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THE CLEARING HOUSE℠
Advancing Payment Solutions Worldwide

January 31, 2005

Catherine McGuire
Associate Director and Chief Counsel
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Regulation B

Dear Caite:

Enclosed please find responses to the questions you and your staff posed regarding proposed Regulation B. The responses were developed in consultation with a group of banks that are members of either or both of the American Bankers Association and The Clearing House.

Although the enclosed document addresses the three questions you raised regarding the trust activities and custody exceptions, we note that many other issues remain with respect to those exceptions, as well as with respect to the treatment of employee benefit accounts under the exemption and the networking and sweep exceptions. In addition, the regulation of bank employees who are also dually employed by registered broker-dealers must be resolved before any implementing regulations become effective. We have attempted to outline the industry's position with respect to all of these issues in our document named *Regulation B Principles*, a copy of which is also enclosed. Collectively, these documents evidence the banking industry's serious and continuing desire to work with the Commission and its staff to develop regulations that are not unduly complex and burdensome.

We also strongly support the views expressed by the federal banking regulators in their letter to the Commission dated October 14, 2004. Given their familiarity with, and substantial role in the regulation of many of the activities at issue in the Commission's proposed Regulation B, we believe their participation and views need to be an integral part of the rulemaking process. As you know, the Chairman, Ranking Member and other key bipartisan members of the House Financial Services Committee have suggested that the Commission enter into joint rulemaking with the bank regulators.

We believe this or some similar process may be the best way of (1) ensuring that the final rule reflects the perspective of all interested regulatory agencies; and (2) avoiding a problematic and controversial outcome. Previous joint efforts between the Commission and these agencies have produced appropriate final rules under such disparate statutes as the Government Securities Act and the privacy provisions of Title V of the Gramm-Leach-Bliley Act. We believe that the same result could and should be achieved here.

Sincerely yours,

Sarah A. Miller, Director
Center for Securities, Trust
and Investment
American Bankers Association
and
General Counsel
ABA Securities Association

Norman R. Nelson, General Counsel
The Clearing House Association L.L.C

cc: Linda Stamp Sundberg

Enclosures

January 21, 2005

Responses to SEC Questions

Q. **Custody exemption**: Would the industry be willing to accept some solicitation limitations in exchange for being able to: (1) accept orders without limit under the custody exception as was permitted under the Interim Final Rules, and (2) assess a securities movement fee as proposed to be permitted under Regulation B?

A. The solicitation limitations contained in the Interim Final Rules[1] and Regulation B[2] are not acceptable. They are overly broad, prohibit activities that do not create investor protection concerns, and impose unreasonable burdens and restrictions on the ability of banks conducting banking activities to compete with one another. For instance, the restriction contained in both the Interim Final Rules and Regulation B pursuant to which sales literature may not be prepared by an

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[1] The bank does not solicit securities transactions except through the following activities:

(A) Delivering advertising and sales literature for the security that is prepared by the registered broker-dealer that is the principal underwriter of an investment or prepared by an investment company that is not an affiliated person, as defined in Section 2(a)(3) of the Investment Company Act of 1940;

(B) Responding to inquiries of a potential purchaser in a communication initiated by the potential purchaser of the security, provided, however, that the content of such responses is limited to information contained in a registration statement for the security filed under the Securities Act of 1933 or sales literature prepared by the principal underwriter that is a registered broker-dealer;

(C) Advertising of trust activities, if any, permitted under Section 3(a)(4)(B)(ii)(II), and

(D) Notifying its existing customers that it accepts orders for securities in conjunction with solicitations related to its other custody activities.

[2] The bank does not directly or indirectly solicit such securities transactions except through responding to inquiries of a potential purchaser in a communication initiated by the potential purchaser of the security; provided, however, that the content of such responses is limited to:

(A) Information contained in a registration statement for the security filed under the Securities Act of 1933, and

(B) Sales literature prepared by the principal underwriter that is a registered broker or dealer or prepared by a registered investment company that is not an affiliated person of the bank.

investment company that is an affiliated person of the bank is problematic. In effect, it prevents a bank custody department from providing customers with the sales literature of an SEC-registered mutual fund that is advised by an SEC-registered investment adviser that is an affiliate of the bank. Another example of the problems raised by these solicitation requirements is the restriction contained in both the Interim Final Rules and in Regulation B whereby the bank may respond to inquiries that are "initiated by the potential purchaser of the security." We believe that this restriction is unduly vague and raises significant interpretive issues. These are merely two examples of the way in which the solicitation limitations contained in the Interim Final Rules and Regulation B would prejudice the ability of banks to conduct their traditional activities, and are not intended to constitute a definitive list of the adverse impacts of these limitations.

As outlined in the industry's document named "Regulation B Principles," a copy of which is attached, the industry would be willing to accept reasonable limits on its ability to solicit custodial order-taking. Specifically, banks do not advertise, sell or market order-taking services on a stand-alone basis and would be willing to accept a restriction that prohibits any such <u>stand-alone</u> solicitations. Solicitations by broker-dealer affiliates, however, cannot and should not be attributed to banks in the context of the safekeeping and custody exception.

Q. **Bank employee compensation limits under the custody exception.** Is the limitation on bank employee compensation proposed in Regulation B problematic? That limitation provides that "[a]ny bank employee effecting such transactions [order taking] does not receive compensation from the bank, the executing broker or dealer, or any other person related to the size, value, or completion of any securities transaction effected pursuant to this exemption."

A. Compensation of account officers is frequently based on the revenues, including securities movement fees, generated by accounts for which they are responsible. Because securities movement fees are only charged when a transaction occurs, they could arguably violate the proposed condition that bank employee compensation not be based on the "completion of any securities transaction effected." To the extent this limitation would restrict the ability of banks to compensate employees based on revenues generated by the account, including securities movement fees, it would be extremely problematic. The compensation of account officers may also be based on the value of assets in custody. Because any orders taken under this exception could lead to additional assets in custody, the restriction on compensation "related to size, value and completion of an order to purchase securities" would call normal bank compensation programs into question. In addition, these fees are paid by the custodial account holder regardless of whether the order was effected through the bank or a broker-dealer. We do not believe that it is appropriate for the SEC to regulate bank employee compensation programs that comply with applicable federal and state banking laws. Finally, the perceived concern that this limitation is intended to address, namely that brokerage business could be conducted in a bank custody department, is simply not warranted, as explained in further detail in our document entitled "Why Banks Don't Conduct Brokerage Business in a Bank," a copy of which is attached.

Q. Trust and Fiduciary exception. Assume that the line of business definition is fixed and that the percentage of sales compensation allowed under the exception is large. Under those circumstances, could the industry live with the requirements to review the compensation in each account when opened[3] and when the trustee bank individually negotiates with the accountholder to increase the proportion of sales to relationship compensation?[4]

A. While we have given this approach careful consideration, we believe that any requirement to review accounts upon opening and when the trustee individually negotiates with the accountholder to increase the proportion of sales to relationship compensation creates additional and unnecessary burdens for banks. Specifically, it requires banks to speculate about the future activity of certain individual accounts on an account-by-account basis and then include these individual accounts in the aggregate calculations to be conducted on a line-of-business basis at the end of the year. This creates the requirement for banks to establish duplicative procedures that are unduly burdensome, that would not ultimately be useful in ensuring compliance and that are neither necessary nor appropriate to ensure investor protection. Consistent with the position taken by the industry in its document named "Regulation B Principles," compliance with the annual chiefly compensated test on a line-of-business or department-wide basis fulfills the statute's chiefly compensated requirements without the need for a duplicative review of individual accounts.

In addition, circumstances arise under which, as a practical matter, banks must waive fees that qualify as relationship compensation. Because such a waiver would trigger the requirement to review the individual account that is affected (or accounts that are affected) we believe that the requirement to review compensation when the trustee individually negotiates with the account holder is unnecessarily burdensome and would inhibit banks from waiving or reducing relationship fees, much to the detriment of the consumer accountholder. There is

[3] Specifically, the bank would be required to "maintain procedures reasonably designed to ensure that, before opening or establishing an account for which it will act in a trustee or fiduciary capacity, the bank reviews the account to ensure that the bank is likely to receive more relationship compensation that sales compensation with respect to that account."

[4] This condition would require the bank to "maintain procedures reasonably designed to ensure that, after opening or establishing an account for which it will act in a trustee or fiduciary capacity, at such time as the bank individually negotiates with the accountholder or beneficiary of that account to increase the proportion of sales compensation as compared to relationship compensation, the bank reviews the account to ensure that the bank is likely to receive more relationship compensation than sales compensation with respect to that account."

no need for, nor should there be, a requirement to review individual accounts because of bona fide waivers of relationship compensation.

Trust and Fiduciary

- "Chiefly compensated" test should be measured on a broadly defined line-of-business or department-wide basis rather than on an account-by-account basis

- Method of calculation must be revised so that banks will not be forced to build expensive new reporting systems. There should be only <u>two</u> categories of fees: Banks should either calculate the ratio of "relationship compensation" to "total compensation," or conversely the ratio of "sales compensation" to "total compensation"

- Ceiling on "sales compensation" must be substantially greater than proposed level of 11%, and even higher to extent that Rule 12b-1 fees are treated -- inappropriately -- as "sales compensation," and broad exemption is not provided for employee benefit plans

Safekeeping and Custody

- As provided under the statute, banks must be permitted to take orders for securities transactions from employee benefit and IRA custodial customers

- In addition, as is customary with current bank custodial activities, banks must be permitted to (a) take orders for securities transactions from <u>all</u> other custodial customers and (b) charge securities movement fees that do not differ based on whether the order was taken by the bank directly from the customer (including through his/her adviser), or from the customer's broker

    - <u>Reasonable</u> limits on ability to <u>solicit</u> custodial order-taking are acceptable

Referral Fees

- Bank bonus plans must not be affected by prohibition on paying referral fees to unregistered bank employees <u>unless</u> bonus is clearly a conduit for paying impermissible referral fees

    - E.g., if bonus is contingent on number of factors, and only one factor relates to securities activities, bonus plan should <u>not</u> be deemed an impermissible conduit

- Rule must not affect payments made by broker-dealers to banks (as opposed to payments made to individual bank employees)

- "Nominal referral fees," which are permissible, should not be further defined by regulation, given standards used by bank examiners and given that circumstances change over time

    - Banks should be allowed to pay higher referral fees to unregistered bank employees for the referral of certain corporate, institutional, governmental and not-for-profit customers

Sweep Accounts

- Definition of "no load" must not be so restrictive as to interfere with banks' long-standing practices for sweeping deposits into money market funds

Dual Employees

- The problems with dual employee relationships (between banks and broker-dealers) caused by NASD Rule 3040 need to be resolved through coordination with the bank regulators

Why Conducting a Brokerage Business Inside the Bank Is Not Feasible

The concern has been expressed that a business that should legitimately be subjected to SEC regulation as a broker (a "Brokerage Business") under the Securities Exchange Act of 1934 (the "Exchange Act") could be conducted under a bank charter and thus escape SEC oversight. We believe that this concern is misplaced.

I. Background

A. Prior to enactment of the Gramm-Leach-Bliley Act (the "GLB Act"), banks were completely excluded from the definition of "broker" under a statutory exception in the Exchange Act.

1. Thus, nothing under the Exchange Act stood in the way of a bank operating a Brokerage Business.
2. Nevertheless, banking organizations that wanted to enter the Brokerage Business established SEC-registered affiliates.
3. Moreover, brokers did not attempt to use bank charters to conduct a Brokerage Business.

B. Title II of the GLB Act ("Title II") eliminated this complete exception for banks.

1. It prohibited banks from acting as a broker except pursuant to certain exceptions designed to allow banks to continue providing traditional banking services.
2. The statutory conditions to these exceptions prevent banks from being able to conduct a Brokerage Business in a bank.

C. The SEC's proposed Regulation B goes beyond the language of Title II by imposing a number of additional strict restrictions on a bank's ability to continue conducting these statutorily-protected activities.[1]

1. These burdensome restrictions are not needed to prevent a bank from conducting a Brokerage Business.

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[1] We believe that these restrictions are not supported by either the language or the legislative history of Title II. See e.g. the letters commenting on Regulation B and submitted by Jeffrey P. Neubert, President and CEO, The Clearing House Association L.L.C., on September 1, 2004; by Sarah A. Miller, Director, Center for Securities, Trust and Investment, American Bankers Association and General Counsel, ABA Securities Association, on September 1, 20004; and by Richard M. Whiting, Executive Director and General Counsel, The Financial Services Roundtable, on September 1, 2004.

II. Banks used SEC-registered vehicles to conduct Brokerage Businesses even before Title II was enacted

A. Historical Business Considerations

1. Banks and broker-dealers have historically operated under very different business models. This is particularly true with respect to banks' fiduciary and custody businesses, on the one hand, and the business of broker-dealers, on the other.

    a. Notable differences include that customers of these businesses are looking for specialized services different from the services provided by a broker; that the methods of supervising employees have tended to be different; and that the contractual arrangements, including methods of charging for services, have been different.

2. Attempting to conduct a Brokerage Business within a bank's fiduciary department would expose that business to the heightened duties owed by a fiduciary to its client.

    a. These heightened duties, although providing protection to the customer, create risks for those departments. Establishing processes and procedures for controlling these risks results in a higher overall cost structure than in the broker-dealer industry and therefore in a need to charge higher fees than are customary in the broker-dealer industry.

    b. An entity attempting to run a Brokerage Business in a bank trust department would have either to price its services lower than would be necessary given the risks it assumes or to price itself out of the market.

3. Similarly, it would not be feasible to conduct a Brokerage Business from a bank custody department.

    a. Historically, banks' custody business arose from their providing safekeeping services (e.g., safe deposit boxes). Banks' custodial functions also include providing recordkeeping services and, for larger clients, settling trades and holding securities in a centralized location (regardless of which broker-dealer executed the trade).

        i. As a result, custodial functions today include holding securities for small investors who do not engage in a high volume of trades and providing safekeeping and settlement services for large investors who effect trades through a variety of brokers but wish that a bank provide safekeeping and settlement services related to all of their trading activity.

ii. The legal relationship between a bank custodian and its customer is that of a bailor and a bailee.

- By contrast, broker-dealers are not bailees with respect to the securities they hold on behalf of clients, enabling them, in certain contexts, to use those securities in the broker-dealer's business.

- The ability to use certain customer securities is a key aspect of conducting the Brokerage Business of many broker-dealers, because it is a critical funding method and securities can be used for securities-lending or other purposes.

- It is integral to banks' custody business that clients' securities are not available to be used in the bank's business, except with the consent of, and pursuant to conditions established by, the customer.

b. In addition, the personnel, systems and fee structures of bank custody departments are simply not suited to sourcing or serving customers who are primarily looking for order execution services.

4. Moreover, customers view banks and brokers as different kinds of entities providing different types of services. To attract brokerage customers a company would need to hold itself out as being a broker – rather than a bank – and to advertise its membership in entities like the NYSE, the NASD and the SIPC.

a. But a bank cannot hold itself out as being a broker nor can it be a member of entities like the NYSE or the NASD.
b. Thus, a company attempting to conduct a Brokerage Business in a bank would have to overcome the obstacle of customers having the expectation that it could not provide the necessary services.

B. Historical Statutory and Regulatory Considerations

1. Bank employees may not be licensed by the NASD unless they are also employed by a registered broker-dealer.

a. This would be a major impediment to recruiting (and retaining) employees to work in a Brokerage Business that is to be run inside a bank.

b. The NASD's rules have required someone to retake all of the tests for his or her license if the person has been away from a registered broker-dealer for more than two years, and employees are very reluctant to move to an employer who cannot carry their license.

2. A bank's ability to conduct secondary market transactions for customers is hindered by the fact that a bank can not become a member of a stock exchange or of the NASD, because those SROs require their members to comply with net capital requirements consistent with Rule 15c3-1 under the Exchange Act.

    a. Banks' lending activities make it economically impossible for them to comply with the net capital requirements of Rule 15c3-1.

3. A bank's ability to conduct primary market transactions is hindered by the facts that:
    a. Under Section 21 of the Glass-Steagall Act, a bank may not underwrite or deal in most types of securities and it may effect transactions in corporate debt and equity securities only as agent.
    b. NASD Rule 2740 prohibits an NASD member firm from granting selling concessions, discounts or other allowances to a non-member in connection with the sale of securities that are part of a fixed price offering (generally, any securities sold at a stated price in a public offering in the U.S.).

III. Title II further restricts a bank's ability to conduct a brokerage business

A. As noted above, the GLB Act eliminated banks' total exception from the definition of "broker", creating new exceptions. The only statutory exceptions that we understand have been pointed to as possibly being used to run a Brokerage Business inside a bank are the trust and fiduciary exception and the custody exception. For the reasons discussed above, neither would be practical.

B. A bank could not successfully operate a Brokerage Business without advertising the general availability of brokerage services.

    1. Because Title II prohibits a bank acting in a trustee or fiduciary capacity from publicly soliciting brokerage business, other than advertising that it effects transactions in securities in conjunction with advertising its other trust activities, a bank's ability to operate a Brokerage Business will be further restricted under Title II.

    2. Banks would be prepared to accept parallel conditions, in the appropriate context, on advertising and soliciting custodial order-taking.

C. Reliance on the custody exception to operate a Brokerage Business would require the bank to be acting in a custodial capacity for all Brokerage Business customers.

1. Banks would be prepared to accept that custodial order-taking be conditioned on the bank not charging a different fee when it takes and forwards orders for execution of transactions as compared to when it merely settles the transaction.

D. Both the trust and fiduciary and the custody statutory exceptions require that a bank relying on either exception must direct any orders for publicly-traded securities to a registered broker-dealer for execution.

1. Thus, a bank that is trying to conduct a Brokerage Business inside a bank would have to execute all of these trades by using a registered broker-dealer to complete the execution of all of these trades.

2. This would be an inefficient approach for banks seeking to compete with registered broker-dealers.

E. Moreover, as a result of the dealer push out provisions of Title II, the Exchange Act itself stands in the way of a bank acting as an underwriter or dealer in most securities, creating another barrier to using a bank as a vehicle to conduct a Brokerage Business.

F. The federal banking agencies will be adopting record-keeping rules under Title II with which banks will have to comply.

G. The federal banking agencies regularly examine banks and would be able to detect the attempt to operate a Brokerage Business inside a bank. In appropriate cases, they would be able to take enforcement action (or refer the matter to the SEC for enforcement action).