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Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises

and the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services
U.S. House of Representatives

Hearing on the
Securities and Exchange Commission's Interim Final Rules Relating to Provisions of
Title II of the Gramm-Leach-Bliley Act

August 2, 2001

My name is Michael Patterson. I am a Vice Chairman of J.P. Morgan Chase & Co., working primarily in the area of Investment Management and Private Banking

I very much appreciate the opportunity you have given JPMorgan Chase to comment on the implementation of Title II of the Gramm-Leach-Bliley Act ("G-L-B Act"). My remarks will focus on certain practical issues raised by the Securities and Exchange Commission's interim final rules (the "Interim Rules"), and they cover matters that have been part of a constructive, ongoing dialogue between banking organizations and the Commission and its staff. I hope that my remarks will be helpful to the Committee in its efforts to understand our concerns.

As many members of this Committee will recall, the so-called "push-out" provisions in Title II of the G-L-B Act were extensively debated prior to passage of the legislation. The provisions that were enacted reflect numerous compromises that were reached in an effort to reconcile two somewhat inconsistent goals: one, that the Commission should regulate broker-dealer activities; and two, that traditional banking activities should remain in banks. We think that the provisions of the Act struck the right balance, but that the Interim Rules reflect a strong—and we believe an inappropriate—bias in favor of imposing securities regulation on bank activities.

The Commission suggests in the introduction to the Interim Rules that part of the motivation behind the passage of G-L-B Act was to protect previously unprotected investors from banks that engaged in securities activities without being subject to the provisions of the federal securities laws. We strongly disagree with this interpretation. No problem of investor protection that needed to be addressed existed. The banking

agencies had been diligent in protecting investors. Rather, the G-L-B Act sought to apply broker-dealer regulation to banks when banks' activities did not qualify for certain newly established exceptions from the definitions of broker and dealer.

I will give you several examples of where we believe the Interim Rules did not appropriately implement Congressional intent and would unduly disrupt the way banks have traditionally conducted their business.

Certain provisions in the Interim Rules implementing the trust and fiduciary exception present banks with serious compliance problems and are not mandated by law. The G-L-B Act provides that a bank will not be regulated as a "broker" solely because it engages in transactions as a trustee or as a fiduciary in its trust department, so long as, among other things, it is "chiefly compensated" on the basis of administrative or certain other fees. A key difficulty is the fact that the "chiefly compensated" test as contemplated by the Commission requires an account-by-account analysis to determine whether "relationship compensation" exceeds "sales compensation." Even the so-called safe harbor alternative test would in fact require this account-by-account analysis. For J.P. Morgan, this would require a review of in excess of 50,000 trust and fiduciary accounts periodically to determine and document their compliance with the proposed test. At J.P. Morgan, and we suspect most other firms, existing management information systems do not collect data using the categories required by this test. Although it would be possible to create a new data collection system given enough time and money, we do not believe Congress could possibly have intended banks to assume a burden of this magnitude in order to demonstrate that a traditional banking business should not be pushed out.

The account-by-account analysis would create other problems as well. Many of these trust accounts have fee arrangements that were individually negotiated years ago, obviously without regard to the detailed definitions of relationship and sales compensation contained in the Interim Rules. If it is determined that particular accounts have too high a level of sales compensation, we could be required to push these relationships out. That might involve amending existing documentation, which is a difficult if not an impossible task, particularly if all of the trust beneficiaries could not be contacted and/or did not have the legal competence to execute agreements. It also might require that one account in an overall relationship composed of many accounts be pushed out to a broker-dealer, while other related accounts remain in the bank. We do not believe Congress intended such a disruption of traditional bank trust and fiduciary relationships.

Instead of the account-by account approach proposed by the Commission, we suggest that the banks and the Commission's staff continue their efforts to establish a suitable test that measures "chiefly compensated" on an aggregated basis. More workable concepts include:

- Permitting banks to apply the "chiefly compensated" test at the business unit or department level.
- Including all trust and fiduciary compensation other than sales compensation as relationship compensation. This should include fees from managing non-securities investments such as real estate. We do not believe that there are any policy reasons to exclude such fees from a

calculation designed to determine what percentage of a business is comprised of sales-based compensation.

- Determining that all or a portion of service fees received from mutual funds be treated as relationship compensation.
- Grandfathering revenues received under fiduciary agreements existing prior to the effective date of Title II of the G-L-B Act, May 12, 2001.

The Interim Rules imply that the term "trustee" is to be interpreted in an unduly narrow manner. The G-L-B Act creates an exception for a bank effecting transactions in a "trustee capacity," a term that is not defined in the Act, but on its face includes all trusteeships. Nevertheless, in the introductory material to the Interim Rules, the Commission raised questions regarding whether certain trustee capacities qualify for the statutory exception" because banks in these situations may not be subject to significant fiduciary responsibilities. "Later in the explanatory materials, the Commission states that "the law is unclear as to whether banks acting in these three capacities [i.e., indenture trustees, ERISA and other similar trustees, and IRA trustees] should be covered by the trust and fiduciary activities exception because they are acting, at most, in a limited fiduciary capacity with regard to investors who direct their investments, despite their 'trustee' label." To "alleviate" this purported "uncertainty", the Commission adopted as exemptive rules defining "trustee capacity" to "include" indenture trustees and trustees for certain tax-deferred accounts *(*e.g., ERISA and IRA accounts). The adoption of an exemptive rule and the language of the explanatory material call into question whether other types of trustee capacities that are not subject to the highest possible fiduciary

standards *(e.g.*, "Rabbi" trusts, estate planning trusts, insurance trusts, and trusts where another *(e.g.*, individual) trustee possesses the investment discretion) qualify for the statutory exception. We see no reason to doubt that Congress intended that all trustee capacities qualify for the trustee exception.

The investment advisory exception is also given an unwarrantedly narrow definition in the Interim Rules. The G-L-B Act defines investment advice for a fee as a fiduciary activity. However, the Interim Rules add additional restrictions that are not in the statute. Under the rules, an investment advisor is engaged in fiduciary activities only if it provides "continuous and regular investment advice" and has an undefined "duty of loyalty" to the customer.

The Interim Rules unduly narrow the definition of "broker" contained in the G-L-B Act by limiting the fees that banks may charge as custodians for order taking and other limited execution services. The term "custody and safekeeping" has traditionally been understood to include order taking, and there is no reason to believe that the G-L-B Act intended to change this understanding. On the contrary, the statute requires that custody trades be executed through a registered broker-dealer. There is no basis for the Commission to impose restrictions on custodial order-taking that go beyond those contained in the statute.

The Commission may be concerned that banks will offer full-service brokerage accounts in the guise of custodial arrangements. Custodial accounts, however, serve many important functions for which brokerage accounts are not suitable. Moreover, banks do not offer custodial services as a way to solicit trading activity; banks in the custodial business merely follow instructions. No salesman commissions are paid for

trades, so there is no incentive to encourage trading activity. Custodial accounts generate shareholder servicing fees paid on the basis of assets held in custody and therefore create no incentive to encourage trading. Finally, we note that the ability of banks to advertise or promote their custodial services is severely restricted by the Interim Rule.

In addition to order taking, certain execution services are inherent in the custody business. For example, in the case of stock splits and mergers, banks must sell shares to give their customers cash in lieu of fractional shares. Custody customers often look to their custodians to sell odd lots of securities. These services should also be recognized as qualifying for the custody and safekeeping exception. Pushing order taking and these other execution services out of banks would adversely affect customers by requiring duplicative accounts (bank and brokerage) and increasing administrative costs.

The provisions of the Interim Rules related to employee compensation also constitute an unnecessary interference with traditional banking activities. One example is the discussion of bonus plans, which are not mentioned in Title II. However, the Commission's explanatory material states that "by their very nature [bonus plans] are incentive compensation," and that unregistered bank employees may not receive "incentive compensation for any brokerage-related activity" (other than permissible referral fees) including bonus plans based in part on securities transactions unless the bonus plan is based on the overall profitability of the bank. But, few, if any, bonus plans are based solely on the stand-alone profitability of a bank (as opposed to the performance of the overall financial institution or a business unit within the institution). The rule amounts to an attempt by the Commission to regulate the structure of bank bonus compensation plans. The final regulation should permit any bonus plan so long as it is

not an indirect conduit for the payment of specific transaction-related referral fees to bank employees that are not registered through a broker-dealer.

The Interim Rules also impose limitations on bank-employee referral compensation that are too rigid. For example, "referral" is limited to arranging the first securities-related contact with an investor, and the term excludes subsequent activity. This is not mandated by the G-L-B Act or by established precedent. As a result, the rule permits referral payments to be based solely on the quantity of referrals made by an employee. Moreover, the Interim Rules define "nominal one time cash fee of a fixed dollar amount" in terms of an employee's hourly salary. This discriminates against lower paid personnel and raises privacy concerns because the administration of this rule will require individuals who would not normally be aware of others' salaries to have access to such information. Contrary to the G-L-B Act, the Interim Rules prohibit conditioning payment of a referral fee upon the opening of an account, or on the customer's completing a profile or providing other information with the assistance of bank personnel. Nothing in the G-L-B Act prohibits a referral fee from being based upon whether an account is actually opened and the size of the account, so long as it is not conditioned on, or calculated on the basis of, transactional activity.

The Commission, in its no-action Chubb Letter, and the bank regulators in the Interagency Guidelines, have already provided flexible guidance about the concept of "nominal one-time referral fee." In that letter the Commission's staff did not find it necessary to quantify the term "nominal" and did not prohibit the payment of referral fees based upon the opening of an account or on amount of assets gathered. The compensation language in the Act is based in large part on these precedents. Such

flexible guidance has enabled banks to develop compensation programs that provide appropriate incentives to bank employees, while ensuring that customers are directed to the product that best suit their needs. After nearly ten years, we are aware of no incidence of abuse or problems that have arisen under the existing guidance. The Commission's rigid new limitations do not enhance customer protection and would require the overhauling of complex compensation plans that have not raised problems in the past.

Ironically, efforts to comply with the Interim Rules would undermine functional regulation and increase regulatory burdens. One way to comply with the rules is to register bank employees as broker-dealer representatives (making them dual employees of the bank and the broker-dealer). Such individuals would continue to perform their functions as bank officers as well as their duties in the broker-dealer. When performing in the latter role, the employees would quite properly be subject to the supervision of the broker-dealer. However, the Commission's discussion in the explanatory material to the Interim Rules indicates that the Commission believes that a broker-dealer should supervise bank securities activities performed in the bank by any dual employee. The position of the Commission appears to be that the conduct by dual employees of securities transactions that are permitted to remain in the bank under the Act are nevertheless subject to broker-dealer approval, record keeping and supervision, and, ultimately self regulatory organization and Commission oversight pursuant to NASD Rule 3040. We believe that this position is clearly inconsistent with Congressional intent, and that transactions properly conducted within the bank should not be subject to approval and oversight by anyone other than the bank itself and its bank regulators.

These issues are intended to be illustrative of the many issues raised by the Interim Rules. Other issues of concern include: the definition of "no load" funds for purposes of the sweep exception, the need for a safe harbor to protect a bank that inadvertently violates the Commission's regulations despite good faith efforts to comply, the need to have adequate time to implement procedures to comply with the final form of the Commission's regulations, the scope of the exemption for asset backed securities under the definition of "dealer," and the need for an exemption for transactions between a bank and a mutual fund's transfer agent.

We encourage members of the Committee to examine each of these issues to determine the extent to which the Commission's Interim Rules are consistent with the G-L-B Act.