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January 18, 2005

Ms. Catherine McGuire,
Chief Counsel, Division of Market Regulation,
Securities and Exchange Commission,
450 5th Street, N.W.,
Washington, D.C. 20549-1001.

Re: Release No. 34-49879 (File No. S7-26-04): Regulation B

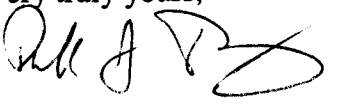
Dear Caite:

Enclosed please find a paper outlining the reasons why banks do not conduct a brokerage business inside the bank and why they will not do so in the future under the statutory exceptions provided in the GLB Act. This paper was drafted in response to a question from Commissioner Glassman by The Clearing House in collaboration with the ABA Securities Association and the Financial Services Roundtable.

If you have any questions or comments regarding this paper, please do not hesitate to contact either Norman Nelson at The Clearing House (212-612-9205) or me (212-558-4077).

Thank you for your consideration.

Very truly yours,



Donald J. Toumey

(Enclosure)

cc: Lourdes Gonzalez
(Securities and Exchange Commission)

Norman R. Nelson
(The Clearing House)

Sarah A. Miller
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John A. Beccia III
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Jonathan Lehmann
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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.

[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 <u>not</u> 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).