Laurence H Meyer: The securities activities of banks

Testimony of Mr Laurence H Meyer, Member of the Board of Governors of the US Federal Reserve System, before the Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, US House of Representatives, 2 August 2001.

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I appreciate the opportunity to present the views of the Federal Reserve on the interim final rules issued by the Securities and Exchange Commission (SEC or Commission) to implement the bank securities provisions of the Gramm-Leach-Bliley Act (GLB Act). The manner in which these rules are implemented is extremely important to banks and their customers and well deserves your attention.

As the banking agencies detailed in our official comment to the Commission on the rules, we believe they are, in a number of critical areas, inconsistent with the language and purposes of the GLB Act, and create an overly complex, burdensome, and unnecessary regulatory regime. The rules as currently drafted would disrupt the traditional operations of banks and impose significant and unwarranted costs on banks and their customers.

In our comment letter, the banking agencies also objected to the Commission adopting the rules in final form and making them effective beginning October 1 of this year. The banking agencies urged the Commission to treat the interim final rules as proposed rules and to give banks sufficient time after modified rules are adopted by the Commission to implement systems and make other changes necessary to comply with the rules.

We support the Commission's recent actions to extend the public comment period on the rules until September 4, 2001, and to extend the effective date of the interim final rules and the statutory provisions that they implement until at least May 12, 2002. We also support the Commission's statement that it will further extend the effective date for an appropriate period of time to provide banks with a sufficient transition period to come into compliance with any revised rules the Commission ultimately adopts. We believe these procedural steps are both necessary and appropriate to ensure that the public comment process, which is so critical to the development of fair and effective rules, allows for meaningful comment and the collection of much needed information regarding the practical effects of the SEC's rules on the traditional activities of banks. Most importantly, we look forward to engaging in a constructive dialogue with the Commission and its staff and to assisting them in modifying the substance of the rules in a manner that both gives effect to the Congress' intent and does not disrupt the traditional customer relationships and activities of banks.

Before highlighting some of the most significant provisions of the interim final rules that we believe must be modified, a brief background of the treatment of banks under the Securities Exchange Act of 1934 and the purposes of the GLB Act's bank securities provisions is useful.

History of the bank exception and bank securities activities

In 1934, the Congress first adopted a federal scheme requiring all entities that act as securities brokers or dealers to register with the SEC. The Securities Exchange Act of 1934, however, specifically exempted all banks from the definitions of "broker" and "dealer" and, accordingly, did not require banks providing securities services to their customers to register with the SEC as broker-dealers. Although the ability of banks to underwrite, deal in, and purchase securities was limited by the Glass-Steagall Act of 1933, banks continued to have the ability to buy and sell securities for the account of their customers and to buy and sell securities for their own account when specifically authorized by law. The Congress recognized that these permissible securities activities were already supervised and examined by the appropriate federal and state banking authorities and that subjecting these activities to an additional layer of regulation was not necessary or appropriate. In fact, one of the primary purposes of the Securities Exchange Act of 1934 was to subject nonbank stockbrokers and securities traders to the type of government supervision and examination that was already applied under the banking laws to banks.

Long before 1934 and since, banks have offered their customers securities services in a variety of circumstances in connection with their banking activities. For example, banks have long bought and sold securities for their trust and fiduciary customers. These services are an essential part of the trust and fiduciary operations of banks-operations that have long been considered a core banking function. Banks that have discretionary investment authority over a trust or fiduciary account purchase and sell securities for the account to ensure that the account is properly diversified and managed in the manner required by the governing trust agreement and applicable fiduciary principles. Banks also provide investment advice concerning securities, real estate, and other assets to non-discretionary fiduciary accounts, and have long been able to execute securities transactions for these accounts.

Another core banking function is providing custody and safekeeping services. The five largest global custodians are banks, and banks, both large and small, act as trusted custodians for the securities, real estate, and other assets of customers. One of the most recognizable custody services provided by banks is for Individual Retirement Accounts (IRAs). Under applicable Internal Revenue Service regulations, banks may act as custodians for IRAs, and bank-offered custodial IRAs provide consumers throughout the nation with a convenient and economical way to buy and sell securities for retirement purposes on a tax-deferred basis. Banks, as part of their customary banking activities and as an accommodation to their customers, also have long permitted customers that hold securities in custody accounts at the bank to buy and sell securities related to the account. These services allow customers to avoid the unnecessary expense of having to establish a separate securities account at a broker-dealer to effect such trades. Other securities services traditionally offered by banks include "sweeping" deposit funds into overnight investment vehicles, such as money market mutual funds, privately placing securities for customers, and providing transfer agency services to issuers and benefit plans.

Banks have offered these services to their customers without significant concerns for years. It is important, moreover, to highlight that these activities are *not* unregulated – they are supervised, regulated, and examined by the relevant federal and state banking agencies. In the trust and fiduciary area, these protections are enhanced and supplemented by well-developed principles of state and federal trust and fiduciary law that provide customers with strong protections against conflicts of interests and other potential abuses. Bank examiners regularly examine a bank's trust and fiduciary departments for compliance with these fiduciary principles. These examinations frequently are conducted by examiners who have received special training in trust and fiduciary law and practice, and the federal banking agencies assign banks engaged in fiduciary activities separate ratings under the Uniform Interagency Trust Rating System. These ratings are based on an evaluation of, among other things, the capability of management; the adequacy of the bank's operations, controls, and audits; the bank's compliance with applicable law, fiduciary principles and the documents governing the account; and the management of fiduciary assets.

GLB Act

It was in the context of this existing regulatory framework that the Congress, during consideration of the GLB Act, reviewed the blanket exception for banks from the definitions of "broker" and "dealer" in the Securities Exchange Act. This review of the blanket exception was not undertaken because abuses or concerns existed concerning the traditional securities activities of banks. In fact, banks generally have conducted their securities activities responsibly and in accordance with bank-regulatory requirements and other applicable law, including the antifraud provisions of the federal securities laws.

Rather, the review of the bank exception was undertaken to address a concern that, if the blanket exception for banks was retained at the same time that the barriers hindering the affiliation of banks and securities broker-dealers were removed, securities firms might acquire a bank and move the securities activities of the broker-dealer into the bank in order to avoid SEC supervision and regulation. Some parties also expressed concern that banks might in the future significantly expand their securities activities outside the services traditionally provided customers under the blanket exception. The Congress sought to balance these concerns with the desire to ensure that banks could continue to provide their customers the securities services that they had traditionally provided as part of their customary banking activities, without significant problems, and subject to the effective supervision and regulation of the banking agencies.

The end result, the GLB Act, replaced the blanket exception for banks from the definitions of "broker" and "dealer" with fifteen exceptions tailored to allow the continuation of key bank securities activities. These exceptions were broadly drafted and were intended to ensure that banks could continue to provide their customers with most, if not all, of the services that they traditionally had received from banks. For example, these statutory exceptions permit banks, subject to certain conditions, to continue to (1) buy and sell securities for their trust and fiduciary customers, (2) buy and sell securities for their custodial clients as part of their customary banking activities, (3) establish so-called "networking" arrangements with registered broker-dealers to offer securities services to the bank's customers, (4) sweep deposit funds into shares of no-load money market mutual funds, (5) privately place securities with sophisticated investors, (6) issue and sell to qualified investors securities that are backed by assets predominantly originated by the bank, its affiliates or, in the case of consumer-related receivables, a syndicate formed by the bank and other banks, and (7) broker securities in up to 500 transactions per year that are not otherwise exempt.

Interim final rules adopted by the SEC

The interim final rules as currently written are, in many respects, not consistent with the language or purposes of the GLB Act and would impose unnecessary costs and burdens on banks and their customers. In the interest of time, I will focus only on some of our most significant concerns with the substantive provisions of the rules. A more detailed discussion of our numerous concerns is included in the comment letter issued jointly by the Federal Reserve, the OCC, and the FDIC.

Trust and fiduciary activities

We are most concerned with the provisions of the interim final rules that implement the statutory exception for the trust and fiduciary activities of banks. In our judgment, these provisions would significantly disrupt the trust and fiduciary customer relationships and activities of banks. As I noted above, trust and fiduciary activities are part of the core functions of banks, and banks have long bought and sold securities for their trust and fiduciary customers under the strong protections afforded by fiduciary laws and under the supervision and examination of the banking agencies.

In light of this history, the GLB Act specifically permits banks to effect transactions in a trustee capacity, and to effect transactions in a fiduciary capacity in any department of the bank that is regularly examined by bank examiners for compliance with fiduciary principles. To ensure that banks did not attempt to operate a full-scale brokerage operation out of their trust department, the GLB Act established two limitations. First, a bank relying on the trust and fiduciary exception must be "chiefly compensated" for the securities transactions it effects for its trust and fiduciary customers on the basis of certain types of traditional trust and fiduciary fees specified in the act. Second and importantly, the act prohibits the bank from publicly soliciting securities brokerage business other than in conjunction with its trust activities. The Congress did not expect that these compensation requirements and advertising restrictions would interfere with the traditional trust and fiduciary activities of banks, nor were these provisions intended to grant the SEC broad authority to regulate or "push-out" the trust and fiduciary activities of banks. In fact, the Conference Report for the GLB Act specifically states that the "Conferees expect that the SEC will not disturb traditional bank trust activities" under this exception.[1]

The interpretation of this exception currently reflected in the interim final rules, however, would significantly disrupt the customary trust and fiduciary activities of banks and is at odds with both the language and purposes of the exception. Most importantly, the interim final rules provide that a bank qualifies for the exception only if *each* of its trust and fiduciary accounts independently meets the act's "chiefly compensated" requirement. We strongly believe that the act's "chiefly compensated" requirement was intended to apply to a bank's *aggregate* trust and fiduciary activities and not on an account-by-account basis. An approach focused on the bank's aggregate trust and fiduciary activities is consistent with the nature and operations of bank trust departments and would – in conjunction with the act's prohibition on banks publicly soliciting brokerage business apart from their trust and fiduciary activities – effectively prevent banks from running a full-scale brokerage operation out of their trust departments.

The account-by-account approach adopted by the interim final rules, on the other hand, is both unworkable and overly burdensome. First, this approach appears premised on the notion that an individual trust or fiduciary account that engages in a significant number of securities transactions during a year is not a traditional trust and fiduciary account. This premise is flawed, however. It is entirely natural for a bank to engage in numerous securities transactions for a trust or fiduciary account. For example, there may be numerous securities transactions for an account when a trust is initially established and the assets provided by the grantor are initially invested or when the investment

[1] See H.R. Conf. Rep. No. 106-434 at 164 (1999).

strategy of a fiduciary account is altered to reflect changes in the beneficiary's investment objective. An account-by-account approach also does not accommodate the complex, multi-account relationships that a bank's trust department is frequently called upon to establish to achieve the individualized wealth preservation and transfer goals of its customers.

The account-by-account approach also proves too much. To put this in context, a moderately sized trust department may have on the order of 10,000 separate trust and fiduciary accounts and a large trust department may have more than 100,000 such accounts. Under the account-by-account approach adopted by the interim final rules, changes in the amount of compensation received during a year from a *single* trust or fiduciary account could cause a bank and its entire trust operation to become an unregistered broker-dealer, thereby opening the bank to the threat of enforcement action by the SEC and, after January 1, 2003, suits by private parties for the rescission of securities contracts entered into by the bank. Such a result is unreasonable, especially because a bank would not be able to determine an account's compliance with the rules' "chiefly compensated" requirement until the end of a year, and then may have only a single day to restructure its operations if the compensation from one account did not meet the rules' requirements.

The proposed account-by-account approach also would impose significant and unnecessary burdens on banks. Most banks do not have the systems in place to track the various categories of compensation that they receive from each individual trust and fiduciary account. In order to comply with the rules, and to continue providing traditional trust and fiduciary services, banks would have to establish complex and costly systems and procedures for monitoring the amount and types of fees received from each trust and fiduciary account and these costs likely would be passed on to consumers.

The Commission recognized the significant burdens imposed by the rules' account-by-account requirement and used its discretionary authority under other provisions of the securities laws to adopt an exemption for banks that comply with certain conditions established by the Commission. These conditions, however, require the bank to establish procedures to ensure that *each* trust and fiduciary account complies with the rules' chiefly compensated requirement, effectively maintaining the account-by-account approach from which the exemption was supposed to provide relief. In addition, a bank may take advantage of the exemption only if it significantly limits its receipt of fees that would otherwise be permissible under the GLB Act.

The rules also impose restrictions on the trust and fiduciary activities of banks that simply are not found in the statute and that are not consistent with the nature of the trust and fiduciary operations of banks. For example, although the statutory exception is, by its terms, available for all accounts where a bank acts as trustee, the rules suggest that the SEC will review bank-trustee relationships and may determine that some of these relationships do not qualify for the exception. Accordingly, the rules not only cast doubt on whether banks may continue to effect securities transactions for a wide variety of traditional trust accounts, such as self-directed personal trust accounts and charitable trusts, but also suggest that the SEC intends to review and regulate the types of trust relationships that banks may have with customers. The interim final rules also place restrictions on when a bank will be deemed to be acting in a "fiduciary capacity" that were not included in the statute or contemplated by the Congress.

Finally, the rules interpret the statute's examination requirement in a manner that will effectively prevent many banks from taking advantage of the statutory trust and fiduciary exception at all. As I mentioned earlier, the Congress required that any securities transactions under the exception be effected either in the bank's trust department or in another department that is regularly examined by bank examiners for compliance with fiduciary principles and standards. These requirements ensure that the customer's relationship with the bank continues to be subject to the fiduciary examination programs of the banking agencies that have effectively protected customers for years.

The interim final rules, however, allow a bank to effect transactions for a trust or fiduciary account only if all aspects of the transaction – including associated data processing and settlement – occur in a department regularly examined by bank examiners for compliance with fiduciary principles and standards. Many bank trust and fiduciary departments outsource securities settlement and processing functions to a third party or affiliate, or delegate these functions to other departments of the bank to achieve cost and operational efficiencies. The customer relationship is fully protected by trust and fiduciary principles in this case, while the mechanics of the transaction are handled in the most cost-efficient manner. However, banks that have structured their operations in these ways would be prohibited by the rules from taking advantage of the exception granted by the Congress, even though their relationships with customers are maintained in a trust or fiduciary department and regularly examined by bank examiners for compliance with fiduciary principles.

In our view, the end result of these narrow interpretations and burdensome requirements is that banks will be forced to significantly restructure their traditional trust and fiduciary activities, and some banks may well be required to cease providing these traditional banking services to customers. In addition, customers that have chosen to establish relationships with banks will be forced to terminate these relationships or have duplicate accounts at the bank and a broker-dealer, resulting in increased costs and burden.[2] We do not believe that this was the result intended by the Congress.

Custodial and safekeeping activities

Another of the exceptions included by the Congress in the GLB Act was designed to protect the custodial and safekeeping services that banks have long provided as part of their customary banking activities. In particular, the act allows banks, as part of their customary banking activities, to provide safekeeping and custody services with respect to securities and to provide custodial and other related administrative services to Individual Retirement Accounts and pension, retirement, and other similar benefit plans.[3] In this area, as well, the Commission has interpreted the exception in a manner that is inconsistent with the language and purposes of the act and that prevents or significantly disrupts the customary banking relationships and activities that Congress sought to preserve.

In particular, as I noted a moment ago, the act explicitly permits banks to continue providing custodial and related administrative services to IRAs and benefit plans. This language was added to the bill during the House-Senate Conference to resolve any ambiguity concerning the ability of banks to continue to provide securities execution services to their custodial IRA customers and to benefit plans that receive custodial and administrative services from the bank. Bank-offered custodial IRAs provide consumers throughout the United States with a convenient and economical way of investing for retirement on a tax-deferred basis, and banks have long executed securities transactions for these accounts subject to IRS requirements and the supervision and regulation of the banking agencies. Banks also provide benefit plans with custodial and administrative services, including securities execution and recordkeeping services, under the direction and supervision of the plan's fiduciaries. These bank-offered services allow plan administrators to obtain securities execution and other administrative services in a cost-effective manner, thereby reducing plan expenses and benefiting plan beneficiaries.

The Commission, however, has stated that the custody exception does not allow a bank to effect securities transactions for its custodial IRA or benefit plan accounts. This position essentially reads the explicit authorization adopted by the Congress out of the statute, is completely contrary to the purposes of the act, and would disrupt long-standing relationships between banks and their customers.

In addition, the interpretation of the custody exception adopted by the Commission would prohibit banks from executing securities transactions for their custodial customers on an accommodation basis. Banks, as part of their customary banking activities, have for many years effected securities transactions as an accommodation to their custodial clients. These customer-driven transactions occur only upon the order of the customer and allow the customer to avoid having to go through the unnecessary expense of establishing a separate account with a broker-dealer to effect occasional securities trades associated with the customer's custodial assets at the bank.

In an effort to mitigate the adverse impact of these interpretations on the banking industry, the Commission proposed two exemptions that would permit small banks, on one hand, and all banks, on the other hand, to continue to accept orders from their custodial clients. These SEC-granted exemptions, which could be revoked or modified by the SEC at any time in the future, would not be necessary if the rules gave effect to the language and purposes of the custody exception adopted by the Congress. Furthermore, these exemptions are subject to numerous and burdensome restrictions that were not contemplated by the act and that will make it difficult, if not impossible, for many banks to take advantage of the exemptions.

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2 The GLB Act already requires that banks send any U.S. securities trades for a trust or fiduciary account to a registered broker-dealer for execution. See 15 U.S.C. § 78c(a)(4)(C).

3 See 15 U.S.C. § 78c(a)(4)(B)(viii).

Third-party networking arrangements

The GLB Act also permits banks to establish so-called "networking" arrangements with registered broker-dealers, under which the broker-dealer makes securities brokerage services available to the bank's customers. One provision of the statutory exception permits bank employees who are not registered representatives of the broker-dealer to receive a nominal, one-time cash fee for the referral of customers to the broker-dealer so long as payment of the fee is not contingent on whether the referral results in a securities transaction.

This exception was intended to reflect and codify the arrangements that the SEC staff has sanctioned in no-action letters issued to the banking and securities industries concerning networking arrangements.[4] These letters, like the statutory exception, permit bank employees to receive a nominal, one-time fee for the referral of customers to the broker-dealer, and do not attempt to establish a rigid mechanism for determining what constitutes a "nominal" fee in every circumstance. This flexible approach has worked well for both the banking and securities industries and has not, to our knowledge, caused significant problems.

Despite the success of this flexible approach, the interim final rules establish a rigid and complex approach for determining whether a referral fee is "nominal." In addition, the rules impose, or request comment on, other restrictions on referral fees that were not authorized by the Congress. For example, the rules provide that a referral fee is nominal if it does not exceed one hour of the gross cash wages of the employee receiving the fee. By pegging permissible fees to the hourly wage of each employee, the rules create significant administrative problems and may conflict with state privacy requirements that restrict access to information concerning an employee's salary. Although the rules also allow a bank to pay referral fees in the form of "points" in a bonus program, the rules require that any points awarded must not only be nominal, but also must be the lowest amount awarded for any product or service covered by the bonus program. Thus, for example, the points awarded for a securities referral could not exceed the amount of points awarded for a safe deposit referral, even if the points awarded for the securities referral were nominal in amount.

Failure to address all exceptions or adopt cure or leeway periods

The interim final rules also fail to address the scope of a majority of the exceptions to the definitions of "broker" and "dealer" that were adopted in the GLB Act. Given the fact that the Board believes that many of the SEC's interpretations of the scope of the exceptions it has chosen to address do not comport with the unambiguous words of the GLB Act and the legislative intent of the Congress, we are concerned about the manner in which the SEC will interpret the other exceptions. The Board fears that if the SEC does not adopt rules concerning the scope of *all* of the exceptions, it will aggressively interpret some of the exceptions through enforcement actions and no-action letters, without banks and other members of the public having the opportunity to comment on these interpretations.

The interim final rules also fail to provide any cure or leeway periods to banks that are attempting in good faith to comply with the exceptions when they discover that some of their securities transactions do not comply with the exceptions due to inadvertent errors or unforeseen circumstances. Given the complexity of the exceptions, it is expected that banks that are attempting to conform their securities activities to the exceptions will identify some securities transactions that do not meet the terms of the exceptions. In some circumstances, banks will not even be able to confirm that their securities transactions will comply with an exception at the time they are conducted. For example, banks will not be able to confirm that they meet the "chiefly compensated" standard in the trust and fiduciary exception until they review all of their compensation earned at the end of the year. For these reasons, the Board believes that the SEC must provide banks that have adopted policies reasonably designed to comply with the exceptions a reasonable period of time to cure any inadvertent or unforeseen violations. This period of time must at least be long enough for a bank to establish an affiliated broker-dealer to which nonqualifying securities activities can be transferred.

Preserving regulatory roles established by the Congress

On a broader level, we also are concerned that several aspects of the rules appear to reflect an attempt by the Commission to regulate the *banking* activities of banks. For example, as I mentioned earlier, the interim final rules seek to limit the traditional trust, fiduciary, and custodial activities of

[4] See Chubb Securities Corp., 1993 SEC No-Act. LEXIS 1204 (Nov. 24, 1993).

banks and would indirectly give the Commission the ability to regulate the scope and nature of these activities. Similarly, there is language in the adopting release concerning the networking exception that would appear to impose restrictions on employee bonus programs operated by banks in general, even where the affected employees have no connection with any networking arrangement established with a broker-dealer.

In addition, NASD Rule 3040, which is referenced in the preamble to the rules, purportedly provides the Commission and the NASD the authority to review all the securities activities engaged in by an employee who is both an employee of a bank and a broker-dealer, including those securities transactions that are conducted as part of the bank's traditional banking activities and protected by one of the GLB Act's exceptions. We anticipate that such dual employee arrangements will become more common, as banks seek to modify their activities to ensure compliance with the GLB Act. We believe that subjecting these activities, which the Congress has identified as part of the business of banking, to dual regulation by both the banking agencies and the SEC would be inconsistent with the principles of functional regulation and subject banks to unnecessary and duplicative regulation.

Conclusion

The Board believes that the manner in which the bank securities provisions of the GLB Act are implemented is critically important to the ability of banks to continue to provide high-quality banking services to their customers. We appreciate the steps the SEC has taken to extend the public comment period on the interim final rules and delay the effective date of the rules and the statute. However, the Board believes that significant substantive changes must be made to the interim final rules so that they reflect the words of the statute and the intention of the Congress. The Board stands ready to work with the SEC and the banking industry in revising the interim final rules.