) plan accounts, for example, where some bank trustees have chosen to not charge fees at the account level but receive all of their compensation in the form of mutual fund servicing fees. Federated also is considering whether it and/or the Federated Funds will need to establish new fee arrangements with banks and take other measures if the "chiefly compensated" test remains unchanged.

The treatment of mutual fund fees under the Interim Rules appears to be based on a misunderstanding of the law governing bank fiduciary compensation and a reading of the "chiefly compensated" test in the statute to suggest that bank trust departments are paid sales commissions. Under trust law, bank trustees are not permitted to receive sales commissions or other compensation for "selling" investments or other services to their trust accounts. State trust law specifically addresses the types of compensation that bank trustees may permissibly receive from mutual funds and does not permit bank trust departments to receive "sales commissions" or other rewards designed to compensate them for promoting particular products and services.

In nearly all of the states, trust law permits bank trustees to receive fees for the performance of services in connection with investments of fiduciary assets in mutual funds. The fees that Federated pays to bank trust departments are pursuant to service contracts designed to comply with state trust law. Federated has obtained legal opinions from local trust counsel in nearly every state addressing the permissibility of the fees it pays to bank trust departments and in each case local counsel has opined that the fees are permissible service fees—not sales compensation—under applicable trust law.

Banks similarly are restricted in the type of compensation they may receive from mutual funds under ERISA. The Department of Labor, in various interpretive letters and class exemptions, has permitted banks acting as ERISA trustees to receive service fees from mutual funds while prohibiting them from receiving sales commissions.[1]

We thus would urge the Commission to reconsider the dichotomy it has drawn between "sales compensation" and "relationship compensation" in the Interim Rules and instead focus on the applicable fiduciary principles and standards that apply to fiduciary compensation. Only in cases where a bank trust department receives sales commissions for effecting securities transactions for trust accounts should the chiefly compensated test become an issue. In such a case, the trust department likely will be in violation of applicable trust law.

If the Commission retains its current test for applying the "chiefly compensated" language, Federated urges the Commission to allow the service fees it pays to bank trust departments to be counted as qualifying compensation. These fees are "consistent with fiduciary principles and standards" and are

[1] *See, e.g.,* Department of Labor, Prohibited Transaction Class Exemption (PTCE) 77-4, 42 Fed. Reg. 18,732 (April 8, 1977), exempting the investment of ERISA plan assets in proprietary mutual funds subject to certain conditions, including that the plan not pay a sales commission in connection with the investment.

asset-based fees, in accordance with the statutory language of the trust exemption.

We note that the statute does not limit the sources of a bank's compensation for purposes of the "chiefly compensated" test, and the purposes of the "chiefly compensated" test can be met without limiting qualifying compensation to fees paid directly by trust accounts. Congress enacted the trust exemption to allow banks to continue traditional fiduciary activities and included the "chiefly compensated" test to discourage banks from using the exemption to engage in the sale of securities on commission in the manner of a retail brokerage business. As noted above, fiduciary law bars a trustee from receiving sales commissions and thus it is unlikely that a bank trust department would be engaged in a retail brokerage business. In any event, to the extent that shareholder servicing fees are paid out of mutual fund assets, they are a direct charge against the assets of fund shareholders, *i.e.*, the trust beneficiaries whose assets are invested in the funds. In this sense, such fees are paid directly by trust beneficiaries and may properly be counted as qualifying compensation for purposes of the "chiefly compensated" test.

401(k) and IRA Accounts

Federated supports the exemption for banks acting as trustees for 401(k) plan and IRA accounts as provided in the Interim Rules. We also believe that the exemption should encompass banks acting as custodial trustees for IRA accounts. While the language of the exemption appears to cover these custodial activities, the *Federal Register* notice states otherwise, creating confusion.

For the reasons stated in our letter to the Commission's staff dated March 13, 2001, Federated believes that a bank acting in the capacity of a trustee is entitled to the trust exemption under the express language of the Gramm-Leach-Bliley Act even if its fiduciary duties are limited. Particularly when a bank is designated as a "trustee" under federal law, such as under ERISA in the case of 401(k) plan accounts or the Internal Revenue Code in the case of individual retirement accounts ("IRAs"), Federated believes the Commission should honor the bank's trustee status and not deny the trust exemption, even when the bank's role is limited to that of a custodial trustee.

The absence of comprehensive fiduciary duties does not necessarily give rise to investor protection concerns. In the case of participant-directed 401(k) plan and IRA accounts, the bank's fiduciary duties are limited under federal law because the bank's role in effecting transactions for the investor is limited. The bank's role generally is limited to providing investment advice and custodial services and acting as an introducing broker. As noted in our March 13, 2001, letter, registered investment advisers who act as introducing brokers are not subject to broker-dealer regulation, and it would create a regulatory anomaly to subject banks to broker-dealer regulation for engaging in the same activities.

In any case, a directed trustee of a 401(k) plan is deemed to be a fiduciary for purposes of ERISA even if the trustee does not provide investment advice for a fee, lacks investment discretion, and the plan participant directs the trustee with respect to investments. In such a case, although a directed trustee is relieved of fiduciary liability for the direct consequences of a participant's exercise of control under section 404(c) of ERISA, the directed trustee is not relieved of its fiduciary status for other purposes under ERISA. The Internal Revenue Service ("IRS") also takes the position that a trustee for a self-directed IRA is a fiduciary for purposes of the prohibited transaction rules under the IRC.[2]

It is unclear what investor protection concerns would be addressed by broker-dealer regulation that are not addressed under ERISA. We are unaware of any abuses in the offering of participant-directed 401(k) plan or IRA accounts by banks that would justify disregarding the trust exemption and subjecting banks to broker-dealer regulation. The abuses cited in the Commission's *Federal Register* notice accompanying the Interim Rules involved registered broker-dealers, not banks.

In the *Federal Register* notice, the Commission recognized that a bank acting as an IRA custodian performs the same functions as an IRA trustee but concluded, mistakenly in our view, that the custodian is not entitled to the trust exemption because it lacks the label of "trustee":

> [A]n IRA custodian is virtually indistinguishable from an IRA trustee, but does not take on the "trustee" label. Thus, it is not eligible for the definitional exemption in Rule 3b-17(k).[3]

In fact, an IRA custodian does have the label of "trustee." As noted in our March 13, 2001, letter, under Section 408(h), a custodial IRA is treated as a trust and the custodian of such an account is treated as the trustee thereof:

> For purposes of this section, a custodial account shall be treated as a trust if the assets of such account are held by a bank . . .[I]n the

[2] *See* 29 C.F.R. § 2509.75-8, D-3; 26 U.S.C. § 4975(e)(3).
[3] 66 Fed. Reg. at 27, 772.

> case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof.[4]

Under the language of the Interim Rules, a bank acting as an IRA custodian would be entitled to the trust exemption because it is treated as a "trustee" under section 408(h). The Interim Rules define the term "trustee capacity" for purposes of the trust exemption to include a bank acting as trustee for a tax-deferred account described in Section 408 of the Internal Revenue Code of 1986. The *Federal Register* notice accompanying the Interim Rules has created confusion, however, by stating that the exemption "does not apply to IRA custodians."[5]

We urge the Commission to clarify that the exemption *does* apply to IRA custodians, as provided in the Interim Rules. Absent such a clarification, many banks may feel compelled to change their IRA agreements with customers to substitute trust agreements for custodial agreements, but without any change in the services they provide. Such an effort would be costly, disruptive and potentially confusing to customers, and would seem an unreasonable and unnecessary burden on bank trust departments attempting to comply with the terms of the trust exemption.

In any event, as noted below, we believe that banks offering custodial IRA accounts are covered by the GLBA exemption for custody activities.

Account-by-Account Analysis for "Chiefly Compensated" Test

Many of Federated's clients have expressed concern that it would be excessively burdensome to comply with the "chiefly compensated" test on an account-by-account basis as required by the Interim Rules. Although banks typically maintain fixed fee schedules, generally based on assets under management, many banks vary their prices by offering discounted fee arrangements on a customer-by-customer basis, resulting in a wide range of fee variations. Moreover, a single customer may maintain several accounts with a bank that are priced differently.

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[4] 26 U.S.C. § 408(h).
[5] 66 Fed. Reg. at 27,768 n. 83.

The task of evaluating thousands of accounts to ensure compliance with the "chiefly compensated" test would be especially burdensome given the broad definition of "sales compensation" included in the Interim Rules.

Treatment of Fee Waivers and Discounts

As noted, bank trust departments often discount their trust account fees in order to take into account the bank's relationship with the trust customer, the size of the trust account or other factors. Bank trust departments also may grant fee waivers, rebates or credits with respect to accounts that are invested in mutual funds that pay fees to the bank or its affiliates. A bank may offset 12b-1 fees against trustee fees in order to comply with Department of Labor interpretations under ERISA, for example.[6]

The Interim Rules do not address how such fee discounts, waivers, rebates, credits, or offsets are treated for purposes of the "chiefly compensated" test. In particular, the Rules do not indicate whether such fee concessions should be subtracted from a bank's compensation and, if so, whether the deduction should be made from "relationship compensation" or "sales compensation."

How a fee concession is characterized could determine whether a bank satisfies the chiefly compensated test or not. Assume, for example, that a bank receives $1000 in trustee fees from a trust account and $500 in 12b-1 service fees from a mutual fund in which the trust account has invested. Assume further that the bank credits the trust account with the $500 to offset the 12b-1 fees. If the definition of sales compensation in the Interim Rules remains unchanged, the bank will fail the chiefly compensated test because its relationship compensation will not exceed its "sales compensation." On the other hand, if the bank does not reduce its trust account fee but instead waives the $500 in 12b-1 fees, the bank will satisfy the "chiefly compensated" test because all of its compensation will be in the form of relationship compensation. In both cases, the bank is receiving, and the customer is paying, $1000 in fees.

This anomaly demonstrates the complexity of the chiefly compensated test and its uncertain implications for the structuring of trustee compensation arrangements. The chiefly compensated test should not become a determinative factor in how banks structure their trustee fees and we would urge the

[6] *See, e.g.*, DOL Advisory Opinion 97-15A (Frost National Bank) (May 22, 1997).

Commission to consider whether the chiefly compensated test in the Interim Rules can be revised to avoid this result.

10 Percent Safe Harbor

Based on an informal survey of its bank clients, Federated believes that the 10 percent safe harbor concept in the Interim Rules would mitigate the compliance burden of the chiefly compensated test for many banks. Most of the banks Federated queried indicated that "sales compensation" represents less than 10 percent of their "relationship compensation" from fiduciary activities. Some of the banks indicated that they would feel more comfortable with a 15 percent safe harbor, however, in order to provide a larger margin for error due to uncertainty about the treatment of mutual fund fees for purposes of the chiefly compensated test.

Notwithstanding the benefits of the safe harbor, Federated is concerned that the procedural requirements of the safe harbor may substantially diminish its value as a relief measure. As we understand, the intent of the safe harbor is to eliminate the need for an account-by-account calculation to determine compliance with the chiefly compensated test. The procedural requirements, however, would require a bank to conduct such a calculation any time the bank changes its fees, which could be on an annual or more frequent basis. In addition, in applying the 10 percent test, a bank must review each account to exclude charges for non-securities transaction services, such as tax preparation, estate administration and other special services. The procedural requirements thus will result in a substantial compliance burden that may defeat the purpose for which the safe harbor was intended.

Accordingly, we would urge that the Interim Rules be amended to either eliminate the review procedures altogether or allow a bank to adopt an across-the-board fee increase without triggering the need for an account-by-account compliance review.

Investment Advisory Accounts

Under the Interim Rules, the trust exemption applies to an investment advisory account only if the bank provides "continuous and regular investment advice to the customer's account that is based on the individual needs of the customer" and the bank owes a duty of loyalty. As a preliminary matter, we note that this limitation on the exemption is not imposed by the statutory language of GLBA and may create uncertainty as to the scope of the exemption.

Nevertheless, it appears to harmonize with past precedents of the Office of the Comptroller of the Currency describing the investment advisory activities of national banks[7] and is consistent with Federated's understanding of how such activities are performed by bank trust departments.

The *Federal Register* notice accompanying the Interim Rules indicates that a bank, in determining whether it provides "continuous and regular" investment advice, may rely on the standard used under the Investment Advisers Act for measuring when an investment adviser has "assets under management" of $25 million or more and thus is required to register with the Commission under the Investment Advisers Act.[8] For purposes of the Investment Advisers Act, "assets under management" are defined to mean accounts as to which the adviser provides "continuous and regular supervisory or management services."[9] The instructions to Form ADV provide examples of when an adviser may be deemed to provide continuous and regular supervisory or management services for an account, including when the adviser:

> Has discretionary authority to allocate client assets among various mutual funds; or
>
> Does not have discretionary authority, but provides the same allocation services and has ongoing responsibility to select or make recommendations, based on the needs of the client, as to specific securities or other investments the account may purchase and sell and, if such recommendations are accepted by the client, is responsible for arranging or effecting the purchase or sale.

Federated believes that this guidance is useful to the extent that it would appear to encompass within the trust exemption most asset allocation services provided by bank trust departments.

We note that the Form ADV instructions indicate that an adviser is deemed *not* to provide "continuous and regular" supervisory or management services if it makes an initial asset allocation without continuous and regular monitoring and reallocation. We assume that the periodic rebalancing of asset

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[7] *See, e.g.*, OCC Fiduciary Precedent 9.2100 stating that a national bank's investment department "will make continuous reviews and recommendations as to the holdings in a customer's portfolio, and arrive at an investment and general policy to be applied to each account."

[8] 66 Fed. Reg. at 27,771.

[9] 15 U.S.C. § 80b-3a.

allocation models by banks would be viewed as providing "continuous and regular" investment advice for which a bank would retain the trust exemption. It would be helpful if the Commission clarified that this view is correct.

Federated does have some concern that the "continuous and regular" requirement may create undesirable pressure on banks to recommend more frequent transactions in a customer's investment account than otherwise would be appropriate under sound investment principles. Many bank customers invest for the long-term and follow a "buy and hold" investment strategy in accordance with advice given by their investment counselors (and innumerable investment newsletters). Most investors understand that it is unwise to make frequent changes in their holdings because of the transaction costs and the risks of chasing the market by "selling low and buying high." Indeed, broker-dealer regulation discourages frequent trading by prohibiting "churning" of customer accounts. The Commission ought not to adopt a regulation that encourages unnecessary trading in a customer's account.

To avoid this possibility, we would urge the Commission to consider adopting a safe harbor rule under which a bank would be deemed to satisfy the requirements of the exemption if it reviews a customer's investment advisory account at least annually to determine whether the customer's investments remain appropriate in light of the customer's investment objectives and financial needs.

Recordkeeping Requirements

The Gramm-Leach-Bliley Act requires the federal banking agencies, after consulting with the Commission, to adopt recordkeeping requirements to ensure compliance by banks relying on the exceptions from broker-dealer regulation. The banking agencies are required to make available compliance information to the Commission upon request.

In view of this statutory mandate, it seems evident that Congress intended the Commission to rely on the banking agencies to ensure compliance with the exemptions rather than adopt its own compliance requirements, consistent with the separate scheme of federal banking supervision and regulation. To the extent that a bank is exempt from broker-dealer registration, the bank is not within the Commission's jurisdiction. The adoption by the Commission of separate compliance requirements would represent a major shift of jurisdiction that we do not believe Congress intended. Congress directed the banking agencies to consider the Commission's views in adopting recordkeeping requirements, and we would encourage the Commission to work with the banking agencies in establishing appropriate requirements designed fulfill the statutory intent.

Treatment of Escrow Activities

Banks frequently act as escrow agents for various business purposes. In this capacity, they act in a manner similar to that of an indenture trustee, holding and investing funds in no-load money market mutual funds according to the instructions of parties to a business transaction. In many cases, under a negotiated fee arrangement, the bank may rely on mutual fund fees rather than account fees as its primary compensation for performing escrow services, thus facing the same difficulty as indenture trustees in complying with the "chiefly compensated" test.

The Gramm-Leach-Bliley Act defines "fiduciary capacity" for purposes of the trust exemption to include "any other similar capacity" in addition to the fiduciary capacities specifically enumerated in the statute. A bank performing escrow services is acting in a "similar capacity" to an indenture trustee. Although the bank's role as escrow agent is primarily ministerial and its fiduciary duties are limited, the functions performed by the bank involve the same recordkeeping, custodial, and asset management functions of an indenture trustee. To the extent that the bank effects transactions in securities, such transactions are incidental to the bank's role as escrow agent. The typical escrow agreement is not entered into for the purpose of buying and selling securities but rather as a means of facilitating a business transaction through a trusted third party.

We do not believe that Congress intended to force banks to transfer their traditional escrow agent services to broker-dealer affiliates which, in many cases, lack familiarity with the types of business transactions that utilize escrow services and are ill-equipped to perform the duties of an escrow agent. Accordingly, we urge the Commission to adopt an exemption for escrow agent services similar to that for indenture trustees.

Custody Exemption

The exemption in the Gramm-Leach-Bliley Act for bank custodial activities specifically exempts a bank from broker-dealer registration when the bank "as part of customary banking activities . . . serves as a custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan." The Commission has interpreted this exemption as not allowing a bank to effect securities transactions in its capacity as a custodial trustee for IRA accounts.

As noted above, we believe the trust exemption covers a bank when it acts as a custodial trustee for IRA accounts because the Internal Revenue Code deems the bank to be a "trustee." We also believe that the custody exemption covers a bank acting as a custodial trustee for IRA accounts.

The GLBA exemptions apply only if a bank is acting as a "broker." If the bank is not acting as a broker, the bank is not subject to broker-dealer registration and the exemptions are irrelevant to the bank's activities. The term "broker" is defined in the Securities Exchange Act of 1934 Act to mean "any person engaged in the business of effecting transactions in securities for the account of others."[10] Accordingly, if a bank is not "effecting transactions in securities," the bank is not subject to broker-dealer registration and does not need an exemption. The GLBA exemptions—including the custody exemption—thus must be read as exempting activities that involve "effecting transactions in securities."

The custody exemption may be read as allowing only limited "effecting transactions in securities" in the case of certain custodial functions of banks, such as securities lending or borrowing, where the exemption includes limiting language. The custody exemption for IRA accounts, however, is not so limited.

Whether under the trust or custody exemption, Congress clearly intended to allow banks to continue effecting transactions in securities for custodial IRA accounts. As stated in the Senate Banking Committee Report on the Gramm-Leach-Bliley Act:

> The Committee does not believe that an extensive "push-out" of or restrictions on the conduct of traditional banking services is warranted. Banks have historically provided securities services largely through their trust departments, or as an accommodation to certain customers. Banks are uniquely qualified to provide these services and have done so without any problems for years. . . . Under IRS regulations, banks must offer self-directed Individual Retirement Accounts ("IRAs") in either a trustee or custodial

[10] 15 U.S.C. § 78c(a)(4)(A).

> capacity. Services rendered as a trustee do not require registration as a broker-dealer to the extent that these services fall within the trust exemption. The Committee believes that bank custodial, safekeeping, and clearing activities with respect to IRAs do not need to be pushed-out into a Commission registered broker-dealer.[11]

It is highly unlikely that Congress would have provided an exemption allowing banks to act as custodians for IRA accounts without allowing them to effect transactions for such accounts. There simply is no market for an IRA account that does not allow the account holder to conduct transactions in the account. Such an IRA account does not exist.

Accordingly, we would urge the Commission to interpret the custody exemption to allow banks acting as custodial trustees for IRA accounts to effect transactions for such accounts.

Transactions by Bank-Affiliated Broker-Dealers

The *Federal Register* notice accompanying the Interim Rules cites an interpretive letter of the Office of the Comptroller of the Currency in which the OCC took the position that a national bank may not effect securities transactions for trust accounts through an affiliated broker-dealer, even on a nonprofit basis.[12] As a point of clarification, we note that the OCC has changed its position and now permits national banks to effect transactions for trust accounts through affiliated broker-dealers on a nonprofit basis. The OCC's new position is reflected in the OCC's *Handbook on Conflicts of Interest* in which national bank examiners are instructed as follows:

> If the bank uses an affiliated broker to effect securities transactions for fiduciary accounts, determine that:
>
> - Applicable law does not prohibit the use of an affiliated broker to effect securities transactions;
>
> - The bank's payment of affiliated broker's fees for effecting brokerage transactions cover the cost of effecting the transaction and no more. Under no circumstances, unless authorized by applicable law, should the bank or its brokerage

[11] S. Rep. No. 106-44, 106th Cong., 1st Sess. 10 (1999).

[12] 66 Fed. Reg. at 27,774, n. 139, *citing* OCC Trust Interpretive Letter No. 273 (Sept. 23, 1992).

affiliate profit from a securities transaction effected for a fiduciary account.

- The bank's records establish, through a detailed cost analysis, that the amount of the fee charged by the affiliated broker is justified by the cost of the securities transactions executed. All fees paid to an affiliated broker should be clearly disclosed. The bank should also ensure, when applicable, that the affiliated broker adheres to the NASD's best execution requirement.[13]

Conclusion

The Interim Rules offer many accommodations to traditional banking activities while serving the investor protection objectives of the Securities Exchange Act of 1934, consistent with the intent of Congress in the Gramm-Leach-Bliley Act. We have commented on certain areas where we believe additional clarification or relief to bank trust departments is needed.

Federated appreciated this opportunity to comment on the Interim Rules and would be pleased to answer any questions or provide additional information on the issues we have addressed at your request.

Sincerely,

Melanie L. Fein

cc: Eugene F. Maloney, Esq.
Executive Vice President and Corporate Counsel
Federated Investors, Inc.

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[13] OCC *Handbook on Conflicts of Interest* (June 12, 2000) at 22.

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March 30, 2001

Robert Colby
Deputy Director
Catherine McGuire
Associate Director and Chief Counsel
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Mail Stop 10-1
Washington D.C. 20549

Dear Mr. Colby and Ms. McGuire:

On behalf of my client, Federated Investors, Inc., I hereby request an exemption pursuant to Section 15(a)(2) of the Securities Exchange Act of 1934 (the "Act") from the broker-dealer registration provisions of the Act with respect to the purchase by banks, acting solely at the direction of an issuer of indenture securities under the Trust Indenture Act of 1939, of shares of open-end investment companies registered under the Investment Company Act of 1940 and that hold themselves out as money market mutual funds ("money market mutual funds") and for which Federated acts as investment adviser, when the bank receives all of its compensation for acting as indenture trustee in the form of service fees paid by such funds and/or Federated.

As you know, for the reasons we have previously communicated to you, we believe that a bank in such circumstances is entitled to the bank trust exemption under Title II of the Gramm-Leach-Bliley Act. Nevertheless, we understand that the Staff may not agree with our view and would prefer to address this matter in the context of an exemption request under Section 15(a)(2) of the 1934 Act. Accordingly, we are hereby requesting such an exemption.

Background

Since 1977, Federated has been instrumental in securing the passage of laws in all 50 states permitting an indenture trustee that is required to invest bond proceeds in U.S. government obligations to effectuate such instructions through the use of money market mutual funds which hold otherwise eligible securities. Federated also has been successful, through a combination of litigation, legislation and administrative determinations, in having distributions from its funds retain their character as U.S. government interest for state tax purposes.

At the present time, virtually every corporate trustee has elected to utilize eligible money market mutual funds in lieu of buying Treasury bills directly since, by doing so, all amounts they administer can be placed in an interest-earning vehicle and they are relieved of the time-consuming and expensive task of matching the maturity of an instrument with the often unpredictable draw schedule of the project the bond proceeds are to finance.

Corporate trust is a scale business and is intensely competitive. For over a decade, it has been customary for trustees to receive substantially all of their compensation for providing services to the issuer and bondholders in the form of fund level shareholder or administrative service fees rather than fees directly charged to the issuer or bondholders.

Indenture Trustees are Fiduciaries

A bank acts in a fiduciary capacity when it serves as a trustee for an indenture under the Trust Indenture Act. Although the fiduciary obligations of the trustee generally are limited to the terms of the indenture and the trustee's role often is ministerial, the Trust Indenture Act and state trust laws impose standards of fiduciary conduct and responsibility on indenture trustees designed to protect and enforce the rights and interests of bondholders.

The Trust Examiner's Manual of the Federal Deposit Insurance Corporation states that performance as trustee under a bond indenture "is normally the only true trust relationship administered by a corporate trust department."[1] The FDIC's Manual describes the duties of an indenture trustee as follows:

[1] FDIC, Trust Examiners Manual § 6 at 1.

- Arranging for the printing and issuance of the bond instruments
- Maintaining required records, accounts and documentation
- Paying principal and interest
- Holding beneficial title to collateral
- Safeguarding and appraising collateral
- Investing idle cash (if permitted or directed under the indenture)
- Ensuring the issue is in compliance with legal requirements
- Monitoring for default under the indenture during the life of the bonds
- Identifying and reacting properly if a default occurs.[2]

With respect to the maintenance of funds held pursuant to a bond indenture, the FDIC's Manual describes the indenture trustee's duties as follows:

> Many bond trusteeships involve the maintenance of separate funds, used for sinking funds, construction, building maintenance, etc. The assets of these funds are invested according to the provisions of the bond indenture. The bank trustee usually has little or no discretion in such investments. Proper separation of the various funds, investment of their assets, and administration of these funds is essential.
>
> The trustee must not only provide reports and recordkeeping for the obligor, but must also protect the interests of the bondholders. Reporting of distributions, and interest and dividend payments, to both tax authorities and security holders is also required of the trustee. These responsibilities are important since the trustee can be held liable if the bonds

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[2] *Id.* at 3.

> default and subsequent loss is attributable to the trustee's negligence. The acts of omission as well as commission by the trustee are critical in the event of default.
>
> Many bond issues have become exceedingly complex, imposing a host of additional duties on bank trustees. For instance, credit enhancements such as letters of credit and municipal bond insurance may have their own requirements for the trustee. The risks of managing such issues must be adequately addressed by the bank and reviewed by the examiner.[3]

The FDIC's Manual states that "[a]s in all areas of fiduciary administration, the bank should formulate and have adopted by the trust committee and board of directors written policies regarding account acceptability, conflicts of interest, internal operations, auditing, and profitability.[4] The Manual provides guidance as to appropriate policies in this regard.

Exemption Request

The exemption from broker-dealer registration for bank trust activities enacted in the Gramm-Leach-Bliley Act reflects a Congressional determination to allow banks to continue their traditional fiduciary activities without registering as broker-dealers.[5] The Staff has indicated, however, that the trust exemption may not apply when a bank trustee receives more than 50 percent of its compensation from fund level fees as opposed to account level fees.

Without necessarily agreeing with the Staff's view, we are requesting an exemption under Section 15(a)(2) of the 1934 Act to remove any doubt that a bank would be required to register as a broker-dealer when purchasing shares of Federated's money market mutual funds in the bank's capacity as indenture trustee and receiving all of its compensation for acting as indenture trustee in the form of service fees paid by such funds and/or Federated.

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[3] *Id.* at 8-9.
[4] *Id.* at 6.
[5] 15 U.S.C. § 78c(a)(4)(ii), *as amended by* Title II of the Gramm-Leach-Bliley Act.

Under Section 15(a)(2) of the 1934 Act, the Commission may exempt from broker-dealer registration any broker or dealer or class of brokers or dealers as it deems consistent with the public interest and the protection of investors. We believe that an exemption allowing banks to purchase money market mutual funds in their capacity as indenture trustees would be consistent with the public interest and the protection of investors.

Banks perform a valuable public service when acting as indenture trustees. The ability to utilize eligible money market mutual funds in lieu of buying Treasury bills directly is an important tool that enables bank trustees to administer indenture trust funds more efficiently consistent with the purposes of the Trust Indenture Act. As noted above, by placing funds in a managed investment vehicle with a stable net asset value such as a money market mutual fund, banks are relieved of the time-consuming and expensive task of matching the maturity of an instrument with the often unpredictable draw schedule of the project the bond proceeds are to finance. An exemption from broker-dealer registration would allow banks to continue their traditional role as indenture trustees without altering the form of compensation they receive in the form of fund level compensation rather than account level fees.

Investor protection concerns are not raised when banks purchase shares of mutual funds as indenture trustees because of the fiduciary context that governs the activities of banks under the Trust Indenture Act. Moreover, a bank acting as indenture trustee does not deal directly with individual investors, render investment advice to individual investors or handle any individual investor funds other than in connection with its duties under the trust indenture. The bank's employees do not receive any commissions or transaction-based compensation when acting in the bank's capacity as indenture trustee. Any securities transactions effected by the bank acting as indenture trustee arise not because a customer has come to the bank for brokerage or investment services, but because the bond issuer has selected the bank for its services as indenture trustee. The concerns that broker-dealer registration is intended to address are not present and no regulatory purpose would be served by requiring bank indenture trustees to register as broker-dealers when they invest funds held pursuant to a trust indenture in mutual funds.

We note that the Gramm-Leach-Bliley Act expressly exempted banks from broker-dealer registration when they offer sweep arrangements utilizing money market mutual funds.[6] The exemption is limited to money market mutual funds presumably because of the nature of such funds as highly liquid cash substitutes. The exemption reflects a Congressional determination that such arrangements do not give rise to the concerns that broker-dealer regulation was intended to address.

Congress also exempted banks with respect to transactions in exempted securities,[7] including primarily U.S. treasury securities, in recognition that such transactions do not give rise to broker-dealer regulatory concerns. Money market mutual funds that invest solely in U.S. Treasury securities have been viewed as the functional equivalent of exempted securities in many contexts, including state laws governing investments by indenture trustees and in interpretations of the Glass-Steagall Act.[8]

Conclusion

Based on the foregoing, we respectfully request an exemption under Section 15(a)(2) of the Securities Exchange Act of 1934 to allow banks acting as indenture trustees pursuant to the Trust Indenture Act of 1939 to invest assets held under a trust indenture in money market mutual funds for which Federated acts as investment adviser notwithstanding that such banks receive all of their compensation for such services in the form of asset-based service fees paid by such mutual funds and/or Federated.

Your attention to this matter is greatly appreciated.

Sincerely,

Melanie L. Fein

cc: Lourdes Gonzales

[6] 15 U.S.C. § 78c(a)(4)(v), *as amended by* Title II of the Gramm-Leach-Bliley Act.
[7] 15 U.S.C. § 78c(a)(4)(iii), *as amended by* Title II of the Gramm-Leach-Bliley Act.
[8] *See, e.g.*, OCC Circular 220 (Nov. 21, 1986) and 12 C.F.R. § 208.124, allowing banks to purchase for their own account mutual funds that invest in government securities, based on the authority of banks to invest directly in government securities under the Glass-Steagall Act.

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March 13, 2001

Robert L. D. Colby, Deputy Director
Catherine McGuire, Associate Director and Chief Counsel
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Mail Stop 10-1
Washington D.C. 20549

Dear Mr. Colby and Ms. McGuire:

On behalf of my client, Federated Investors, Inc. ("Federated"), I hereby request your confirmation that the Staff of the Division of Market Regulation concurs with our view that that a bank may act as trustee for participant-directed employee pension benefit plans pursuant to ERISA ("401(k) plan accounts") and as trustee/custodian for self-directed individual retirement accounts ("IRAs"), as described below, without registering as a broker-dealer under the Securities Exchange Act of 1934 (the "1934 Act").

Federated is the sponsor and distributor of the Federated family of investment companies registered under the Investment Company Act of 1940 ("mutual funds") with approximately $130 billion in total assets under management. Many of Federated's mutual funds are made available through 401(k) plan accounts and IRAs trusteed by banks. Federated thus has an interest in the applicability of federal securities to such services at banks. The legal basis for our request is set forth in the enclosed memorandum. We appreciate your consideration and attention to this matter.

Sincerely,

Melanie L. Fein

Melanie L. Fein

EXEMPT STATUS OF BANKS ACTING AS TRUSTEES TO PARTICIPANT-DIRECTED 401(K) PLANS AND IRAS UNDER THE SECURITIES EXCHANGE ACT OF 1934

CONTENTS

Based on the following legal analysis, we believe that banks acting as directed trustees to self-directed 401(k) plans and individual retirement accounts (IRAs) are exempt from registration as broker-dealers under the Securities Exchange Act of 1934 ("1934 Act") in the circumstances described below.

I. Trust Exemption under Gramm-Leach-Bliley Act

Title II of the Gramm-Leach-Bliley Act ("GLBA") amended the1934 Act to eliminate the bank exemption from broker-dealer registration effective May 12, 2001. After that time, banks will become subject to broker-dealer registration under the 1934 Act if they engage in the "business of effecting transactions in securities for the account of others" and do not qualify for an exception under the Act.[1]

GLBA provided eleven exceptions from broker-dealer registration for banks. Among the exceptions is an exception for certain bank fiduciary activities—the so-called "trust exemption."[2] The trust exemption is available under the following conditions:

> The bank effects transactions in a trustee capacity, or effects transactions 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, and—
>
> (I) 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 trustee and fiduciary customers, or any combination of such fees; and
>
> (II) does not publicly solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising in other trust activities.[3]

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[1] 15 U.S.C. § 78c(a)(4), *as amended by* Title II of the Gramm-Leach-Bliley Act.
[2] 15 U.S.C. § 78c(a)(4)(B)(ii).
[3] 15 U.S.C. § 78c(a)(4)(B)(ii).

The exception for trust activities does not apply unless (i) the bank directs trades in publicly traded securities to a registered broker-dealer for execution, (ii) the trade is a cross trade or other substantially similar trade of a security that is made by the bank or between the bank and an affiliated fiduciary, and is not in contravention of fiduciary principles established under applicable Federal or State law, or (iii) the trade is conducted in some other manner permitted under the SEC's rules and regulations.[4] For purposes of this memorandum, we assume that these requirements are met by a bank that acts as directed trustee for participant-directed 401(k) plans and IRAs. We also assume that the bank will not publicly solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising in other trust activities.

II. Description of Exempt Activities

A. Participant-Directed 401(k) Plan Accounts

A bank trust department that serves as directed trustee to participant-directed 401(k) plan accounts typically performs the following duties pursuant to instructions:

- opening and maintaining individual participant accounts
- receiving contributions from the plan sponsor and crediting them to individual participant accounts
- investing contributions in shares of mutual funds or other securities and reinvesting dividends and other distributions
- redeeming, transferring, or exchanging shares of mutual funds or other securities
- making distributions from the plan to participants or beneficiaries
- maintaining custody of the plan's assets.

A bank trust department also may perform the following services for 401(k) plans, depending on the particular arrangement with the employer/sponsor of the plan:

- withholding amounts on plan distributions

[4] 15 U.S.C. § 78c(a)(4)(C).

- making sure all plan loan payments are collected and properly credited
- conducting plan enrollment meetings
- preparing newsletters and videos relating to the administration of the plan; and
- providing investment education to plan participants.

A bank trustee offering such services generally will provide information to assist the employer that acts as the plan sponsor in developing a selection of mutual funds to be made available as investment options to the plan's participants. If the bank has its own family of mutual funds, the employer may include those funds among the fund options available to plan participants.

As a general matter, bank employees do not make investment recommendations or discuss the specific investments made by individual 401(k) plan participants other than to give account related information, take transaction orders, or provide investment education services of the type allowed under DOL guidelines. The activities of bank employees are restricted in order to limit the bank's liability in accordance with section 404(c) of ERISA. Under that section, a bank trustee is not liable for any loss that is the direct and necessary result of the plan participant's exercise of control of his or her own account. If the bank exercises discretion over plan investments or gives investment advice for a fee, however, the bank is not relieved of liability for 401(k) plan investment losses resulting from its breach of fiduciary duty. The incentive for a bank trustee of participant-directed 401(k) plan accounts thus is to avoid directing or controlling the plan's investments.

The only communication the bank trustee has with plan participants generally is for the purpose of enrolling participants and responding to telephone inquiries for current balance and account information, changes in investment elections, withdrawals and terminations. The bank also may mail periodic account statements and otherwise perform administrative functions necessary to administer the accounts as described above. In the case of a 401(k) plan where the participant may invest in individual securities, the bank may take purchase and sale orders from the participant to be executed through a broker-dealer.

Bank employees who deal with 401(k) plan accounts are compensated on a normal salary plus bonus basis and do not receive any transaction-based compensation. Accordingly, there is no incentive for bank employees to "churn" 401(k) plan accounts.

All prospectuses and other information relating to the mutual funds within the menu of funds available to 401(k) plan participants are prepared by a registered broker-dealer (typically an affiliate of the mutual fund sponsor) and are delivered to the plan sponsor to be distributed to the plan participants. In some cases, the plan sponsor may ask the broker-dealer or the bank trustee to mail the information directly to the plan participants.

In some cases, the plan sponsor, in conjunction with the mutual fund sponsor or its broker-dealer affiliate and/or the bank trustee, may hold educational seminars for the purpose of educating 401(k) plan participants as to the investment options available under the plan and explaining the process for making investments and answering questions. Such seminars are conducted in accordance with DOL guidance on participant investment education and no individualized investment recommendations or advice is given to plan participants at such seminars.[5]

Although the fee structures applicable to 401(k) plans may vary,[6] a bank acting as a trustee to a participant-directed 401(k) plan generally is compensated by a fee calculated as a percentage of the participant's plan assets maintained by the bank. The fee may be charged to or debited from each plan participant's account or charged t the plan sponsor.

In addition, pursuant to the conditions described in DOL Advisory Opinions 97-15A and 97-16A,[7] bank trustees that offer Federated mutual funds within the menu of funds available to 401(k) plan participants may receive fees from Federated for performing shareholder services in connection with investments in such funds by plan participants. Such services include recordkeeping and subaccounting services, processing of mutual fund purchase and redemption transactions, and providing mutual fund prospectuses and other enrollment materials to plan participants. Other mutual fund families pay similar shareholder service fees also.

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[5] *Id.* As noted in the DOL interpretive bulletin relating to participant investment education, the DOL's regulation relieving a plan fiduciary from liability in connection with participant directed-accounts is conditioned, in part, on the plan participants being provided with sufficient investment information regarding the investment alternatives available under the plan in order to make informed investment decisions. As the DOL stated, "[c]ompliance with this condition, however, does not require that participants and beneficiaries be offered or provided either investment advice or investment education."

[6] *See generally*, Pension and Welfare Benefits Administration, Study of 401(k) Plan Fees and Expenses: Final Report (April 13, 1998), prepared for PWBA by Economic Systems, Inc.

[7] DOL Advisory Opinion 97-15A (May 22, 1997) (Frost National Bank); DOL Advisory Opinion 97-16A (May 22, 1997) (Aetna Services, Inc.).

B. Self-Directed IRA Accounts

Bank trust departments also act as trustees for self-directed IRA accounts. A bank trust department acting in such a capacity generally performs recordkeeping, accounting and safekeeping duties similar to those for 401(k) plan accounts, subject to fiduciary standards imposed under section 408 of the Internal Revenue Code ("IRC"). The trust department does not exercise investment discretion with respect to such accounts, but is responsible for implementing the investment instructions of the IRA customer and fulfilling the requirements of section 408 of the IRC.

Bank trustees may charge administrative fees to self-directed IRAs and receive shareholder service fees on a basis similar to that for 401(k) plan accounts. Bank employees who deal with IRA customers are compensated on a normal salary plus bonus basis and do not receive any transaction-based compensation.

III. Discussion

For the following reasons, we believe that a bank acting as directed trustee to participant-directed 401(k) plan accounts and IRA accounts is acting in a fiduciary capacity and is entitled to rely on the trust exemption under the 1934 Act, as amended by GLBA.

A. A Bank Trustee Acts in a Fiduciary Capacity for Participant-Directed 401(k) Accounts

In general, ERISA requires that "all assets of an employee benefit plan shall be held in trust by one or more trustees."[8] A plan trustee is a "fiduciary" for purposes of ERISA if the trustee:

- exercises any discretionary authority or control over management of the plan or any authority or control over management or disposition of its assets;

- renders investment advice for a fee or other compensation, direct or indirect, with respect to any plan moneys, or has any authority or responsibility to do so; or

- has any discretionary authority or responsibility in the administration of the plan.[9]

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[8] 29 U.S.C. § 1103.

Even when a bank does not exercise discretionary authority or control over the investments by a 401(k) plan account, or render investment advice for a fee, the DOL takes the position that a bank acting as a directed trustee for an employee benefit plan is deemed to be a plan fiduciary under ERISA "by the very nature of his position."[10] As such, the bank is subject to fiduciary duties prescribed in ERISA, including the duty of loyalty and prudent man standard of care which state:

> a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan;
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.[11]

ERISA contains prohibited transaction rules under which certain classes of transactions involving a "party in interest" or self-dealing or conflicts of interest are prohibited, even if they otherwise would be prudent and otherwise satisfy ERISA's fiduciary standards.[12] A "party in interest" includes a plan fiduciary and persons who provide services to a plan, among others.

The courts have held that the fiduciary duties established by ERISA should be broadly construed.[13]

A directed trustee of a 401(k) plan thus is deemed to be a fiduciary for purposes of ERISA even if the trustee does not provide investment advice for a

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[9] 29 U.S.C. § 1002(21)(A).
[10] *See* 29 C.F.R. § 2509.75-8, D-3.
[11] 29 U.S.C. § 1104(a).
[12] 29 U.S.C. § 1106.
[13] *See Martin v. National Bank of Alaska*, 828 F. Supp. 1427 (D. Alaska 1992).

fee, lacks investment discretion, and the plan participant directs the trustee with respect to investments. In such a case, although a directed trustee is relieved of fiduciary liability for the direct consequences of a participant's exercise of control under section 404(c) of ERISA,[14] the directed trustee is not relieved of its fiduciary status for other purposes under ERISA.

For example, a trustee of a participant-directed 401(k) plan is deemed to have residual fiduciary responsibility for determining whether a participant's investment instructions are proper in accordance with the plan documents and do not violate ERISA. In addition, under DOL regulations, the trustee may be responsible for determining whether participant instructions could jeopardize the plan's tax qualified status under the Internal Revenue Code, result in a direct or indirect purchase of securities issued by the employee's employer except as permitted under regulations, or result in a loss in excess of a participant's or beneficiary's account balance.[15] Furthermore, such a trustee remains subject to ERISA's fiduciary rules in connection with those aspects if the transaction that are not participant directed.[16] For example, if a participant gives investment instructions that may be carried out in more than one way, such as by not specifying a particular broker-dealer through which the trustee is to execute transactions, the trustee may be liable for engaging in a prohibited transaction if it uses an affiliated broker rather than an unaffiliated broker.[17]

The DOL has stated, therefore, "it is the view of the Department that a directed trustee necessarily will perform fiduciary functions."[18]

Moreover, to the extent the bank recommends to the plan sponsor the advisability of investing in particular funds, monitors the performance of the funds, and reserves the right to add or remove mutual fund families that it makes

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[14] 29 U.S.C. § 1104(c).
[15] 29 C.F.R. § 2550.404c-1(d).
[16] 29 C.F.R. § 2550.404c-1(f)(7).
[17] *Id.*
[18] DOL Opinion No. 97-15A (May 22, 1997) re Frost National Bank.

available in a manner described in DOL Advisory Opinion 97-15, the bank will be acting as a fiduciary of a self-directed 401(k) plan subject to fiduciary duties.[19]

B. A Bank Trustee Acts in a Fiduciary Capacity for Self-Directed IRAs

A bank that acts as a directed trustee to an IRA is a trustee and is subject to fiduciary standards under section 408 of the IRC. Section 408 states, "the term 'individual retirement account' means a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries" subject to specified requirements.[20]

Section 408 further states that, "[f]or purposes of this section, a custodial account shall be treated as a trust if the assets of such account are held by a bank . . . and, if the custodial account would, except for the fact that it is not a trust, constitute an individual retirement account . . . . [I]n the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof."[21]

The Internal Revenue Service ("IRS") takes the position that a trustee for a self-directed IRA is a fiduciary for purposes of the prohibited transaction rules under the IRC.[22] Such a trustee thus is subject to the prohibited transaction restrictions to the same extent as a trustee for a participant-directed 401(k) plan. A bank trustee for a self-directed IRA will incur liability for engaging in a prohibited transaction, for example, if it invests the account's assets in deposits of the bank unless the investment is expressly authorized by the account holder.[23] The DOL administers the prohibited transaction restrictions with respect to IRA trustees and has addressed various situations in which the prohibited transaction provisions may be applicable to a self-directed IRA trustee. For example, the

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[19] DOL Opinion No. 97-15A (May 22, 1997) re Frost National Bank ("The Department points out that the act of limiting or designating investment options which are intended to constitute all or part of the investment universe of an ERISA 404(c) plan is a fiduciary function which, whether achieved through fiduciary designation or express plan language, is not a direct or necessary result of any participant direction of such plan."). If the bank trustee does not make any recommendations concerning the selection of particular mutual funds but another plan fiduciary independently selects, from mutual fund families made available by the bank, particular funds to be made available for investment by plan participants, these duties will not arise if the bank gives notice to the plan sponsor before modifying the list of funds available for investment by plan participants. *See* DOL Advisory Opinion 97-16A (May 22, 1997). *See also* 29 C.F.R. § 2550.404c-1(f)(8).

[20] 26 U.S.C. § 408(a).

[21] 26 U.S.C. § 408(h).

[22] *See* 29 C.F.R. § 2509.75-8, D-3; 26 U.S.C. § 4975(e)(3).

[23] *See* 26 U.S.C. § 4975(d)(4).

DOL has addressed whether the purchase of parent company stock by a bank acting as an IRA trustee at the sole direction of IRA account holders would constitute a prohibited transaction.[24]

One of the requirements for an IRA is that the trustee be a bank or "such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section."[25] A registered broker-dealer is not eligible to serve as a trustee/custodian for IRA accounts, for example, unless it satisfies certain fiduciary requirements under regulations issued by the IRS pursuant to section 408. The fiduciary requirements applicable to nonbank IRA trustees demonstrate the extent to which the IRS views an IRA trustee which is a bank as exercising fiduciary obligations as part of its trustee role.

Under the IRS regulations, a nonbank trustee of an IRA must "demonstrate in detail its ability to act within accepted rules of **fiduciary** conduct."[26] The nonbank trustee must "assure the uninterrupted performance of its **fiduciary** duties"[27] and "have **fiduciary** experience or expertise sufficient to ensure that it will be able to perform its **fiduciary** duties."[28] Evidence of fiduciary experience must include "proof that a significant part of the business of the applicant consists of exercising **fiduciary** powers similar to those it will exercise if its application [to act as an IRA custodian/trustee] is approved" and "proof that the applicant employs personnel experienced in the administration of **fiduciary** powers similar to those the applicant will exercise if its application is approved."[29]

The IRS regulations establish **"rules of fiduciary conduct"** for nonbank IRA trustee/custodians.[30] Such rules provide the following, among other requirements:

> "The owners or directors of the applicant will be responsible for the proper exercise of **fiduciary** powers by the applicant." Rule 1.408-2(e)(5)(i)(A)(1).
>
> "All employees taking part in the performance of the applicant's **fiduciary** duties will be adequately bonded." Rule 1.408-2(e)(5)(i)(B).

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[24] *See* DOL Letter dated April 15, 1988 re Bank of Prattville, 1988 WL 192826 (E.R.I.S.A.).
[25] 26 U.S.C. § 408(a).
[26] 26 C.F.R. § 1.408-2(e)(2).
[27] 26 C.F.R. § 1.408-2(e)(2)(i).
[28] 26 C.F.R. § 1.408-2(e)(2)(iii).
[29] *Id.*
[30] 26 C.F.R. § 1.408-2(e)(5).

> "The applicant will employ or retain legal counsel who will be readily available to pass upon **fiduciary** matters and to advise the applicant." Rule 1.408-2(e)(5)(i)(C).
>
> "At least once during each period of 12 months, the applicant will cause detailed audits of the **fiduciary** books and records to be made by a qualified public accountant. At that time, the applicant will ascertain whether the **fiduciary** accounts have been administered in accordance with law, this paragraph, and sound **fiduciary** principles." Rule 1.408-2(e)(5)(iii)(A).
>
> "Funds held in a **fiduciary** capacity by the applicant awaiting investment or distribution will not be held uninvested or undistributed any longer than is reasonable for the proper management of the account." Rule 1.408-2(e)(5)(iv).
>
> "[T]he investments of each account will not be commingled with any other property." Rule 1.408-2(e)(5)(v).
>
> "The applicant must keep its **fiduciary** records separate and distinct from other records." Rule 1.408-2(e)(5)(vii).

These rules apply to "passive trustees" of IRA accounts as well as to IRA trustees with investment discretion.[31]

The courts have recognized that IRA trustees act in a fiduciary capacity. Courts have held, for example, that a bank acting as an IRA custodian may not set off a debt of the IRA owner against the balance in the IRA account because the bank is acting in a fiduciary capacity rather than the general corporate capacity in which it acted as lender.[32]

In another case, the court held that a bank's offering of an IRA collective investment fund "constitutes a 'sale of fiduciary services' rather than a mere 'sale of investments'" and thus was a permissible activity for a national bank.[33] The court based its decision on the following analysis:

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[31] 26 C.F.R. § 1.408-2(e)(6).
[32] *See In re Sopkin*, 57 B.R. 43 (Bkrtcy. D.S.C. 1985); *First National Bank of Blue Island v. Estate of Philp*, 436 N.E.2d 15 (Ill. 1982); *In re Todd*, 37 B.R. 836 (Bkrtcy. W.D.La. 1984).
[33] *Investment Co Institute v. Clarke*, 630 F. Supp. 593, 597 (D.C. Conn.), *aff'd* 789 F.2d 175 (2d Cir.), *cert. denied*, 479 U.S. 940 (1986).

> [The bank] is the trustee under Connecticut law of both the Fund and the individual IRA trusts and therefore is required to administer all of these trusts "with the care of a prudent investor." [citation omitted] As the Comptroller [of the Currency] observed in his decision,
>
>> Connecticut law imposes upon the Trustee significant fiduciary duties and obligations, including the duty to obey the donor's instructions, to protect the fund, to exercise due diligence, to be completely loyal to the interests of the beneficiaries, and to avoid being influenced by any third-party or personal interest which may conflict with duties as Trustee.
>
> Moreover, [the bank's] relationship to the Fund and to the individual IRA trusts is regulated under ERISA as well as under Connecticut law. For example, ERISA requires that the individual IRA trusts be established "for the exclusive benefit of an individual or his beneficiaries" pursuant to written governing instruments that satisfy specified requirements. 26 U.S.C. § 408(a)(1). The trustee bank is prohibited under the Internal Revenue Code from engaging in various forms of self-dealing with the trusts. *See* 26 U.S.C. § 4975. A person may contribute no more than $2,000 per year to an IRA trust. *See* 26 U.S.C. § 408(a)(1). The assets in an IRA trust can be distributed only when the individual trustor reaches age 59½, dies or becomes disabled unless he is willing to incur a substantial tax penalty. *See* 26 U.S.C. § 408(f). The trustor's interest in his IRA is not transferable except by death, *see* 26 U.S.C. § 408(a), and is not to be used as security for indebtedness. *See* 26 U.S.C. § 408(e)(4).[34]

C. In Both Cases, the Bank is Exempt

In the case of both 401(k) plans and IRAs, a bank trustee qualifies for the trust exemption under the 1934 Act, as amended by the Gramm-Leach-Bliley Act.

In both cases, the bank "effects transactions in a trustee capacity, or effects transactions 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."

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[34] *Id.* at 595-96.

The term "fiduciary capacity" is defined in the 1934 Act, as amended by GLBA, and includes acting "in the capacity as trustee."[35] The GLBA definition is identical to the definition of "fiduciary capacity" in the Comptroller of the Currency's trust regulations.

In 1995, the OCC and other banking agencies clarified that the Interagency Statement on Retail Sales of Nondeposit Investment Products is inapplicable to fiduciary accounts administered by a depository institution. The agencies clearly viewed 401(k) and IRA accounts as trust accounts, stating that, although such accounts would not be subject to the Interagency Statement, "[h]owever, the disclosures prescribed by the Interagency Statement should be provided to non-institutional customers who direct investments for their fiduciary accounts, *such as self-directed individual retirement accounts.*" (emphasis added)

Whether acting as trustee for a self-directed 401(k) plan or an IRA, the bank 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 trustee and fiduciary customers, or any combination of such fees."

In neither case is there any danger of churning or other types of abuses at which broker-dealer regulation is aimed. Because the bank generally is compensated on the basis of a flat fee or percentage of assets fee and its employees receive no transaction-based compensation, the kind of salesman's stake that one might find in the sale of securities by a broker-dealer is absent. Moreover, as noted above, when a bank acts as trustee to a 401(k) plan or IRA, the bank is subject to fiduciary standards under ERISA and the Internal Revenue Code, as well as state trust law, that protect against conflicts of interest and self-dealing. To the extent that a bank receives compensation from a mutual fund in connection with fund investments by 401(k) plans and IRAs for which it acts as trustee, any such compensation must be in accordance with fiduciary standards under ERISA, the Internal Revenue Code, and state trust law.

IV. Conclusion

Based on the foregoing, it is our view that a bank acting as trustee for a self-directed 401(k) plan or IRA is not subject to broker-dealer registration under the 1934 Act. The bank in both cases has the title of "trustee" and is acting in a fiduciary capacity subject to the fiduciary requirements and prohibitions of ERISA, the Internal Revenue Code, and state trust law. The bank thus is entitled to rely on the trust exemption from broker-dealer registration under the 1934 Act, as amended by the Gramm-Leach-Bliley Act.

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[35] 15 U.S.C. § 78c(a)(4)(D).

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March 7, 2001

Robert Colby
Deputy Director
Catherine McGuire
Associate Director and Chief Counsel
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Mail Stop 10-1
Washington D.C. 20549

Dear Mr. Colby and Ms. McGuire:

On behalf of my client, Federated Investors, Inc. ("Federated"), for the reasons indicated in the enclosed memorandum, I hereby request your confirmation that the Staff of the Division of Market Regulation concurs with our view that banks in their capacity as fiduciaries may offer managed asset services, as described in the enclosed memorandum, without registering as broker-dealers under the Securities Exchange Act of 1934 (the "1934 Act").

Federated is a sponsor and distributor of mutual funds with approximately $130 billion in total assets. Many of Federated's mutual fund products and services are made available through managed asset services offered by banks. Federated thus has an interest in the applicability of federal securities laws to such services. Given the approach of the May 12, 2001, effective date of Title II of the Gramm-Leach-Bliley Act, your timely attention to this matter is appreciated.

Sincerely,

Melanie L. Fein

Melanie L. Fein

MEMORANDUM IN SUPPORT OF REQUEST FOR CONFIRMATION THAT BANK ASSET ALLOCATION PROGRAMS ARE EXEMPT UNDER GLBA

A. The Gramm-Leach-Bliley Act

As you know, Title II of the Gramm-Leach-Bliley Act ("GLBA") amended the Securities Exchange Act of 1934 ("1934 Act") to eliminate the bank exemption from broker-dealer registration effective May 12, 2001. After that time, banks will become subject to broker-dealer registration under the 1934 Act if they engage in the "business of effecting transactions in securities for the account of others" and do not qualify for an exception under the Act.[1]

GLBA provided eleven exceptions from broker-dealer registration for banks. Among these is an exception for certain bank fiduciary activities—the so-called "trust exemption."[2]

Federated believes that certain investment management services offered by bank trust departments in a fiduciary capacity, as described below, are covered by the trust exemption and requests the Staff's assurance that a bank may offer such programs without registering as a broker-dealer under the 1934 Act.

B. Bank Managed Asset Services

Managed asset services are an important part of the fiduciary services provided by bank trust departments to trust clients seeking asset allocation and investment management services. Such services involve the management of fiduciary assets in mutual funds through asset allocation models established by the bank's trust department based on investment advice and recommendations given to an individual client after a review of the client's specific financial situation, needs and objectives as reflected in an interview with the client and the client's responses to a questionnaire. Such services are offered subject to the standards of prudence, diversification and loyalty prescribed in the Uniform Prudent Investment Act as adopted by nearly all of the States.

In the typical managed asset relationship, if the trust department determines that the client's managed asset needs and objectives can best be met by investing in mutual funds, the trust department will recommend an allocation of the customer's assets among different mutual funds sponsored by Federated and/or other mutual fund sponsors based on an asset allocation model designed to meet the customer's particular profile. In the case of the Federated funds, customer assets are allocated among no-load funds with institutional or trust classes of fund shares.

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[1] 15 U.S.C. § 78c(a)(4), *as amended by* Title II of the Gramm-Leach-Bliley Act.
[2] 15 U.S.C. § 78c(a)(4)(B)(ii).

If the client agrees with the trust department's recommendations, the trust department will invest the client's assets in accordance with the recommended asset management model. The trust department exercises discretion in selecting the asset management models and mutual funds that are recommended to clients and also may exercise discretion in making periodic adjustments in the asset allocation models to reflect changing market conditions and economic assumptions. The trust department generally has the discretion to substitute different mutual funds into the asset allocation formula.

Transactions in connection with the trust department's managed asset services are directed to the appropriate mutual fund transfer or servicing agent for execution. In the case of the Federated funds, purchase and redemption transactions generally are handled by Federated Securities Corp., a registered broker-dealer. No brokerage commission is charged for investments in the Federated no-load funds.

Trust clients who utilize the trust department's managed asset services generally are charged a fee, payable to the trust department, equal to a percentage of the client's assets that are invested through the program. Such fees may be in the range of 100-150 basis points and compensate the bank for providing investment advice and recommendations relating to the client's asset management needs, developing or selecting appropriate asset management models, making adjustments in the models as necessary, processing transactions, responding to the client's inquiries concerning its account, monitoring the client's account, and otherwise handling the client's account.

If permitted by applicable fiduciary law, the trust department also may receive compensation from Federated or the relevant mutual fund sponsor in the form of a shareholder servicing or administration fee generally in the amount of 25 basis points or less. This fee compensates the bank for performing recordkeeping and subaccounting services that the fund's administrator or transfer agent otherwise would need to provide. In the case of the Federated funds, the fee is not a 12b-1 fee charged to fund assets. Rather, it is paid directly by a Federated affiliate from the affiliate's own revenues.

Managed asset programs of the type described frequently are offered by community banks that do not have the resources to establish and maintain a broker-dealer affiliate. The customers of these banks are accustomed to obtaining investment advice and management services from the bank's trust department and may be uncomfortable transferring their accounts to an unaffiliated securities broker-dealer. Some bank customers might even object to doing business with an affiliated brokerage firm given the different sales culture of broker-dealers generally.

The trust exception afforded by GLBA was intended to allow bank trust departments to continue serving these customers. In some small communities, broker-dealer services might not be conveniently available and, if customers cannot obtain managed asset services from their local bank, they may be deprived of convenient access to such services altogether.

C. Bank Managed Asset Services Satisfy the GLBA "Chiefly" Test and Advertising Restriction

Managed asset programs offered by bank trust departments as described herein generally comply with the requirements as to compensation under the trust exception. Specifically, the trust department is "chiefly" compensated for such transactions in a manner consistent with fiduciary principles on the basis of an administration or annual fee or a percentage of assets under management. In the cases of which Federated is aware, more than 50 percent of the trust department's compensation from each account comes from a fee based on assets under administration. The shareholder servicing fee paid by Federated in no case exceeds fifty percent of the trust department's total compensation for asset allocation services for any single account, and is an asset based fee in any event.

In accordance with the trust exception under GLBA, bank trust departments that offer managed asset programs in reliance on the trust exception will comply with the provision in GLBA under which they may not "publicly solicit brokerage business other than by advertising that they effect transaction in securities in conjunction with advertising other trust services."

D. The Literal Language of GLBA Exempts Bank Managed Asset Services Regardless of Whether They Are Discretionary or Non-Discretionary

The literal language of the trust exception makes clear that managed asset services programs of the type described herein are entitled to the trust exception regardless of whether they are discretionary or nondiscretionary. The trust exception is applicable when a bank effects 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" and meets certain other requirements. The term "fiduciary capacity" is expressly defined in the 1934 Act, as amended by GLBA, to include acting "as an investment adviser if the bank receives a fee for its investment advice":

> [T]he term 'fiduciary capacity' means—
>
> in the capacity as trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gift to minor act, or ***as an investment adviser if the bank receives a fee for its investment advice***;
>
> in any capacity in which the bank possesses investment discretion on behalf of another; or
>
> in any other similar capacity.[3]

Accordingly, under the literal language of the 1934 Act, a bank trust department is not required to possess investment discretion when acting as an investment adviser in order to qualify for the trust exception. The statute does not state that the bank, when acting as an investment adviser, must possess discretion in order to be deemed to be acting in a fiduciary capacity. Investment discretion is required if a bank is relying on clause (ii) of the definition of "fiduciary capacity" but not clause (i). Under rules of statutory construction, the omission of any reference to investment discretion in clause (i) may be construed to mean that Congress intended to omit it. If an investment adviser were required to possess discretion in order to be deemed to be acting in a fiduciary capacity for purposes of the trust exception, then the reference to investment advisers in clause (i) would be redundant and have no meaning.

This reading of the trust exception is consistent with Congressional intent as reflected in the legislative history of GLBA. The Senate Banking Committee Report indicates that Congress did not intend to force bank trust departments to dramatically alter their product offerings as a result of GLBA:

> The Committee does not believe that an extensive "push-out" of or restrictions on the conduct of traditional banking services is warranted. Banks have historically provided securities services largely through their trust departments, or as an accommodation to certain customers. Banks are uniquely qualified to provide these services and have done so without

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[3] 15 U.S.C. § 78c(a)(4)(D) (emphasis added).

> any problems for years. Banks provided trust services under the strict mandates of State trust and fiduciary law without any problems long before Glass-Steagall was enacted; there is no compelling policy reason for changing Federal regulation of bank trust departments, solely because Glass-Steagall is being modified.[4]

The Conference Report on GLBA also makes clear that the trust exception is to be construed in such a manner as to avoid disrupting the services offered by bank trust departments: "The Conferees expect that the SEC will not disturb traditional bank trust activities. . . ."[5]

E. Investment Advice is a Fiduciary Activity under OCC Trust Regulations and ERISA

Under the trust regulations of the Comptroller of the Currency, a national bank that provides investment advice for a fee is deemed to be acting in a fiduciary capacity.[6]

Similarly, under the Employee Retirement Income Security Act of 1974 ("ERISA"), a person that provides investment advice for a fee to an employee benefit plan or exercises discretionary authority with respect to a plan is deemed to be a fiduciary.[7] The Department of Labor has indicated that a bank trustee offering managed asset services to participant-directed ERISA plan accounts may be deemed to be exercising discretionary authority if it reserves the right to add or remove mutual funds that it makes available to the plan accounts, even if the trustee does not recommend specific fund investments to individual plan participants.[8]

F. The Supreme Court and SEC Have Long Treated Investment Advice as a Fiduciary Service

The Supreme Court as long ago as 1963 made clear that an investment adviser is a fiduciary.[9] The SEC itself has long treated investment advisers as

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[4] S. Rep. No. 106-44, 106th Cong., 1st Sess. 10 (1999).
[5] H. Rep. No. 106, 434, 106th Cong., 1st Sess. 164 (1999).
[6] 12 C.F.R. § Pt. 9.
[7] 29 U.S.C. § 1002(21)(A).
[8] DOL Advisory Opinion 97-15A (May 22, 1997) (Frost National Bank). In such cases, however, the bank trustee is relieved of responsibility for the plan participant's investment decisions, but is otherwise a fiduciary. *Id.* at n. 9, citing 57 Fed. Reg. 46,906, 46,924 n. 27 (1992).
[9] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191, 194 (1963).

acting in a fiduciary capacity regardless of whether they possess investment discretion.[10]

G. The SEC Does Not Require Non-Bank Investment Advisers to Register as Broker-Dealers When They Offer Asset Allocation Programs

The SEC does not require investment advisers that offer asset allocation programs to register as broker-dealers, even when such programs are non-discretionary. The SEC has taken the position that an investment adviser is not engaged in "effecting" securities transactions and is not required to register as a broker-dealer merely because it has discretionary authority to place orders with brokers and to execute securities transactions for client accounts without specific compensation for this function.[11]

A contrary position would require thousands of investment advisers to register as broker-dealers and would undermine the scheme of separate regulation of investment advisers and broker-dealers enacted by Congress. An inequitable regulatory scheme would result if the SEC required banks but not investment advisers to register as broker-dealers when they provide asset allocation services.

H. Broker-Dealer Registration Does Not Hinge on Whether a Broker is Exercising Discretion

Broker-dealers are required to register under the 1934 Act regardless of whether they exercise discretion. The definition of "broker" under the 1934 Act means "any person engaged in the business of effecting transactions in securities for the account of others" unless an exception applies.[12] The exercise of investment discretion is not a criterion in the basic registration requirement for broker-dealers.

I. A Contrary Position Would Negate the Exemption for Banks from Registration under the Investment Advisers Act

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[10] 59 Fed. Reg. 13,464, 13, 469 (1994) ("Investment advisers are fiduciaries . . .").
[11] *See* Release No. IA-1000 (Dec. 5, 1985), 50 Fed. Reg. 49,835 49,839 (1985). An investment adviser thus may act in the role of an introducing broker without being required to register as a broker-dealer.
[12] Securities Exchange Act 3(a)(4)(A), *codified at* 15 U.S.C. § 78c(a)(4)(A).

A position that banks must register as broker-dealers if their trust departments offer managed asset services would have the effect of subjecting bank investment advisory activities to SEC regulation under the Investment Advisers Act of 1940 ("Advisers Act"), contrary to the express statutory exemption for banks from such regulation. Although GLBA repealed the bank exemption from broker-dealer registration under the 1934 Act, it did *not* repeal the bank exemption from investment adviser registration under the Advisers Act.

A broker-dealer is required to register as an investment adviser if it offers a discretionary or non-discretionary asset allocation program. Broker-dealers may perform advisory services without registering under the Advisers Act only if the advisory services are "solely incidental" to the conduct of a securities brokerage business and the broker receives no "special compensation" for advisory services.[13] SEC no-action letters and releases indicate that the offering of an asset allocation program is not "solely incidental" to the conduct of a securities brokerage business[14] and thus a broker-dealer that offers such a program is required to register as an investment adviser.[15]

Accordingly, while bank managed asset services are subject to neither the 1934 Act nor the Advisers Act under the Gramm-Leach-Bliley Act, they would become subject to both acts if the trust exception is interpreted by the Staff in such a way as to require such programs to be transferred to a registered broker-dealer that must also register as an investment adviser.

J. Bank Trust Departments are Subject to Fiduciary Duties and Standards That Protect Customers Who Utilize Managed Asset Services

Bank trust departments are subject to strict standards of fiduciary conduct under state trust law when they provide managed asset services to fiduciary customers. In addition to standards of prudence under the Prudent Investor Rule, bank fiduciaries are subject to the duty of loyalty which requires a fiduciary to act solely in the interests of the beneficiary and to refrain from self-dealing.

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[13] Investment Advisers Act § 202(a)(11)(c).

[14] Investment Management & Research, Inc. (pub. avail. Jan. 27, 1977), *cited in* Townsend and Associates, Inc. (pub. avail. Sept. 21, 1994); Investment Advisers Act Release No. 471 (Aug. 20, 1975), *cited in* Townsend and Associates, Inc.

[15] *See* Investment Advisers Act Release No. 1401 (Jan. 13, 1994); National Regulatory Services, Inc. (pub. avail. Dec. 2, 1992).

These fiduciary standards applicable to bank trust departments include a duty to ensure that recommended investments are suitable for investment advisory customers. Although the SEC at one time proposed imposing a suitability standard on investment advisers registered under the Investment Advisers Act of 1940, the proposal never was adopted.[16] Bank trust departments thus are subject to a higher standard of fiduciary conduct than an investment adviser.

While bank trust departments are exempt from broker-dealer and investment adviser registration, they are not exempt from the anti-fraud provisions applicable to broker-dealers and investment advisers under the federal securities laws. Moreover, to the extent that most trust department managed asset services involve investments in mutual funds, fiduciary clients benefit from all of the disclosure and other requirements that protect mutual fund shareholders under the Investment Company Act of 1940.

Accordingly, bank customers who avail themselves of managed asset services of bank trust departments are amply protected under the law and are not harmed or disadvantaged by the absence of broker-dealer or investment adviser regulation.

K. The Distinction Between "Discretionary" and "Non-Discretionary" Is Unclear and Not a Proper Basis for Registration

The SEC's own regulations and interpretations are inconsistent as to when an asset allocation program may be deemed to be discretionary or non-discretionary. The requirement for broker-dealer registration should not be based on such an unclear distinction.

1. Bank Managed Asset Services May Be Non-Discretionary under Form ADV

Managed asset services of the type offered by many bank trust departments could be treated as non-discretionary for purposes of Form ADV required if they were offered by a registered investment adviser under the Investment Advisers Act of 1940.

Part I of Form ADV requires investment advisers to provide information concerning discretionary and non-discretionary assets. Each investment adviser is

[16] 59 Fed. Reg. 13,464 (1994) (proposed rule).

required to state the aggregate market value of securities portfolios that receive "continuous and regular supervisory or management services" on both a discretionary basis and non-discretionary basis.[17]

The Instructions to Form ADV attempt to explain the distinction between discretionary and nondiscretionary accounts. The Instructions set forth a general criteria under which an investment adviser will be deemed to provide "continuous and regular supervisory or management services" if the adviser either:

> (1) has discretionary authority over and provides ongoing supervisory or management services with respect to the account; or
>
> (2) does not have discretionary authority over the account, but has an ongoing responsibility to select or make recommendations, based upon the needs of the client, as to specific securities or other investments the account may purchase or sell and, if such recommendations are accepted by the client, is responsible for arranging or effecting the purchase or sale.[18]

The Instructions give the following as an example of accounts that receive continuous and regular supervisory or management services:

> Accounts for which the [investment adviser] allocates assets of a client among mutual funds (even if it does so without a grant of discretionary authority, but only if the general criteria for non-discretionary accounts is satisfied and the factors suggest that the account receives continuous and regular supervisory or management services).[19]

Thus, the SEC's Form ADV recognizes that some asset allocation programs are discretionary and some are non-discretionary, even though both receive "continuous and regular supervisory or management services." While most managed asset services offered by bank trust departments likely would be considered discretionary for purposes of Form ADV, some such services might fall into the non-discretionary category.

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[17] Form ADV, Part I, Question 18.
[18] Form ADV, Instructions to Schedule I of Form ADV, Instruction 7.
[19] *Id.*

2. Bank Managed Asset Services are Treated as Discretionary under Rule 3a-4

The SEC addressed asset allocation programs similar to the managed asset services offered by bank trust departments when it adopted Rule 3a-4 under the Investment Company Act of 1940 in 1997.[20] Rule 3a-4 provides a nonexclusive safe harbor from the definition of investment company for certain programs under which investment advisory services are provided on a discretionary basis to a large number of advisory clients having relatively small amounts to invest.

When Rule 3a-4 was proposed for comment, several commenters asked the SEC to clarify that non-discretionary asset allocation programs generally do not need the safe harbor to avoid investment company status. The SEC responded that a non-discretionary program would not need to rely on the safe harbor. The SEC defined a "nondiscretionary" program as "one in which the investor has the authority to accept or reject each recommendation to purchase or sell a security made by the portfolio manager, and exercises judgment with respect to such recommendations."[21] The SEC suggested that some non-discretionary asset allocation programs would be deemed to be discretionary:

> Whether a program is nondiscretionary is inherently a factual determination. A program designated as "nondiscretionary" in which the client follows each and every recommendation of the adviser may raise a question whether the program in fact is nondiscretionary.[22]

As a result of this guidance, it is unclear whether certain asset allocation programs may be deemed discretionary or non-discretionary. Under the Rule 3a-4 guidance, most managed asset services offered by bank trust departments would be discretionary to the extent that the customer generally accepts the bank's asset allocation recommendations and the bank exercises discretion in periodically adjusting the asset allocation models.

3. The 1934 Act Provides a Different Distinction

The statutory definition of "investment discretion" in the Securities Exchange Act of 1934 adds further confusion as to when investment advice is discretionary and when it is non-discretionary. Under the 1934 Act, a person is

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[20] 62 Fed. Reg. 15,098 (1997).
[21] 62 Fed. Reg. at 15,101.
[22] 62 Fed. Reg. at 15,101, n. 18.

deemed to exercise "investment discretion" with respect to an account if the person "directly or indirectly":

> is authorized to determine what securities or other property shall be purchased or sold by or for the account,
>
> makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions, or
>
> otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.[23]

Under paragraph (B), a person could be deemed to exercise investment discretion if the person "indirectly" makes investment decisions without having actual discretionary authority. The Commission has not adopted a regulation pursuant to paragraph (C).

It should be noted that the 1934 Act designates the federal banking agencies—not the SEC—as the appropriate agencies with rulemaking authority with respect to persons exercising investment discretion over an account. Section 3(a)(34)(F) of the Act clearly states that the term "appropriate regulatory agency . . . when used with respect to a person exercising investment discretion with respect to an account" means the federal banking agencies.[24]

4. Bank Managed Asset Services are Discretionary under ERISA

As noted earlier, the Department of Labor has indicated that a bank trustee offering managed asset services to participant-directed ERISA plan accounts may be deemed to be exercising discretionary authority if it reserves the right to add or

[23] Securities Exchange Act of 1934, § 4(a)(35).

[24] This section is relevant for purposes of Section 11(a)(1) of the 1934 Act which states "It shall be unlawful for any member of a national securities exchange to effect any transaction on such exchange for its own account, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion." Under section 23 of the 1934 Act, the federal banking agencies have rulemaking authority to implement section 11(a)(1).

remove mutual funds that it makes available to the plan accounts, even if the trustee does not recommend specific fund investments to individual plan participants.[25]

L. Conclusion

For the foregoing reasons, Federated believes that it would be contrary to the language and intent of the Gramm-Leach-Bliley Act for the Commission to subject managed asset services offered by bank trust departments to broker-dealer registration. Accordingly, we respectfully request the Staff to confirm that it agrees with this view and will not recommend enforcement action to the Commission if a bank trust department offers managed asset services of the type described herein.

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[25] DOL Advisory Opinion 97-15A (May 22, 1997) (Frost National Bank). In such cases, however, the bank trustee is relieved of responsibility for the plan participant's investment decisions, but is otherwise a fiduciary. *Id.* at n. 9, citing 57 Fed. Reg. 46,906, 46,924 n. 27 (1992).