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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I. 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").[1] 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).[2]

The Act's compensation and advertising limitations were designed to prevent a bank from "conduct[ing] a full-scale securities brokerage operation in

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[1] 15 U.S.C. § 78c(a)(4)(B)(ii).

[2] See id.

the trust department exempt from SEC regulation."[3] 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 acquire a securities firm and then transfer the securities firm's brokerage activities into the bank's trust department to evade SEC regulation.[4]

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."[5] 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

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[3] 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).

[4] 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).

[5] 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.")

regulation of bank trust departments, solely because Glass-Steagall is being modified."[6]

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.[7]

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.

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

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

[7] 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).

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.[8] For large, complex banking organizations, periodic examinations are supplemented by a more continuous and interactive supervisory

[8] 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.

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.

A. 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.[9] In

[9] 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").

addition, we do not believe an account-by-account calculation of compensation is consistent with the wording or purposes of the Act.[10] 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 fees enumerated in the statute.[11] 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.[12]

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.[13] If,

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

[11] 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.

[12] 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).

[13] 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.

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.[14]

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.

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

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[14] 15 U.S.C. § 78cc(b).

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.

B. 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.[15] 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;
    (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

[15] See Adopting Release at 27776.

(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 not 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 each 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 10 percent of the relationship compensation received from such accounts. Thus, even though sales compensation could account for 49 percent 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 10 percent 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.

C. Definition of Trustee and Fiduciary Capacity.

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."[16] 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.[17]

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.[18]

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."[19] 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

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[16] 15 U.S.C. § 78c(a)(4)(B)(ii).

[17] See 15 U.S.C. § 78c(a)(4)(D).

[18] See 12 C.F.R. § 9.2(e).

[19] 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.

bank in a trust or fiduciary capacity could remain in the bank and would not have to be "pushed out" to another entity.

1. 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.

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.[20] 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

[20] 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").

acknowledged that banks acting in a trustee capacity operate "at the highest level of responsibility."[21]

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.[22] 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.

2. 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."[23]

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[21] 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).

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

[23] 15 U.S.C. § 78c(a)(4)(D)(i).

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).[24]

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.[25]

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.[26] 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

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[24] Interim Final Rules § 240.3b-17(d).

[25] 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).

[26] 12 C.F.R. § 9.2(e).

activities.[27] The "continuous 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.[28] 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.[29] In fact, the securities laws also do not

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[27] 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 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).

[28] 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.

[29] See 12 C.F.R. §§ 9.2(e), 9.101.

require a person to have a duty of loyalty as a precondition to being considered an investment adviser under the Advisers Act.[30] 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.

D. 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.[31] 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.[32]

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.[33] 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).

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[30] See 15 U.S.C. § 80b-2(a)(11).

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

[32] See Adopting Release at 27772.

[33] Id.

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 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.

E. 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.

1. 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.[34] 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 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.[35] The plain language of the Act, however, allows a per order processing fee to include any cost incurred by a bank "in connection with

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[34] Interim Final Rules § 240.3b-17(i).

[35] Interim Final Rules § 240.3b-17(b).

executing securities transactions for trustee and fiduciary customers."[36] 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.

2. 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

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

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.[37]

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."[38] 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.[39] 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.[40] 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

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[37] Interim Final Rules § 240.3b-17(j)(6).

[38] See Adopting Release at 27775.

[39] 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.

[40] NASD Notice to Members 93-12 (1993) at Question 17.

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.[41] The Banking Agencies 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.[42] 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.[43] 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]."[44] This provision is vague, potentially overbroad, and provides banks little guidance in determining how to comply with

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[41] 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 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.

[42] 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).

[43] Interim Final Rules § 240.3b-17(j)(6).

[44] See Adopting Release at 27775.

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.[45] 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 principles.[46] 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.

F. 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,

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

[46] 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).

and stock purchase plan brokerage activities, even though the Act places no advertising restriction on those bank permissible securities activities.

II. 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."[47] 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
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> (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.[48]

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 as a custodian or clearing agency, effecting securities lending and borrowing transactions for customers, and holding securities pledged by a customer.[49]

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

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[47] 15 U.S.C. § 78c(a)(4)(B)(viii).

[48] See id. at § 78c(a)(4)(B)(viii)(I)(aa) and (ee).

[49] See id. at § 78c(a)(4)(B)(viii)(I)(bb), (cc) and (dd).

mere surplusage in the statute.[50] 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.[51] 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."[52]

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.

A. Customary Order-Taking Activities of Custodial Banks.

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

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[50] 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).

[51] 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.

[52] See H. Rep. No. 106-74, pt. 3, at 168 (1999)

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.[53] Applicable Internal Revenue Service regulations generally require that a bank serve as trustee or custodian for an IRA,[54] 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.

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[53] 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.

[54] 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.

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 to a registered broker-dealer for execution and would be required to continue doing so under the GLB Act.[55]

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.[56] 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.[57] 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.[58] Based on our supervisory experience, banks customarily conduct

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[55] See 15 U.S.C. § 78c(a)(4)(C).

[56] See Universal Pensions, Inc., 1998 SEC No-Act. LEXIS 192 (Jan. 30, 1998).

[57] 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).

[58] 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

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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 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.[59]

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and administrative services including access to the bank's trading department for the purchase and sale of securities at the customer's instructions).

[59] 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

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In this regard, prior versions of the Custody and Safekeeping Exception did not include specific language relating to custodial IRA accounts and benefit plans.[60] 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."[61] 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."[62] 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.[63] 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.[64] 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

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package of custodial, recordkeeping and "other plan administrative services", including securities execution services).

[60] See, e.g., H.R. Rep. No. 106-74, pt. 3, at 57 (1999); S. Rep. No. 106-44 (1999).

[61] See H.R. Rep. No. 105-164, pt. 3, at 135 (1997).

[62] S. Rep. No. 106-44 at 10 (1999); S. Rep. No. 105-336 at 10 (1998) (emphasis added).

[63] 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.

[64] 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.

burdens and expenses to effect occasional trades related to 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.[65] 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.

B. 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.[66] 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.

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[65] See Adopting Release at 27781, n. 182.

[66] See Adopting Release at 27782, 27783.

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."

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 only for custodial IRA accounts and other specified types of tax-deferred accounts (excluding 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 only 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 3 percent of the bank's annual net interest and noninterest income;

Advertising Restrictions:

The bank is generally prohibited from advertising that it effects any kind 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 <u>any compensation</u> 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 <u>all</u> 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.

III. 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.[67] 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 fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction."[68]

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

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[67] 15 U.S.C. § 78c(a)(4)(B)(i).

[68] Id. at § 78c(a)(4)(B)(i)(VI).

> their value) awarded for referrals involving securities are not greater than the points (and their value) awarded for activities not involving securities.[69]

In addition, the Commission states that referral fees cannot be paid in the form of bonuses.

A. 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.[70] 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.[71] 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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[69] Interim Final Rules § 240.3b-17(g)(1).

[70] 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).

[71] 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."[72] 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.

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[72] Interim Final Rules § 240.3b-17(g)(1)(ii).

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 any other product or service."[73] 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.

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."[74] 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

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[73] Adopting Release at 27765 (emphasis added).

[74] Id. at 27766.

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.

B. 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.[75] 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.

C. 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."[76] 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.[77]

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[75] Id.

[76] 15 U.S.C. § 78c(a)(4)(B)(i)(VI).

[77] See Interim Final Rules § 240.3b-17(g)(2).

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.

IV. 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.[78] 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.

A. 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

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[78] See 15 U.S.C. § 78c(a)(5)(C)(iii).

guided by the language in section 4(n) of the Bank Holding Company Act, as amended by the GLB Act.[79]

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."[80] 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.

B. 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

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[79] 12 U.S.C. § 1843(n).

[80] See Webster's Ninth New Collegiate Dictionary (1991).

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 the syndicate exception in the GLB Act, and will have seriously deleterious effects on bank securitization activities.

V. 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").[81] 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."[82]

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.[83] 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.[84]

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

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[81] 15 U.S.C. § 78c(a)(4)(B)(v).

[82] NASD Rule 2830(d)(4).

[83] Adopting Release at 27779.

[84] See Proxmire Financial Modernization Act of 1988, S. 1886, 100th Cong. § 301 (1988); 12 C.F.R § 240.3b-9(b)(4).

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 customers to make up for the fees paid by the money market mutual fund that they no longer can accept.

VI. 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."[85]

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."[86] Read literally, this regulatory proscription effectively negates the statutory exception by

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

[86] See Adopting Release at 27783.

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.

VII. Time Period for Banks to Comply with Exceptions.

A. 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 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.[87] In fact, in light of the significant

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[87] 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

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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.

B. 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

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new requirements ultimately adopted do not unnecessarily and adversely affect the existing operations of the relevant industry.

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.

VIII. Areas Not Addressed by the Interim Final Rules

A. 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.[88]

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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[88] 15 U.S.C. § 78c(a)(4)(B)(iv).

B. 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.[89] 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

[89] NASD Rule 3040(c).

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.

IX. Solicitation of Comments on Recordkeeping Requirements.

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.[90] 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

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[90] Adopting Release at 27763.

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.