Testimony of

Edward D. Higgins

On Behalf of

The American Bankers Association

and

The ABA Securities Association

Before a joint hearing of

The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

and

The Subcommittee on Financial Institutions and Consumer Credit

Committee on Financial Services

United States House of Representatives

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Chairmen Baker and Bachus, Representatives Kanjorski and Waters, distinguished members of the subcommittees, my name is Edward D. Higgins. I am Managing Director of the Private Client Group at Firstar Bank-US Bank. US Bancorp, the parent company of Firstar Bank and US Bank, is the eighth largest domestic financial services holding company with $160 billion in assets and $116 billion in assets under management. We have over 10 million customers and operate through more than 2,200 branches and 5,200 ATMs located in 25 states, primarily in the West, Midwest and Florida.

I appear here today on behalf of the American Bankers Association and the ABA Securities Association. The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks—makes ABA the largest

banking trade association in the country. ABASA is a separately chartered trade association subsidiary of the ABA, formed in 1995 to develop policy and provide representation for those bank and financial holding companies involved in investment banking and other similar capital markets activities.

I commend you, Messrs. Chairmen, for holding this hearing to focus on the interim final rules recently issued by the Securities and Exchange Commission ("SEC"). The issues raised by the SEC's interim final rules are of very great concern to members, both large and small. Like my bank, many of our members offer trust and asset management services to individuals, pension plans, and charitable foundations and endowments. Many services offered to these clients, including our self-directed IRA accountholders and 401(k) plan participants, will be significantly and negatively impacted if the SEC's interim final rules are not amended. Brokerage services offered to retail customers from the bank lobby though registered broker-dealers and sweep services offered to deposit account holders are two other services that will suffer tremendously under the SEC's rules. Many of these and other issues raised by the interim final rules are discussed in detail in the ABA and ABASA comment letter filed with the SEC on July 17, 2001.

Today, I wish to highlight in my testimony the following four issues:

- The hugely burdensome and expensive "chiefly compensated" standard imposed by the SEC's rules under the trust and fiduciary exception;
- The inability to perform in the bank customary order taking activities on behalf of our custodial clients, including self-directed IRA customers and 401(k) plan participants;

- The requirement to completely restructure our employee referral programs, despite the fact that these programs comply with all existing guidance issued to date by the SEC, the bank regulators and the Congress; and
- The inability to continue sweeping bank deposit balances into money market mutual funds.

Before I discuss these issues in greater detail, however, I wish to go on record regarding recent initiatives undertaken by the SEC. Specifically, the ABA and ABASA are extremely grateful that the SEC has moved the compliance date from October 1, 2001 to May 12, 2002 and has indicated further that additional time to comply will be given once the SEC issues amended final rules. We were especially heartened by the SEC's announcement that it did not expect banks to develop compliance systems until it amended its rules. Before the SEC made this announcement, my bank was just one of the many banks confronting the prospect of spending many millions of dollars and countless employee hours to comply with some of the more onerous provisions of the interim final rules. I can assure you that the industry breathed a collective sigh of relief upon hearing this most welcome announcement.

The announcement demonstrates that the SEC has heard the banking industry loud and clear on the need for more time for banks to get into compliance. Since the SEC first issued the interim final rules in mid-May, members of the SEC's senior staff have conducted a series of meetings with various industry groups in order to get a clearer understanding of the difficulties that the industry would experience when the interim final rules when into effect. We believe these discussions have been very helpful and hope that they will continue as the SEC continues to learn more about our industry.

The "Chiefly Compensated" Test under the Trust and Fiduciary Exception

The Gramm-Leach-Bliley Act recognized that traditional banking activities involving securities transactions should not trigger broker-dealer registrations requirements. Accordingly, Title II lists several exceptions under which banks would not be required to push certain securities activities out of the bank and into a broker-dealer affiliate (the so-called "push-out" exceptions). One such exception is the trust and fiduciary exception.

That exception requires that the bank: (1) not publicly solicit brokerage business, other than by advertising that it effects transactions in securities as part of its overall advertising of its general trust business; (2) be chiefly compensated by way of an administration or annual fee, a percentage of assets under management, a flat or capped per order processing fee that does not exceed the cost of executing the securities transactions, or any combination of such fees; and (3) generally direct all trades of publicly traded domestic securities to a registered broker-dealer for execution.

In providing this exception, the Congress recognized that "[b]anks are uniquely qualified to provide [trust] services and have done so without any problems for years. Banks provided trust services under the strict mandates of State trust and fiduciary law without problems long before Glass-Steagall was enacted; there is no compelling policy reason for changing Federal regulation of bank trust departments, solely because Glass-Steagall is being modified." S. Rep. No. 106-44, 106th Cong. 1st Sess. at 10 (1999). The House and Senate Conferees ratified this view when stating their expectation that "the

SEC…not disturb traditional bank trust activities under this [the trust and fiduciary] provision." Conf. Rep. 106-434, 106th Cong. 1st Sess. at 164 (1999).

The ABA and ABASA would submit that the SEC has interpreted the "chiefly compensated" requirement imposed by the statute in such a manner that, as a practical matter, banks will, in fact, be forced to "push-out" many traditional trust and fiduciary activities in direct contravention of Congressional intent. We also strongly oppose the SEC's interpretation, as it will create huge compliance burdens for the industry and, most importantly, harms consumers.

Several of our members have indicated that if the SEC continues to adhere to its position that each individual trust and fiduciary account must be individually analyzed according to the SEC's overly complex formulation of the "chiefly compensated" test, banks will be forced to expend millions of dollars to develop the requisite technology required to comply. One very large bank estimated a total technology cost to comply with the interim final rules of $15 million. In addition, many regional and smaller trust institutions outsource much of their system needs. System providers estimate that the costs to develop software required by the SEC's rules would be significantly higher than $15 million. These same providers have expressed doubt as to whether half or more of their client base could even afford the developed system.

We believe the SEC has taken what should be a fairly simple test requiring compensation permissible under the statute to outweigh or exceed brokerage or sales compensation and, instead, made the test one that is overly complex and burdensome. What should take a paragraph to explain has taken 11 pages of narrative text. The regulatory burdens associated with this test are enormous.

For example, bank trust and fiduciary departments often receive compensation for fiduciary services provided to one account from sources other than the account beneficiary. Employer/plan sponsors will often negotiate for bank trustees of company 401(k) plans to be compensated through the use of 12b-1, shareholder servicing fees, and other fees paid by mutual funds in which plan assets are invested.

This practice is allowed by the Department of Labor, the agency charged under the Employee Retirement Security and Income Act ("ERISA") with regulating 401(k) and other employee benefit plans. Extensive disclosure concerning these fee arrangements is given to bank fiduciary customers. Nevertheless, accounts earning these fees will not pass "the chiefly compensated" test as adopted by the SEC.

Trustee compensation paid by way of 12b-1 fees or shareholder servicing fees is not compensation permitted under the statute, the SEC tells us, because it is not paid out of fiduciary assets nor is it paid directly by the customer or beneficiary. Nowhere in Title II is there a suggestion that compensation under the trust and fiduciary exception must be paid from a particular source in order for it to be permissible under the "chiefly compensated" standard.

In addition, the SEC's position is not good for consumers. Companies that sponsor employee benefit plans for their employees like these fee arrangements. Moreover, for many small employers, it is the only way they can afford to offer their employees access to 401(k) plans. Plan sponsors understand prices quoted in an all-in or on a net asset value ("NAV") basis rather than a separate line disclosure for trustee services provided. If trustee expenses were not paid through 12b-1 or shareholder servicing fees, the plan's trustee or recordkeeper would, on a daily basis, have to

calculate a unit value for each investment option under the plan, deducting from the NAV of each mutual fund option the proportionate trustee and recordkeeping charges for the day. This would be incredibly expensive and time-consuming and would discourage employers from offering employees the ability to save for their retirement though 401(k) plans.

A similar result occurs under the SEC's interpretation of "chiefly compensated" where families have several trusts with different family members as beneficiaries. All fees charged for services provided to all the trusts are charged to the founding grantor's trust.

Even if the SEC were to eliminate the "source" requirement, accounts earning these fees would still fail the "chiefly compensated" test. This is because the SEC maintains that these fees are sales compensation and that each account must pass the "chiefly compensated" test. Nothing in the statutory language creating the trust and fiduciary exception requires these calculations to be made on an account-by-account basis.

The purpose of the exception is to allow banks to keep in the bank the types of trust and fiduciary activities that banks have engaged in for many, many years, even where a substantial portion of those activities could involve fees that would otherwise trigger broker registration requirements. The Congress recognized that, unlike several other push-out exceptions, where banks conduct securities transactions in their fiduciary capacity they are subject to an entirely separate scheme of bank fiduciary regulation. In that context, where customers have alternative regulatory protections, the statute

expressly recognizes that securities activities ought to be permissible in the bank even where there are significant amounts of transaction-based compensation.

The ABA and ABASA have repeatedly urged the SEC to require the "chiefly compensated" test to be performed on a line-of-business basis rather than on an account-by-account basis. A line-of-business calculation would comport with current bank practices, systems capabilities, and regulatory reporting requirements; would not result in increased regulatory burden for bank trust and fiduciary departments; and would be consistent with the statute and Congressional purposes in enacting the exemption.

Banks and regulators use line-of-business in order to track fiduciary fees, manage fiduciary business lines, and report fiduciary business to bank regulators. Specifically, banks and trust companies generally charge fees for fiduciary services according to fee schedules that vary from business line to business line.

In addition, many bank trust departments and trust companies currently generate internal tracking reports along lines of business. For example, bank trust departments generate monthly management reports that track, on a business-line basis, revenues earned and expenses incurred. Finally, bank regulatory reports also require income earned by bank trust departments to be reported on a line-of-business basis. In short, fees are generally tracked and aggregated on a line-of-business basis, and not on the more "granular" basis of types of fees charged to individual accounts.

Making the "chiefly" calculation on a more detailed or "granular" basis, would, in many cases, be extremely burdensome and practically unworkable. Banks would be required to perform yearly analyses of fees charged to over 19 million accounts valued at over $22 trillion. Expensive new software would have to be developed and installed;

systems would have to be substantially reconfigured; and such fine-tuned reporting would become more complex and burdensome.

The SEC maintains that a complex and burdensome "chiefly compensated" test is necessary to ensure that banking organizations do not in the future move their retail brokerage operations out of their broker-dealer affiliates, away from SEC supervision, and into the bank's trust and fiduciary departments.

I have over thirty years experience in the trust and asset management business. During those thirty years, I have worked in four major bank trust departments and managed three of them. I can tell you that, without a doubt, this will not happen. The market will not allow it.

Retail brokerage customers will not pay for trust services they neither need nor want. And bank trust departments will not assume fiduciary responsibilities and potential liability for accounts that are not priced to assume those risks and responsibilities. Let me explain.

Trust and fiduciary customers generally pay an annual fee, charged monthly, based upon the fair market value of the total assets held in their account. The fee is generally a percentage that declines as the size of the account increases, so for example, the fee may be 1.10% on the first $1 million, 1.00% on the next $2 million, 0.60% on the next $2 million and so on. In addition, most banks have a minimum annual fee, which varies depending on the size of the bank. Fees will also be assessed for other services including tax and accounting, distribution, certain transactions and specialized investments made, and certain extraordinary services. In addition, banks will also be

compensated through 12b-1 fees, shareholder servicing and other fees paid by third parties.

Retail brokerage customers, on the other hand, pay a fee based on the dollar value of the transaction. Generally there is a minimum fee and then a commission rate multiplied by the dollar value of the transaction. For example, a full service brokerage firm might charge a minimum fee of $42 per trade plus 6 cents times the dollar value of the transaction. Discount brokerage operations charge much less.

Brokerage and trust services are priced according to the level of service demanded by the client—the more involved the service and the more complicated the system required to provide that service, the higher the cost of the service. Trust accounting systems, for example, are much more complicated than those used by brokerage firms. Trust systems must be able to separate principal and income on cash and investments whenever an account has primary income beneficiaries, as well as remainder or contingent beneficiaries. Brokerage accounting systems generally are not so complex.

Management of these trust and brokerage accounts differs significantly, as well, justifying the different pricing structures. Strict fiduciary duties require bank trust departments to perform frequent reviews of account holdings to determine, among other things, whether changing beneficiary needs require a modification in investment objectives; whether there are any inappropriate concentrations of investments; and whether the use of any affiliated brokers, mutual funds or bank deposits is appropriate. Serving as trustee may also involve arranging for home health care, paying all the client's bills, preparing tax returns, and maintaining various properties.

Regulatory oversight differs significantly, again justifying the pricing differential. As a general matter, bank trust departments are physically examined every 12 to 18 months depending on the size of the institution. Some larger institutions, like mine, even have examiners on-site at the bank. All bank examiners interface frequently with the institutions they examine as quarterly updates of the institution's risk ratings are required.

Bank trust department fees reflect the increased liabilities associated with assuming strict fiduciary responsibilities and the "high touch" service requirements of those accounts. Retail brokerage customers neither need nor want the services offered by bank fiduciaries and would not tolerate the fees that must be charged trust customers by banks. As a result, the market will not permit banks to move retail brokerage into bank trust departments and away from the SEC's oversight.

Of course, the "chiefly" language, interpreted reasonably on a line-of-business basis, along with the requirements of separate broker-dealer execution of securities trades resulting from fiduciary activities and the prohibition on brokerage advertising, further ensures that the trust exception may not be used simply to transfer a full-scale securities brokerage operation into a trust department to evade Commission regulation.

Order-taking under the safekeeping and custody exception

The Congress determined in the Gramm-Leach-Bliley Act that a bank that engages in safekeeping and custody activities, in accordance with the conditions outlined in the exception, would not be considered a broker under the Securities Exchange Act of 1934. Order taking clearly comes within the ambit of "custody services" and, contrary to the SEC's position, should not be "pushed out" of the bank.

Order taking is most easily understood in the context of self-directed individual retirement accounts ("IRAs") and 401(k) and other defined contribution plans. Generally speaking, employees who have contributed over the years to their company-sponsored 401(k) plans or participated in their employer-funded defined contribution plans will, upon leaving their jobs, opt to roll-over assets from their plans into IRA accounts. If employees have the time and the inclination to direct their own investments, they will frequently choose to open self-directed IRA custodial accounts. In this way, they can direct the custodian institution regarding the investment of their retirement assets.

Both banks and broker-dealers serve as custodians to self-directed IRA accounts. Individuals frequently choose banks to serve as custodians to their IRA accounts on the basis of the strong capital supporting that institution, the regulatory oversight provided by bank examiners, and the convenience and comfort of dealing with a local institution.

Other times, an employer/plan sponsor will hire a bank as a custodian to service the company's 401(k) or other defined contribution plan. Most often, those plans permit employee/plan participants to select investments from a range of options offered by the plan. Custodian banks effectuate securities trades only after taking employee/plan participants' investment orders.

The Gramm-Leach-Bliley Act provides, without limitation, that banks, "as part of customary banking activities," that offer "safekeeping and custody services with respect to securities" will be excepted from brokerage registration. Order taking or buying or selling securities at customer direction and as an adjunct to custody relationships has long been a customary custody service provided by banks. The Department of the Treasury,

bank regulators and well-known trust authorities all have recognized order taking as a customary custody service.

In addition, the specific language of the exception recognizes that bank custodians take direction regarding the purchase and sale of securities from individual clients. One of the conditions to the exception requires that banks transmit publicly traded security buy or sell orders to a registered broker-dealer for execution. Clearly, if banks were not taking orders from consumers, there would be no need for any legislative requirement to direct the transaction to a registered broker-dealer.

Another provision of the statute makes clear that self-directed IRA custodial accounts are to remain in the bank. This provision was specifically added during the House and Senate Conference because questions had been raised as to whether self-directed IRA accounts were adequately protected under the legislation. By definition, banks take direction from the IRA customer when servicing these accounts.

Despite such clear evidence to the contrary, the SEC nevertheless claims that "…the exception does not allow banks,….to accept orders to purchase and sell securities." Under the SEC's narrow interpretation of the custody exception, banks would be **prohibited** from taking orders from 401(k) plan participants, self-directed IRA customers, and many other consumers. We do not believe that the Congress intended such a disruption to traditional bank custodial activities.

While the SEC maintains that the Gramm-Leach-Bliley Act does not protect bank order-taking activities, the SEC has nevertheless chosen to provide two regulatory exemptions that would allow banks, in certain limited circumstances, to engage in order-taking activities. While we appreciate the need for these regulatory exemptions given the

SEC's narrow reading of Title II, the issue remains that if the SEC had embraced the clear Congressional intent behind the custody exception, no need for these regulatory exemptions would exist.

Moreover, the exemptions adopted by the SEC do not provide any degree of meaningful relief for banks, both large and small, engaged in order-taking activities. The exemptions are conditioned on so many restrictions—restrictions that do not reflect current realities of the custody business—as to render them unworkable.

For example, one of the most troublesome exemptive conditions placed on banks providing order-taking services is the inability to charge customers for services provided. We are unalterably opposed to the notion that in order to keep a legitimate customary banking activity in the bank, a bank must forego compensation. Nothing in the Gramm-Leach-Bliley Act suggests that restricting compensation received by banks for providing safekeeping and custody services is warranted.

The fact is that banks do charge customers for providing order-taking services. Unlike brokerage firms, however, banks generally charge a flat fee to effectuate the transaction, i.e., the fee is not dependent on the number of securities involved in the transaction. The order-taking exemption provided by the SEC would force banks to provide these services to many customers at a significant loss, raising serious safety and soundness concerns. Moreover, the exemption prevents banks from establishing pricing structures that charge clients for the bank services they use.

We are equally concerned about several other conditions incorporated into the exemptions. These include the inability to have in the custody department dual employees—employees who are employed by both the bank and an affiliated brokerage

firm; the inability to compensate employees for securing new custodial business; and the requirement to make only certain investment products available to custodial customers.

Banks unable or unwilling to meet the conditions of the exemptions would have to move their order-taking activities to broker-dealer affiliates unrestricted by similar SEC rules. This, of course, assumes that the banking organization has an affiliated broker-dealer firm. For many of our smaller bank members engaged in order-taking activities, this would not be true.

In any event, many broker-dealer firms affiliated with banks have expressed concern about assuming order execution responsibilities for bank custodial accounts. Thousands of accounts would have to be opened under individual customer account names. Records for these accounts would have to be established and maintained. Compliance responsibilities would be expanded by adding these accounts to the broker's book. Yet no assets would be held in the account as the actual custodial account and assets would remain in the bank. Consequently, not even our members' broker-dealer affiliates wish to assume a business that significantly increases compliance costs and regulatory burdens for very little compensation.

Bank referral fee programs under the networking exception.

The networking exception is the only push-out provision in which the Congress chose to address employee compensation, as opposed to bank or department compensation. Specifically, the exception provides that bank employees may not receive incentive compensation for any brokerage transaction but "may receive compensation for the referral of any customer if the compensation is a nominal one-time cash fee of a fixed

dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction."

The SEC has defined the term "nominal one-time cash fee of a fixed dollar amount" to mean a payment that does not exceed one hour of the gross cash wages of the unregistered bank employee making the referral. The definition also provides that a nominal one-time cash fee of a fixed dollar amount may be a payment in the form of points in a system or program that covers a range of bank products and non-securities related services, where the points count toward a bonus that is cash or non-cash, if the points awarded for referrals involving securities are not greater than the points awarded for products or services not involving securities.

Our members, banks and broker-dealers alike, have long operated their referral fee programs in compliance with all applicable regulatory guidance including guidance issued by the SEC applicable to broker-dealers operating on financial institution premises. That guidance generally has permitted referral fee programs where:

- The fee is a nominal, fixed-dollar amount;
- The amount of the referral fee is unrelated to the execution of securities transactions or the volume of securities traded by the customer;
- The referral fee is determined and paid by the financial institution and not the broker-dealer;
- No more than one fee per customer may be paid; and
- Non-cash referral programs are structured similarly to cash referral programs.

These requirements have formed the framework for the development of many

bank referral fee programs involving products and services ***other than securities***. For example, the federal banking regulators, as directed by the Gramm-Leach-Bliley Act, recently adopted rules that required banks to adopt referral fee programs for insurance products that closely follow guidance given in the Interagency Statement on Retail Sales of Nondeposit Investment Products and SEC no-action letters. Currently, bank compliance staffs are reviewing and modifying, as necessary, their referral fee programs to reflect this recently issued regulatory guidance. It is patently unfair and extremely burdensome for the SEC now to rewrite the very rules that have serve as the framework for ***all*** bank referral programs, especially as the Congress never prescribed these revisions.

We list below many of the significant requirements the SEC has added by way of the interim final rules to bank referral fee programs that will take considerable time and money to implement, including:

- Calculating a flat dollar amount for each employee based on their gross hourly wages;
- For salaried employees, calculating their hourly wage and setting an appropriate referral fee based on that wage;
- Tracking of salaries and gross hourly wages of all employees eligible for referral fee programs;
- Revising point programs to ensure that points paid for brokerage referrals received the lowest point referrals for all products included in the point program, including points awarded for safety deposit boxes, savings accounts, checking accounts, etc., and

- Reviewing all referral fee programs to ensure that the value of the securities account, the value of the customer's bank account, or the customer's financial status are not included in any established referral fee programs.

Banks ability to continue sweeping deposits into money market mutual funds under the sweep exception.

Title II provides an exception from push-out for those banks that sweep on a nightly basis demand deposit balances out of the bank and into no-load money market mutual funds; the next day, the balances are swept back into the customer's deposit account to meet daily transactional requirements. These sweep accounts offer both commercial and retail customers the ability to make cash deposits productive and allow banks offering these services to compete against other financial services providers offering corporate cash management accounts that look and feel like checking accounts, but pay market rates of interest. Of course, banks are legally prohibited from paying interest on corporate demand deposit accounts, although H.R. 974 recently approved by the House would eliminate this prohibition.

The SEC has taken the position that a "no-load" money market mutual fund is a fund that is not subject to either a front-end or back-end load and the fund's total charges against net assets to provide for sales related expenses and/or service fees do *not* exceed 25 basis points. We agree that no-load is generally understood to mean no front-end or back-end sales charges. We do not agree with the SEC's determination that no-load also means that sales related expenses and/or service fees cannot exceed 25 basis points.

Nothing in the legislative history supports the SEC's conclusion. Indeed, former-Chairmen Leach and Gramm have recently indicated to the SEC that, in approving the sweep exception, the Congress did not intend to disturb existing bank sweep activities.

Moreover, the SEC's interpretation ignores the reality of the situation. These accounts are marketed and sold as deposit accounts with sweep services being merely incidental to the account itself. Interest earned on the sweep is posted to the deposit account and disclosed to the customer on the monthly account statement. To the consumer, the account looks and feels like a deposit account and should be treated as such under the push-out provisions.

Finally, ABA and ABASA would suggest that before any action is taken by the SEC that might encourage consumers to move their sweep accounts to broker-dealer firms, consideration should be given as to what impact, if any, such a movement would have on the availability of deposits to fund loans in local communities. Many banks offers sweep services that only sweep amounts in excess of a target amount, for example, $50,000. Amounts below that target amount are then made available with other deposit account balances to fund loans. It would be prudent for the SEC and the bank regulators to consider this issue jointly before any regulatory action is taken that could cause significant disintermediation of bank deposits.

Conclusion

In conclusion, the ABA and ABASA appreciate the opportunity to share with you our views regarding the SEC's interim final rules and their impact on the banking industry. While we continue to oppose the rules on the grounds that they do not comport

with Congressional intent and impose huge and unnecessary regulatory burdens on our members, we pledge to work with the SEC and the banking regulators to develop final rules that are workable and, most importantly, reflect Congressional intent.