



April 19, 2007

Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

Ms. Jennifer J. Johnson  
Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street & Constitution Avenue, N.W.  
Washington, DC 20551

Re: Definition of Terms and Exemptions Relating to the “Broker”  
Exceptions for Banks; SEC File No. S7-22-06; FRB Docket No. R-  
1274 (the “Proposing Release”)

Dear Ms. Morris and Ms. Johnson:

The NASD staff appreciates the opportunity to express its view on proposed Regulation R, which recently was issued by the Securities and Exchange Commission and Board of Governors of the Federal Reserve System (collectively, the “Agencies”) under the Gramm-Leach-Bliley Act (the “Act”).<sup>1</sup> This proposal provides certain exceptions from the definition of “broker” for banks that engage in specified securities activities. While proposed Regulation R does raise an important matter that we wish to address in this letter, NASD commends the Agencies on the time, thought and effort that they have put into these rules.

Our comments are limited to the proposed treatment of fees paid pursuant to Rule 12b-1 of the Investment Company Act of 1940, as it applies to the trust and fiduciary exception to broker-dealer registration.<sup>2</sup> In particular, we are concerned with the proposed inclusion of *all* Rule 12b-1 fees within the scope of “relationship compensation.” This approach apparently conflicts with the language and purpose of the Act. It also seems to be at odds with the purpose, nature, and history of Rule 12b-1 and NASD Rule 2830.

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<sup>1</sup> The comments provided in this letter are solely those of the staff of NASD; they have not been reviewed or endorsed by the Board of Governors of NASD. For ease of reference, the letter may use “we,” “NASD” and “NASD staff” interchangeably, but these terms refer only to NASD staff.

<sup>2</sup> Proposed Rule 721 in Regulation R.

For these reasons, we recommend that the Agencies amend the proposal, so that it includes only those Rule 12b-1 fees that are used for shareholder servicing, within the scope of “relationship compensation.”

### **1. The Act Limits the Type of Compensation that Banks May Receive**

The Act states that in order to qualify for the trust and fiduciary exception, a bank must be “chiefly compensated for [transactions in a trust or fiduciary capacity] consistent with fiduciary principles and standards” on the basis of certain fees, including a percentage of assets under management.<sup>3</sup> Apparently, because Rule 12b-1 fees are paid according to a percentage of assets under management, the Agencies determined to treat all Rule 12b-1 fees as “relationship compensation.”<sup>4</sup>

However, this interpretation overlooks the limiting language of the Act, that the compensation must be “consistent with fiduciary principles and standards.” Congress expected the Agencies to “interpret this exception, and, in particular, the references to ‘chiefly’ and ‘fiduciary principles and standards’ . . . so as to limit a bank’s ability to receive incentive compensation or similar compensation that could foster a ‘salesman’s stake’ in promoting a securities transaction.”<sup>5</sup>

There are essentially two types of Rule 12b-1 fees, as described in our Rule 2830.<sup>6</sup> The first type consists of “service fees,” or payments by an investment company for personal service or the maintenance of shareholder accounts. This type of Rule 12b-1 fee arguably constitutes a form of “relationship compensation.” We understand that many investment advisers believe that receipt of these service fees is consistent with their fiduciary responsibilities and with their exemption from broker-dealer registration.

The second type of Rule 12b-1 fee consists of “asset-based sales charges,” which are used for distribution. These asset-based sales charges constitute an alternative to front-end loads, which also compensate broker-dealers for distribution. Just as front-end

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<sup>3</sup> Section 3(a)(4)(B)(ii)(1) of the Securities Exchange Act of 1934.

<sup>4</sup> Proposing Release at 32.

<sup>5</sup> H.R. Rep. No. 106-74, Pt. 3 at 164 (1999).

<sup>6</sup> NASD Rule 2830(d) prohibits broker-dealers from offering or selling the shares of any mutual fund and certain closed-end funds and unit investment trusts if the fund’s sales charges are “excessive.” The rule deems sales charges as “excessive” if they exceed certain prescribed limits on front-end, deferred and asset-based sales charges and service fees. Among other things, the rule deems as excessive asset-based sales charges that exceed 0.75% and service fees that exceed 0.25% of average net assets per annum. *See* NASD Rules 2830(d)(2)(E)(i) and 2830(d)(5).

loads provide a “salesman’s stake” in the outcome of the recommended sale, so do these asset-based sales charges.<sup>7</sup>

Proposed Regulation R would treat even asset-based sales charges as “relationship compensation.” This interpretation seems at odds with the language and purpose of the Act, since receipt of asset-based sales charges would provide bank trust departments with a “salesman’s stake” in promoting mutual funds. Accordingly, we respectfully recommend that the Agencies not treat the receipt of asset-based sales charges as relationship compensation.

## **2. Treating All Rule 12b-1 Fees as “Relationship Compensation” Could Have at Least Two Deleterious Consequences**

At least two other unintended consequences would result from treating all Rule 12b-1 fees as “relationship compensation.”

First, the characterization of all distribution-related Rule 12b-1 fees as “relationship compensation” could confuse the treatment of Rule 12b-1 fees under federal investment company regulation. According to a recent study, about 40% of Rule 12b-1 fees are used for the sale of fund shares.<sup>8</sup> This use of mutual fund assets for distribution has always been perceived as a conflict of interest that must be subject to carefully designed regulation.

Accordingly, the SEC adopted Rule 12b-1 only after extensive consideration and in doing so, it imposed a variety of requirements to address these conflicts of interest.<sup>9</sup> For example, in order to rely on Rule 12b-1, a fund must adopt “a written plan describing all material aspects of the proposed financing of the distribution” that is approved by the fund’s board of directors, including the independent directors, and shareholders.<sup>10</sup>

To now treat asset-based sales charges as “relationship compensation” seems inconsistent with this longstanding treatment of Rule 12b-1 fees. We are concerned this

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<sup>7</sup> NASD adopted the limitations on asset-based sales charges largely because we already had capped front-end sales loads, and sought to achieve “approximate economic equivalency” between these alternative distribution fee structures. *See* Order Approving Proposed Rule Change Relating to the Limitation on Asset-based sales charges as Imposed by Investment Companies, SEC Rel. No. 34-30897 (July 13, 1992).

<sup>8</sup> *See* Investment Company Institute, *Fundamentals: Investment Company Institute Research in Brief*, February 2005 at 2. *See also* Investment Company Institute, *Fundamentals: Investment Company Institute Research in Brief*, Aug. 2000 (1999 survey of fund companies found that 63% of the revenue from Rule 12b-1 fees was used to compensate broker-dealers and other sales professionals, while 32% was used for ongoing shareholder administrative services).

<sup>9</sup> *See* SEC Rel. No. IC-11414 (Oct. 28, 1980), 45 Fed. Reg. 73898 (Nov. 7, 1980).

<sup>10</sup> *See* Rule 12b-1(b) under the Investment Company Act of 1940.

approach could cause misunderstandings within the various financial service industries, and could confuse mutual fund boards when they consider whether to approve Rule 12b-1 plans.

Second, the proposed characterization of all Rule 12b-1 fees as “relationship compensation” would provide disparate treatment of investment advisers and bank trust departments. Indeed, as the House Report states, the term “fiduciary capacity” in the Act includes banks that act as investment advisers if the bank receives a fee for its investment advice.<sup>11</sup> Regulation R would create a disparity between banks that act as investment advisers and nonbank investment advisers that are not permitted to receive asset-based sales charges. This result seems to conflict with one purpose of the Act, to create functional regulation and level the playing field among financial service providers.

### **3. NASD Staff Recommends that Only Service Fees be Treated as “Relationship Compensation”**

For these reasons, we respectfully recommend that the Agencies amend proposed Regulation R to treat only Rule 12b-1 service fees – and not asset-based sales charges – as “relationship compensation.” The Act itself calls for such an interpretation and the longstanding history of Rule 12b-1 seems to contemplate it. Moreover, this treatment should not confuse the various financial services industries that produce and distribute mutual fund shares. Some banks who have commented on Regulation B and the Interim Final Rules apparently agree that Rule 12b-1 fees should count as relationship compensation only when they are used for shareholder servicing and not when they are paid for distribution.<sup>12</sup>

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<sup>11</sup> H.R. Rep. No. 106-74, Pt. 3 at 165 (1999).

<sup>12</sup> See, e.g., Letter from Richard H. Walker, General Counsel, Deutsche Bank AG, to Jonathan G. Katz (September 24, 2004) (“Banks generally do not control the basis upon which a fund company chooses to pay fees. It is not uncommon for mutual fund companies to compensate banks for administrative services out of their [Rule] 12b-1 Plans. It should be the purpose of the fees, not their source, that determines whether the fees are sales compensation, and therefore such fees should be excluded from sales compensation *so long as they compensate banks for administrative services*”) (emphasis added); see Letter from James S. Keller, Chief Regulatory Counsel, The PNC Financial Services Group, Inc., to Jonathan G. Katz (July 17, 2001) (“Fees paid pursuant to a Rule 12b-1 plan . . . should . . . be defined as ‘relationship compensation’ *unless [they are] specifically determined to be fees for providing distribution-related shareholder services.*”) (emphasis added).

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Of course, we would be willing to discuss our concerns at any time. Please feel free to contact me if you have any questions concerning this letter at (240) 386-4533.

Sincerely,

A handwritten signature in cursive script, appearing to read "Thomas Selman". The signature is written in black ink and is positioned below the word "Sincerely,".

cc: Catherine McGuire, Chief Counsel  
SEC Division of Market Regulation

Robert Plaze, Associate Director  
SEC Division of Investment Management