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July 30, 2001

Writer's Direct Contact
202-887-1515
rkurucza@mofo.com

By Messenger

Clerk
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Written Testimony of Robert M. Kurucza

Clerk of the Committee:

With respect to the joint hearing of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and Subcommittee on Financial Institutions and Consumer Credit, to be held on August 2, 1001, I am writing to confirm my acceptance of each respective Subcommittee Chairman's invitation to testify.

Pursuant to Rule 3(d)(2) of the Committee on Financial Services, I have enclosed 200 copies of my written statement of proposed testimony and a short biographical summary. Under separate cover I will be forwarding copies of the disclosure form required by Clause 2(g) of Rule XI of the Rules of the House and the Rules of the Committee on Financial Services.

I am submitting as my written statement, for inclusion in the hearing record, a copy of the comment letter that I submitted on behalf of the Bank Securities Association to the Securities and Exchange Commission concerning the interim final rules on the bank broker-dealer exceptions in Title II of the Gramm-Leach-Bliley Act (the "Interim Final Rules"). I believe that this comment letter is directly responsive to the Subcommittees' request that written testimony address procedural and substantive issues raised by the Interim Final Rules.

Please do not hesitate to contact me at the above telephone number or address with any questions or comments.

Very truly yours,

/s/ Robert M. Kurucza

Robert M. Kurucza

cc: Carter McDowell
Enclosures

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July 17, 2001

Writer's Direct Dial Number
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By Messenger

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Comments of the Bank Securities Association to Interim Final Rules Relating to Definitions of Terms in, and Specific Exemptions for Banks Under, Section 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934; File No. S7-12-01

Dear Mr. Katz:

As you are aware, on May 18, 2001, the Securities and Exchange Commission ("Commission") published in the Federal Register interim final rules with a request for comments relating to definitions of terms in, and specific exemptions for banks, savings associations and savings banks under, Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 (the "Exchange Act") (SEC File No. S7-12-01) (the "Interim Final Rules").[1] This letter, which is being filed on behalf of the Bank Securities Association ("BSA"),[2] is the response of such association to the Interim Final Rules.

I. Summary of BSA's Position

As a threshold matter, the BSA appreciates the opportunity to comment on the Interim Final Rules and hopes that this letter will be of benefit to the Commission as it considers what further action is appropriate. The BSA generally applauds the

[1] 66 Fed. Reg. 27,760 (May 18, 2001).

[2] The BSA is the nation's leading membership-based not-for-profit trade association dedicated exclusively to representing the interests of banks and other financial institutions in connection with the offering of securities and investment products and services. The membership of the BSA includes commercial banks, thrift institutions, securities firms, investment companies and other organizations in the financial services industry. The members of the BSA range from some of the largest financial institutions in the country to smaller community banks and savings institutions.

Commission's efforts to attempt to provide financial institutions with guidance on the application and scope of the various broker-dealer exceptions contained in Title II of the Gramm-Leach-Bliley Act (the "GLB Act") (together, the "Title II Exceptions"). The BSA also wants to acknowledge the wisdom of the Commission in delaying the effectiveness of the Title II Exceptions beyond the May 12th statutory date, which clearly was appropriate under the circumstances. Unfortunately, however, we must regrettably conclude that the Interim Final Rules are in many respects fatally flawed from both a procedural and substantive perspective.

With respect to process, for the reasons discussed below, the BSA believes that a substantial doubt exists, from a legal standpoint, as to whether the Commission, in promulgating the Interim Final Rules as "final rules," has met the stringent standards imposed under Section 553 of the Administrative Procedures Act (the "APA"). In this regard, the BSA is at a loss to understand why the Commission felt compelled to publish the Interim Final Rules without the provision of prior notice and opportunity to comment, which are critical elements of any normal rulemaking. There clearly was no urgent need to adopt definitive rules relating to the Title II Exceptions. The only thing that had to happen immediately was the delay of the May 12th effective date.

As the Commission acknowledged in the adopting release for the Interim Final Rules, over 90% of banks already use registered broker-dealers that are subject to Commission and National Association of Securities Dealers Regulation, Inc. ("NASDR") regulation to effect securities transactions. Accordingly, the traditional bank activities covered by the Title II Exceptions represent a relatively small percentage of overall bank securities-related activities, albeit very important activities for banks and their customers. It also is important for the Commission to keep in mind that until now banks were generally not required to register as broker-dealers in order to engage in these activities. Nevertheless, many banks have for some time elected to *voluntarily* conduct their "core" securities activities, such as retail full-service brokerage operations, through a regulated broker-dealer. This fact should tell the Commission that when banks recognize the appropriateness of functional regulation for a "true" securities activity, they submit to it even though not required. On the other hand, when, as is the case under the Interim Final Rules, long-standing banking activities, such as trust and fiduciary and cash sweep account services, are being subjected to inappropriate and unnecessary broker-dealer regulation through regulatory fiat, banks are going to protest vociferously. This should not be a surprise to the Commission.

To our knowledge, there has been no indication of any significant problems with respect to any of the traditional bank activities covered by the Title II Exceptions. Moreover, these traditional bank securities-related activities are not conducted in a regulatory vacuum; the respective federal banking agencies, as well as state banking authorities, continue to regulate these activities, as they have, in many cases, for over one hundred years. Despite the Commission's attempt to offer a basis supporting the adoption of the Interim Final Rules as final rules, the proffered reasons are "thin reeds" at best.[3] Against this backdrop, it is hard to imagine a compelling regulatory reason, let alone sufficient legal basis for APA purposes, warranting the Commission's action in adopting the Interim Final Rules as final rules, or attempting to take the positions that it has under these rules.

With regard to substance, the BSA believes that many of the Interim Final Rules improperly erect barriers that will prevent or greatly diminish the ability of banks to engage in traditional securities-related activities. Accordingly, they clearly are contrary to Congressional intent and reflect a basic lack of understanding as to the nature, structure and pricing of the activities covered by the Title II Exceptions. Even in cases where the Commission ostensibly is attempting to provide relief or flexibility, it conditions the availability of the relief on such onerous and unworkable conditions that the relief is rendered meaningless.

As the Commission is well aware, the Interim Final Rules have already been universally condemned by various banking industry groups, including the BSA, and most significantly, by the federal bank regulatory agencies and various Congressional quarters. We expect that this sentiment will be echoed in the comments received by the Commission in response to its request for comments on the Interim Final Rules.

Some quarters of the banking industry and Capitol Hill have strongly advocated that the Commission withdraw the Interim Final Rules, citing the numerous departures from Congressional intent[4] and other fundamental flaws in the Interim Final Rules. As a general matter, the BSA agrees with the underlying objections to the Interim Final Rules made by the withdrawal advocates; however, we would suggest a somewhat more pragmatic approach at this juncture. By the time this letter is filed with the Commission, the comment period on the Interim Final Rules will have ended. While we doubt that the Commission will receive the type of detailed, thoughtful comments typical in a normal rulemaking process given the basic objections of the banking industry to the Interim Final Rules, it nonetheless will receive some valuable input. We hope this input will be considered seriously.

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[3] It is telling that the Interim Final Rules, which are replete with requests for comments not only on specific provisions, but also on basic approaches, read in many ways more like an advanced notice of proposed rulemaking rather than even a proposed rulemaking.

[4] Although Congress issued no formal report in connection with the passage of the GLB Act, the Conference Committee did issue a Joint Explanatory Statement. It states: "The Conferees retained certain limited exemptions to *facilitate* certain activities in which banks have traditionally engaged (emphasis added)." It goes on to note, with respect to the trust and fiduciary exception, "[t]he Conferees expect that the Commission will not disturb traditional bank trust activities under this provision."

We would respectfully urge the Commission to issue, after evaluation of the comments by the staff and consideration by the Commission at an open meeting (as opposed to a seriatim procedure), a revised set of rules for public comment. After the proposed rules (which hopefully will be fashioned in a manner more consistent with Congressional intent and the limited and relatively innocuous nature of these traditional bank securities-related activities) have been properly vetted with the public in accordance with the procedures mandated by the APA, then the Commission will be in an appropriate position to proceed with adopting final rules regarding the Title II Exceptions.

After any final rules are adopted by the Commission, it will be critical to allow a realistic period of time for compliance. In this regard, it is important to keep in mind that depending on the final form of the definitive rules, many smaller community banks, for example, will be subjected to broker-dealer regulatory requirements for the first time, and some long-standing bank operations and practices may need to be recast. The banking agencies in their joint comment on the Interim Final Rules[5] suggested a one year delayed effective period after the adoption of any final rules. The BSA generally agrees with this position since it will allow the next step of functional regulation to take place in the orderly fashion that Congress envisioned.

The following sets forth the detailed comments of the BSA regarding the promulgation of the Interim Final Rules under the APA and specific provisions of such rules.

II. Process Under the APA

The Interim Final Rules were adopted under Section 553(b) of the APA which, under certain limited conditions, permits an agency to issue rules that bypass the usual public rulemaking process. Specifically, the APA provides that prior notice and comment is not required "(A) [for] interpretive rules, general statements of policy, procedure, or practice; or (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefore in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."[6]

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[5] Joint Comment Letter from the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency, dated June 29, 2001 (the "Banking Agencies Letter").

[6] 5 U.S.C. § 553(b)(B).

A. The "Interpretive Rule" Exception

The Commission does not state whether it has adopted, in whole or in part, the Interim Final Rules pursuant to the so-called "interpretive rule" exception or "good cause" exception. However, because the Commission provides a statement of good cause, we have assumed that the Interim Final Rules were intended to be adopted under the "good cause" exception.

The Commission (contrary to what we believe to be the case) does note that the Interim Final Rules "do not impose any new obligations in addition to those created by the GLB Act, but rather provide guidance as to the meaning of certain provisions of that statute or provide exemptive relief consistent with those provisions."[7] Accordingly, the Commission could attempt to categorize at least some of the Interim Final Rules as promulgated under the "interpretive rule" exception. However, there is ample judicial precedent to suggest that the Interim Final Rules have "legal effect" and, unlike no-action letters, are not merely procedural or interpretive but rather legislative in nature, thereby making the "interpretive rule" exception unavailable.[8]

B. The "Good Cause" Exception

As to the "good cause" exception, the legislative history of the APA indicates that Congress intended the exception in §553(b)(B) to be narrow[9] and reluctantly countenanced. When citing the "good cause" exception as a basis for promulgating a rule, an agency must *in fact* find good cause and not merely recite that good cause exists. There are three enumerated grounds in §553(b)(B) for finding good cause: notice and comment would be "impracticable, unnecessary, or contrary to the public interest."[10] The Commission did not state on which of the three bases it was relying, so we address each.

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[7] Interim Final Rules, 66 Fed. Reg. at 27,789.

[8] *See* American Mining Congress v. Mine Safety & Health Admin., 995 F.2d 1106, 1112 (D.C. Cir. 1993); Megia-Ruiz v. INS, 51 F.3d 358 (2nd Cir. 1995); and Metro. Sch. Dist. of Wayne Township v. Davila, 969 F.2d 485 (7th Cir. 1992), *cert. denied*, 113 S.Ct. 1360 (1993).

[9] National Nutritional Foods Ass'n v. Kennedy, 572 F.2d 377, 384 (2d Cir. 1978) ("*National Nutritional Foods*"); Methodist Hosp. of Sacramento v. Shalala, 38 F.3d 1225, 1236 (D.C. Cir. 1994).

[10] The Senate Report on the APA states: "The exemption of situations of emergency or necessity is not an escape clause in the sense that any agency has discretion to disregard it terms or the facts. A true and supported or supportable finding of necessity or emergency must be made and published. 'Impracticable' means a situation in which the due and required execution of the agency functions would be unavoidably prevented by its undertaking public rule-making proceedings. 'Unnecessary' means unnecessary so far as the public is concerned, as would be the case if a minor or merely technical amendment in which the public is not particularly interested were involved. 'Public interest' supplements the term 'impracticable' or 'unnecessary'; it requires that public rule-making procedures shall not prevent an agency from operating and that, on the other hand, lack of public interest in rule making warrants an

With respect to the "impracticable" ground, the Attorney General's Manual[11] explains that "a situation is 'impracticable' when an agency finds that due and timely execution of its functions would be impeded by the notice otherwise required..., as when a safety investigation shows that a new safety rule must be put in place immediately." This ground for finding good cause cannot possibly apply here. It would *not* have been impracticable for the Commission to have proposed rules well before (or even after, for the reasons discussed herein) the May 12th effective date of the Title II Exceptions.

The Commission states as a basis for finding good cause the "short time available between the time members of the banking community requested specific guidance as to the meaning of certain provisions of the GLB [Act] and the date on which those provisions bec[a]me effective." The BSA finds it difficult to believe that the Commission was not aware that it was going to be necessary to issue guidance, in some form, relating to the Title II Exceptions. Particularly given the heavily "negotiated" nature of the Title II Exceptions from a legislative perspective, a number of these provisions are unclear or ambiguous in many cases. Moreover, there were 18 months between the date of enactment of the GLB Act and the date on which Title II became effective. In any event, contrary to the Commission's assertion, the period between the time that some members of the banking industry requested guidance and the effective date of Title II was relatively short because the Commission had not issued any guidance during that period. That is to say, the banking industry at large had been waiting for guidance to which it could react, and when by early 2001 the industry had not received any guidance, a growing number of members of the industry understandably began asking more questions given the approaching May 12th effective date. To suggest now that this short period in some way should serve as a showing of good cause is pure sophistry.

Moreover, a desire to provide immediate guidance, no matter how well-intended, does not amount to good cause.[12] If "conclusory statement[s] that normal procedures were not followed because of the need to provide immediate guidance and information... constituted 'good cause,' then an exception to the notice and comment requirement would be created that would swallow the rule."[13]

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agency to dispense with public procedure." *National Nutritional Foods*, 572 F.2d at 385 (citing S. REP. NO. 79-752 (1945)).

[11] UNITED STATES DEPARTMENT OF JUSTICE, ATTORNEY GENERAL'S MANUAL ON THE ADMINISTRATIVE PROCEDURE ACT 30-31 (1947) ("ATTORNEY GENERAL'S MANUAL").

[12] Mobil Oil Corp. v. Department of Energy, 610 F.2d 796, 803 (Temp. Emer. Ct. App.), *cert. denied*, 446 U.S. 937 (1979).

[13] Nader v. Sawhill, 514 F.2d 1064, 1068 (Temp. Emer. Ct. App.) (1975).

In adopting the Interim Final Rules, the Commission also notes that it has taken its lead from the banking agencies, which adopted interim final rules in connection with certain provisions of the GLB Act.[14] However, the Commission's "good for the goose, good for the gander" attempt at justifying its action is inapposite. The banking agencies in many respects were charged with actually *implementing* parts of Title I of the GLB Act—that is to say, those provisions allowing banks and other institutions to take advantage of the affiliation provisions of the statute would not have taken effect absent rulemaking by the banking agencies. Moreover, the banking agencies had a significantly shorter period of time in which to issue rules. For example, Title I became effective March 11, 2000, and Title V (Privacy) became effective on November 12, 2000. Title II became effective a full 18 months after enactment of the GLB Act. And unlike the need for the banking agencies to adopt rules to implement particular provisions of the GLB Act, the Commission was not charged with specifically implementing any part of Title II of the GLB Act. Basically, the Title II Exceptions self-executed and would have done so notwithstanding the Interim Final Rules, although some type of guidance from the Commission was obviously necessary.

Accordingly, while it may have been impracticable for the banking agencies to propose a rule with prior notice and opportunity for public comment, it appears to us that it would not have been "impracticable" for the Commission to have done so with respect to the Title II Exceptions well before, or even after, May 12, 2001, once it took the necessary step of delaying the compliance date.

With regard to the "unnecessary" ground, it cannot be maintained that notice and comment were "unnecessary," because the Interim Final Rules can hardly be classified as "a minor or merely technical amendment."[15] In the Interim Final Rules, the Commission proffers a conclusory statement that the amount of input it already had received from the banking industry was sufficient, and thus presumably made further comments "unnecessary." Clearly, that is not enough under the standard. One court has ruled that notice and comment might not be necessary when the "rule is a routine determination, insignificant in nature and impact, and inconsequential to the industry and to the public."[16] This formulation comports with the explanation in the Attorney General's Manual that "'[u]nnecessary' refers to the issuance of a minor rule in which the public is not particularly interested."[17] The Commission's issuance of the Interim Final Rules clearly does not fit that mold. At the risk of a gross understatement, the Interim Final

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[14] The Commission states, "as the banking regulators found with respect to certain of their regulations under the GLBA, we find good cause...." Interim Final Rules, 66 Fed. Reg. at 27789.

[15] *See supra* note 10.

[16] South Carolina v. Block, 558 F. Supp. 1004, 1016 (D.S.C. 1983).

[17] ATTORNEY GENERAL'S MANUAL at 31.

Rules are something about which many members of Congress, the banking agencies and the banking industry, are vitally interested and concerned.[18]

As to the "public interest" ground for finding good cause, the Attorney General's Manual states that this "connotes a situation in which the interest of the public would be defeated by any requirement of advance notice," as when the announcement of a rule would enable the sort of financial manipulation the rule sought to prevent.[19] Nothing of the sort is present here and nothing that the Commission has cited as a reason constituting good cause suggests that it needed to forego notice and comment in order to prevent a public harm resulting from a delay in the effective date of the Title II Exceptions.

The Commission further attempts to finesse the good cause requirement by noting the "interim nature of the rules...which invite further comment, with possible revision of the rules in light of those comments." It appears that the Commission believes that a "volunteered" request for comments should somehow alleviate any concern that the Interim Final Rules precluded the opportunity for interested parties to comment in the usual manner in a typical public rulemaking under the APA. However, because the Interim Final Rules became effective on May 11, 2001 (with delayed compliance until October 1, 2001, and, in certain cases, January 1, 2002), financial institutions are placed in the untenable position of having to make preparations to comply with the Interim Final Rules *as written* or face the legal risk of not being in compliance by those dates, or to "roll the dice" and speculate as to how the Interim Final Rules might change or be further delayed. Accordingly, the possibility that the Interim Final Rules will be re-written or modified only exacerbates the conundrum of the banking industry. It underscores why the "good cause" exception should be rarely used and sparingly sanctioned, and why it cannot be found here.

For the reasons set forth above, the BSA believes that substantial legal doubt exists as to whether Interim Final Rules were properly promulgated under the APA. Accordingly, to avoid any question in this regard, and as an act of fundamental fairness by a regulatory agency, the BSA strongly urges the Commission to follow the procedural approach outlined in the beginning of this letter.

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[18] *See* Interim Final Rules, 66 Fed. Reg. at 27,789, notes 258-263 (citing at least some of the letters from various members of the public expressing interest in the way in which the Commission might issue guidance on the Title II Exceptions, even before the Commission issued the Interim Final Rules).

[19] *See* Attorney General's Manual at 31; *see also* Utility Solid Waste Activities Group v. E.P.A., 236 F.3d 749, 755 (D.C. Cir. 2001).

III. Substantive Issues

As a whole, the BSA finds the Interim Final Rules to be the product of an overly narrow interpretation of the Title II Exceptions that is not at all reflective of Congressional intent. As noted above, Congress adopted the Title II Exceptions in order to preserve and facilitate the conduct of the activities covered by these exceptions that banks have conducted safely and soundly without broker-dealer regulation for many years. The Interim Final Rules neither preserve nor facilitate the continued conduct of these activities by banks. To the contrary, they will ensure that banks will either be forced to incur the substantial costs, direct and indirect, of pushing-out these activities to registered broker-dealers or be forced to stop offering increasingly demanded securities-related products and services to their customers. Banks, large and small, and their customers will be negatively affected. However, smaller community banks and their customers will undoubtedly suffer the greatest adverse effects. We hope that the Commission will keep in mind that, in many cases, these smaller community banks and branches of larger banks in small communities are the only source of these securities-related products and services for their customers. No other financial intermediary is generally interested in serving these customers.

The BSA believes that the Commission should and need not have chosen the cumbersome regulatory path that it has in formulating the Interim Final Rules. This is true particularly in light of the relatively few activities, both in number and scope, that the Title II Exceptions cover. Moreover, as noted above, banks already conduct the vast majority of their securities activities through registered broker-dealers. Many securities-related activities conducted internally within a bank (such as trust and custody activities) are already subject to an extensive bank regulatory scheme, including scrutiny under the highest fiduciary standards. It is ironic that, in many instances, these bank regulatory standards are far more stringent than the broker-dealer standards that the Commission would wish to substitute. We fail to see how this result will benefit consumers or protect investors.

The following sets forth our comments on certain specific definitions and exemptions outlined in the Interim Final Rules. As you will note, the order of the BSA's comments do not necessarily track the order of the Title II Exceptions; rather they follow the priority of interests of BSA members. They also reflect an informal "sharing" arrangement as to specific issues among the bank industry trade associations.[20]

[20] In many cases, you will find that the BSA has largely adopted the positions set forth in the Banking Agencies Letter with respect to particular issues, and has not always developed separate or amplified analyses on these points when we believe that the Banking Agencies Letter has effectively addressed these issues. We have done this, in part, to avoid unnecessarily burdening the Commission staff with analyzing comment letters which are, in effect, making the same fundamental points.

A. Definitions of Broker and Dealer

Before providing our views on the specific aspects of the Title II Exceptions and Interim Final Rules, we thought it important to emphasize that the Title II Exceptions are in fact exceptions, which need only be considered if a bank, as a threshold matter, comes within the definition of either "broker" or "dealer" under the Exchange Act. Stated another way, if a particular bank securities-related activity (*e.g.*, a trust or custody activity) does not cause a bank to fall within these definitions, the Title II Exceptions are never reached. We understand that this may be an obvious statement. However, we believe that it would be very helpful for the banking industry to receive confirmation from the Commission as to this point. It may help resolve some of the questions and concerns that banks have in connection with particular activities, such as trust activities. We believe that a clear articulation of this position will be particularly helpful in light of the absence of any discussion on this point in the adopting release for the Interim Final Rules and also the language in certain of the Interim Final Rules (which may have unintentionally given the impression that an activity discussed in a specific Interim Final Rule caused a bank to be deemed a "broker" or "dealer").

In this regard, Section 3(a)(4) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." Section 3(a)(5) defines a "dealer" as "any person engaged in the business of buying and selling securities for his own account through a broker or otherwise." These definitions have been interpreted by the Commission in numerous no-action letters.[21] One such context that the Commission has addressed is whether registered investment advisers must also register as broker-dealers when they place trades for managed accounts (*i.e.*, exercising brokerage placement as part of their duties). In this connection, the Commission staff has taken the position that these investment advisers do not have to register as broker-dealers under the Exchange Act if they do not receive commissions or other transaction-based compensation, and they otherwise do not fall within the definition of "broker" or "dealer."[22]

As the Commission is well aware, in many instances, banks acting in a fiduciary or trustee capacity provide functionally equivalent services to those of registered investment advisers. For example, both offer discretionarily-managed accounts in which they exercise brokerage placement authority. Presumably, since the exercise of brokerage placement authority does not trigger the need for broker-dealer registration for registered investment advisers, the same would hold true for a bank. The underlying

[21] *See, e.g.*, First Atlantic Investment Advisory Corp., SEC No-Action Letter (Feb. 20, 1974); ICU Services Corporation, SEC No-Action Letter (Sept. 22, 1974); and Invescap of Florida, Inc., SEC No-Action Letter (Mar. 28, 1975).

[22] *See* 1st Global, Inc., No-Action Letter (May 7, 2001).

basis for reaching this conclusion is that brokerage placement in and of itself does not cause an entity to be in the "business of effecting transactions in securities."[23]

The confirmation of this point, as well as similar issues regarding the treatment of particular activities under the definitions of "broker" and "dealer," would be very useful, and may serve to eliminate some unnecessary concerns.

B. The Sweep Account Exception

Section 201 of the GLB Act, as it amends 3(a)(4)(B)(v) of the Exchange Act, allows banks to "[effect] transactions as part of a program for the investment. . . of deposit funds into any no-load, open-end management investment company registered under the [Investment Company Act of 1940, as amended (the "1940 Act")] that holds itself out as a money market fund" (the "Sweep Exception"). Accordingly, a bank may engage in the offer and sale of money market mutual funds involved with a sweep program without registering as a broker-dealer and, in turn, have its employees register as representatives as long as the fund is a "no-load" money market fund. The GLB Act, however, does not define the term "no-load."

In arriving at a definition of "no-load" for purposes of the Sweep Exception, the Commission apparently has been guided by the NASDR interpretation of the term "no-load," as reflected in National Association of Securities Dealers, Inc. ("NASD") Conduct Rule 2830.[24] In this regard, the NASDR determined in 1993 that, for disclosure purposes, a "no-load" fund is one that does not have any front-end or contingent deferred sales charge, or one whose "total charges against net assets to provide for sales related expenses and/or service fees [do not] exceed .25 of 1% of average net assets per annum."[25]

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[23] Exchange Act Section 3(a)(4)(A). This position was confirmed by Commission staff at the BSA Legislative and Regulatory Symposium (June 4-5, 2001).

[24] Memorandum from Annette L. Nazareth to Chairman Levitt re: Section 201 of the Gramm-Leach-Bliley Act: Interpretation of the Money Market Fund Exception from Broker-Dealer Registration, dated Jan. 25, 2001, which accompanied a letter dated January 29, 2001 from Chairman Levitt to former Chairman Leach (the "Levitt Memorandum").

[25] *See* Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Publication of Clarification of Issues Relating to NASD Rule Governing Asset-Based Sales Charges in the Sale of Mutual Fund Shares, 58 Fed. Reg. 19,505 (Apr. 8, 1993). In 1994, the Commission staff adopted, also for disclosure purposes, the NASD definition of "no-load" stating that it applied to mutual funds regardless of whether a fund is associated with an NASD member or not. Letter from Barry P. Barbash, Director, Division of Investment Management to Paul Schott Stevens, General Counsel, Investment Company Institute (Aug. 22, 1994) (the "1994 Letter").

Unfortunately, in the Interim Final Rules, the Commission elected to adopt the NASDR definition as the operative definition of "no-load." In so doing, the Commission erred because this definition of "no-load" is contrary to Congressional understanding and intent, and also contrary to the unambiguous purposes that underlie the Sweep Exception, as well as all of the other provisions of Title II—to leave long-standing traditional bank securities-related activities undisturbed and free from broker-dealer regulation.

Contrary to Congressional Intent

The essential language of the Sweep Exception has existed in many prior iterations of financial services modernization legislation, going back at least as far as the important Proxmire Financial Services Modernization Act of 1988.[26] In the 1980s when the Proxmire Bill was under consideration by Congress, the term "no-load" was commonly understood to mean either front-end or contingent deferred sales charges; it was not understood to encompass any recurring asset-based fees. It was not until April 1993, when the NASD amended Section 26 of the NASD Rules of Fair Practice (the predecessor to NASD Conduct Rule 2830)[27] that it adopted its now-current position on the definition of "no-load" for disclosure purposes. This was <u>five</u> years <u>after</u> the Proxmire Bill.

Ms. Nazareth, in the Levitt Memorandum, advocates a first-in-time approach to interpretation. In support of the fact that the NASDR adoption of its position in April 1993 and the 1994 Letter were first-in-time and, therefore, should control the GLB Act definition, she states: "The letter from the Division of Investment Management [*i.e.*, the 1994 Letter] was issued publicly several years before Gramm-Leach-Bliley was enacted." Under this theory, however, should not the definition that is truly first-in-time (*i.e.*, the understanding at the time of the Proxmire Bill) control? The Commission staff has apparently ignored the fact that the term "no-load" appeared in proposed legislation that *preceded* the adoption of the NASDR position in April 1993 and the 1994 Letter.

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[26] The Proxmire Financial Services Modernization Act, 100th Cong. 2nd Sess. 1988 (the "Proxmire Bill") excepts from registration "(vi) [banks that effect] transactions as part of a program for the investment or reinvestment of bank deposit funds into any no-load open-end investment company registered pursuant to the Investment Company Act of 1940 that attempts to maintain a constant net asset value...."

An even earlier use of the "no-load" Sweep Exception language appeared in the ill-fated Rule 3b-9 issued by the Commission in 1985, which was struck down in court (*see* American Bankers Association v. SEC, 804 F.2d 739 (D.C. Cir. 1986)) on the grounds that the Commission did not have the legal authority under the Exchange Act to adopt it in light of the general bank exclusion. The Rule 3b-9 sweep account language, in fact, served as a language template for later financial modernization efforts. Clearly, the Commission staff would not maintain that the commonly understood meaning of "no-load" in 1985 included recurring asset-based charges.

[27] *See* supra note 26.

Clearly, the term "no-load" that appeared in the Proxmire Bill is the same term (surrounded by essentially the same language) that appears in the GLB Act. To suggest that, under the GLB Act and its progeny, Congress intended the term "no-load," as it appears in the Sweep Exception, to mean what the NASDR and Commission staff later deemed it to be in an unrelated context is clearly not compelling.

In 1988 (and before), a "no-load" money market fund was commonly understood to mean a money market fund without a front-end or back-end sales load, irrespective of the existence of any recurring asset-based fees. This is the only position that Congress could have reasonably understood and intended "no-load" to mean in 1988, and this is what Congress understood and intended "no-load" to mean in 1999 in the Sweep Exception. As the Commission is well aware, as one of the major regulatory participants in the over decade-long debate over financial modernization, there is a clear reason why the meaning of the term "no-load" in the Sweep Exception should be read to have the same meaning as that term in the Proxmire Bill in 1988. The issue of bank sweep accounts was debated and settled in 1988. No one dared thereafter to change the language or intended meaning of the sweep account exception in any way, since it could disrupt the very delicate compromise reached by interested parties—both regulators and industry groups—on this provision. This obviously was the case with the other Title II Exceptions as well. Stated simply, the deal was struck as to the bank sweep exception language in 1988, "no-load" could only mean no front-end or back-end sales load (and not include any recurring asset-based fees). The issue was not revisited or changed thereafter. Now, the Commission in the Interim Final Rules is trying to alter the deal that Congress struck, and on which the banking industry has relied.[28]

Our view is strongly supported by two letters[29] from named sponsors of the GLB Act. Congressman James Leach, Chairman Emeritus of the House Committee on Financial Services, and Senator Phil Gramm, Ranking Member of the Committee on Banking, Housing, and Urban Affairs, both wrote to former Chairman Arthur Levitt noting in substance that the Commission's definition of "no-load," insofar as it applied to the Sweep Exception, is not supportable. Senator Gramm notes that "[i]n enacting the broker-dealer exemptions in Title II...Congress intended to permit banks to continue to engage in certain activities, such as sweep accounts, that they have been conducting in a safe and sound manner for many years....Congress did not intend that [Commission] rules, definitions or interpretations would be changed in a way that would limit the

[28] It is telling that, to our knowledge, there is nothing in the legislative history regarding the GLB Act that suggests that Congress intended that "no-load" should mean what the Commission has determined by fiat that it now means.

[29] Letter from Congressman James A. Leach, Chairman of the House Committee on Banking and Financial Services, to Chairman Arthur A. Levitt (Jan. 2, 2001); and Letter from Senator Phil Gramm, Chairman of the Committee on Banking, Housing, and Urban Affairs, to Arthur A. Levitt (Feb. 6, 2001).

current activities preserved by the exemptions." We cannot imagine a stronger statement in support of our position.

In any event, even if Congress were somehow put "on notice" that the term "no-load" had different meanings in different contexts that it should have been aware of, such as in the NASDR definition, it seems unlikely that Congress would have meant to embrace the NASDR definition for purposes of the Sweep Exception. We believe that a far more relevant and recognized definition of "load/no-load" appears in Form N-1A, the integrated form that mutual funds, including money market funds, use to register under the 1940 Act and the Securities Act of 1933.[30]

Although Form N-1A was recently overhauled and modernized by the Commission, one prospectus disclosure requirement in that Form that was not substantially revised was the fee table required by Item 3. This item requires every mutual fund to set forth in a table early in its prospectus, both the shareholder fees (fees paid directly from a shareholder's investment) and annual fund operating expenses (expenses that are deducted from fund assets) that it charges. As a general matter, mutual funds may not vary the table from the format proscribed by Form N-1A. Under the heading "Shareholder Fees," the Form calls for the "maximum sales charge (load) imposed on purchases, maximum deferred sales charge (load), and maximum sales charge (load) imposed on reinvested dividends." Under the separate heading "Annual Fund Operating Expenses," the Form calls for "management fees, distribution [and/or service](12b-1) fees, and other expenses." Form N-1A treats loads as those charges which are front-end, contingent deferred or charges on reinvestment of dividends. In the Form, distribution and service fees are not treated as items to be included with the "load" items in the table. The treatment in Form N-1A of what are "loads" and what are not "loads" leads to precisely the interpretation of "no-load" that we believe Congress intended in the Sweep Exception.

The 1940 Act also provides a definition of "sales load"[31] that supports this approach. The 1940 Act definition plainly states that a sales load is the difference between the price of a mutual fund's shares and the net amount invested less any non-

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[30] Indeed, to the extent the Commission somehow believes that it has the absolute authority to interpret the term "no-load" in the Sweep Exception, it is inexplicable as to why it would have ignored the Form N-1A differential approach, which is at least as logical a definition/usage of load as the NASD position.

[31] Investment Company Act of 1940, 15 U.S.C. § 80a-2(35), provides in pertinent part: "Sales Load means the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer...less any portion of such difference deducted for trustee's or custodian's fees, insurance premiums, issue taxes, or administrative expenses or fees which are not properly chargeable to sales or promotional activities."

sales related component of this differential. In lay terms, this means front-end and back-end sales charges, and not any recurring asset-based fees.

If the Commission, in adopting the NASDR definition, seeks definitional consistency across the federal securities laws, it would appear to us that the meaning of "load" (which, of course, is the reciprocal of "no-load") provided in Form N-1A or the 1940 Act is at least as logical a choice as the NASDR definition. If the Commission is truly interested in determining what Congress intended, it is far more likely that the Senators and Representatives who voted on the GLB Act understood what was a "load" and what was not a "load" from reading a money market prospectus (which shows "load" as not including any recurring asset-based fees), as opposed to being aware of a relatively obscure NASD rule.

Contrary to the Underlying Purposes of Title II

As noted above, in the Interim Final Rules, the Commission largely chose to ignore the compelling arguments put forth earlier by Congressman Leach, Senator Gramm and the BSA, ostensibly for the sake of achieving a consistent definition. That is to say, because the Commission staff, borrowing the NASDR position, had defined "no-load" once in the context of disclosure (*i.e.*, whether a fund could hold itself out to the public as a "no-load" fund), it believed that the term should be defined consistently in other contexts, no matter how different. This approach may be sound when the contexts have similar purposes. However, as we note below, there is no need for consistency in this case because there is no real regulatory similarity between a disclosure context and an activity threshold for broker-dealer registration.

The underlying purposes of the Title II Exceptions contemplate that banks will be allowed to continue to engage in traditional securities-related activities. However, unlike securities underwriting and dealing activities, for example, one has to ask whether there is any meaningful public policy served by requiring banks and their personnel to register as broker-dealers and representatives merely because a money market fund may not be "no-load" as the Commission would define such term.

In the Interim Final Rules, the Commission notes that public policy may be served because "payments by investment companies of asset-based fees to distributors...create a conflict of interest for the brokers and banks that are distributing these shares." This view reveals two things: (i) that the Commission, which we believe is being somewhat disingenuous given its stringent and quite effective regulatory requirements applicable to money market funds, overstates the riskiness of money market funds and the role of a registered representative in selling them; and (ii) that the Commission staff may not, at this point, fully appreciate how bank sweep accounts are structured.

First, although the Commission acknowledges the "limited risks to bank customers because of the constant net asset value of [a money market fund]," it nevertheless seems to believe that abuses may occur absent broker-dealer registration. Presumably, the Commission thinks that it is important that the full panoply of customer protection rules afforded by broker-dealer registration should apply to the offering of bank sweep accounts. It is telling that even if the Commission has its way on the definition of "no-load," this will not be the case.

Quite significantly, the NASD's suitability rule, which is one of the primary customer protection rules in the securities arena, exclude transactions with customers where investments are limited to "money market mutual funds."[32] Clearly, the NASDR has recognized that, in light of the limited risks presented by money market funds and the relatively minor variability of their performance, there really is no need to subject the sale of any money market fund, whether or not it has a load under the NASDR definition, to the suitability rule. We believe that it is anomalous and disingenuous for the Commission to maintain, in the face of this exclusion (which we believe is clearly appropriate) that somehow it is necessary to subject bank sweep accounts to broker-dealer registration simply because the money market fund involved does not meet the NASDR's definition of "no-load."

Second, we are very concerned that the Commission staff may not fully appreciate how these products are structured and priced. As a general matter, in a bank sweep account arrangement, a bank transaction account is linked with a very limited number (frequently a single fund) of money market funds.[33] These money market funds can be provided by third-party mutual fund complexes or they can be part of a bank proprietary fund complex. The sweep account product is offered as an integrated/linked product that generally cannot be unbundled. To provide otherwise would be operationally unworkable and would result in costs that would make the product economically not viable.

Cash sweep accounts are offered to a variety of different bank customer segments, including business, institutional and retail customers. Not surprisingly, given the different types of bank customers using sweep accounts, there are numerous permutations of pricing for these "linked" products to give customers flexibility as to how they pay for the sweep account. Some accounts are priced exclusively at the account level, others are priced solely on the basis of fund level fees, and others are priced on a combination of account level and fund level fees. These different pricing options are intended to give

[32] *See* Notice to Members 90-12 (April 5, 1990).

[33] A sweep account customer generally does not have the ability to choose any money market fund. The choices are limited to those money market funds that are included in the arrangement.

customers a range of options as to how they pay for cash management services. In some cases the pricing options available to a specific customer base may be dictated or limited by regulatory requirements (*e.g.*, ERISA).[34]

We would strongly urge the Commission to keep these facts in mind as it gives further consideration to the Sweep Exception.

Consequences of the Commission's "No-Load" Definition

For many banks that offer sweep products, the money market fund that serves as the investment vehicle has sales-related and shareholder servicing fees that exceed 25 basis points and therefore do not meet the "no-load" definition in the Sweep Exception. If these money market funds are not deemed to be "no-load" funds for purposes of the Sweep Exception, bank personnel involved in offering the sweep product (*e.g.*, corporate cash management personnel who offer a variety of other non-securities products) will have to be qualified registered representatives of a broker-dealer in order to continue to offer the sweep product. This would require, for example, that such bank personnel be "dually employed" by a registered broker-dealer affiliate (if one exists), or that a broker-dealer be created if none exists and no other exemption from broker-dealer registration is available. This will, of course, dramatically increase the costs for a bank offering a sweep product. In many cases, this will make the product economically not viable, and thereby deny many customers access to these products

We emphasize that this issue affects not only bank-advised mutual funds. Many sweep programs are structured whereby a third-party mutual fund serves as the sweep vehicle for the bank's customers. The bank's personnel are typically involved in selling the sweep product, and thereby the mutual fund's shares, to its customers. Again, if banks and their personnel are required to register as broker-dealers and representatives, the program may not be economically feasible. Accordingly, mutual fund providers who serve the bank marketplace will be adversely affected as well.

In summary, we urge the Commission to adopt a definition of "no-load" that reflects Congressional intent and the purposes behind the Sweep Exception. In short, for the compelling reasons set forth above, we believe that the definition of "no-load" should encompass only front-end and back-end sales charges and not recurring asset-based

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[34] The Commission has indicated that it not would assert broker-dealer regulation over a bank sweep account that was priced exclusively at the account level. We believe that this is the correct legal position for the Commission to adopt, but we also believe that it is the correct legal position for <u>all</u> bank sweep accounts, irrespective of how they are priced. Given the context, there is no real regulatory reason for the Commission to strain to regulate any bank sweep account as an activity requiring broker-dealer registration.

fees.[35] Importantly, no customer protections will be compromised if the Commission proceeds on this basis. In fact, it will likely preserve access to sweep account products for businesses, institutions and individuals, who would otherwise lose access to these products.

C. The Networking Exception

Section 201 of the GLB Act, as it amends 3(a)(4)(B)(i) of the Exchange Act, provides an exception from the definition of "broker" for banks that enter into third-party brokerage or "networking" arrangements (the "Networking Exception"). Accordingly, a bank will not be considered a broker-dealer if it "enters into a contractual or other written arrangement" with a registered broker/dealer through which the broker-dealer "offers brokerage services on or off the premises of the bank."

The Networking Exception has a list of statutorily imposed conditions, such as the separation of brokerage and banking services and compliance with advertising conditions. In particular, one condition prohibits unregistered bank employees from receiving "incentive compensation...for the referral of any customer...except 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."[36]

This language is not new for banks in that this restriction has, in effect, applied to banks since 1984 under guidelines set forth under the Interagency Statement on Retail Sales of Nondeposit Investment Products ("Interagency Statement"). What is new, however, is that the Commission has chosen to narrowly interpret the term "nominal one-time cash fee of a fixed dollar amount."

Under new Rule 3b-17(g) under the Exchange Act, the Commission has interpreted the term to be limited to only payments that do not exceed one hour of the gross cash wages of the bank employee making the referral, or points in a system that cover 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 (and their value) awarded for referrals involving securities are not greater than the points (and their value) awarded for activities not involving securities. In addition, the Commission states that the referral fees cannot be paid in the form of bonuses.

[35] Assuming *arguendo*, that the Commission's definition of "no-load" prevails, we believe that, for all the reasons discussed above, the Commission should exercise its authority to exempt, without any other conditions or qualifications, all activities involving bank sweep accounts from broker-dealer regulation, so long as the sweep account involves a money market fund.

[36] Exchange Act, Section 3(a)(4)(B)(i)(VI).

The BSA appreciates that the Commission, by recognizing that some banks use "point" systems, wishes to provide banks some flexibility as to the form of referral payment that they may make to bank employees. However, the Commission definition imposes unnecessary limitations on the securities referral programs of banks that are not required by statute and creates administrative burdens that seemingly are inconsistent with the Commission's own policies.

Specifically, we believe that the Commission's definition places severe and unworkable limits on the payment of referral fees. The Commission's scheme clearly is intended to reduce a perceived "salesman stake" in the sale of securities of an unregistered bank employee. However, this fear is grossly misplaced. Under the Networking Exception, a bank employee can only refer a customer to a registered representative of a broker-dealer. That registered representative must then qualify and otherwise interface with the customer consistent with all applicable NASD rules. Quite frankly, the potential for abuse in this context is largely overstated.[37]

With regard to amounts, the Commission has long taken the position that registration requirements are not triggered under the Exchange Act by networking arrangements in which a bank employee receives a "nominal fee" for referrals to a broker-dealer.[38] And, in fact, as the Commission notes in the Interim Final Rules, it is this position that served as the basis for the Networking Exception. However, in none of these precedents, has the Commission provided a definition of "nominal." Why the Commission chooses now to define the term in the Interim Final Rules is perplexing to us. Under the Interim Final Rules, bank employees might be paid a referral fee, before taxes, that could be at the rate of minimum wage of $5.15. We believe that this threshold is far too low and that amounts permitted under the Interagency Statement are a more appropriate measure.

The methodology for determining "nominal" under the Interim Final Rules is impractical and unworkable. Banks typically offer all of their employees, from private bankers to tellers, the same nominal amount value for referring securities customers. Under the methodology in the Interim Final Rules, banks will be forced to incur a significant administrative burden because a separate "permissible referral fee" calculation will be required for each employee. This calculation is further complicated by the fact that some employees' compensation is not based on an hourly wage. The Commission

[37] While we understand that the term "nominal amount" is statutory, we have trouble understanding how the payment of even a moderate amount of compensation would create an environment for potential abuse. It is important to keep in mind that in all cases the customer is being referred to a registered representative who is subject to all applicable NASD rules and who will be the <u>only</u> party making recommendations as to securities transactions for the customer.

[38] *See* Chubb Securities Corp., SEC No-Action Letter (Nov. 24, 1993).

notes in the Interim Final Rules that translating yearly salaries into hourly wages should be a simple task. This may be the case, but wages can often be tied to variable factors such as bonuses, incentive payments or the value of stock or stock options. Providing an accurate translation of that compensation into an hourly figure is not simple. In any event, to impose such an administrative burden on banks in this context is entirely unnecessary and inappropriate.

While the BSA again appreciates the Commission's effort to provide flexibility by permitting a point system, the Commission's determination that the system must cover a range of bank products and non-securities-related services and that referral points for securities services and products have a value that is no greater than the points received under the system for any other product or service, is unjustifiable. There is absolutely no requirement in the statute with regard to these restrictions, only that the payment be "nominal." Again, in this regard, we believe that the Commission has exceeded its authority under the GLB Act in interpreting these terms.

The BSA also objects to the Commission's prohibition on the payment of referral fees in the form of bonuses. In this regard, the Commission appears again to have gone beyond the mandate of the statute. The GLB Act does not prohibit payment in this manner. In fact, allowing year-end bonuses could further the goals of the Interim Final Rules (*i.e.*, reducing a salesman's stake in an excepted activity). Separating the time between the actual referral and the time that a referral fee is paid would seem to reduce the salesman's stake.

The BSA does not believe that it is appropriate or necessary for the Commission to change its practice regarding referral fees or to define the upper limits of permissible fees. The Commission should instead allow, as under current practice, banks to structure the corporate aspects of these referral fee programs in a manner consistent with the standards applicable under the Interagency Statement.

The BSA also is extremely concerned that any attempt by the Commission to regulate the total amount of referral fees paid to an individual would be inconsistent with the GLB Act, which does not provide any basis for imposing aggregate compensation limits. To the contrary, the law specifically allows a bank employee to be paid "a nominal one-time cash fee" for <u>each</u> referral, without regard to total referral compensation paid.

D. The Trust and Fiduciary Exception

Section 201 of the GLB Act, as it amends 3(a)(4)(B)(ii) of the Exchange Act, allows a bank to act as a trustee or fiduciary without having to register as a broker-dealer if it meets certain conditions, including that the bank be "chiefly compensated for such transactions, consistent with fiduciary principles and standards, on the basis of an administration or annual fee (payable on a monthly, quarterly or other basis), a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing such securities transactions or any combination of such fees" (the "Trust and Fiduciary Exception").

Of great concern to the BSA are those provisions in the Interim Final Rules that "interpret" the Trust and Fiduciary Exception in a manner which we believe is inconsistent with Congressional intent. This exception was designed to allow banks to continue to engage in trust and fiduciary activities without having to register as broker-dealers.[39] These types of activities have been a key component of the business of banking for many years and have long been offered to the public without significant problems or abuses. Moreover, as discussed above, these activities are regulated extensively, and effectively, by federal and state bank regulators.[40] Congress determined that pushing-out such activities was unwarranted in light of the effective regulation of bank trust and fiduciary activities by federal and state regulators, even though they may have certain securities-related aspects. The Interim Final Rules relating to the Trust and Fiduciary Exception diverge substantially from this Congressional mandate and would severely disrupt and hamper these traditional activities.

The Interim Final Rules also impose unworkable requirements that have no support in the Trust and Fiduciary Exception, making the exception (and related exemptions offered by the Interim Final Rules), in practical terms, unavailable to most banks. Moreover, the Interim Final Rules suggest a lack of fundamental understanding of the ways in which banks provide services as fiduciaries and trustees under federal and state law.

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[39] "Banks have historically provided securities-related services largely through their trust departments, or as an accommodation to certain customers. Banks are uniquely qualified to provide these 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 reason for changing Federal regulation of bank trust departments, solely because Glass-Steagall is being modified. S. REP. NO. 106-44, at 10 (1999). *See also, supra* note 4.

[40] The federal banking agencies' examiners regularly examine the trust departments of banks, as well as other departments that conduct fiduciary activities (such as private client banking and asset management departments). Among other things, these agencies review: the processes and controls used by banks to recommend investments; the effectiveness of a bank's policies and procedures for preventing self-dealing and other conflicts of interest; the qualification of bank employees; a bank's operational and procedural controls; and compliance with applicable securities-related rules. See the Federal Reserve Board's *Trust Examination Manual* (www.federalreserve.gov/boarddocs/supmanual), the Federal Deposit Insurance Corporation's *Trust Examination Manual* (www.fdic.gov/regulations/trust/trust/secaa.html) and the Office of the Comptroller of the Currency's *Comptroller's Handbook for Fiduciary Activities* (www.occ.treas.gov/pubscrpt.htm).

We generally agree with the positions set forth in the Banking Agencies Letter regarding the Trust and Fiduciary Exception, and accordingly, see little reason to repeat the substance of those comments. Nonetheless, we have highlighted below those issues that are of paramount concern to us.

Account-By-Account Calculation of Compensation

In defining what "chiefly compensated" means, the Commission has determined that the compensation received for each trust or fiduciary account must be separately calculated, rather than calculated on a department- or bank-wide basis. The Interim Final Rules provide that the "relationship" compensation received from each trust and fiduciary account during a year must not exceed the "sales" compensation from the account—that is to say, "relationship" compensation must equal more than 50% of total compensation.

As a general matter, we believe that the Commission has come to a reasonable judgment in defining the term "chiefly" to mean more than 50%. However, we believe that the Interim Final Rules improperly and unnecessarily require an account-by-account calculation of compensation. The House Report on the GLB Act notes that: "[a] bank must be chiefly compensated for *its* trust and fiduciary activities"[41] on the basis set forth in the GLB Act. Contrary to the Commission's conclusion that the phrase "chiefly compensated for such transactions" compels a reading that Congress intended account-by-account calculations, the above excerpt suggests that "such transactions" refer to all of the transactions effected by a bank in a trustee or fiduciary capacity. There is no reference in this exception to individual accounts. Moreover, common sense and the lack of any compelling regulatory imperative to the contrary, would strongly support the conclusion that a bank-wide calculation is the only appropriate standard to adopt here.

From a regulatory policy perspective, imposing the "chiefly compensated" requirement on each account will interfere with traditional bank trust and fiduciary activities. Under the Interim Final Rules, a bank at the end of a year, after engaging in the muddled calculation methodology required, could find that a single account has jeopardized its status under the Exchange Act and potentially subjected it to enforcement action by the Commission and private law suits, including recission demands. Particularly in a bear market, we believe this scenario is more than merely a speculative possibility. In any event, there is no reason why banks should be subjected to <u>any</u> risk in this regard, no matter how remote.

The requirement in the Interim Final Rules that banks track the compensation received from all trust and fiduciary accounts on an account-by-account basis will impose unfathomable administrative burdens and costs (which likely will be passed on to

[41] H.R. Rep. 106-74, at 164 (1999).

customers in the form of higher fees). As a result, banks may be forced to decide that attempting to satisfy the conditions necessary to obtain exemptive relief are too onerous and have to push-out these activities to a broker-dealer. In this case, the Interim Final Rules, if left unchanged, will cause the disruption and fragmentation of long-established relationships between a bank trustee and its customer by requiring the unnecessary and cumbersome involvement of a broker-dealer for part of the relationship. This will undoubtedly result in additional costs that are unnecessary in light of the strong protections already afforded customers under existing federal and state banking laws. It also will be a result totally at odds with the intentions of Congress.

The Exemption from an Account-By-Account Calculation of Compensation

The Commission correctly acknowledges that its interpretation of the Trust and Fiduciary Exception's "chiefly compensated" requirement will result in increased costs and burdens.[42] In light of this recognition, the Commission has offered an exemption (embodied in Rule 3a4-2) that allows a bank to avoid calculating on an account-by-account basis if it:

- demonstrates that the total sales compensation received from its trust and fiduciary accounts during the year does not exceed 10% of the relationship compensation received from such accounts during the year;

- maintains procedures reasonably designed to ensure that each trust and fiduciary account is chiefly compensated from relationship compensation (i) when each account is opened; (ii) when the compensation arrangements for the account are changed; and (iii) when sales compensation received from the account is reviewed by the bank for purposes of determining any employee's compensation; and

- complies with the GLB Act's limitations on the public solicitation of brokerage business for trust and fiduciary accounts.

We concur with the Commission's assessment that relief from the account-by-account calculation requirement is needed. However, we do not believe that Rule 3a4-2 accomplishes this goal. The requirement that each trust and fiduciary account must be "chiefly compensated" in order to take advantage of the 10% exemption essentially nullifies the exemption—calculations must still be made on an account-by-account basis when any account is opened or a compensation arrangement is changed. This is a regulatory "sleight of hand" if there ever was one.

[42] Interim Final Rules, 66 Fed. Reg. at 27,776 ("[The exemption] should minimize the costs and regulatory burdens on banks arising from the GLBA requirements relating to the trust and fiduciary compensation computations....").

Furthermore, even if the Commission modified the exemption to address these concerns, a bank relying on the exemption would have to ensure that during any year, the sales compensation received from all of its trust and fiduciary accounts did not exceed 10% of the "relationship" compensation received from such accounts. Accordingly, a bank could still be "chiefly" (*i.e.*, more than 50%) compensated from "relationship" compensation on a department- or bank-wide basis, but the exemption would not be available because the Commission has set the "real" bar at 10%.

Together, these requirements make the exemption virtually unattainable and fail to relieve the regulatory burdens imposed by the Commission's definition of "chiefly compensated." The approach adopted by the Commission, while welcomed in concept, needs fundamental reworking to be of any meaningful use.

Scope of "Fiduciary Capacity"—Investment Advisory Services

The Trust and Fiduciary Exception specifically excepts a bank from the definition of "broker" when it acts in a "fiduciary capacity," which includes acting "as an investment adviser if the bank receives a fee for its investment advice."

The BSA is concerned about various aspects of the Commission's interpretation of the term "fiduciary capacity" generally in the Interim Final Rules. In this regard, we believe that the well-settled understanding as to the meanings and scope of the terms "trustee capacity" and "fiduciary capacity" should be observed by the Commission, as opposed to reducing their historical scope, as the Commission appears to be doing in the Interim Final Rules. This is clearly what Congress envisioned in enacting the Trust and Fiduciary Exception.

The BSA is particularly concerned with the way that the Commission has interpreted "acting as an investment adviser if the bank receives a fee for its investment advice." The Interim Final Rules provide that a bank will be deemed to be acting in an investment advisory capacity for purposes of the fiduciary exception only if the bank provides continuous and regular "investment advice" to the customer's account that is based upon the individual needs of the customer; and owes a duty of loyalty to the customer (arising out of state or federal law, contract, or customer agreement).[43]

The definition of the term "fiduciary capacity" comes largely from Part 9 of the Office of the Comptroller of the Currency's fiduciary regulations.[44] However, neither

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[43] As discussed *infra*, we have assumed a bank would only need to consider whether the Trust and Fiduciary Exception is available if it, as a threshold matter, comes within the definition of "broker."

[44] 12 C.F.R. § 9.101(a) (2001). Under Part 9, a national bank provides investment advice for a fee only if the bank provides advice or recommendations concerning the purchase or sale of specific securities.

Part 9 nor any language in the Trust and Fiduciary Exception provides that a bank acts in a "fiduciary capacity" only when the bank provides "continuous and regular" investment advice. The BSA does not believe that there is any basis for this Commission-imposed requirement. The Trust and Fiduciary Exception only requires that a bank receive a fee for the investment advice that it provides. This requirement is included in the Trust and Fiduciary Exception to distinguish situations when a bank provides investment advice only as an incident to, for example, securities brokerage activities without separate compensation (*i.e.*, acts as a full-service broker).

By imposing a "continuous and regular" requirement, the Commission has again exceeded its mandate. The BSA believes that this requirement could, on its face, prevent banks from relying on the Trust and Fiduciary Exception even in clearly non-securities brokerage-related circumstances. Under the Interim Final Rules, a bank, for example, should not be considered to be acting in a "fiduciary capacity" if the bank, in return for a fee, provides a one-time account review for a new customer. This clearly is a permitted activity under bank regulatory rules and does not involve a securities brokerage activity.[45]

E. The Safekeeping and Custody Activities Exception

Section 201 of the GLB Act, as it amends 3(a)(4)(B)(viii) of the Exchange Act, allows banks to act in a variety of custodial and safekeeping-related activities as part of its customary banking activities (the "Custody Exception"). This exception permits a bank to: provid[e] safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers; and serv[e] as a custodian or provider of other related administrative services to any IRA, pension, retirement, profit sharing, bonus, thrift savings, incentive or other similar benefit plan.

The Custody Exception generally was intended to allow banks to engage in all activities which are part of their customary safekeeping and custody operations, such as facilitating the transfer of customer funds or securities. Like the Trust and Fiduciary Exception, Congress intended the Custody Exception in the GLB Act to allow banks to continue traditional custody and related activities without having to register as broker-dealers, even if such activities had certain securities-related aspects.

In the Interim Final Rules, however, the Commission again appears to have exceeded its authority under the GLB Act. By asserting that the Custody Exception does not permit banks to handle securities orders for their custodial IRA customers, for 401(k) and benefit plans that receive custodial and administrative services from the bank or as an

[45] As noted above, we do not believe that this activity meets the definition of "broker" under the Exchange Act. Accordingly, there should be no need for a bank to consider this exception. As mentioned above, clarification from the Commission regarding this and similar points would be most helpful.

accommodation to custodial customers, the Commission has ignored Congressional intent and the very reason that the Custody Exception was included in the GLB Act in the first place.

The GLB Act assumes that banks will execute securities transactions in connection with their customary custodial duties. To assume, as the Commission has, that these activities are not covered by the Custody Exception makes the Custody Exception superfluous. In enacting the Custody Exception, Congress recognized that "bank safekeeping and custody services may involve effecting transactions for bank customers."[46] Curiously, the Commission staff, in at least two no-action letters, has generally recognized that banks provide a broad range of related services, including securities execution services, as part of providing custodial services.[47]

The Interim Final Rules do include two exemptions for custodial-related transactions that, but for the Commission's tortured view of the Custody Exception, would be unnecessary. In any event, as is discussed below, the Commission has all but ensured that these exemptions will be of little utility given the numerous and burdensome conditions it has imposed.

Typical Custodial, Order-Taking Functions of Banks

Banks acting as custodians have long-provided securities-related execution to self-directed IRA accounts. In this regard, the Internal Revenue Service ("IRS") generally requires that a bank serve as a trustee or custodian for an IRA.[48] These services are subject not only to strict regulation by the IRS but also by the federal banking agencies and have been offered for years without creating concerns. With banks acting in this capacity, customers are able to avoid the unnecessary expense and administrative complexity associated with establishing a separate brokerage account. Banks serving as a custodian or trustee for a self-directed IRA account, transmit all securities transactions to a registered broker-dealer for execution and would be required to continue to do so under the GLB Act.

Banks also provide custodial and safekeeping services for 401(k) and other retirement and benefit plans. Frequently, banks will bundle custodial services with other recordkeeping, reporting, tax-preparation and administrative services. In this regard, the custodial bank will perform order-taking and order-execution functions pursuant to the direction of a plan fiduciary. These bank-offered services allow plan administrators to

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[46] H. REP. NO. 106-74, at 158 (1999).

[47] *See* Provident National Bank, SEC No-Action Letter (Oct. 6, 1982) and Universal Pensions, Inc., SEC No-Action Letter (Jan. 30, 1998).

[48] 26 C.F.R. § 1.408-2(b)(2)(i) and (d) (2001).

obtain securities execution and other administrative services in a cost-effective manner, thereby reducing plan expenses. The Commission has improperly interpreted the Custody Exception in a manner that would disrupt the efficient delivery of these services without any corresponding benefit to consumers.

The Commission has stated that it adopted its restrictive approach in light of the Congressional intent that the Custody Exception was not meant to allow banks to engage in broader securities activities. By eliminating the ability of banks to accept orders from customers to purchase or sell securities (other than in the very circumscribed manner permitted in the Custody Exception), the Commission has gone overboard. The Custody Exception excepts custody and safekeeping and related activities only; it is not "open-ended" and would not, as the Commission fears, allow banks to somehow generally offer brokerage services to the public.[49] In any event, the GLB Act's restrictions on a bank's ability to publicly advertise these services should address these unfounded fears.

The Custody Exemptions

Again, rather than interpreting a Title II Exception in a responsible and useful manner, the Commission has chosen to narrowly interpret a Title II Exception and then, recognizing that its interpretation will disrupt traditional bank securities-related activities, the Commission offers an exemption in an attempt to justify its initial unsupportable position. In this case the Commission has offered Rule 3a4-4 and Rule 3a4-5, which permit banks to accept orders from their custody customers. While we again support the Commission's desire to provide flexibility to banks with regard to the Custody Exception, we believe that these exemptions ultimately provide little, and establish conditions inconsistent with Congressional intent and any fair reading of the Custody Exception.

In Rule 3a4-4, a bank may effect securities transactions for a custodial client subject to an almost absurd number of conditions.[50] In addition, the exemption under

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[49] Again, we continue to be amazed that the Commission believes that banks are somehow intent on avoiding broker-dealer regulation when the record shows that banks have embraced broker-dealer regulation for securities activities, like full service brokerage, that justify such regulation.

[50] These conditions include that the bank must have had less than $100 million in assets as of Dec. 31st of both of the two prior calendar years; the bank is not, since Dec. 31st of the 3rd prior calendar year, affiliated with a bank holding company that as of Dec. 31st of the prior two calendar years had consolidated assets of more than $1 billion; the bank is not associated with a broker-dealer; the bank does not have a networking arrangement with a broker-dealer as expressly permitted under the Networking Exception; the bank may accept orders only for custodial IRA accounts and other specified types of tax deferred accounts (but not 401(k) accounts) for which the bank acts as custodian; the bank may accept orders from such accounts only for the purchase and sale of Commission-registered mutual funds; if the bank makes available shares of an affiliated mutual fund, the bank must also make available shares of an unaffiliated mutual fund that has "similar characteristics"; the total compensation received by the bank for effecting

Rule 3a4-5 provides that a bank may effect transactions for its custodial customers only if the bank does not, directly or indirectly, receive any compensation.

Needless to say, we cannot imagine very many scenarios where banks will be able to take advantage of these exemptions, even assuming that it is possible to devise a system adequate to ensure compliance with the exemption's conditions in a cost-effective manner. Once again, the Commission has fashioned exemptions that are largely nugatory.

In sum, neither the GLB Act nor its legislative history provides any justification for prohibiting banks from charging fees for their customary custody and safekeeping activities, including providing related securities processing services. Moreover, the two exemptions offered by the Commission provide very little real relief.

F. Cure Provisions and Extensions of Time

Cure Provisions

The Interim Final Rules do not address the prospect that, particularly given how many of the Interim Final Rules are structured, a bank will only be able to determine whether or not the conduct of a particular activity qualifies for a Title II Exception on a retrospective basis. Therefore, a bank may only find after the fact that it needed to have been registered as a broker-dealer. As a result, for even a small technical violation, a bank could be subject to enforcement by the Commission, civil suits or and other draconian consequences.

At a minimum, the Commission should offer banks a reasonable period of time with which they could bring their operations into compliance in these circumstances. In this regard, a useful analogy can be made to Rule 3a-2 under the 1940 Act, which allows inadvertent investment companies a one year period to come into compliance with the 1940 Act.[51]

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securities transactions under the Custody Exception (including any 12b-1 fees received from the mutual funds in which the customer invests) may not exceed 3% of the bank's annual net interest and noninterest income; the bank does not advertise that it effects any kind of securities transactions and must otherwise limit its securities advertising activities; the bank's employees effecting these transactions must not be associated with a broker-dealer, must primarily perform duties for the bank other than effecting securities transactions for customers and must not receive compensation for effecting securities transactions under the exemption from the bank, the executing broker-dealer or any other person related to (i) the size, value, or completion of any securities transaction; (ii) the amount of securities-related assets gathered; or (iii) the size or value of any customer's securities account; and the bank must direct trades to a broker-dealer.

[51] Exchange Act Rule 3a-2(a) states: "[A]n issuer is deemed not to be engaged in the business of investing, reinvesting, owning, holding, or trading in securities during a period of time not to exceed one

Extensions of Time

The BSA applauds the Commission's efforts with regard to providing banks additional time with which to comply with the Title II Exceptions, and to delay the ability of private parties to bring a cause of action against banks under Section 29(b) of the Exchange Act on the basis that the bank is not in compliance with the broker-dealer registration provisions of the Exchange Act.

However, as discussed earlier, the BSA believes that a substantial question exists as to whether the Interim Final Rules were properly adopted under the APA and that, in any event, significant and material revisions need to be made to these rules. In this regard, in order be in compliance with the Title II Exceptions and the Interim Final Rules by October 1, 2001 (or January 1, 2002), banks would already have had to start making arrangements to recast their operations. Yet, banking organizations and industry trade associations (as well as the Commission staff) expect that the Interim Final Rules will be changed in some fashion before they are truly finalized. Accordingly, the banking industry is in a paradox. On the one hand, it must begin (or have already begun) the costly initiative to come into compliance with the Interim Final Rules as written or face the possibility of violating the law. On the other hand, if it does begin (or has begun) this undertaking, banks face the possibility of having to further modify their operations after the "final" version of the Interim Final Rules is published.

Given this "Catch-22" dynamic, we believe that the Commission should set new compliance deadlines, irrespective of how the Interim Final Rules proceed, and that the new compliance deadlines should be set as one year from the date of issuance of definitive rules. In the meantime, we would strongly urge the Commission to promptly issue a statement that the October 1st and January 1st deadlines are being deferred, pending final resolution of the Interim Final Rules by the Commission. This would relieve some of the angst within the banking industry.

<u>IV. Conclusion</u>

As discussed above, the BSA believes that the Interim Final Rules should be re-published under normal APA public rulemaking procedures as proposed rules and revised in accordance with our comments and the Banking Agencies Letter. To do otherwise will cause great disruption to banks and the long-standing services that they have provided their customers, with no corresponding benefit to the public. This certainly is not what Congress intended when they enacted Title II of the GLB Act.

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year; provided, that the issuer has a bona fide intent to be engaged primarily, as soon as is reasonably possible (in any event by the termination of such period of time)...."

If you have questions regarding this letter, please do not hesitate to call the undersigned at (202) 887-1515.

Very truly yours,

/s/ Robert M. Kurucza

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